## Box C: Impact of the Promissory Note Announcement on the Government Accounts

In February 2013, the Government announced a set of transactions related to official support for the financial sector, including the orderly wind-up of the state-owned IBRC and the replacement of the promissory notes (PNs) issued by the Government to IBRC with a portfolio of Irish Government bonds. The transactions are explained in a number of Department of Finance documents (see, for example, Department of Finance 2013b and 2013c). The details in this box are based on the calculations and assumptions in the documents published by the Department of Finance at the time of the transaction.

### Overview of the Pre- and Post-Promissory Note Transaction

The February transactions involve the Exchequer and the General Government sector, as well as a number of institutions outside the General Government sector:

- The former IBRC, a vehicle set up to wind down two nationalised financial institutions:
- Anglo Irish bank and Irish Nationwide Building Society.
- The National Asset Management Agency Investment Ltd (NAMAIL), a special purpose vehicle in which the Government has a 49 percent stake.[35]
- The Central Bank of Ireland (CBI), which is owned by the Government but remains independent in the performance of its functions.

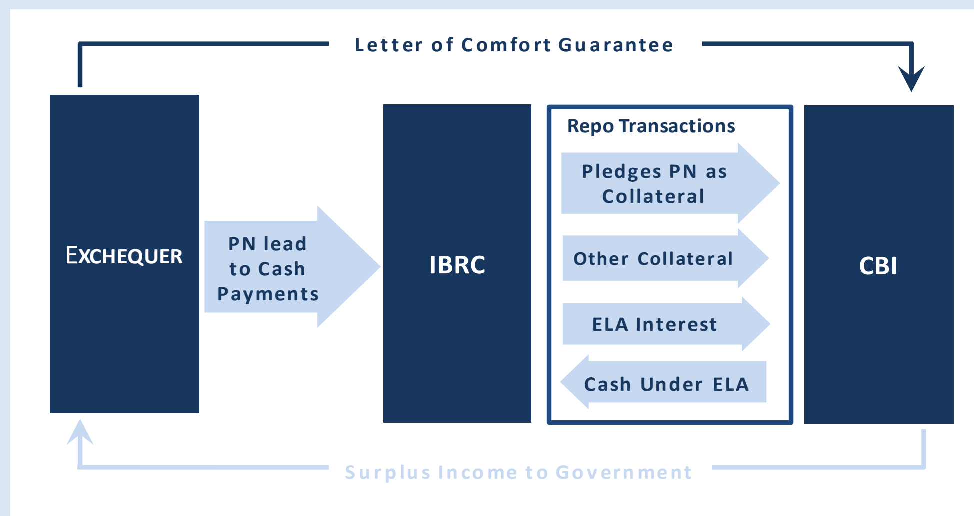
Immediately prior to the February 2013 transactions, the Exchequer was committed to making annual interest and remaining principal payments under the PN with a nominal value of approximately €25 billion that had been previously issued to IBRC. The arrangement aimed to provide capital to IBRC and allowed it to access CBI funding. Exceptional Liquidity Assistance (ELA) from the CBI was secured by the PNs, along with a Ministerial Guarantee and a floating charge over all IBRC assets. The majority of CBI net interest income from the ELA facility provided to IBRC was remitted back to the Exchequer, allowing for the cost of funding to the Eurosystem and any retention of profits by the CBI in accordance with legislation.

The PN required the Government to make fixed payments for a number of years. The full details of the arrangements are complex and were set out in IFAC (2012a, pp. 26-29). From 2011 to 2023, the Government was committed to paying €3.1 billion each year (including an interest charge and amortisation of the capital) with lower final payments out to 2031.[36]

[35] "In order to achieve its objectives, NAMA established a special purpose vehicle (SPV), National Asset Management Limited, which is responsible for the purchase, management and disposal of loan assets from participating institutions and financing such purchases through the issuance of debt securities. The SPV is owned jointly by private investors (51%) and NAMA (49%) through an investment holding company, National Asset Management Agency Investment Limited. NAMA maintains a veto over all activities of the SPVs. The annual return to the private investors is capped as it is linked to the Irish Government 10 year bond yield at the time it is declared with the potential upside of 10% of capital invested to be paid at maturity if NAMA meets its objectives. All other profits and losses accrue to NAMA" (NAMA 2010, p.15).

[36] Total Government payments due under the PN to IBRC amounted to €47.4 billion (€30.6 billion in capital and €16.8 billion in interest) over the twenty year period to 2031.

The operation of these arrangements is summarised in the following diagram:




The February 2013 transactions had several elements. There is an orderly wind up of IBRC. The CBI took economic ownership of the PNs that it held as collateral for the provision of ELA. The CBI then exchanged this for a portfolio of new Irish Government bonds and also took ownership of a related bond held by Bank of Ireland.[37,38] NAMA paid its own senior bonds in exchange for the remaining assets in IBRC which were secured by a floating charge.

