Box B: Fiscal Implications of the Promissory Notes[30]

The promissory notes issued by the Government to Anglo Irish Bank and Irish Nationwide Building Society (INBS) during 2010 have important implications for Ireland's fiscal position, funding requirements and the outlook for debt sustainability. The use of the notes as collateral to secure funding also impacts significantly on the financial operations and balance sheet of the Central Bank of Ireland (CBI).

On March 31 2010, the first promissory note (PN) was issued by the Irish Government to Anglo Irish Bank in an amount of €8.3 billion. Subsequently the total amount of PNs issued to both Anglo and INBS increased to €30.6 billion (Anglo €25.3 billion and INBS €5.3 billion). Following the amalgamation of Anglo Irish Bank and INBS into one entity, the Irish Bank Resolution Corporation (IBRC), in July 2011, the separate notes were combined as one PN.

The purpose of the PN, which is carried on the IBRC balance sheet as an asset, is to ensure that IBRC can be considered a sound bank for capital adequacy purposes. The inherent value of the PN was recognised at the time of receipt as an accounting reserve. Accounting and revenue reserves qualify as capital for regulatory purposes. The PNs must be valued at par at the time of receipt in the institutions' accounts, otherwise the fair value on receipt would be less than par and more notes would be required. The interest rate charged is therefore based on the long-term Government bond yield appropriate at the time of issue by the Government.

Under the terms of the PNs, following an initial interest payment in 2010, a two year interest "holiday" is specified in 2011 and 2012. To compensate, this is followed by a higher rate applicable in 2013 and subsequent years such that the average rate on the PNs over their entire life is sufficient to allow them to be recorded in the institutions' balance sheets at face value. The weighted average interest rate of the PN (absent the interest holiday) is estimated to be 5.8 per cent. However, due to the interest holiday the weighted average interest rate from January 2013 is 8.2 per cent.

Payment by the Government to IBRC of the principal and interest amounts due under the PNs began in 2011 and ends in 2031. Table B.1 shows the cash payments due over the lifetime of

[30] Note that, with the exception of the Update section of this box, the information was prepared prior to the March 29 announcement by the Minister of Finance on the March 31 promissory note payment.

the PN. Total payments (interest plus amortisation) amount to €3.1 billion annually during 2011-2023 and decline thereafter, with a total cost of €47.4 billion.

Table B.1: Promissory Note Schedule: Anglo and INBS

€ billions	Total Payments Due	Of which: Capital	Of which: Interest		Total Payments Due	Of which: Capital	Of which: Interest
2011	3.1	2.5	0.6	**2022**	3.1	2.2	0.9
2012	3.1	3.1	0.0	**2023**	3.1	2.3	0.8
2013	3.1	2.6	0.5	**2024**	2.1	1.5	0.6
2014	3.1	1.2	1.8	**2025**	0.9	0.5	0.5
2015	3.1	1.3	1.8	**2026**	0.9	0.5	0.4
2016	3.1	1.4	1.7	**2027**	0.9	0.6	0.3
2017	3.1	1.5	1.6	**2028**	0.9	0.7	0.3
2018	3.1	1.6	1.4	**2029**	0.9	0.7	0.2
2019	3.1	1.7	1.3	**2030**	0.9	0.8	0.1
2020	3.1	1.9	1.2	**2031**	0.1	0.1	0.0
2021	3.1	2.0	1.1	**Total**	**47.4**	**30.6**	**16.8**

Source: Oireachtas Priority Questions [29344/11], 13 October 2011.

Note: Figures rounded to one decimal place.

Impact on the Exchequer Borrowing Requirement

The effect of the PN on the Exchequer Borrowing Requirement (EBR) is significant. Figure B.1 shows the projected EBR from *Budget 2012* out to 2015. Starting in 2011, €3.1 billion was added directly to the EBR as a result of the repayment of part of the PN. The impact gradually reduces as the PN is paid down (reflecting the schedule shown in Table B.1).

Impact on the General Government Balance (GGB) and Debt

The GGB is calculated on an accruals (as opposed to cash) basis and the PN treatment is slightly more complex. In 2010, the full amount of the PN was accrued to the GGB, which added €30.85 billion (19.8 per cent of GDP) to the deficit. In addition, there was an interest charge of €0.6 billion added to the GGB in 2010.[31] Combined, these two factors contributed to the 31.3 per cent General Government deficit in that year.

[31] This also includes the promissory note to EBS.

