INTERACTION OF BANK AND SOVEREIGN DEBT RESOLUTION

Compilation of Notes for the Monetary Dialogue

NOTES

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Compilation of Notes
for the Monetary Dialogue of March 2011

Abstract
These three briefing papers were written in view of the preparation of the Monetary Dialogue of March 2011 and analyse the interaction of bank resolution and sovereign debt resolution. They develop similarities and differences, possible designs, as well as links between these different resolution regimes.
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INTRODUCTION

The financial crisis has highlighted the issue of establishing effective bank resolution regimes in order to allow for the orderly wind-down in particular of large international financial institutions. This could contribute to reducing the challenge posed by 'Systemically Important Financial Institutions' (SIFIs) to financial stability. In the context of designing such a resolution framework, there would be a need to decide on a burden sharing between owners, creditors (i.a. other banks whose viability may in turn be negatively affected), other stakeholders and if necessary the wider public. The European Commission is expected to come forward with a proposal on this subject in the spring 2011.

Moreover, following turbulent times in the government bond markets, and the opening of the credit lines of the EFSM and EFSF for Ireland, the European Stability Mechanism (ESM) has been proposed by the Council, to be created under Art 136 TFEU. Also for this, the European Commission is expected to come with proposals soon. It is expected that the ESM will be a successor of the EFSF and include three components:

1) a macroeconomic adjustment programme,
2) an intergovernmental financing instrument and
3) case by case involvement of private creditors.

Although the ESM will not be of direct help in the current turbulences, its mechanism design will send a signal. In the future 'haircuts' or 'bail-ins' may be applied to some bond holders and debt instruments. This should ideally happen in a way that should not endanger the stability of the system and of solvent banks.

The three notes contained in this compilation seek to answer the following questions:

- What are the similarities and differences in these potential 'second order' failures triggered by the resolution of financial institutions and sovereigns?
- How can proposals to contain these risks be developed?
- What would these proposals look like?
- How should the ESM and the bank resolution regime be intelligently linked to each other in order to account for this circuit of debt that is currently being passed from the private sector to the public sector?
- How can a circuit breaker of debt be best implemented?
NOTE

Daniel GROS, with input from
Cinzia ALCIDI and Thomas MAYER

Abstract
The failure of a sovereign usually leads to widespread banking failures and the resolution of an entire banking system would bring the sovereign into difficulties. This problem is particularly acute within the euro area, but it could be manageable. Forcing banks to hold capital on their holdings of government debt would make a sovereign failure less disruptive. Bank resolution could be made simpler with a more clearly defined ‘waterfall’ of priority claims (depositors prior to bond holders).
LIST OF ABBREVIATIONS

ABS  Asset-Backed Securities
AIG  American International Group
CDR  Capital Requirements Directive
CDS  Credit Default Swap
ECB  European Central Bank
EFSF European Financial Stability Facility
EFSM  European Financial Stability Mechanism
EMU  European Monetary Union
ESM  European Stability Mechanism
GDP  Gross Domestic Product
HRE  Hypo Real Estate
IMF  International Monetary Fund
SMP  Securities Markets Programme
EXECUTIVE SUMMARY

In a systemic crisis, sovereign and banks' failures become intertwined. In almost all cases the failure of a sovereign leads to widespread banking failures; and the resolution of an entire banking system taxes the fiscal capacity of sovereign to the limit. This problem is particularly acute within the euro area where national governments no longer have access to the printing press, but it could, and should, be dealt with.

The main prevention tools should be regulatory.

At present banks do not have to hold any capital on their investment in euro area government debt (mostly in the form of bonds). Forcing banks to hold capital on their holdings of government debt would make a sovereign failure much less disruptive (and would provide warning signals in the form of higher funding costs). This would require a change in the Capital Requirements Directive (CRD). Since other changes to this directive (CRD IV) will anyway be discussed soon, the European Parliament will have an occasion to put an increase in capital requirements on government debt on the agenda.

A regime for dealing with sovereign debt crisis is of course also needed (see Gros and Mayer, 2010), but this seems to take shape now in the form of the European Stability Mechanism (ESM).

Bank resolution should also be made simpler with a clearer defined ‘waterfall’ of priority claims which would enable resolution authorities to impose a haircut on bondholders, but not necessarily on deposits. The current proposals of the Commission regarding bondholder bail-in thus go in the right direction.

Regulatory changes are important to prevent future crisis, but come too late to have an impact on the current one. But how the EU will be able to manage future crises will be significantly affected (and their likelihood of occurring even more reduced) by the way the present crisis is dealt with. If the present crisis is ‘resolved’ by bailing out all banks (e.g. in Ireland) and all sovereigns (including Greece), a further concentration of sovereign risk in financial institutions and of the risk of financial institutions in the sovereign will be encouraged.

