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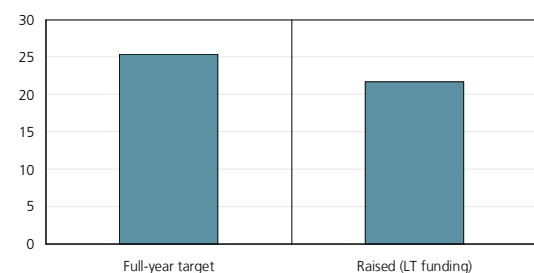
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## Government finances and banks

# Irish state's funding outlook clearer than it was six months ago

### Ireland long-term funding versus target in 2009



Source: NTMA; Department of Finance; Davy estimates

### Irish state's funding 85% complete for 2009; net debt has to be the focus in future years thanks to NAMA

- The Irish state has already met 85% of its long-term debt issuance targeted for 2009. That compares with a euro area average of about 60% year-to-date.
  - General government debt will of course spike when NAMA is set up, but that will no longer be a meaningful metric. NAMA will contain billions in written-down assets to offset against the government paper issued to the banks. Net debt will rise only to the extent that NAMA fails to realise value over time.
- ### Initial banking re-cap burden for the state is lower than many believe as government is no longer the only capital provider
- We estimate that initial re-cap costs for the Irish banking system will amount to €19bn. Net of 'self help' measures, in particular debt buybacks, the government may need to contribute €14.6bn, of which it has already accounted for €11bn.
  - However, if Allied Irish Banks and Bank of Ireland can raise equity from their shareholders or through disposals (e.g. Poland), the ultimate figure will be lower than this.
- ### NAMA RWA relief is often overlooked too, although this benefit is illusory as state may have to fund a 'second loss'
- Moving €80bn of loans across to NAMA at a 20% haircut provides a significant risk-weighted asset (RWA) benefit for the banks, which also reduces the initial re-cap burden on the state.
  - However, this 'saving' is offset by an unrealised loss sitting in NAMA of at least €4bn and probably much more. Whether the state has to fund this is dependent on how aggressively NAMA works out its positions, market conditions and the timing/magnitude of any future levy on the banks.

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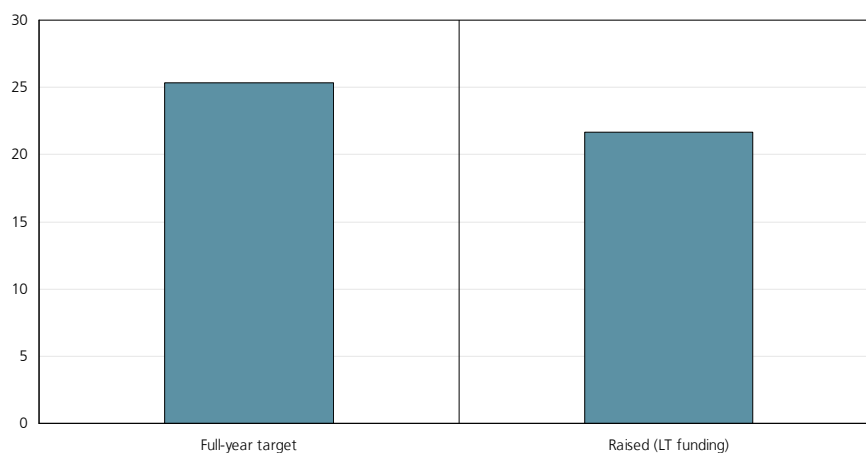
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## Irish funding for 2009 is 85% complete excluding further banking re-caps

The Irish government has already met the majority of its long-term funding requirement for 2009 (see Figure 1). We reckon the funding programme is now more than 85% complete.

**Figure 1: Ireland long-term funding versus target in 2009 (€bn)**



Source: NTMA; Department of Finance; Davy estimates

Here is the breakdown of required long-term gilt issuance for 2009 (see Table 1). The full year Exchequer deficit will amount to about €24.3bn this year, and €5bn was required to redeem a five-year bond that matured in April. But that total of €29.3bn overstates the actual target. The initial €4bn re-capitalisation of Anglo Irish Bank (€3bn has gone in with €1bn to follow) will be financed from existing cash balances that were generated by short-term debt issuance in late 2008, limiting the target for funding via long-term bonds to €25.3bn.

