



An Phríomh-Oifig Staidrimh
Central Statistics Office

ESA95 accounting treatment of July 2011 capital injections into Irish banks

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Commercially sensitive data used in compiling this methodological paper have been redacted from this published version. Where this has happened, it has been marked with '[...]'.

1 Summary

This paper examines the statistical classification of the State's July 2011 capital injections, totalling €16.5bn, into the 'covered banks' (Bank of Ireland Group (BoI), the merged entity EBS Limited / Allied Irish Banks plc (AIB/EBS), and Irish Life and Permanent Group Holdings (IL&P)). These injections are outlined in Table 3.

Table 1 - State's July 2011 investments, €bn (source: Department of Finance)

	AIB/EBS	BoI	IL&P	Total
Equity and capital contribution	11.1	0.2	2.3	13.5
Contingent capital contribution (10% coupon)	1.6	1.0	0.4	3.0
Total	12.7	1.2	2.7	16.5

All the injections into BoI, and all the injections in the form of contingent capital contributions, are to be recorded as financial transactions (see 3.2.3 and 3.3 below).

For the injections into AIB/EBS and IL&P in the form of equity and capital contributions, we have used a partitioning methodology developed in section 3.4 below to estimate a split of the transactions as follows:

- AIB/EBS: €5.2bn capital transfer, €5.9bn purchase of equity
- IL&P: €0.6bn capital transfer, €1.7bn purchase of equity

In total, this gives rise to a €5.8bn worsening of the 2011 general government deficit.

2 Background

2.1 State interventions in banks prior to July 2011

In order to address serious solvency and liquidity issues in the Irish banking system, the State made a number of interventions in BoI and AIB/EBS prior to July 2011: these are summarised in Table 2 below.

The sector classification implications of these transactions were as follows:

- EBS passed into State control following the March 2010 SIS investment, and was reclassified as a public financial corporation from that date.

- Similarly, following the €3.7bn equity injection into AIB in December 2010, that bank passed into State control and was reclassified as a public financial corporation¹.
- However, the State remained a minority shareholder in Bol, which continued to be classified as a private financial corporation.
- In the case of IL&P, there were no State interventions prior to July 2011.

Table 2 - State transactions with AIB/EBS and Bol prior to July 2011 (€m)

When	What	Bol	AIB/EBS		ESA
			AIB	EBS	
Mar-2009	Preference shares @ 8% with warrant	3,500			F3
May-2009	Preference shares @ 8% with warrant		3,500		F3
Feb-2010	Pref. share dividend paid in equity	214			F5
Mar-2010	EBS special investment shares (SIS)			100	D99
Apr-2010	Pref. share conversion: 8% shares retired	-3,500			F3
Apr-2010	Pref. share conversion: ordinary shares acquired	1,715			F5
Apr-2010	Pref. share conversion: new pref. shares @ 10.25%	1,837			F3
Apr-2010	Pref. share conversion: cash received	491			F2
May-2010	Pref. share dividend paid in equity		280		F5
Dec-2010	EBS special investment shares (SIS)			525	D99
Dec-2010	EBS promissory note			250	D99
Dec-2010	Ordinary and 'cumulative non-voting' shares		3,700		F5
Feb-2011	Pref. share dividend in cash	214			F2
May-2011	Pref. share dividend paid in equity		280		D99
	Net total AF3 investment (nominal)	1,837	3,500	0	
	Net total AF5 investment (nominal)	1,929	3,980	0	
	Cash received (disposals + dividends)	705	0	0	
	Capital transfers recorded	0	280	875	

2.2 Restructuring of Irish banking system 2010-2011

On 28 November 2010 the Irish government announced that a Programme for Support had been agreed with the European Commission and the International Monetary Fund (IMF) in liaison with the European Central Bank (ECB) ('the Programme'). The Programme required rapid deleveraging of the Irish banks (2.2.1 below), a stringent review of the banks' capital adequacy and liquidity (2.2.2) and the expedited passage of legislation to allow fundamental restructuring of the Irish banking system (2.2.3).

¹ The combination of that December 2010 injection and the payment of dividends due on the State preference share investment in May 2010 and May 2011 brought the State share of AIB's equity capital to 93.1%.

2.2.1 Deleveraging target

Under the Programme, the Irish banks are required to reach a 122.5% loan to deposit ratio by end-2013.

At end-2010, AIB and IL&P had loan to deposit ratios of 166% and 248% respectively. A notably rapid deleveraging process is therefore required for those banks to reach their deleveraging targets.

2.2.2 PCAR and PLAR

An in-depth and comprehensive Prudential Capital Adequacy Review ("PCAR") and a Prudential Liquidity Assessment Review ("PLAR") (the "PCAR/PLAR exercise")² were performed from January to March 2011 by the Central Bank of Ireland with the support of external technical experts.