In order to discourage this, Gros and Mayer (2011) present a proposal on how one could deal with the present crisis through a large debt exchange program which would imply a bail-in for the private sector while avoiding a formal default. In addition, through the current stress tests, banks could be forced to either accept the debt exchange or supply full provision for losses. It is highly unlikely that bond purchases (including buy-backs, i.e. specific bond repurchase programs) on the open market would achieve a significant debt relief (See Roubini and Setser, 2004, and Bulow, J. and K. Rogoff, 1988).

The remainder of this paper highlights some similarities and differences between potential second order failures triggered by a sovereign default or the resolution of a financial institution and then it suggests an approach aiming at dealing with the current sovereign debt crisis in a way to minimise the cost of a debt restructuring and second order failures on the European financial system.
1. INTRODUCTION

The general post-crisis background in Europe today is not too different from the busts that have followed other credit booms. The key characteristics of a boom are the expansion of private debt and leverage.¹ The key characteristic of the subsequent bust is the explosion of public debt as private debt cannot be serviced and tend to become public. The economies of Ireland and Latvia (and to some extent Spain) offer good examples of this trend: in both countries public debt was not an issue prior to the crisis (which was then only about 25% of GDP in Ireland and close to zero in Latvia) but this assessment has changed radically in less than a couple of years. In 2011 (gross) public debt in Ireland is expected to reach about 110% of GDP and soar beyond 50% in Latvia.

However the crisis has highlighted one particular aspect which is specific to Europe. This is that within the euro area, the usual assumption that public debt is riskless does not hold because no individual euro area country has access to the printing press (which is what makes government debt risk-free in nominal terms in countries with their own currency). In this sense in the peripheral euro area countries public debt has more of the characteristics of private or so called ‘sub-sovereign’ debt. Only the public debt of countries with solid public finances (essentially Germany) remains public debt in the sense in which the term is usually used, namely the one kind of debt that is riskless.

What is thus happening in the euro area is the age-old process whereby creditors put pressure upon governments to support the weaker debtors (banks, euro peripheral countries). If history serves as any guide, this pressure will prevail because the alternative is perceived to be a potentially disruptive breakdown in markets and hence further delay in the recovery. In this sense, Europe seems destined to repeat the classic bust scenario in which private debt becomes public debt but with the difference that governments of core euro area countries take on the debt of peripheral countries, both private and public. However, the willingness and ability of the core countries to accept this burden have their limits. Hence one needs to prepare for the second stage of crisis, namely an increased risk of sovereign default. This danger is likely to persist for some time.

Against this background the question is what the consequences of a sovereign default on the system could be.

¹ See Alcidi & Gros (2009).
2. RESOLUTION OF FINANCIAL INSTITUTIONS AND SOVEREIGN DEFAULT: SECOND ORDER EFFECTS

In general sovereigns are less ‘interconnected’ than financial institutions. Hence, in principle, haircuts or bail-ins applied to government bond holders should have smaller effect on the financial system as whole, or even on single elements of it, than in the case of holders of bank debt instruments. The holders of sovereign debt securities (and thus the source of potential second order failures) can usually be identified more easily than holder of debt issued by banks. Lehman Brothers was only a medium size investment bank, but it still had over 600 thousand derivatives contracts outstanding involving almost all other major financial institutions. When Lehman went bankrupt all these contracts were initially frozen and then had to be resolved with millions of claims and counterclaims between various creditors and subsidiaries of Lehman. It will take years before all these claims can be settled. Given this uncertainty over the size and distribution of the losses of bankruptcies, it is clear that in a nervous market the insolvency of a highly interconnected financial institution could lead to more second order failures.

The holdings of Greek and peripheral government debt by EU financial institutions are unknown to market participants but known to the supervisors. It would thus be sufficient to make this information public and to re-capitalise those institutions which do not have enough capital to withstand a loss.

However, the potential for second order failures can be higher for a sovereign default than for a bank failure, in terms of unit of eventual loss, if banks do not have sufficient capital to withstand the shock, because the sovereign default would drag banks down. And at present, it is unclear whether European banks have enough equity. What it is certain is that they are not required by the regulator to have any capital against most of their long-term holdings of government debt, as most EU financial regulation considers euro area government debt as riskless. This is why financial institutions in Europe may have very large exposures to sovereign risk relative to their capital. This is not the case for the exposure of financial institutions to bank debt, or other financial institutions, which is by regulation limited to a fraction of capital (e.g. large exposure directive). For this reason the failure of Lehman did not directly cause any second order failures although caused widespread financial panic. Most of the failures (or near failures, like AIG, Fortis or HRE) that followed the Lehman insolvency were not due to losses on claims on Lehman, but due to the fact that these institutions had made similar bets as Lehman (for example too much exposure to sub-prime mortgages, directly (Wamu) or in the form of ABS (HRE and Fortis) and the CDS market (AIG)).