- Note that the initial €4bn for Anglo will be sourced from existing government cash balances raised via the government's 2008 commercial paper programme

There is one caveat: the €25.3bn target excludes any public monies required to further re-capitalise the banking system this year. The Irish government may still have to come up with €3.6bn as an initial re-cap, but we do not know how much of it will arise in 2009 (see Tables 4 and 7) or how it will be financed (we do assume, however, that long-term bonds will be issued rather than running down state cash or liquidating National Pensions Reserve Fund (NPRF) assets).

**Table 1: Long-term funding requirement for 2009 (€bn)**

Exchequer Borrowing Requirement	24.3
Redemption	5.0
less: Anglo re-cap from last year's short-term funding	4.0
Full-year target	25.3
Raised year-to-date	21.7

Source: NTMA; Department of Finance; Davy estimates

Note that the Exchequer Balance rather than the often-referenced General Government Balance (GGB: the EU-wide metric) is the one to

- Five H2 auctions will be enough to meet full-year target for long-term bonds

concentrate on in terms of funding. The General Government deficit will be lower than the Exchequer Borrowing Requirement (EBR) as borrowed funds used for bank re-capitalisation do not affect the GGB – they are counted as a financial transaction and not expenditure.

**Mixture of syndicated deals and auctions conducted successfully**

To meet the funding objective, the government has conducted three syndicated deals and four auctions, raising €20.7bn in long-term funds (see Table 2). It has also raised €1bn from savings products in the retail market, leaving the remaining funding gap at less than €4bn. Scheduled auctions in the second half of the year (on July 21st, August 18th, September 15th, October 20th and November 17th) will meet that requirement.

**Table 2: Funding detail 2009 year-to-date (€bn)**

	<i>Issue(s)</i>	<i>Coupon</i>	<i>Maturity</i>	<i>Deal</i>
08 Jan 2009	6.00	4.0%	2014	Syndicated
25 Feb 2009	4.00	3.9%	2012	Syndicated
24 Mar 2009	0.91	4.5%	2020	Auction
	0.39	4.0%	2011	Auction
21 Apr 2009	0.76	4.5%	2018	Auction
	0.30	4.0%	2014	Auction
19 May 2009	0.70	4.4%	2019	Auction
	0.31	4.0%	2014	Auction
16 Jun 2009	0.65	4.6%	2016	Auction
	0.65	3.9%	2012	Auction
23 Jun 2009	6.00	5.9%	2019	Syndicated
Other: An Post/Prize Bonds	1.00			
<b>Total</b>	<b>21.668</b>			

Source: NTMA

It is positive that Ireland has completed the vast majority of its funding for the year before the half-year stage. Ten years on from the introduction of the single currency, euro area long-term debt issuance is unprecedented in 2009 at almost €900bn. But governments have been active in the market throughout the year: euro area sovereigns have completed on average 61% of their annual funding needs (see Table 3).

- Ireland has completed 85% of its funding for 2009 versus 61% in the euro area

That means Ireland ranks well, having completed 85% of its issuance by the end of H1. Only Belgium and Greece have done more, at 87% and 86% respectively. At the other end of the spectrum, Austria, Italy and Germany have reached less than 60% of their target.

<b>Table 3: Euro area long-term debt issuance (€bn)</b>			
	<i>Gross issuance required</i>	<i>Year-to-date issued</i>	<i>% complete</i>
Belgium	31	27	87
Greece	50	43	86
<b>Ireland</b>	<b>25</b>	<b>22</b>	<b>85</b>
Portugal	15	11	73
Finland	11	7	64
Netherlands	48	30	63
Spain	100	63	63
France	165	103	62
<b>Euro area</b>	<b>871</b>	<b>534</b>	<b>61</b>
Austria	26	15	58
Italy	235	126	54
Germany	165	87	53

Source: HSBC; EC; Davy estimates

**Gross general government debt may reach €188bn by end-2010, but true net debt may only be half as big**

What about the debt level now and where does the National Asset Management Agency (NAMA) fit in? Irish government debt has risen significantly, but net debt is still much lower. Because Ireland has set up an asset management agency that has to be initially financed by government bonds, gross debt will be a misleading metric in the years to come until the value is realised from the NAMA assets to pay off those bonds. Keep in mind that Ireland also has two other stores of value to net off against gross debt. It has access to the NPRF (which had €11bn in liquid assets at end-March) if really needed. In addition, the state's cash balances stand at €16bn or almost 10% of 2009 GDP.