The CBI will assign rights and entitlements over the remaining IBRC assets to NAMA in exchange for NAMA bonds. The Special Liquidators of IBRC will be obliged to dispose of the assets and apply the proceeds of the sale to discharge the creditors of IBRC including NAMA. Any assets not sold to third parties will be acquired by NAMA. Any resulting losses for NAMA will be compensated by the Government. The full impact on the Government accounts will, therefore, not be known until the final required transfers to NAMA are concluded.

The new Irish Government bonds pay interest based on the variable 6-month Euribor interest rate plus an interest margin which averages just over 2.6 percent. The maturities range from 25 to 40 years and have bullet redemptions, meaning that the capital is only repaid at end of the life of the bond rather than being amortised during the course of the loan. The maturities are:

- Three tranches of €2 billion each maturing after 25, 28 and 30 years.
- Three tranches of €3 billion each maturing after 32, 34 and 36 years.
- Two tranches of €5 billion each maturing after 38 and 40 years.

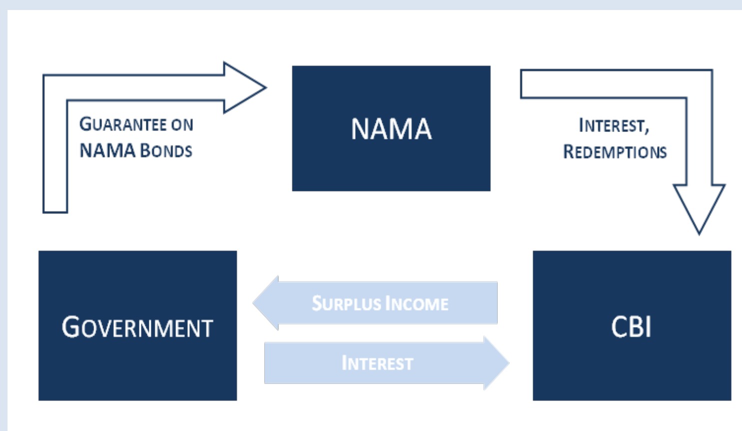
[37] The 2025 Government bond repo agreement between IBRC and Bank of Ireland has been unwound with the CBI now holding this asset. This bond related to the settlement of the 2012 PN payment.

[38] In contrast to the original PN structure, the February transaction involves fully marketable instruments.

The new arrangements imply that the Government will pay interest to the bond holders, eventually repaying the capital beginning in 2038.[39] Where the CBI continues to hold these assets, it will receive income from the coupon payments on the bonds. The CBI will continue to remit surplus income to the Exchequer in accordance with accounting standards and legislative requirements.

The CBI has undertaken to sell the Irish Government bonds that it owns due to the liquidation of IBRC to market investors "as soon as possible" but subject to financial stability considerations.[40] The CBI has committed to a minimum schedule of sales beginning by end-2014. These sales will result in an inflow of cash to the CBI, thereby allowing it to reduce Eurosystem *TARGET* liabilities. However, future interest payments and redemptions on those bonds sold will be made to private investors, which will reduce future potential CBI surplus income payable to the Exchequer. Any capital gains or losses on CBI bond holdings could also affect the surplus income to be transferred to the Exchequer. Sales of the CBI bond holdings to the market may have a broadly similar market impact as an increase in sales of Government bonds directly to the primary market.[41]

The initial operation of these arrangements, prior to CBI sales to the private sector, are shown in the following diagram:




[39] See NTMA (2013) for details.

[40] In addition, the CBI will have an option to exchange a portion of new floating rate bonds for fixed coupon bonds.

[41] These bond sales will add to the Exchequer Borrowing Requirement by, at least, the amount of the reduction in surplus income that will be returned to the Exchequer. The income recorded by the CBI is determined by a number of factors including market valuations.

### Accounting Treatment in the General Government Accounts

On a cash basis in the Exchequer accounts, €3.1 billion of PN payments were included in the Exchequer borrowing requirement from 2011 and would have been added to the Exchequer Accounts in every year to 2023 (with smaller amounts out to 2031). In 2012, this PN payment was settled through the issuance of a 2025 Government bond rather than in cash. This bond was held by Bank of Ireland through a repo with IBRC, which is now being unwound, with the CBI now holding the bond.

