

**THE HIGH COURT  
JUDICIAL REVIEW  
2012 No. 55 JR**

IN THE MATTER OF

**SECTION 193 OF THE NATIONAL ASSET MANAGEMENT AGENCY ACT 2009**

BETWEEN:

**TREASURY HOLDING, SPENCER DOCK DEVELOPMENT COMPANY LIMITED,  
SDDC (No. 1) LIMITED, SDDC (No. 2) LIMITED, SDDC (No. 3) LIMITED, FAXGORE  
LIMITED, REAL ESTATE OPPORTUNITIES PLC, COOLRED LIMITED,  
TENDERBROOK LIMITED, WINTERTIDE LIMITED, TWYNHOLM LIMITED,  
RIGOL LIMITED, RUSHRID LIMITED, IREO IRISH REAL ESTATE  
OPPORTUNITIES FUND PUBLIC LIMITED COMPANY, CARRYLANE LIMITED,  
CALLSIDE DEVELOPMENTS LIMITED, RADTIP PROPERTIES LIMITED,  
SENCODE LIMITED, LORNABAY LIMITED, BALLYMUN SHOPPING CENTRE  
LIMITED, MOTEVETRO II LIMITED AND TREASURY HOLDINGS CHINA  
LIMITED**

APPLICANTS

-AND-

**THE NATIONAL ASSET MANAGEMENT AGENCY  
AND NATIONAL ASSET LOAN MANAGEMENT LIMITED AND  
BY ORDER, IRELAND AND THE ATTORNEY GENERAL**

RESPONDENTS

-AND-

**KBC BANK IRELAND PLC  
IRISH BANK RESOLUTION CORPORATION LIMITED  
LUKE CHARLTON AND DAVID HUGHES**

NOTICE PARTIES

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**AFFIDAVIT OF DR. MICHAEL I. CRAGG**

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I, **MICHAEL I. CRAGG**, aged eighteen years and upwards, **MAKE OATH AND SAY** as follows:

## **I. INTRODUCTION**

### **A. BACKGROUND AND QUALIFICATIONS**

1. My name is Michael I. Cragg, and my business address is 44 Brattle Street, Cambridge, Massachusetts, 02138, United States of America.
2. I make this affidavit at the request of the Applicants in the above entitled proceedings, for the purpose of providing an expert opinion to the Court. I understand that the duty and the role of an expert witness are to assist the court and that experts have a duty to be impartial. I have abided by this duty and make this affidavit from facts within my knowledge, save where otherwise appearing and where so appearing I believe the same to be true.
3. I have a Ph.D. in economics from Stanford University, and was an economics professor at Columbia University in New York and the Anderson School of Management at the University of California, Los Angeles. I have published broadly and have also taught courses in corporate finance and microeconomics, at both the undergraduate and graduate levels. My research has been sponsored by a variety of foundations, including the National Bureau of Economic Research and the National Science Foundation. I am currently a Principal and the Chief Operating Officer of *The Brattle Group*, a global economic consulting firm headquartered in Cambridge, Massachusetts with offices in London, Rome, Madrid, Brussels, Washington DC, and San Francisco.
4. I have conducted research, published, testified, taught, and made presentations on the subjects addressed in this affidavit including the current financial crisis, commercial and investment banking failures, financings of property and real estate development, structured finance products, securitizations, and other financings. I have also carefully investigated the investments, balance sheets and financings of many small and large commercial and investment banks and insurance companies including ABN-AMRO, Barclays, Royal Bank of Scotland, JP Morgan, Wells Fargo, the Bank of New York, Fifth Third Bank, BB&T, Sovereign Bank, Citibank, Lloyds, Principal Life, and TIAA-CREF to mention a few and several high profile failures including the bankruptcy of Lehman Brothers, and the failures

of AIG, Executive Life Insurance, Enron, and Long Term Capital Partners. I have also studied and analyzed real estate markets in general, conducted real estate valuations and evaluated numerous real estate financings and securitizations in disputes, bankruptcies and as a participant in commercial transactions. I have also studied the Irish economy, its banking system, and NAMA in particular and have sworn an affidavit in support of the Applicants in the matter of *Dellway Investments Limited and others -v- National Asset Management Agency and others* [2010 No 909 J.R.]. For more detail on my qualifications and experience, refer to my Curriculum Vitae, upon which I have marked “MIC 1” and signed my name prior to the swearing hereof.