- Total system re-cap costs are the salient figure to analyse potential extra funding needs

From a long-term borrowing viewpoint, the key question is how much in extra funds will be required to meet banking re-capitalisation needs. We think that system re-capitalisation costs will come to around €19bn (see Table 6). Of that €19bn, 72% or €13.6bn has already been accounted for:

- €7bn committed to Allied Irish Banks (ALBK) and Bank of Ireland (BKIR), of which €4bn came from existing NPRF assets and €3bn from the Exchequer;
- €2.6bn raised by the banks themselves in buybacks; and
- a further €4bn has been earmarked for the nationalised Anglo Irish Bank (ANGL) to initially shore up its balance sheet, of which the Exchequer has thus far injected €3bn (from existing cash balances).

Our estimates suggest that the government will have to find €3.6bn more to initially re-capitalise the system (the residual €1.7bn will come from the banks themselves through debt buybacks etc.). This re-cap obligation will probably be triggered when assets are transferred into NAMA, although the exact timing of this is uncertain.

- Government may only need to find an extra €10bn in next couple of years ignoring any value not realised by NAMA over its long life

As a result, €3.6bn may be added to gross government debt unless an equivalent amount of assets in the NPRF is liquidated or existing cash balances (already financed through the government's commercial paper programme) are used (see Table 4). For now, we assume that the funds

are unlikely to come from existing NPRF assets. So we conservatively assume that it will come from long-term borrowing, although it is plausible that Exchequer cash will be run down. Cash balances currently stand at a healthy €16bn (accounting for the €4bn committed to ANGL).

**Table 4: Estimated General Government debt profile 2008-2010 (€m)**

	2008E	2009F	2010F
Gross General Government Debt (start of year)		80296	168246
Increase in debt due to net Exchequer borrowing		20350	19904
Further bank re-cap (assume it occurs in 2009)*		3600	
NAMA-issued government bonds		64000	
Gross General Government Debt (end-year)	80296	168246	188149
NPRF	16500	15500	15500
Cash balance**	20000	16000	16000
Net General Government Debt (end-year)	43796	136746	156649
GDP	185768	172142	165368
Gross General Government Debt/GDP (end-year)	43%	98%	114%
Net General Government Debt/GDP (end-year)	24%	79%	95%
Net General Government Debt assuming NAMA realises full value of assets		72746	92649
Net General Government Debt assuming NAMA realises full value of assets % GDP		42%	56%

\* based on system re-cap costs of €19bn

\*\* Anglo €4bn re-cap from existing cash balances

Source: Davy estimates

- **NAMA will endeavour to realise enough value over a long period to repay new government paper**

### **Gross debt jumps on NAMA introduction, but net debt will only rise to the extent that NAMA fails to extract value over time from assets**

The second consideration is the government-backed bonds that NAMA will issue to the banks in return for their written-down assets. We assume these bonds (note that the government is not issuing any bonds to the market) will total €64bn, i.e. the 'economic value' of assets initially in NAMA. Government debt rises automatically by this amount on the advent of NAMA. But NAMA will endeavour to extract full value from the assets over a long period, possibly at least ten years.

Clearly, it is only accurate to assume that net debt jumps as much as gross debt today if one assumes that the net present value extracted from the NAMA assets is zero. That won't happen. For illustrative purposes, Table 5 provides some sensitivity analysis, taking gross General Government debt in 2010 as the starting point (all other things equal).

Gross General Government Debt (end-2010)	188149
% of GDP	114%
Full value of NAMA assets	64000
Net General Government Debt assuming full value of NAMA assets realised	92649
% of GDP	56%
Net General Government Debt assuming 90% realised	99049
% of GDP	60%
Net General Government Debt assuming 80% realised	105449
% of GDP	64%
Net General Government Debt assuming 70% realised	111849
% of GDP	68%

Source: Davy estimates

- **Net General Government Debt is the crucial metric: likely to remain manageable even if NAMA does not realise full value**

Even if NAMA were to realise only 70% of the value in 2010 money (a very bearish assumption), net General Government Debt would not exceed 70% of GDP. However, if this looked like being the trajectory for value-realisation, it could create funding problems with regard to the perceived value of the bonds that the banks will receive from NAMA well before that. In a more realistic (but yet pessimistic scenario) where 90% of value is extracted, net General Government Debt comes in at a manageable 61% of GDP.