Moreover, the systemic importance of government debt depends on the degree of intermediation: in the EU around 30% of all government debt is held by the banking system whereas in the US this proportion is only 3%. In the EU households thus often do not invest directly into government debt, but they deposit their savings into bank accounts which the banks then use to buy government debt (and sometimes to extend credit directly to sub-sovereigns). Ironically, if all Greek government debt were held by households or other ‘real money’ investors there should be no danger at all of second round failures. Lehman had somewhat more bonds outstanding than the Government of Greece, but the holdings were so widely distributed that no single bank or other financial institution lost a large fraction of its capital due to a loss on Lehman bonds.
Many commentators (but not the author) would argue that the real threat to systemic financial stability does not come from directly induced second order failures, but from ‘contagion’, i.e. a rapid and indiscriminate extension of the perception of risk to an entire asset class and a generalised increase in risk aversion. For example, it has been argued that any default by the government of Greece (however small the haircut is) would induce investors to shun the government debt of all peripheral euro area countries, which would then need to be bailed out by the ESM or would become insolvent themselves. The reason advocated by the ECB against allowing banks to default (or at least imposing haircuts on senior bond holders), and in particular against letting any Irish bank fail, is again the fear of contagion, i.e. that any loss, however small compared to the overall euro area banking market, would lead to a run (flight of depositors) from all Irish banks and potentially many other euro area banks, thus triggering a crisis compared the one following the failure of Lehman Brothers in 2008.

Whether or not any loss on sovereign debt or on senior bank bonds would lead to immediate indiscriminate contagion effects is impossible to prove or disprove as this depends on arbitrary assumptions about irrational investor psychology. It is clear, however, that irrational contagion become more unlikely as the financial system becomes more robust.

The question of the potential for second order failures after the presumably disorderly resolution of a financial institution or a sovereign default (a sovereign is not ‘resolved’) is quite different from the more concrete question of potential second order failures after a haircut or bail in for holders of (senior) bank bonds. It should also be clear that for both bank and sovereign debt crises, second order failures depend on how the failure is managed and to what extent it is anticipated. A well managed failure can reduce losses considerably and if the failure is widely anticipated the losses should have been provisioned for.
3. HOW TO DEAL WITH THE PRESENT CRISIS: A CIRCUIT BREAKER OF DEBT

Gros and Mayer (2011) start from the observation that the creation of the European Financial Stability Facility (EFSF) with its headline figure of EUR 750 billion at a dramatic weekend meeting in May 2010 calmed markets only temporarily. The adjustment programme of the EFSF for Ireland failed to restore market confidence in the EU’s ability to deal with countries experiencing financial difficulties. One reason is that the interest rate Ireland was given, close to 6%, is so much above the likely growth rate of the country for the near future that it will worsen its debt dynamics materially. Another reason might be that the lending capacity of the EFSF is de facto constrained by the guarantees of the remaining AAA-rated countries, which amount to about EUR 255 billion. But more fundamentally, the continuing tensions have in their view been caused more by three developments:

i) The increasing fear that at least one EMU government may be insolvent and hence unable to service its financial debt without help from abroad.

ii) The message from policy-makers that private creditors of an insolvent country will have to suffer losses in the future but that official creditors are not willing to share any losses, as evidenced by the declaration that the claims of the post-2013 ‘European Stability Mechanism’ would be senior to private claims.

iii) The failure of policy-makers to explain how creditors would participate in a debt restructuring of an insolvent country and, in particular, what would happen to presently outstanding debt.

The ECB has provided an element of stability by reluctantly intervening intermittently in the government bond market; officially to restore orderly market conditions, but in reality its interventions have been only of a ‘one-way’ character, sustaining the price of peripheral government debt. At the same time, however, the ECB has let it be known that in the end, it will not let (fiscal) policy-makers off the hook by a wholesale funding of old and new debt of troubled countries via money creation. The ECB was thus not able to resolve the fundamental tensions created by the factors listed above.

The inability to clarify what happens in case an EMU country not only suffers from a temporary liquidity crisis but is unable to repay its debt in the indefinite future has uncovered a major flaw in the architecture of EMU and triggered a flight from all but the safest sovereign bonds of EMU countries.

Institutional innovations always take some time. However, even within the present setup, an integrated set of measures is possible and should be taken immediately to reduce uncertainty and restore orderly market conditions. They propose the following approach to debt reduction:

Step 1. The European Financial Stability Facility (EFSF) offers holders of debt of the countries with an EFSF programme (probably Greece, Ireland and Portugal, ‘GIP’) an exchange into EFSF paper at the market price prior to their entry into an EFSF-funded programme. The offer would be valid for 90 days. Banks would be forced in the context of the ongoing stress tests to write down even their banking book and thus would have an incentive to accept the offer.
Step 2. Once the EFSF had acquired most of the GIP debt, it would assess debt sustainability country by country.

a) If the market price discount at which it acquired the bonds is enough to ensure sustainability, the EFSF will write down the nominal value of its claims to this amount, provided the country agrees to additional adjustment efforts (and, in some cases, asset sales).

b) If under a central scenario this discount is not enough to ensure sustainability, the EFSF might agree on a lower interest rate, but with GDP warrants to participate in the upside.