5. For the purposes of preparing this affidavit, I have been provided with copies of: the Affidavit of Rory Williams, dated January 31, 2012; the Affidavit of Mary Birmingham, dated February 3, 2012; the Affidavit of John Bruder, dated January 25, 2012; the Affidavit of Edward Dillon, dated February 3, 2012; the Affidavit of Michael Moriarty, dated February 3, 2012; the National Asset Management Agency Act 2009; and the Amended Statement Required to Ground Application for Judicial Review, dated January 31, 2012. My affidavit uses defined terms similar to these documents.

#### **B. OVERVIEW AND SUMMARY OF CONCLUSIONS**

6. The primary purpose of my affidavit is to evaluate National Asset Management Agency's (“NAMA”) decision to appoint receivers in this case and to identify the economic issues related to whether these appointments should have been made.
7. My conclusions can be summarized as follows:
  - a. NAMA’s approach is susceptible to opportunistic behavior.
  - b. In the absence of an orderly, predictable process for NAMA’s asset disposition, the public interest will be harmed.
  - c. NAMA’s actions with respect to appointing receivers to Treasury do not follow an economically reasonable due process and are inconsistent with good public policy because they risk the destruction of value in a case when potentially viable acquirers exist.

- d. There are compelling economic reasons as to why NAMA should not have appointed receivers to Treasury, as this course of action does not serve the interests of Treasury, the interests of NAMA, or the wider national interest. On the basis of the information I have seen, Treasury was not afforded the opportunity to present these reasons.
8. The remainder of my affidavit proceeds as follows. First, I outline the role of long-term relationships in the banking sector in addressing the asymmetric information problems that are pervasive in this industry and discuss how NAMA's structure is distinctly different from typical banks and distorts its economic incentives in dealing with borrowers. Second, I explain how NAMA's ability to foreclose on assets in the absence of an orderly, predictable process can give rise to situations that are inconsistent with the public interest. Finally, I comment on the economic and public policy implications of NAMA's decision to appoint receivers to liquidate Treasury's assets.

## **II. NAMA FACES DIFFERENT ECONOMIC INCENTIVES THAN BANKS**

### **A. THE ROLE OF LONG-TERM RELATIONSHIPS IN THE BANKING SECTOR**

9. In large part, the structure of financial institutions and markets is a response to issues arising from differences in information available to borrowers and lenders. These information differences—or asymmetries—give rise to problems of moral hazard and adverse selection.
10. Moral hazard in banking arises because the lender is often unable to monitor important dimensions of borrower behavior. Aware of this deficit, a borrower that is shielded from the consequences of its actions has an incentive to alter its activities in a way that harms the interests of the lender. For example, real estate developers will have an incentive to invest in risky ventures when their prospective gains are unbounded but their prospective losses are not. The Irish real estate frenzy exacerbated moral hazard problems, as developers raced to build and flip properties in the absence of sufficient bank oversight.
11. Adverse selection in banking arises for two reasons. First, borrowers differ with respect to the likelihood of loan repayment. Second, lenders cannot perfectly identify reliable borrowers. Given these conditions, a change in the terms of credit being provided can result in a change in the characteristics of the population applying for loans. For example,

when a lender raises interest rates on the loans that it offers, borrowers with a high probability of repayment may withdraw from the group, leaving behind only those borrowers who have a low likelihood of repayment. With these changes in the population of borrowers, it is difficult for lenders to ensure that the interest rates and other loan terms correspond to the risks that they face.

12. Banks rely on a number of standard practices to address these moral hazards and adverse selection concerns, including collateral requirements, underwriting standards, consumer credit scoring, and the requirement that borrowers receiving construction loans meet specific milestones before obtaining additional funds.
13. Long-term relationships between lenders and borrowers are another primary means through which the banking industry addresses adverse selection and moral hazard concerns. Long-term commercial banking relationships help to address adverse selection issues by helping banks to identify which borrowers are good risks as opposed to bad risks. A bank will gain confidence in a commercial borrower as it builds a reputation for good performance over time. With this reputation for good behavior, the borrower can expect its banker to offer lower interest rates, increased loan amounts, and reduced requirements for collateral and information reporting. Moreover, all of these benefits extended to the borrower are mutually beneficial, producing greater lender profits at a lower level of risk.
14. Long-term relationships also help to address moral hazard problems by providing both borrowers and lenders with strong incentives to act in a mutually beneficial manner even in difficult, complex economic environments. This is because each party sees a long stream of future ongoing benefits from maintaining the relationship. Under these circumstances, the borrower and the lender can enjoy the benefits of a more flexible and efficient relationship, as well as lower contracting costs.