## Outlook for capital in the banking system

In order to estimate the burden the banks will create for the Irish state, we have to answer two key questions. The first is what the initial re-capitalisation requirement is, i.e. we need to estimate the level of capital required to fill the hole caused by bad debts so as to meet certain accepted ratios. Having done this, we need to determine how much of this will need to come from the government as opposed to other sources or 'self help' efforts by the banks themselves.

The second question is what the 'second loss' or the potential loss that could be incurred by NAMA is bearing in mind that it will be paying above market value for property loans.

The initial re-cap requirement will have to be met in the next several months, whereas the second loss (if any) will depend on how aggressively NAMA works through its assets, future market conditions and any levy imposed on the banks down the road.

### Impairment losses now put at over 8% of loans

Following various results and trading statements we have updated our estimate for system losses across the six Irish banks, which we last published in early April (see Table 6). We now expect cumulative impairments over the 2008-2010 period across the six covered banks to reach 8.3% of 2008 loans or €33bn. We previously had estimated €23bn or 5.8% of loans. Around €6bn of the €10bn increase is related to the non-quoted banks, which represent only 25% of the aggregate loan pool. Our new impairment estimates range from 1.6% at Irish Life & Permanent (IPM) to 5.5% at BKIR, 8.6% at ALBK and as high as 15% for ANGL and 22% for Irish Nationwide Building Society (INBS).

All our figures are at/beyond each bank's worst-case scenarios. For ALBK, we have pencilled in €11.2bn in bad debts versus the last published stress case of €8.4bn (€8.7bn if we allow for the increase in 2009 guidance). For BKIR, we are at €7.4bn versus management's €6.0bn worst case. Meanwhile, our projections for ANGL and, by extrapolation, INBS take account of the board's worst-case scenario of €11bn over the three years 2009-2011. We have a similar €11.3bn in for the 2008-2010 period.

Pre-provision profits are projected to be around €17bn over the three years. The core equity base started this year at €23bn, but we see this being down to under €8bn by end-2010. NAMA will obviously accelerate the impairment recognition process as we see it crystallising up to 55% of the cumulative impairment figure we have in of €11bn at ALBK and nearer 37% at BKIR.

Our capital calculations in table 6 here follow the impact of certain 'self help' measures at ALBK, BKIR and IPM. In the case of ALBK, the bank has committed to raising €1.5bn by the year-end and has already reached €1bn through a debt swap. Any NAMA-related write-down will trigger a

- We now expect cumulative impairments over the 2008-2010 period across the six covered banks to reach 8.3% of 2008 loans or €33bn

further capital call. BKIR has raised a similar €1bn in a debt buyback, while the projections for IPM already reflect a €120m reinsurance arrangement. In table 6 we have not yet included any new capital at ANGL, either a debt buyback or in the form of a government injection.

**Initial re-cap costs of €19bn, which is lower than some estimates as government is no longer the only provider of capital**

In Table 6 we also show various re-cap costs that flow from different required levels of capital at the bottom of the cycle (which we assume will be 2010). At a core equity ratio of 5%, the requirement is €10.8bn; at 6%, it is €14.3bn; at 7%, which is closer to what UK banks will probably end up on, this rises to €17.9bn.

The Irish government has chosen to inject preference shares into ALBK and BKIR and has indicated that if NAMA triggers an incremental capital requirement then this will be filled with equity. So required minimum capital levels are likely to reflect a combination of core tier 1 prefs and equity. Crucially too, the re-cap numbers computed in Table 6 ignore the RWA benefit that NAMA provides to the banks' capital which is very significant.