A key condition for this approach to succeed in restoring access to private capital markets is that the EFSF claims are not made senior to the remaining claims and the new private bondholders. EFSF support must be comparable to an injection of equity into the country.

While the EFSF concentrates on the exchange of the stock of bonds, the IMF could fund the remaining deficits in the usual way with bridge financing, until the fiscal adjustment is completed. The ECB would of course immediately stop its ‘Securities Market Programme’ (SMP), which would have lost its raison d’être.
4. CONCLUDING REMARKS

The piecemeal approach to dealing with the euro area’s combined bank and sovereign debt crisis (instead of a comprehensive solution along the lines sketched above) runs the risk of cutting off one country after another from market funding. It has been suggested that the EFSF be increased to cover all potential problem countries. But simply increasing the size of the EFSF may raise market fears of a financial over-burdening of the core countries and hence extend the crisis of trust eventually to all EMU member countries. It has also been suggested that the ECB step up its bond purchase programme and acquire EUR 1-2 trillion of bonds of troubled EMU countries. In our view, however, this, as well as the suggestion to assume joint liability for EMU countries’ entire debt, would undermine the contractual basis of EMU and seriously weaken acceptance of EMU in the core countries.

A market-based scheme that is combined with some pressure by supervisors offers the best hope to achieve a substantial reduction in debt for the most distressed sovereign borrowers. This scheme could serve as a bridge from the present situation under which a combination of a weak banking system and acute insolvency problems creates tensions that require ever more public funds.

A debt exchange for sovereign bonds does not constitute a silver bullet that will solve all issues. To work, it will require an intensification of the adjustment efforts in all countries and an aggressive programme of asset disposal in Ireland and Spain to ensure the solvency of the sovereign in both countries. In both these countries it might also be useful to consider debt for equity swaps for the most distressed banks, both to relieve the pressure on the sovereign and to establish the principle for the future that governments are not always obliged to bail out senior bond holders at par.

Having dealt with the emergency, a new EMU architecture can then be constructed that enshrines the lessons learnt from the current crisis. What is needed in our view is a further step towards economic integration combined with some risk-sharing of EMU countries while still preserving the character of EMU as a ‘limited liability company’.

In this longer-term perspective, we regard our proposal as a key step to establishing the principle that losses on sovereign lending are possible. It is extremely important that markets and regulators actually have the experience of suffering some loss as this is the only way to ensure more market discipline (however imperfect it may be) in the future and a regulatory framework that abandons the concept that sovereign lending is riskless. The present situation is untenable as it contains an inherent contradiction between the insistence on the legal fiction that there will never be a bail-out and the repeated cave-ins by the authorities at the first sign of serious market pressure.
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Bank Resolution Regimes

NOTE

Anne SIBERT

Abstract
The euro area sovereign debt crisis has been exacerbated by an on-going banking problem and the sovereign debt crisis has worsened the prospects for euro area banks. This makes it urgent that policy makers find a solution to the problem of dealing with troubled financial institutions. This paper discusses the challenges associated with designing bank resolution regimes.
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EXECUTIVE SUMMARY

- The euro area sovereign debt crisis has been exacerbated by an ongoing euro area banking problem and the sovereign debt crisis has worsened the prospects for euro area banks. As sovereign spreads rise, so do concerns about counterparty risk. This makes it urgent that euro area policy makers find a solution to the problem of dealing with troubled financial institutions.

- When confronted with the insolvency of Lehman Brothers in September 2008, there were only three possible options for policy makers: attempting to use conventional bankruptcy legislation to support or wind down the firm; using taxpayers’ funds to prop up the ailing institution; or finding another institution to buy the failed firm. Each of these options has serious drawbacks.

- In thinking about how to structure a bank resolution regime, it is useful to consider what regimes are now in place elsewhere. I describe the experience of the United States in handling the failure of relatively simple depository financial institutions.

- When a financial institution fails, many parties have claims against its assets. There is wide agreement that if the firm’s assets are insufficient to meet these claims, that the depositors should be protected, at least up to a point, and that the shareholders should lose their money. There is less agreement over whether or not other claimants should be protected and whether society or other financial institutions should fund any shortfall.

- There is a conflict between efficiency and property rights in the design of bank resolution regimes. If a financial firm’s business is to continue without interruption, it is best to take it over before it becomes insolvent. But, if the firm has not yet failed then there may be a chance that it might not fail and in this case seizing it amounts to confiscation.

- One of the most important and challenging problems in designing a bank resolution mechanism is how to deal with multinational banks. An international banking group’s foreign branches are subject to the resolution regime of the country in which the group is licensed. Its foreign subsidiaries, however, are subject to the resolution mechanism of their host country. Conflicts between these regimes have the potential to be disastrous.