#### **B. NAMA'S STRUCTURE AND INCENTIVES ENCOURAGE OPPORTUNISTIC BEHAVIOR TOWARDS BORROWERS**

15. In contrast to traditional banks, NAMA has little incentive to engage in a long-term mutually beneficial relationship with its borrowers. First, unlike traditional lenders that derive their profits from a long-term relationship with a credit-worthy borrower, NAMA's

stated goal is to obtain a 25% debt reduction within 3 years and 100% within 10 years. Consistent with this description, Frank Daly, chairman of NAMA, described NAMA as a "workout vehicle" seeking rapid repayment through: (i) payment demands accompanied by either the threat of or realized foreclosure sale; and (ii) NAMA's professed goal of demanding accelerated principal amortization. Thus NAMA replaces the traditional borrower lender relationship with a workout-based mindset of speeding repayment and severing relationships.

16. Second, without the ability to meaningfully extend credit, NAMA lacks access to a primary means for cultivating a long-term mutually beneficial relationship with borrowers. In a long-term banking relationship, if both the bank and the borrower have behaved in a mutually beneficial manner, the bank will rollover credit facilities upon loan expiration. This automatic credit rollover provides profit incentives for future good (non-opportunistic) behavior. However, NAMA is not a bank and does not have the same ability to provide rollover credit on a long-term basis. Additionally, NAMA does not have the ability to provide meaningful loan syndication in which it maintains a meaningful piece of the replacement financing often necessary for lenders to rework a failed financing through the identification of replacement lenders. Thus, the future rewards to be gained from cooperative behavior now are severely constrained if not entirely absent.
17. Given these incentives, NAMA and its borrowers can be expected to behave more opportunistically than would be the case in a traditional borrower lender relationship. These issues make it more difficult for NAMA to find replacement borrowers, particularly in the absence of a clearly defined negotiation process with clear hurdles for replacement lenders, a clear timeline and clear implications for negotiation failure; a range of downside outcomes including both foreclosure and additional negotiation does not meet these requirements. Moreover, having been given far more power over its borrowers than an ordinary commercial bank, NAMA is well-positioned to act on these opportunistic incentives.
18. Given NAMA's opportunistic incentives and extraordinary powers to act on those incentives, it is crucial that NAMA follow an orderly and well-established process for liquidating assets. In the absence of such a process, borrowers, NAMA and potential

replacement lenders will find it difficult to negotiate rationally because the economic environment is not conducive for fostering predictable behavior on any of the participants' parts. For loans such as Treasury's that have potential buyers, care must be taken to ensure that the potential buyers are allotted a fair hearing on a reasonable timetable. Failure to do so will result in discounted values and avoidable losses resulting from forced sales in a weak property market. Chairman Daly of NAMA acknowledges that the market is weak ("...[it] is in no condition to absorb a large volume of property sales right now..."), yet it remains the objective of NAMA to force substantial principal reduction targets upon borrowers over the next three years or "where a borrower cannot convince NAMA that he can meet the target, the only option is foreclosure."<sup>1</sup>

### III. FLAWS IN NAMA'S PROCESS OF DEALING WITH TREASURY

#### A. NAMA'S PLAN TO UNILATERALLY FORECLOSE ON TREASURY'S PROPERTIES DESTROYS VALUE

19. On its face, NAMA's failure to accept the proposals from Macquarie and Hines would appear to be economically irrational. As I understand it, NAMA is being offered a price in excess of that which it paid, fulfilling the requirement that it realize a return for the Irish state. Further, there is enhanced value to offering Treasury's properties as a package, rather than foreclosing on, and selling, each individually. Given an illiquid market, this approach maximizes the potential return for NAMA and the Irish state—as NAMA is required to do.
20. The losses associated with NAMA's hasty seizure and disposition of Treasury's assets would result in societal *and* private losses for two reasons:
  - a. **First**, a foreclosure severs long-term relationships among the parties who use, finance, manage and own the property, thereby changing these parties' incentives to operate in a mutually beneficial manner. Prospective buyers, recognizing these changed incentives and the resulting increased potential for opportunism, offer lower prices for foreclosed properties than for other types of property. In past crises where governments have