**Table 6: Estimated banking system losses and re-cap costs\***

	<i>ALBK</i> Dec 2008	<i>BKIR</i> Mar 2009	<i>IPM</i> Dec 2008	<i>ANGL</i> Sep 2008	<i>EBS</i> Dec 2008	<i>INBS</i> Dec 2008	<i>Total</i>
Loans	€129	€134	€40	€72	€17	€10	€402
<b>Bad debts 2008-2010 (€bn)</b>	<b>€11.2</b>	<b>€7.4</b>	<b>€0.7</b>	<b>€11.3</b>	<b>€0.6</b>	<b>€2.3</b>	<b>€33.3</b>
As a % of loans	8.6%	5.5%	1.6%	15.7%	3.4%	22.5%	8.3%
Pre-provision profits (€bn)	€6.6	€4.5	€1.1	€3.7	€0.2	€0.7	€16.8
Other deductions (€bn)	€1.1	€0.7	€0.0	€1.2	€0.1	€0.2	€3.2
P&L losses (€bn)	-€3.5	-€2.2	€0.4	-€6.4	-€0.3	-€1.4	-€13.4
Equity tier 1 2008 (€bn)	€7.7	€6.5	€2.1	€4.7	€0.6	€1.2	€22.7
Equity tier 1 2009 (€bn)	€5.6	€5.7	€2.0	€0.3	€0.5	€0.8	€14.8
Equity tier 1 2010 (€bn)	€3.6	€4.4	€1.9	-€2.3	€0.2	-€0.2	€7.6
RWA 2008 (€bn)	€134	€105	€22	€86	€11	€12	€370
RWA 2009 (€bn)	€137	€103	€22	€77	€10	€12	€361
RWA 2010 (€bn)	€138	€101	€21	€69	€10	€12	€352
Equity tier 1 2008 %	5.8%	6.2%	9.2%	5.5%	5.2%	9.8%	6.1%
Equity tier 1 2009 %	4.1%	5.5%	8.9%	0.3%	4.5%	6.7%	4.1%
Equity tier 1 2010 %	2.6%	4.3%	8.9%	-3.4%	2.2%	-1.3%	2.2%
Bad debts (€bn) (baseline 8.3% of loans)							
100bp more, i.e. 9.3%	€12.5	€8.7	€1.1	€12.0	€0.7	€1.5	€37.4
200bp more, i.e. 10.3%	€13.8	€10.1	€1.5	€12.7	€0.9	€1.6	€41.4
300bp more, i.e. 11.3%	€15.1	€11.4	€1.9	€13.5	€1.1	€1.7	€45.4
400bp more, i.e. 12.3%	€16.4	€12.7	€2.3	€14.2	€1.2	€1.8	€49.4
Equity tier 1 2010 %							
100bp more, i.e. 9.3%	1.8%	3.3%	7.4%	-4.2%	1.0%	3.9%	0.9%
200bp more, i.e. 10.3%	1.1%	2.2%	5.9%	-5.0%	-0.2%	3.2%	0.0%
300bp more, i.e. 11.3%	0.3%	1.2%	4.4%	-5.9%	-1.5%	2.5%	-0.9%
400bp more, i.e. 12.3%	-0.4%	0.1%	2.9%	-6.7%	-3.0%	1.8%	-1.7%
Additional equity reqd. to get 5% (€bn)							
<b>Current forecasts</b>	<b>€3.3</b>	<b>€0.7</b>	<b>€0.0</b>	<b>€5.8</b>	<b>€0.3</b>	<b>€0.7</b>	<b>€10.8</b>
100bp more, i.e. 9.3%	€4.4	€1.7	€0.3	€6.4	€0.4	€0.1	€13.4
200bp more, i.e. 10.3%	€5.4	€2.8	€0.7	€7.0	€0.5	€0.2	€16.6
300bp more, i.e. 11.3%	€6.4	€3.9	€1.0	€7.5	€0.7	€0.3	€19.8
400bp more, i.e. 12.3%	€7.5	€4.9	€1.3	€8.1	€0.8	€0.4	€23.0
Additional equity reqd. to get 6% (€bn)							
<b>Current forecasts</b>	<b>€4.7</b>	<b>€1.7</b>	<b>€0.2</b>	<b>€6.5</b>	<b>€0.4</b>	<b>€0.8</b>	<b>€14.3</b>
100bp more, i.e. 9.3%	€5.7	€2.7	€0.6	€7.1	€0.5	€0.2	€16.9
200bp more, i.e. 10.3%	€6.8	€3.8	€0.9	€7.6	€0.6	€0.3	€20.1
300bp more, i.e. 11.3%	€7.8	€4.9	€1.2	€8.2	€0.8	€0.4	€23.3
400bp more, i.e. 12.3%	€8.9	€6.0	€1.5	€8.8	€0.9	€0.5	€26.5
Additional equity reqd. to get 7% (€bn)							
<b>Current forecasts</b>	<b>€6.1</b>	<b>€2.7</b>	<b>€0.5</b>	<b>€7.2</b>	<b>€0.5</b>	<b>€1.0</b>	<b>€17.9</b>
100bp more, i.e. 9.3%	€7.1	€3.8	€0.8	€7.8	€0.6	€0.4	€20.4
200bp more, i.e. 10.3%	€8.2	€4.8	€1.1	€8.3	€0.7	€0.4	€23.6
300bp more, i.e. 11.3%	€9.2	€5.9	€1.4	€8.9	€0.9	€0.5	€26.8
400bp more, i.e. 12.3%	€10.2	€7.0	€1.7	€9.5	€1.0	€0.6	€30.1