- The European Commission is addressing the problem posed by systemically important financial institutions, with the goal of ensuring that these firms can be allowed to fail without creating significant risk to financial stability or costs to taxpayers. Its 20 October 2011 communication is a careful and sensible assessment of the challenge.

- Without a harmonised European resolution regime and a single European regulator, there is no perfect way of dealing with systemically important financial groups with corporate entities in multiple European countries. The existence of financial groups with corporate entities both inside and outside Europe further complicates the issue.
1. INTRODUCTION: THE BANKING CRISIS AND SOVEREIGN DEBT

The euro area sovereign debt crisis has been exacerbated by an on-going euro area banking problem. For example, the Greek sovereign debt crisis has been described as a German and French banking crisis in disguise: the heavy exposure of German and French banks to Greek debt may have precluded an otherwise desirable pre-emptive rescheduling by the Greek government. An imprudent sovereign guarantee of unsecured Irish bank debt, followed by recapitalisation and nationalisation of Irish banks that were far too big to bail out led to the Irish sovereign debt crisis. The sovereign debt crisis in turn worsens the prospects for euro area banks. As sovereign spreads rise, so do concerns about counterparty risk. This leads to higher bank funding costs and the credit rationing associated with adverse selection problems. Thus, both as way of dealing with a sovereign debt crisis and because the sovereign debt crisis has made the problem of failing banks more urgent, euro area policy makers must find a solution to the problem of dealing with troubled financial institutions.

In this report, I consider how policy makers initially responded to the problem of failed financial institutions in the solvency crisis that began in the summer of 2008. I describe how they relied on conventional bankruptcy legislation, taxpayer-funded bailouts and selling troubled firms. The United States has operated an efficient bank resolution regime for relatively uncomplicated depository institutions. As this provides lessons for the EU, I also describe how it functions and assess its limitations and problems. Finally, I discuss how, in light of the experiences with different methods during the financial crisis and the United States’ experience, one might design a bank resolution regime for Europe.
2. OPTIONS POLICY MAKERS HAD FOR DEALING WITH FAILED BANKS IN THE CURRENT CRISIS

A problem associated with the financial sector is that, because of systemic risk factors, the demise of just one or a few sufficiently important financial institutions can lead to the domino-like collapse of a chain of other financial institutions that severely impairs an entire national, or even the global, financial sector. Because of the importance of the financial system to the real economy's functioning, this could be a damaging or even catastrophic blow to the real economy. Unfortunately, the eruption of the solvency crisis has made it clear how unprepared the world was to deal with the collapse of large, systemically important financial firms.

When confronted with the insolvency of Lehman Brothers in September 2008, there were only three possible options for policy makers: attempting to use conventional bankruptcy legislation to support or wind down the firm; using taxpayers’ funds to prop up the ailing institution; finding another institution to buy the failed firm. Each of these options has serious drawbacks.

2.1. Using Conventional Insolvency Laws

Conventional bankruptcy legislation is too slow to be suitable for financial firms and multinational firms face problems associated with different and conflicting bankruptcy regimes in different locales. These problems are illustrated by experience of Lehman Brothers.2

Lehman Brothers filed for Chapter 11 bankruptcy protection on 15 September 2008. At Lehman, it was procedure that all spare cash held by the London subsidiary – a corporate entity subject to British bankruptcy legislation – was sent to the New York parent at the close of each business day. When the directors of this subsidiary realised on Sunday 14 September 2008 that their US parent was going to file for bankruptcy protection the next day, they realised they no longer had the cash to fund their operations. Under British law this meant that the company had to be put into administration and, as a consequence, its access to exchanges and clearing systems was frozen with a large number of trades left open.

Putting the British subsidiary into administration also created a further problem. The British subsidiary used a bewildering array of complex legal structures to hold its client assets. The Lehman Brothers group had a group-wide IT system that was operated out of New York and, after the bankruptcy filing, it ceased to be updated for the British subsidiary. This made it difficult for the administrators to return the client assets – worth about USD 35 billion – held by this subsidiary. The resulting delay greatly increased the market disruption caused by the failure of Lehman Brothers.

2.2. Taxpayer-Funded Bailouts

The second option for dealing with failed financial firms, bailouts with tax payer funds, has been used by many countries since the recent crisis began. Examples are the United States in the case of American International Group (AIG), Germany in the case of Hypo Real and Commerzbank, the United Kingdom in the case of the Royal Bank of Scotland Group and the TSB-HBOS Group, the Netherlands, Belgium and Luxembourg in the case of Fortis Bank and Ireland in the case of Anglo Irish Bank.

2 See Armour (2010) for a detailed description.
There are a number of potential problems with this approach. The first is that it might create moral hazard. If financial firms perceive that they are likely to be bailed out if they run into difficulties then this would tend to cause them to engage in excessively risky behaviour. On the other hand, if the market also believes that insolvent financial firms are likely to be bailed out, then these firms can borrow at more favourable rates than they otherwise could. This raises the value of solvency and might, in principle, mitigate this problem to some extent. However, a recent study of German banks during the period 1996 – 2006 does not support this. It was found that the removal of public guarantees significantly reduced risk taking.\(^3\)

The second problem is that tax payer bailouts can also be politically unpopular, to say the least. In Ireland, parties campaigning against the continued use of tax payers’ money to repay the senior unsecured bondholders of Irish banks gained a large majority in the Irish parliamentary elections of 25 February 2011.