Under PCAR, the banks were given a target capital requirement of 10.5%, plus an additional regulatory buffer imposed by the Central Bank of Ireland: it is worth noting that this is a high level by international standards, imposing a significantly greater burden than the Basel II 8% capital ratio.

The combined results of the PCAR/PLAR exercise, which were announced on 31 March 2011, showed that:

- BOI needed a capital injection of €5.2 billion, of which €4.2 billion (after estimated expenses of €150 million) should be Core Tier 1 capital and €1 billion in the form of contingent capital.
- AIB and EBS combined needed €13.2 billion in common equity (including a regulatory capital buffer imposed by the Central Bank of €1.4 billion) and €1.6 billion in contingent capital.
- IL&P needed €3.6 billion in common equity (including a €0.3bn buffer) and €0.4 billion in contingent capital.

² From the AIB 2011 State Aid decision (26, 27):

The PCAR exercise was undertaken to determine the recapitalisation requirements of the participating credit institutions if they were to meet regulatory capital needs in both a base case and a stress case scenario for the period 2011 to 2013. The base case and the stress case capital targets were respectively 10.50% and 6.0% core tier 1 capital ratio. For this exercise, the Irish Central Bank relied on an extensive loan loss analysis of the banks' loan book performed by external experts. Two buffers were imposed by the Central Bank on top the capital needs determined through the exercise, a regulatory capital buffer in the form of equity and one in the form of contingent capital, expected to cover any unexpected losses beyond those determined by the stress test exercise.

The PLAR exercise was aimed at determining the capital needs that will arise for the same four banks as they embark on a deleveraging path in order to meet a range of target funding ratios. The main target funding ratio is a 122.5% loan to deposit ratio to be reached by the banks by 2013 and which is a requirement under the Irish Programme for Support. For the PLAR exercise, the Irish Central Bank also relied on input from external advisers.

2.2.3 New legislation

The Credit Institutions (Stabilisation) Act, 2010, passed in December 2010, provided the Finance Minister with sweeping temporary powers for the reorganisation and restructuring of the retail banking system. This was followed in March 2011 by the Central Bank and Credit Institutions (Resolution) Act 2011, which established a permanent special resolution regime for failing banks.

2.2.4 Assignment of INBS deposit book to IL&P

As part of the consolidation of the Irish banking sector, IL&P took over the deposit book and corresponding assets of the Irish Nationwide Building Society (INBS) on 24 February 2011. As a result, PTSB gained an additional €3.6 billion in deposits and around 160,000 new customers. The remaining assets and liabilities of INBS were then merged with those of Anglo-Irish Bank to form the Irish Bank Resolution Corporation (IBRC).

2.2.5 Merger of EBS into AIB

On 31 March 2011, the Finance Minister announced the restructuring of the whole Irish banking sector organised around two universal full-service banks as its core pillars: Bank of Ireland will be the first pillar bank and AIB and EBS would be combined to form the second pillar bank. The merger of AIB and EBS, whereby EBS became a fully-owned subsidiary of AIB, was initiated in May 2011 and completed on 1 July.

2.3 The July 2011 recapitalisations

The amounts injected into the three institutions in July 2011 are shown in Table 3.

The final amounts injected were significantly lower than the funding gaps identified by the PCAR/PLAR exercise.

In the case of BoI, this reflects the significant private sector injection, whereas the amounts injected into AIB and IL&P were reduced following a number of asset sales and debt buyback operations.

Table 3 - State's July 2011 investments, €bn (source: Department of Finance)

	AIB/EBS	BoI	IL&P	Total
Equity	11.1	0.2	2.3	13.5
Contingent capital contribution (10% coupon)	1.6	1.0	0.4	3.0
Total	12.7	1.2	2.7	16.5

3 Accounting treatment of July 2011 injections

3.1 Sector classification

Following the recapitalisations, the State now holds 15.1% of BoI, 99.8% of AIB/EBS, and 99.2% of IL&P.

There is therefore no change to the sector classification of BoI and AIB/EBS (respectively, a private and a public financial corporation), but IL&P has now been reclassified as a public financial corporation with effect from the recapitalisation date.

3.2 Makeup of injections

3.2.1 Ordinary equity

The ordinary equity acquired in AIB/EBS and IL&P was purchased at a nominal rate of one cent per share and 6.3 cents per share respectively: this was far below the trading price of shares in the institutions when the PCAR/PLAR results were announced on 31 March 2011³, and resulted in a very significant dilution of the remaining privately held equity in the two banks.