\* Projected equity shortfall ignores RWA benefit of NAMA, which reduces capital requirements at the banks; figures for ANGL are before €4bn government injection and any buyback gains  
Source: Davy estimates

As to what this minimum is and whether the Regulator's interpretation of this will change, we note a recent statement from the Minister for Finance in the Dáil.

*"Regarding the suggestion that there was a danger in raising capital ratios, the UK raised them to give confidence to markets in respect of the banks. We did not follow suit, keeping with the minimum capital ratios. I do not propose to change that because I agree ... that if one raises capital ratios too high we will inhibit lending. We must have a minimum and that must be adhered to."*

This would seem to confirm our suspicion that the Irish government is not planning on setting the capital bar particularly high for the Irish banks post-NAMA. Instead, it plans to let the preference shares help offset a slightly lower level of equity tier 1 (maybe 5%+) versus UK peers. In Ireland, the minimum capital requirement is a core tier 1 of 4%, whereas in the UK the new FSA requirement is 4% but after a severe stress test.

#### **NAMA risk weighting benefit means bottom-up analysis generates a lower re-cap number than top-down – this is often ignored**

As each bank's circumstances are different, with NAMA providing a significant RWA benefit, Table 7 looks at the problem from a bottom-up basis. We can identify €19bn of capital needed across the six covered banks, €14.6bn of which currently will have to come from the Irish government.

- Bottom-up analysis suggests initial re-cap requirement of €19bn

- ANGL is the biggest driver of this

The single biggest driver of this number is ANGL. The Irish government is committed to investing €4bn, and we envisage at most another €1bn on top assuming that €1.3bn in equity can be generated from a debt buyback (so total of €6.3bn). Intuitively, this may seem like a small number given that we are allowing for the bank's worst-case impairment number of €11bn over three years. However, the RWA benefit from NAMA is very significant (we assume €27bn of assets move across) and is not taken into account by media reports, which tend to talk of a capital injection of nearer €7.5bn. The same logic also applies to INBS, where we pencil in up to €1bn in capital (if the loans were kept on balance sheet, the figure would be well in excess of this).

The final bill will obviously depend on many variables, including what level of capital the government lets ANGL run with (we have used 7.5% core equity post-NAMA).

As the bank is in state hands, it arguably does not need to reach the same bar as ALBK or BKIR, particularly if it is subsequently sold on in parts down the road (this just gets reflected in the consideration received). Another factor we have not been able to model is the benefit of the temporary derogations that ANGL has received from the Regulator. These probably run to a few hundred million (see p51/52 of the interims).

Our system figure compares with the €20-25bn identified by S&P in its recent rating report on Ireland. We understand that this was worked off

a minimum hurdle of 6% for core tier 1 in 2011, albeit skewed upwards by a few billion to reflect the rating link with the sovereign credit.

**Table 7: Bottom-up re-cap assessment taking account of NAMA (€bn)**

	<i>Preference shares</i>	<i>Equity</i>	<i>Self help measures</i>	<i>Total capital</i>
ALBK	3.5	1.3	1.5	6.3
BKIR	3.5	0.0	1.0	4.5
ANGL	0.0	5.0	1.3	6.3
IPM	0.0	0.0	0.5	0.5
INBS	0.0	1.0	0.0	1.0
EBS	0.0	0.3	0.0	0.3
<b>Total</b>	<b>7.0</b>	<b>7.6</b>	<b>4.3</b>	<b>18.9</b>

Source: Davy estimates

- No more than €14.6bn should need to come from the state initially

Our analysis points to a maximum of €14.6bn coming from the Irish state initially. Some of this could be clawed back later as the funding window for banks has opened up again, and we see BKIR in a strong position to do a rights issue in Q4 and repay €1.5bn+ of the government preference shares. ALBK could possibly be in a position to do likewise, while there is the possibility that the bank could generate significantly more than the market thinks from any disposal of Poland.