A third problem is that, in some instances, the failed banks are too large for tax payer bailouts to be feasible. Iceland is the most egregious case; the size of the Icelandic banking sector's balance sheet was about 11 times the size of Icelandic GDP before it collapsed. Fortunately, the Icelandic government did not attempt to save its banks, as this would have dragged the sovereign into insolvency along with the banks. The Irish attempt at bailing out banks that were too big to be saved is now threatening sovereign solvency.

Finally, state support of financial institutions may conflict with Article 107(1) of the Treaty on European Union (consolidated version) which says, ‘Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.’ However, Article 107(3)(b) may provide an exception in sufficiently important cases as it allows aid ‘to remedy a serious disturbance in the economy of a Member State’.

### 2.3. Selling Troubled Firms

The third approach to the threatened bankruptcy of a financial firm has been to sell it to or merge it with another financial firm. Fortis’s Belgian banking operations were sold to the French bank BNP Paribas (while its Dutch ABN-Amro operations were sold to the Dutch sovereign), Merrill Lynch was sold to the Bank of America, Bear Stearns was merged with JP Morgan Chase, HBOS was acquired by Lloyds TSB.

This approach, too, has problems. It may require a taxpayer sweetener (as in the case of Bear Stearns) to induce another firm to go along with the deal. Negotiations can be acrimonious (as in the case of Fortis) and take time. Shareholders may try to block the deal if it lowers the value of their shares or reduces their control (as they did at Fortis and JP Morgan). It may weaken the institution that acquires the failed firm. Lloyds TSB share values fell by about a third in value after HBOS posted unexpectedly high losses in early 2009. Some financial firms, such as the Royal Bank of Scotland, are too large to be digested by another.

\(^3\) See Gropp et al (2010).
3. THE BANK RESOLUTION REGIME IN THE UNITED STATES

In thinking about how to structure a bank resolution regime, it is useful to consider what regimes are now in place elsewhere. I describe some of the experience of the United States in handling failed depository financial institutions.

3.1. The Case of the FDIC and Washington Mutual

Washington Mutual (WaMu) of Seattle was the sixth largest bank in the United States, with assets valued at USD 328 billion in 2007. Unfortunately, it suffered heavy losses in the US subprime mortgage market and the price of its shares plummeted from 30 dollars to two dollars between September 2007 and September 2008. On 15 September 2008 its depositors began to run, withdrawing about USD 17 billion. On Thursday 25 September the US Office of Thrift Supervision (OTS), which regulated WaMu, closed the bank and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC auctioned off a package including most of the WaMu’s assets and all of its deposits and secured debt. On Thursday 25 September 2008, JP Morgan Chase was informed that it was the winner.

The collapse of WaMu was the largest bank failure in US history and the second largest bankruptcy after Lehman Brothers. However, unlike in the collapse of Lehman Brothers, WaMu’s business operations proceeded without interruption after its demise. Its branches opened as usual on the morning of Friday 26 September, albeit as JP Morgan branches, its ATMs continued to operate and its online services remained available.

In the United States the FDIC manages a receivership regime for failed banks. It sells their good assets and winds down their bad assets. It currently insures up to USD 250,000 per depositor per bank. If there are more than sufficient funds to pay insured depositors from a bank’s recovered assets, then it uses the extra funds to pay, in order, general unsecured creditors, subordinated debt and stockholders. If there are insufficient funds to pay insured depositors, then it makes up the difference with its Deposit Insurance Fund. A 27 February 2009 press release from the FDIC states: ‘Throughout the FDIC’s 75-year history, no depositor has ever lost a penny of insured deposits. While deposits insured by the FDIC are backed by the full faith and credit of the United States Government, the FDIC is funded not with taxpayer money but with deposit insurance premiums imposed on banks. Though the FDIC has the authority to borrow from the Treasury Department to meet its obligations, it has never done so to cover losses.’

3.2. Limitations of and Problems with the American System

While the FDIC’s demonstrated operational efficiency in the handling of failed depository institutions is enviable, the tasks of the FDIC have been much easier than the ones potentially facing European authorities. WaMu was a big bank by American standards, but it was small compared to behemoths such as BNP Paribas or Royal Bank of Scotland which have assets worth three trillion dollars or more. Moreover, and crucially, WaMu was a domestic corporation with a relatively uncomplicated balance sheet.