The General Government (GG) ESA 95 Eurostat accruals accounting treatment of the PNs was complex. In 2010, the face value of future redemptions under the PN (then amounting to €30.85 billion) worsened the GG deficit and increased GG debt.[42] This amounted to approximately 20 percent of GDP in 2010.[43] For 2011 and 2012, the GG accounts allowed for an "interest holiday" during which no interest payments were made. As a result, in 2013, prior to the February transaction being agreed, there was due to be a sharp increase in recorded interest spending of €1.8 billion. The level of these interest payments under the PN accrued to the GG would have declined gradually in future years.

The Department of Finance estimates that the February 2013 PN transaction may have almost no impact on the GG balance for 2013 but a positive impact of around €1 billion in both 2014 and 2015 based on a no policy change assumption (Table C1). In 2013, there will be costs of approximately €1 billion incurred by the Government associated with claims under the Eligible Liabilities Guarantee (ELG). The improvement in the GG balance in 2014 and 2015 reflects lower (ESA 95) interest costs for the Government, with a small additional benefit in terms of higher CBI surplus income because the interest income for the CBI on the new bonds is higher than the interest income arising from the ELA provided to IBRC. For 2013, these gains are effectively offset by estimated ELG claim costs related to the winding up of IBRC. The Department of Finance did not show the effect of the February transactions on the Structural Budget Balance (SBB). There is likely to be an improvement in the SBB in 2013 as the one-off nature of the ELG claim costs means that it is excluded from this balance.

The impact on the GG debt is shown in Table C2. In 2013, the level of GG debt has been revised up by €1.35 billion due largely to ELG claim costs. The higher interest costs are due to the fact that coupon payments on the newly issued Government bonds exceed the coupon payments on the PN. By 2015 cumulatively there is a slight decline in the GG debt to GDP ratio as a result of the transaction.

[42] The face value of future redemptions had fallen to €25 billion by 2013 due to repayments already made in earlier years.

[43] In 2010 in accordance with ESA 95 rules the full PN amount of €30.85 billion was included in the GG balance for that year.

TABLE C1: GENERAL GOVERNMENT BALANCE IMPACT 2013-2015

| € millions | 2013 | 2014 | 2015 |
|---|---|---|---|
| Promissory Note – GG Interest Savings | 1,875 | 1,775 | 1,675 |
| Government Bonds – Coupons | -800 | -875 | -950 |
| Change in Central Bank Surplus Income | 0 | 50 | 125 |
| Interest Cost Savings[44] | 0 | 100 | 225 |
| ELG Claim Costs | -1,000 | 0 | 0 |
| Interest Costs Adjustment[45] | -50 | -50 | -50 |
| NAMA Compensation | | (not known) | |
| Change in Underlying GGB due to transaction | **25** | **1,000** | **1,025** |
| Change in GGB relative to *Budget 2013* Outlook, % of GDP | **0** | **0.6** | **0.6** |

*Source: Department of Finance (2013b).*

TABLE C2: GENERAL GOVERNMENT DEBT IMPACT 2013-2015

| € millions | 2013 | 2014 | 2015 |
|---|---|---|---|
| Promissory Note – GG Interest Savings | -500 | -1,825 | -1,750 |
| Government Bonds – Coupons | 800 | 875 | 950 |
| Change in Central Bank Surplus Income | 0 | -50 | -125 |
| Interest Savings | 0 | -100 | -225 |
| ELG Claim Costs | 1,000 | 0 | 0 |
| Interest Costs Adjustment | 50 | 50 | 50 |
| NAMA Compensation | | (not known) | |
| Change in GGD in year | **1,350** | **-1,050** | **-1,100** |
| Change in GGD relative to *Budget 2013* Outlook, % of GDP | **0.8** | **0.2** | **-0.4** |

*Source: Department of Finance (2013b).*

This box has focused on the known impact of the February 2013 transactions on the General Government accounts to 2015. The overall impact of these transactions on the General Government accounts may be additionally affected by currently unknown factors, namely, potential capital gains or losses from the sales of CBI held bonds from end-2014 onwards as well as the possibility of transfers being required to NAMA related to IBRC assets.[46] To understand the full impact on the overall public finances, further work is required by means of a comprehensive analysis of the State's balance sheet going beyond the standard General Government Accounts (Barnes and Smyth, forthcoming).[47] In order to undertake a full net present value assessment of the PN transactions, assumptions would also be required regarding key variables such as the discount rate for which a range of alternatives could be considered appropriate.

[44] This relates to savings from lower borrowing requirements.

[45] This relates to interest on borrowings to meet claims under the ELG.

[46] The breakdown of bonds purchasers between domestic and foreign residents will also impact on the CBI's borrowings from the Eurosystem. This would, in turn, affect the CBI's surplus income due to the interest paid by the CBI on these borrowings.

[47] Forthcoming IFAC paper: "Towards a Comprehensive Government Balance Sheet: A Preliminary Analysis", Barnes, S., and Smyth, D.