Post 2010, the PN directly impacts on the General Government deficit through the interest charge. In 2011 and 2012, the terms of the PN provide that no interest payments are to be made. The Irish authorities have confirmed that under ESA95 (Eurostat) government accounting rules, because an "interest holiday" is involved, no interest need be recorded on the PNs on a General Government basis in those years. However, from 2013 onwards (once the interest holiday expires), there is an interest charge accrued to the General Government deficit. This is a significant amount, with an estimated €1.9 billion added to interest (and hence General Government expenditure) in 2013. This directly affects the GGB (Figure B.2). The accrued interest will decline as the notes are repaid but will average close to €1.4 billion a year for the decade from 2013 onwards.

As regards General Government debt, the full value of the PN was added to the stock of debt as of end-2010. For debt purposes, the treatment of the PN is in accordance with Table B.1, other things being equal; the principal repayments reduce the debt.

Figure B.1: Exchequer Borrowing Requirement (*Budget 2012*)

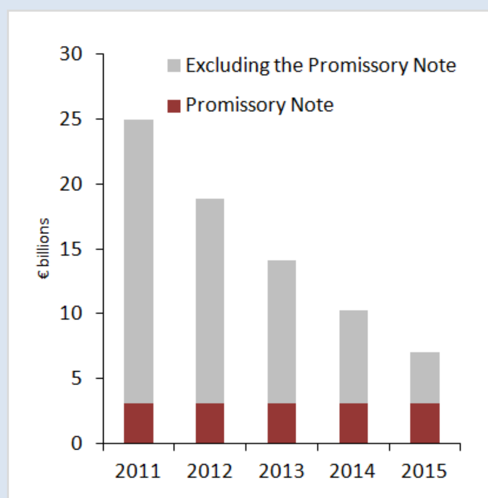
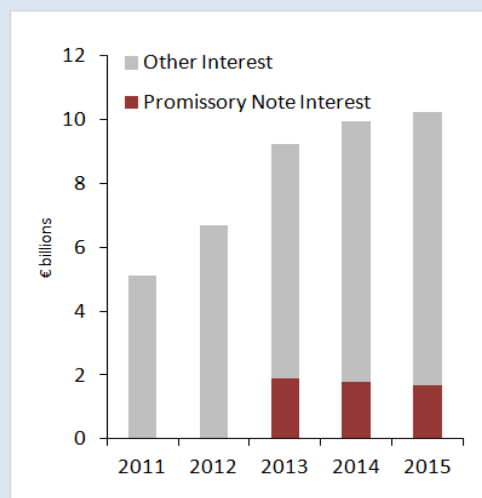


Figure B.2: General Government Interest Expenditure



Source: *Budget 2012*.

Use of the Promissory Note

Although capital under the PN is only subscribed (in cash terms) by the Government on a phased basis, the full par value of the PN of €30.6 billion was recognised initially on the IBRC balance sheet.

As alternative financing sources were reduced the PN was used by IBRC as collateral in order to obtain ever larger amounts of Emergency Liquidity Assistance (ELA) from the CBI in order to be able to meet all of its financial obligations (deposits and bonds) as they fall due for payment. As with all repurchase agreements entered into by the CBI, the PN itself is not shown on the balance sheet of the CBI, but rather is maintained as collateral for the ELA transaction.

ELA is provided under Section 5B(d) of the Central Bank Act of 1942, which empowers the CBI to lend against security to credit institutions in pursuit of financial stability objectives. ELA is extended in return for collateral not accepted as part of the usual Eurosystem monetary operations and the financial risk involved is borne by the CBI. However, the extension of ELA involves "letters of comfort" provided by the Irish Government. These Ministerial guarantees are provided to the extent that the collateral provided does not extend to the complete ELA funding needs of the bank in question.

The interest rate charged by the CBI on ELA extended to IBRC is based on the refinancing rate charged by the ECB plus a margin. As noted above, the level of the interest rate charged on the PN and paid to IBRC affects the cash budgetary outlays of the Exchequer. It will also affect the net financial position of IBRC which is, however, fully owned by the State. Thus, changes in IBRC's financial position would not have an impact on the Government and IBRC combined.

Promissory Note Update

On March 29, the Minister of Finance announced that, following discussions, the payment of €3.06 billion due to be made on March 31, 2012 under the PN arrangement would be settled by the delivery of a long-term Irish Government bond, rather than in cash. It is intended that ultimately this bond will be financed for one year, on commercial terms, with the Bank of Ireland, who may in turn refinance the bond with the ECB. The approach would reduce the level of ELA provided by the CBI to IBRC as scheduled. The planned deferral of the cash payment due on March 31 means that €3.1 billion less will be drawn down from available EU/IMF programme funds in 2012. Owing to the differential in the interest rate on the Government bond used for settlement (6.8 per cent) and the average interest rate on programme funds (3.5 per cent), this change will result in approximately €90 million being added to the General Government deficit over the remaining nine months of this year.