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4 The OTS is no more; its rights and responsibilities have been taken over by the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency.
The plain vanilla depository institutions that are resolved by the FDIC have not had complex contingent claims on their balance sheets and they have not combined principal and agent roles in their transactions, as do the US broker-dealers that act as custodians and clearing agencies in OTC transactions as well as transacting in the same securities on their own accounts. They have not had complex cross-border structures of branches and subsidiaries and, thus, they have not had the coordination and technical problems associated with multinational groups with corporate entities located in several jurisdictions.

The FDIC’s operational efficiency may also have come at the expense of property rights. On 20 March 2009 the shareholders of WaMu, who were nearly wiped out in the FDIC’s sale of WaMu to JP Morgan Chase, filed suit against the FDIC. They are seeking damages for what they view as the unjustified seizure of the institution and its sale at an unreasonably low price.

Until recently, the FDIC’s authority has been limited to depository institutions; this is why Lehman Brothers fell outside of its scope. This has been changed, however, with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 21 July 2010. This Act extends the reach of the FDIC to financial companies whose potential collapse might jeopardise the financial stability of the United States. That a financial firm presents sufficient systemic risk is to be determined by the US Treasury in consultation with the Federal Reserve Board and the FDIC. Necessary funding is to be provided by an Orderly Liquidation Fund that is to be set up by collecting risk-based assessment fees from eligible financial companies. The fees are to be adjusted as necessary so that any borrowing from the Treasury is repaid within five years and, thus, no taxpayer money is used. Claims against assets are largely the same order as in the regime for depository institutions, but the compensation claims of all senior executives are subordinate to those of all junior creditors.

Unfortunately, however, the problem of multiple jurisdictions is not addressed: the Act does not apply to foreign subsidiaries. It is also not entirely credible that the United States has committed itself to never using taxpayer money.
4. DESIGNING A BANK RESOLUTION REGIME

Coming up with a proposal for how to respond to the actual or threatened insolvency of financial firms involves answering three questions. First, who should bear the cost of the institution’s failure or restructuring? Second, increasing a resolution regime’s operational efficiency limits systemic risk, but potentially at the expense of trampling on property rights. How much efficiency does society want and what is the least costly way to get it? Third, how can society resolve the problem of financial institutions operating in multiple jurisdictions?

4.1. Who should bear the cost of a bank failure?

When a financial institution fails, many parties have claims against its assets: its workers and suppliers, tax authorities, depositors, secured debt holders, senior debt holders, junior debt holders and shareholders. There is wide agreement that if the assets are insufficient to meet these claims, that the depositors should be protected, at least up to a point, and that the shareholders should lose their money. There is less agreement over whether or not other claimants should be protected and if so whether society or other financial institutions should foot the bill.

There are two reasons for protecting deposit holders. The first reason is a fragility argument. That is, there exists a possible and socially costly equilibrium supported by self-fulfilling expectations: each depositor runs in the belief that all other depositors will run and the bank will fail. If depositors are insured uninterrupted access to their funds in the event of a bank failure, then there is no incentive for them to run. The second reason is that it may be unreasonable to expect small depositors to monitor the health of complex financial organisations, and hence, they should be protected.

The fragility argument may also be extended to the other creditors of a bank (or other financial firm). Here too there is a socially costly equilibrium where each non-depositor creditor fails to extend new loans or roll over existing loans in the belief that all other such creditors are going to refuse to grant new loans and withdraw the old. In addition, there is an argument based on asymmetric information problems. If creditors cannot perfectly gauge the solvency of banks there may be an adverse selection problem that causes credit markets to freeze. Insuring creditors solves this adverse selection problem.5

If it is accepted that some bondholders should be protected, the question is where to draw the line. It has been argued strongly (although mainly by senior bondholders and their lawyers) that senior bondholders should be protected. The argument is that, unlike equity holders, senior bondholders have no possibility of an upside gain, thus they should not be exposed to downside risk. If they were exposed to such risk then they would require higher interest rates. If the banks were forced to pay higher interest rates, they would then pass this cost on to their consumers. As a result, households would pay more for their mortgages and other loans. In addition, it is claimed, senior bondholders are not typically hedge funds, but insurance companies and pensions funds. If senior bonds become more risky, so do these funds.

5 The fragility argument does not necessarily require insurance. The existence of a fully credible lender of last resort is an alternative.
These arguments, however, are partial equilibrium in nature and neglect the moral hazard problem that arises when creditors believe that they will be bailed out. If, instead, it is believed that senior bonders would be expected to take significant haircuts in the event of insolvency, then they would have an incentive to become more selective about which bonds they purchase. Both they and society, because it cares about the health of pension and insurance funds, would become more careful about monitoring the behaviour of the issuers of the bonds. Consequently, financial institutions that want to issue senior bonds would have an incentive to become more transparent and to engage in less risky behaviour. To the extent that less risk taking on the part of financial institutions is desirable and worth the higher monitoring costs, these changes might offset the harm of the increases in the banks’ costs are passed on to their customers. In addition, it is clear that in the event of the failure of a sufficiently large bank, protecting all senior bond holders may simply not be feasible.