**Our losses now on a par with early 1990s Sweden, but initial government re-cap costs will be at least in line with Finland (9% of GNP)**

- Cumulative loan losses over three years of 8%+ would put us on a par with the damage seen in Sweden in the early 1990s

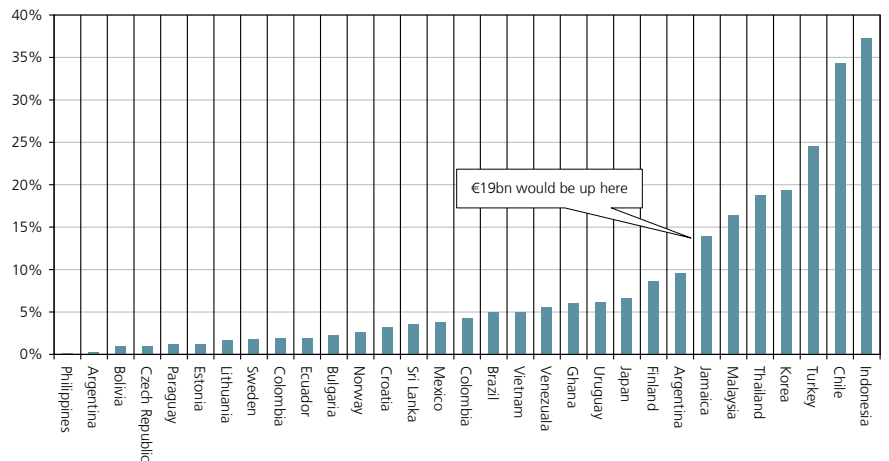
Cumulative loan losses over three years of 8%+ would put us on a par with the damage seen in Sweden in the early 1990s (see Figure 4). However, our equivalent initial re-cap costs as a percentage of GDP, if they are to be fully satisfied by the Irish government (as opposed to the market), will be a lot higher.

In Sweden, government re-cap costs were 4% of GDP (according to the IMF) due to two of their large banks eventually being able to tap the markets for equity rather than relying on government. Our €14.6bn, excluding self help measures, would be nearer 9% of Ireland's peak GNP.

- The adjustment in the Irish economy more closely resembles what happened to Finland rather than Sweden

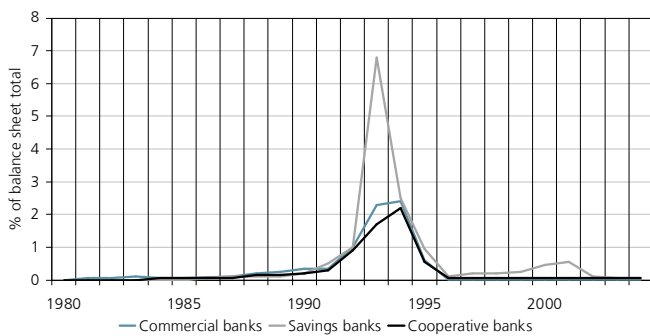
As we have commented before, the adjustment in the Irish economy more closely resembles what happened to Finland rather than Sweden. There, loan losses in the commercial sector were less than 6%, with far greater damage caused in the savings banks (the equivalent of the credit unions in Ireland). Re-cap costs, however, were closer to the same 9% of GDP.

**Figure 2: Financial crises: recap costs as % of GDP**



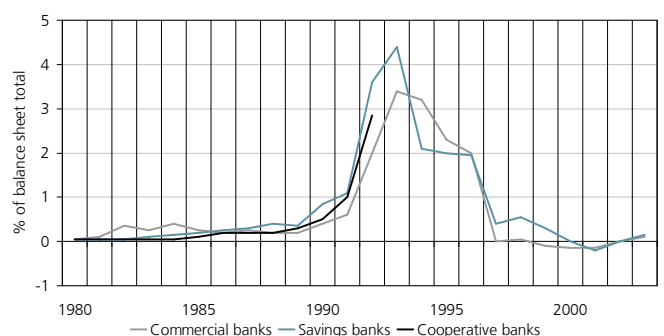
Source: IMF

**Figure 3: Loan loss provisions in Finland (early 1990s)**



Source: Drees and Pazarbasioglu; OECD

**Figure 4: Loan loss provisions in Sweden (early 1990s)**



Source: Drees and Pazarbasioglu; OECD

### System re-cap cost of €19bn ignores second loss

**Our analysis so far ignores the unrealised liability to the state sitting in NAMA – this is €4bn today at a minimum**

Our post-NAMA and base case loan loss projections in our earnings models are more or less aligned, with only differences in timing impacting the capital ratios. The logic for this is that NAMA will pay 'economic value' rather than market value for the assets, so it makes no real sense to assume the post-NAMA outcome will be materially worse. This is particularly so given that our base case models for ALBK and BKIR build in a far worse outcome for impairment than the banks are guiding today.

