

Directorate C: National and European Accounts

04 -11- 2010

Luxembourg,
ESTAT/C-4/JV/AK/dg D(2010) 856534

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Subject: Preliminary view on the ESA95 accounting treatment of time of recording of interest payments on promissory notes payable to Anglo Irish Bank

Ref.: Your letter dated 29 October 2010

Dear Mr Punch,

Thank you for your letter regarding the recording of the interest payments on promissory notes payable to Anglo Irish Bank and the accompanying analytical note. I would like to inform you of the preliminary view of Eurostat on the above-mentioned case.

The accounting issue for which a clarification is requested

Since January 2009, Anglo Irish Bank has been publicly owned and the Irish Government has provided it with a number of capital injections to cover losses incurred on its loan book. Most of these injections have been provided in the form of promissory notes (from March 2010 to August 2010 for a value of 18.9bn EUR) which will be redeemed after some years. These notes pay an interest coupon based on the market interest rate applicable on the date of issue for similar maturity government bonds.

According to the information provided by the Central Statistics Office (CSO), the Anglo Irish Bank continues to operate as a fully licensed bank, classified to the Financial Corporations Sector (S. 12). Early in 2011, subject to EU State Aid approval, the existing bank will be restructured and split into a savings bank and an asset recovery company. However, prior to the restructuring an additional capital injection of some 6.4bn EUR must be made in the existing bank to cover expected remaining losses. As a condition of this remaining injection, the Irish government proposes to alter the interest provisions applying to the previously issued promissory notes. In effect, the Irish government intends to look for a temporary period on all promissory notes and pay zero interest in each of the years 2011 and 2012. To compensate for interest foregone in these two years a higher rate of interest will be paid in 2013 and subsequent years so that the effective rate of interest payable over the full term of the notes is the appropriate market rate. The interest payable may be capitalised and paid only in subsequent years.

As having informed Eurostat previously, the CSO has classified the injections already made as capital transfers in the national accounts. For injections in the form of promissory notes, two transactions were recorded: (1) a notional cash injection by Government, and (2) a simultaneous notional loan (F.4) from the bank to Government of the same value. The resulting loan liabilities therefore increase general government debt. Some 10% of the principal amount of the promissory notes will be redeemed each year, reducing the outstanding AF.4 loan liability.

In the current request, the CSO is asking Eurostat to provide its opinion on the recording of the interest in the temporary period, when no interest is paid.

Methodological analysis and clarification by Eurostat

Eurostat welcomes the detailed analysis provided by the CSO focusing on the recording of the interest in the temporary period when no interest is paid to the bank.

Applicable accounting rules

ESA95 paragraph 4.50 applies in this case. In addition, the Eurostat ESA95 Manual on government deficit and debt (MGDD) Third Edition Part II "Time of recording" and more precisely section II.4.3.13 "Instruments with grace period" applies.

Availability of national accounting analysis

The CSO provided its analysis on the recording of the interest. Following the analysis of the CSO, according to the accrual principle, capitalised interest must be recorded in the period in which the interest liability arises, irrespective of when the interest is actually paid, meaning that capitalised interest on the promissory notes, even if not actually paid until the end of the lifetime of the notes, must be recorded as government expenditure when the interest actually accrues.

Nevertheless, the Irish statisticians argue that the treatment of the "*interest holiday*" (for which the advice has been asked now), that is, deciding whether the interest payable on the notes should be accrued evenly over the term of the notes, including the years 2010 and 2011, even if no interest is actually charged in these years, is a more difficult issue.

The Irish colleagues reason that this precise arrangement appears to be described in Chapter III.3 of the ESA95 Manual on Government Debt and Deficit Second Edition in the section titled "*Instruments with grace periods*" and while the section refers to instances when government is granting loans, it does not exclude cases where government is the borrower. On this basis the CSO is of the view, provided the real rate of interest on the promissory notes in the years 2011 and 2012 is zero, that no interest payments on the promissory notes should be recorded in those two years. Interest payments need only be recognised in 2013 and subsequent years. However, interest paid in 2010 based on the initial arrangements would still be recorded in that year.

Analysis

Eurostat has examined the applicable accounting rules and the analysis of the CSO and preliminary agrees with the view of the Irish statistical authorities.

ESA paragraph 4.50 explicitly says that interest has to be recorded on accrual basis, that is, accruing continuously over time to the creditor. However, it does not deal with specific cases. The MGDD Third Edition chapter II.4., on the Recording of interest, does however interpret and complete the ESA95 rules to allow for the implementation of the basic rule. This chapter comprises specific cases as seen in practice and tries to apply the accrual principle for these.

Concerning the instrument with grace period, it says (paragraph 62): "*Some debt instruments may include a grace period during which no interest is paid. This case is not mentioned in ESA95 and SNA. General government may be involved, notably for loans granted to developing countries or for public policy purposes.*"

Two cases are distinguished under such arrangements. In the first case the instruments bears zero interest during the grace period, in the second case the interest payments are barely postponed during the grace period. While the first case does not require the recording of the accrued interest, in the second case, the interest must be recorded (accrued) also during the grace period.

There are two questions to examine: (1) does this rule apply also to cases where government is the debtor and not the creditor, and (2) which rule must be applied to the current case, the first or the second?

Concerning the first question, whether this case applies also when government is the debtor and not the creditor: the paragraph does not exclude cases when the government is the debtor. Symmetrical treatment is to be applied here, even if this is a very unusual case for government securities.

In order to decide whether interest has to be accrued over the grace period or not (second question), it has to be examined whether the interest is actually zero in the grace period or the payment is simply postponed (interest is really due but capitalised). For this, the actual arrangements need to be checked, whether there is any additional payment in any form (added to the first coupon after the grace period, spread over the remaining period, paid with final payment, possibly under the form of new securities). In the current case, according to the description of the CSO, the government is actually paying zero interest in 2011 and 2012, i.e. the cost of borrowing is really zero. However the government will compensate for interest foregone in these years with a higher interest paid in the following periods, so that the effective rate of interest payable over the full term of the notes is the appropriate market rate, which seems to be in line with the first case as mentioned in the MGDD. However, the CSO must confirm that there are no additional payments in any form. If this is the case, the first rule could be applied, so no interest should be accrued during the grace period.

Conclusion

Based on the preliminary information provided, Eurostat agrees with the CSO's analysis that no interest is to be accrued in the grace period. Eurostat would like to be informed however if any changes are foreseen in the current arrangements and would like to receive a copy of the final agreement as soon as possible to have a final opinion.

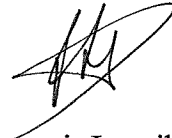
Procedure

This preliminary view of Eurostat is based on the information provided by the country authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view. To this end Eurostat would request to be informed of the final details of the operation.

In this context, we would like to remind you that Eurostat is committed to adopt a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009, as amended and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat is therefore publishing all official methodological advice (ex-ante and ex-post) given to Member States on the Eurostat website. In case you have objections

concerning this specific case, we would appreciate if you let us know. In any case (regardless of whether you have objections or not) we would like to receive an answer from you on the issue no later than 30 November 2010.

Yours sincerely,

A handwritten signature in black ink, consisting of stylized initials and a surname, positioned above the printed name.

Francois Lequiller
Director