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<sup>1</sup> Address by Frank Daly, NAMA Chairman, to the CPA Annual Conference 2010, June 4, 2010, *NAMA – the objective, progress and challenges*, pp. 3 – 4, upon which I have marked "MIC 2" and signed my name prior to the swearing hereof.

managed bank failures through loan seizure, lender foreclosure, and asset liquidations, the results have been costly to taxpayers. The Resolution Trust Corporation, which was set up to deal with the U.S. savings and loan crisis in the 1980s and the Reconstruction Finance Corporation established in 1932 to deal with the U.S. Depression provide examples of how government foreclosure can destroy substantial value. Recent experience in current global real estate markets provides numerous additional examples of this problem.

- b. ***Second***, in the event of foreclosure, NAMA would be taking over management of the property from Treasury, a function outside of its core competencies. Managing properties such as those held by Treasury requires specialized information about the properties. Recognizing this, the Hines and the Macquarie bids provide that the existing Treasury Staff would be transferred into or form part of the new management vehicle that would manage the assets going forward. In contrast, under the proposed foreclosure, it would be impossible for NAMA to obtain a “data dump” of all the requisite information, even if Treasury had the incentives to provide such information. That Treasury’s management has specialized expertise is consistent with their successful sale of over 600,000 square feet of space in 2011, described by Mr. John Bruder in Paragraphs 40 – 42 of his affidavit. This is why the process of transferring assets from one owner to another is typically so costly; the costs associated with lost information and expertise extend well beyond the actual costs of effectuating the transfer. Hence, government seizures (like NAMA’s proposed foreclosure) should not be undertaken without carefully balancing the cost of potential value destruction against societal benefits. Faced with this calculation, banks generally prefer to sell loans rather than foreclose on property, using the latter as a last resort. This potential for value destruction is exacerbated when assets are seized with undue haste.
21. Thus far, I have assumed that NAMA would foreclose on Treasury’s property and dispose of the assets as a group. However, if that were not the case, the potential for value destruction would be even greater. This is because the value to the acquirer of the entire portfolio is likely to be greater than that of the individual pieces—put simply, the whole is greater than the sum of the parts. For a given set of assets that have some common

attributes (in this case, all properties of some type) pooling assets under one central management can lead to the realization of economies of scope, thereby improving profit margins and increasing the purchase price that a willing buyer and willing seller would agree to in an arms-length transaction. Moreover, selling the assets in a bundle rather than piecemeal can be expected to minimize sales-related transaction costs. In contrast, any plan to foreclose on the assets individually and then sell them in a piecemeal fashion risks the realization of lower returns, and societal losses, rather than benefits.

22. Thus, NAMA stands to realize the largest return for itself by transferring the loans to another holder rather than foreclosing. NAMA's plans for speedy foreclosure reduce its potential return on investment and contravene the objective—stated in the NAMA Act—that NAMA realize the best possible return for the Irish state. For these reasons, Ms. Mary Birmingham's statement in Paragraph 17 of her affidavit that NAMA's course of action "will likely lead to a better return for the State" is unlikely to hold true.

#### **B. OTHER ERRORS MADE BY NAMA**

23. Even if foreclosure were the proper approach for disposing of Treasury's holdings, NAMA failed to clearly communicate its decisions. Further, none of the parties could be expected to view foreclosure as imminent, since such a procedure is typically a lender's last resort. There are two best practices relating to foreclosure that were not followed here:
  - a. *First*, there should be clear metrics and timelines presented for determining foreclosure, which I have not seen in any NAMA materials or laid out in sufficient detail in Ms. Birmingham's affidavit upon which a rational investor could make decisions. Simply having the right to pursue an economically irrational course of action, as Ms. Birmingham suggests in Paragraph 96 and Paragraph 100, does not provide guidance to the market on what NAMA's course of action will be. Instead it heightens uncertainty and distorts the search for replacement lenders and the replacement loan negotiation process.
  - b. *Second*, after a bank has determined that foreclosure is necessary, it should begin negotiations with the debtor, any potential buyers, and receivers and take all steps possible to preserve the long-term economic value of the assets. In the present

instance, NAMA decided at some point well before the “standstill” phase that foreclosure was necessary. However, it delayed in communicating that decision to the appropriate parties. In the absence of any communication, Treasury tried to secure deals with Macquarie and Hines that could never have come to fruition due to the pending foreclosure.