3.2.2 Capital contributions

€3.8bn of the €11.1bn injection into AIB was made in the form of a ‘capital contribution’ rather than a direct purchase of shares. In IFRS, we understand that a capital contribution is treated as an increase in the owner's equity interest in a company, made without an increase in the number of outstanding shares.

Following advice from Eurostat in June 2011, we are not making any distinction between the ordinary equity acquired and this capital contribution: the level of State ownership of AIB is so close to 100% that any value to the company from the capital contribution will be reflected in the value of the State's equity stake.

3.2.3 Contingent capital contributions

As these contributions attract a fixed 10% coupon, we have classified them as AF3 assets, and recorded all the transactions involved straightforwardly as the acquisition of such assets, with no capital transfer component.

The potential exists for these assets to be converted into ordinary shares; however, this would only happen if extremely high losses, beyond the PCAR/PLAR stress case, were to be recorded by the banks. Thus, we regard the potential for this conversion event (which would likely trigger a capital transfer) to be a contingent liability of government at this stage.

3.3 Accounting treatment of BoI recapitalisation

In 2011, a group of international fund managers⁴ took a 34.9% stake in BoI, reducing the state's equity from 36% to 15.1%.

³ It is difficult to argue that there was any functioning market in AIB/EBS and IL&P shares after the scale of the capital requirements of the banks became clear on that date.

⁴ Fairfax Financial Holdings; New York buyout firm WL Ross and Co; Boston-based Fidelity Investments; Los Angeles-based Capital Group; and Californian property firm Kennedy Wilson.

In line with the guidance in III.2.2.3 of the MGDD, because of this significant third party participation in the recapitalisation of the bank (on the same terms as the State investment), we have recorded the net €0.2bn equity investment in Bol as a purchase of equity (F5), with no deficit impact.

3.4 ESA95 accounting treatment of AIB/EBS and IL&P recapitalisations

3.4.1 Hybrid nature of investment

The accounting treatment of the injections into AIB/EBS and IL&P is less straightforward.

On the one hand, [...], these institutions are ‘in a very distressed financial situation’ [...]. On the other hand, both institutions remain active as functioning financial intermediaries, and are expected to return to profitability in the short to medium term – AIB is one of the two designated ‘pillar banks’, and the IL&P group includes Irish Life, a well-functioning and saleable business which holds a significant part of the insurance market in Ireland.

Moreover, the large size of the recapitalisations reflects the very stringent capitalisation requirements – higher than international norms – imposed following the PCAR/PLAR tests. In particular, the banks must maintain adequate capitalisation requirements even in the face of the liquidity shock posed by the very rapid deleveraging targets set under the Programme.

It seems clear that not all the money being invested can be adequately remunerated. On the other hand, it seems clear that by no means all the money being invested will be lost. Indeed, the banks are expected to be saleable in the medium term [...].

3.4.2 Manual on Government Deficit and Debt (MGDD) guidance

No private sector investors participated in the July 2011 recapitalisations of AIB/EBS and IL&P. Also, as detailed in the box opposite, both AIB/EBS and IL&P had made significant losses in the years prior to the July 2011 recapitalisations.

Pre-injection losses of AIB and IL&P

Both AIB and IL&P had accumulated significant losses by the time of the July 2011 recapitalisations, though most of these losses were absorbed by the original equity capital in the banks:

- In the case of AIB, some € 13.5bn of losses attributable to shareholders was recorded in the period from January 2009 to July 2011, while EBS recorded €0.7bn of losses in 2009 and 2010. After the opening €9.0bn private equity capital was wiped out, government was responsible for the remaining €4.5bn of these losses. As shown in Table 2 above, injections totalling €1.2bn had already been recorded as capital transfers prior to the July 2011 recapitalisation.
- In the case of IL&P, losses of €0.9bn were recorded in the years 2008 to 2010. All of these losses were absorbed by wiping out private equity capital.

In such a case, the general rule as outlined in section III.2.2.2.1 of the MGDD is that the whole amount of the capital injections should be recorded as a non-financial transaction.

However, the July 2011 recapitalisations greatly exceeded the level of accumulated losses attributable to government. Moreover, they were made in the context of a major restructuring of the

banks intended to restore profitability within a relatively short time-frame (see 2.2 above). Where these two criteria are met, MGDD III.2.2.2.1 suggests that the recapitalisation operations can be partitioned between a non-financial transaction up to the limit of the losses and a financial transaction for the remainder of the injection, if there is evidence that (a) government will benefit from 'a sufficient return on its new investment' and (b) the restructuring will be 'efficient'.

The application of the MGDD guidance to cases such as these in the context of the financial crisis is somewhat problematic:

- Valuation of the banks and their assets is difficult because of the inadequately functioning market.
- Much of the requirement for new capital faced by the banks related not to accumulated past losses already recognised but rather to projections of future losses (themselves arising from transactions already entered into in the past). Thus, it would appear that an adequate methodology for valuing the equity assets acquired must look forward as well as backward.