A question investors will ask though is what, if our loan loss projections prove to be accurate, unrealised liability for the state will be buried within NAMA's portfolio. This is the flipside to the RWA 'benefit' we allude to above in our discussion of ANGL. Strictly speaking, it is a question that one cannot really answer as many of the assets NAMA acquires could be sitting on its books for maybe ten years or more by which time values may have recovered.

- Unrealised loss sitting in NAMA likely to be at least €4bn based on today's property values

Nevertheless, in our research note of April 29th (Irish banks: "Haircuts: not styled purely on property values"), we tried to put a figure on this based on today's market conditions.

In Table 8, we show a haircut of 25% for ALBK and 22% for BKIR. The latter was originally 20%, but we have reduced the assets transferred from €20bn to €17bn on the basis of guidance from the bank. Given that our NAMA models assume a collective write-down of €8.7bn for the two banks, NAMA is paying c.€2.4bn above market on this basis. Extrapolating this across all six covered banks, one is possibly looking at €4bn in today's money.

**NAMA to operate as a statutory body so capital can be injected as required to cover any realised losses**

If values do not recover, then as NAMA assets are realised for cash this '€4bn' will have to be found and injected into NAMA in the form of capital. Adding this €4bn to our €18.9bn from earlier gives a total capital cost of nearer €23bn in today's terms.

Note we understand that NAMA will not be capitalised up-front like a bank or corporate entity but will be operated as a statutory body. This means that the state can inject capital on a phased basis as it is needed.

<b>Table 8: ALBK and BKIR mark to market haircut calculation</b>		
<i>% haircut on transfer</i>	<i>ALBK</i>	<i>BKIR</i>
Land bank	40%	36%
Ireland	44%	44%
UK	24%	24%
Residential development	23%	22%
Ireland	25%	25%
UK	20%	20%
Commercial development	20%	20%
Ireland	21%	21%
UK	19%	19%
Total development	32%	27%
Residential investment	7%	6%
Ireland	8%	8%
UK	5%	5%
Commercial investment	8%	7%
Ireland	9%	9%
UK	5%	5%
Total investment	7%	7%
Development loans (€bn)	21.3	12.4
Investment loans (€bn)	8.7	4.6
<b>Transferred loans (€bn)</b>	<b>30</b>	<b>17</b>
<b>Total haircut %</b>	<b>25%</b>	<b>22%</b>
Market based write-down (€bn)	7.4	3.7
Economic based write-down (20% and 16%)	6.0	2.7
<b>NAMA overpayment</b>	<b>1.4</b>	<b>1.0</b>

Source: Davy estimates

- Risks to our €4bn skewed to the upside

**'Phantom equity' suggests gap between market and economic value could be a lot bigger than our €4bn estimate**

However, our €4bn figure comes with a number of caveats. For instance, we used published LTVs supplied by BKIR and ALBK, whereas we know that some players offered more generous terms. More importantly, our modelling was built on the basis that every development land had equity in the deal (i.e. LTVs were typically 50-60%). However, some of this equity was never cash – it was borrowed on the back of equity tied up in other sites, investment properties and business interests.

To the extent that this security is 'real' or realisable (e.g. if it was an equity release loan on an investment property where the bank geared up to say a standard maximum LTV of 70-80%), then this is captured in our model (i.e. in the loss on investment property loans).

However, if the equity in the land deal was borrowed on the strength of a business which has gone bust or on the basis of just a personal guarantee, then this equity has evaporated (i.e. it is 'phantom equity').

It is impossible for us to know how significant a factor this is. However, it does suggest that the difference between market and economic value or the unrealised loss that NAMA is taking on could be a lot bigger than our €4bn estimate.

- If NAMA records a loss, then the state plans to recover this from the banks

Ultimately, it is the government's intention to levy the banking sector so as to recover any NAMA-related loss in the future. But until this is done, the state will have to shoulder any burden.

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