24. Ms. Birmingham also states incorrectly in Paragraph 18 of her affidavit that Treasury is “past the point of commercial rescue.” This statement is contradicted by the fact that two private investors, Macquarie and Hines, have offered large sums of money to purchase the holdings and debt of Treasury. Such offers would only be made if those firms viewed Treasury’s properties as commercially viable. If Ms. Birmingham’s statement were true, the substantial offers for Treasury’s portfolio of assets made by Macquarie and Hines would suggest that either: (i) Macquarie and Hines were acting altruistically, in giving money away to NAMA, or (ii) Macquarie and Hines had some private knowledge that would allow them to realize profits from Treasury’s portfolio of assets. In either case, NAMA would still realize a profitable return. Whether or not Ms. Birmingham and NAMA believe that Treasury’s properties are commercially viable, if private investors are willing to pay what amounts to above-market rates for the assets, it would be economically nonsensical for NAMA to reject those offers.

#### **IV. FOLLOWING ESTABLISHED PROCEDURES AND PRECEDENTS IS CRITICAL TO ACHIEVING NAMA’S OBJECTIVES**

25. There is an extensive economic literature on the importance of respecting contracts and property rights.<sup>2</sup> This literature views well-functioning institutions as the cornerstone of long-run, sustainable economic growth. The rationale for this is straightforward: investors seek to avoid risk. By having well-functioning, predictable institutions investors need not worry that property rights may be suddenly subverted by the government, or that contracts may not be resolved according to the expected rule of law. The predictability of such

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<sup>2</sup> See, for example, Knack, Stephen and Philip Keefer. November 1995. “Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures.” *Economics and Politics* 7(3): 207 – 227, upon which I have marked “MIC 3” and signed my name prior to the swearing hereof ; and La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny. September 1998. “The Quality of Government.” *NBER Working Paper Series*, Working Paper 6727, upon which I have marked “MIC 4” and signed my name prior to the swearing hereof.

processes and the stability of decision making create an economic environment where investors and managers will act to maximize long-term economic value.

26. A foreclosure process that is unpredictable, where the rules of the game change rapidly or are unforeseeable, does not provide the correct incentives for maximizing long-term economic value. The incentive problems are exacerbated when investors are unable to systematically present all of the relevant information to NAMA. This issue is not specific to NAMA—the foreclosure process is typically a last resort for bankers, for the reasons discussed above.
27. Without the assurance of due process discussed above, foreign investment will flee a given country, due to the increased risk of doing business in that country. Such risk is monetized in the form of artificially depressed asset prices. In the present instance, if NAMA were to foreclose on the properties, contrary to well-established and internationally-respected banking procedures, it would be a signal to the global economy that there is increased risk to investment in Ireland. Further, even if one were to make the implausible assumption that NAMA could realize greater value from foreclosing on Treasury's properties and selling them in a piecemeal fashion, the lost value due to depressed prices in NAMA's remaining holdings would more than offset the assumed short-term benefit. Again, such action would be an economically irrational way for NAMA to achieve its goal of maximizing return for Irish taxpayers.

Subscribed and sworn to before me on this 8<sup>th</sup> day of February, 2012, by Dr. Michael I. Cragg in the city of Cambridge, MA.

*[Handwritten signature in blue ink]*

*[Handwritten signature]*  
\_\_\_\_\_  
Jennifer M. Ossea



Notary Public for the State of MA

Residing at 44 Brattle St. Cambridge, MA 02138

My Commission Expires 2/11/2016

Filed this      day of February, 2012 by

DAC BEACHCROFT DUBLIN Solicitors Fleming Court Fleming Place Dublin 4 on behalf of the Applicants

**THE HIGH COURT  
JUDICIAL REVIEW**

**IN THE MATTER OF SECTION 193  
OF THE NATIONAL ASSET MANAGEMENT AGENCY ACT, 2009**

**RECORD No. 2012 [...] J.R.**

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