3.4.3 Further guidance in 2009 note on financial crisis operations

Section 3 of the 2009 guidance note deals with recapitalisation operations in the context of the financial crisis. Of particular relevance here are the following paragraphs:

With regard to injections in the form of new quoted equity (usually in the form of ordinary shares), ESA95 rules lead to the conclusion that a government payment above the prevailing market price of the equity, or an equivalent valuation, would require the recording of a capital transfer from government to the units selling the equity. It would be expected that the market price, or equivalent valuation, would take into account past losses, whether accumulated or exceptional.

In the event that the rate of return falls below State Aid levels, a partitioning of the injection will be needed into a non-financial and financial element, based on the difference of the required rate of return and the relevant State Aid level.

Here again, a split of recapitalisation operations between a financial and non-financial component is envisaged, based on either (a) the price paid for the equity above the market price 'or equivalent valuation' or (b) the difference between the State Aid level of rate of return and the actual rate of return envisaged.

3.4.4 Methodology for determining remunerable component

Given the inherently hybrid nature of the AIB/EBS and IL&P recapitalisations, and given the existing guidance above, we propose to partition the recapitalisations into a financial and a non-financial component.

In arriving at the basis for this split, we cannot ask by how much the payments made exceeded the market price, as no functioning market existed. Equally, we regard the use of already accumulated losses as too narrow a measure for assessing the split.

We therefore propose to provide an ‘equivalent valuation’ to a market price, by asking how much a rational investor would be willing to pay for the assets acquired. We will then record this amount as an equity injection, and any amount beyond that level as a capital transfer.

We estimate this ‘market-equivalent’ price by using the net present value of the projected net equity value of the two banks at the end of the period covered by their business plans ([...]). By that time, market conditions should have returned to normal, while the restructuring and enforced deleveraging of the banks and their period of exceptional losses should be complete.

Three key assumptions made in this methodology are:

- a) The discounting factor to be used is [...]
- b) The December 2010 injection of €3.7bn in equity into AIB remains classified as an equity injection (as it was legitimately considered to be fully remunerable on the date of the injection), but we record a revaluation of this equity to zero before the July 2011 injection⁵.
- c) We have used the most recent available business plans for AIB/EBS and IL&P – these date from March and February 2012 respectively. We note that –
 - While these plans have been prepared by the banks themselves, they are prepared on the same basis as the plans to be submitted to the Commission as part of the State Aid assessment, and to the Programme partners, so that they are subject to considerable oversight.
 - The plans are based on the base case of the very rigorous PCAR/PLAR methodology used in the July 2011 restructuring plans submitted to the Commission at that time, adapted to reflect new information about the banks and updated macroeconomic assumptions.

[...]

4 Conclusion

Using the methodology developed above yields the following results for AIB/EBS and IL&P (the equivalent results using the July 2011 restructuring plans are shown in the greyed out column for comparison):

⁵ However, as shown in Table 2 above, the €0.3bn in ordinary AIB shares acquired in May 2011 as a dividend payment on the government’s preference shares in AIB has been recorded as a capital transfer.

AIB/EBS			
	<i>Jul 2011 R</i>	Mar 2012 B	
€bn	[...]	[...]	[...]
Shareholders' equity (excl. preference shares)	[...]	[...]	[...]
Govt ownership (%)	99.8%	99.8%	99.8%
Implied undiscounted value of Govt stake	[...]	[...]	[...]
Implied value of Govt stake (discounted at [...])	[...]	[...]	5.9
July 2011 injection		12.7	
Less contingent capital		-1.6	
Cost of equity investment		11.1	
Remunerable component	[...]		5.89
Capital transfer component	[...]		5.16

In the case of AIB/EBS above, we note the similarity between the calculated capital transfer component and the €4.5bn accumulated losses attributable to government.

[...]

IL&P			
	<i>Jul 2011 R</i>	Feb 2012 B	
€bn	[...]	[...]	[...]
Shareholders' equity [...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]
[...]			[...]
[...]			[...]
Estimated total discounted equity value	[...]		1.7
Govt ownership (%)	99.2%		99.2%
Implied discounted value of Govt stake	[...]		1.7
July 2011 injection		2.7	
Less contingent capital		-0.4	
Cost of equity investment		2.3	
Remunerable component	[...]		1.68
Capital transfer component	[...]		0.62

We believe that this is a robust and appropriate methodology for valuing the assets acquired in these recapitalisations, which should yield results close to those implied by the final restructuring plans to be agreed with the Commission later this year.