A legal system that protects some creditors – say some deposit holders and some secured debtors – but leaves open the question of how much of a haircut unsecured debtors are expected to take, leads to increased uncertainty, litigation and acrimony. A partial solution to a lack of political will to clarify matters is for financial institutions to issue securities that are clearly not protected. An example is a contingent convertible bond, or Coco. Such bonds vary in nature, but the ones that are relevant here are bonds which are automatically converted into equity at a pre-specified price when some trigger point is reached. The Basel Committee wants the regulators to decide when the trigger point is reached. While this gives regulators flexibility in dealing with novel situations, it does away with one of the main advantages of Cocos: the rules of the game are clear to all in advance. An attractive alternative may be one where the conversion is triggered by some readily observable and verifiable event. Credit Suisse, Rabobank and Lloyds have all issued Cocos that are triggered if their Tier-1 capital falls below some specified level.

If a failed financial firm’s assets are insufficient to protect the claimants that society wishes to protect then the question of who should cover a shortfall arises. This amounts to a choice between the taxpayers and the financial services industry. It is not necessary to point out the political implications of taxpayer-funded bailouts. In the United States, the recently passed Dodd-Frank act specifically precludes spending taxpayer money to rescue a systemically important institution. Taking the more realistic view that there may be instances where some public funding is inevitable, the UK Banking Act of 2009 allows for this.

It is generally accepted that the owners, creditors or customers of the financial services industry should pay at least some of the short fall. In addition to being popular with taxpayers, this might lessen the moral hazard problem associated with bailouts, especially in countries with just a few large financial firms. If financial institutions provide the funding, then they have an incentive to monitor each other.

Funds could be collected by taxing institutions (and possibly deposit holders or other insured creditors) either ex post or ex ante. The EU has favoured an ex ante approach. In this case the payment can be viewed as an involuntary insurance payment that is collected from financial firms and it might depend upon readily measurable features that indicate its size or contribute to its riskiness.
The United States has favoured an ex post approach. In this case the payment is not insurance, but a tax. If Bank A fails, it is widely perceived as fair that the shareholders and the uninsured creditors should lose their money before the taxpayers step in to pay off the insured creditors. It is not, however, reasonable that Bank B, whose managers behaved prudently and which did not fail, should also be assessed before the taxpayers. It is fair to tax financial institutions and their customers for the provision of insurance, but if reasonable ex ante insurance payments and recovered assets do not cover the insured creditors of a failed financial institution then it is the tax payers who are the natural candidates to contribute.

The current banking crisis is to a large extent the result of supervisory and regulatory failures, as well as governments’ policy blunders. In a democratic society, the ultimate responsibility for much of the crisis then lies with the electorate. In addition to fairness issues, if the failure of an institution causes significant systemic risk and other financial firms must contribute to making up the loss, then it forces financial firms to lose liquidity just when they need it.

4.2. Shareholder Rights vs. Efficiency

Earlier in this essay I extolled the efficiency of the US resolution regime in its handling of WaMu. But, there are those (primarily the shareholders and bondholders of WaMu) who tell a different story. In their version of events, WaMu had been searching for a buyer since early September 2008. On 25 September the FDIC announced that JP Morgan Chase had won an auction to buy the bank. This suggests that the FDIC must have alerted potential purchasers that the bank was going to be seized some time before the sale. This made it impossible for WaMu to find a buyer: why buy a bank from its shareholders and be required to take on all of its liabilities when you can purchase select parts of it in a government-run fire sale? The resulting rumours could well have provoked the bank run. The bondholders and shareholders have also argued that WaMu was solvent and might have remained so; that the FDIC provoked its liquidity crisis and the subsequent seizure amounted to confiscation.

The different spins on the handling of WaMu result from the conflict between efficiency and property rights that is inherent in the design of bank resolution regimes. Such regimes could in principle rely on statute, and thus spell out the rules of the game in advance, promoting fairness and protecting the rights of property owners. Or, they can rely on the discretion of regulators, and thus allow the necessary flexibility to deal with previously unforeseen events.

That trade-off between property rights and efficiency is especially acute when it comes to deciding how to determine when a financial firm can be taken over by the government. To insure that a financial firm’s business continues without interruption, it is best to take it over before it becomes insolvent. But, if the firm has not yet failed, then there may be a chance that it might not fail and in this case, seizing it amounts to confiscation.

The problem is further complicated by the problem that it can be difficult to assess whether or not a financial firm is solvent or likely to become so. In principle, insolvency occurs when the firm is no longer operationally viable in the sense that it is unlikely to be able to repay its debts. If solvency is defined this way, however, then declaring a firm to be insolvent requires the judgement of the regulators.
There are more mechanical definitions that rely less on judgement. Three alternative possible criteria for insolvency are when the firm has negative net worth under the prevailing accepted accounting principles; when the firm would have a negative net value if it were liquidated; when the firm no longer has enough liquidity to continue to pay its bills. However, these criteria can be unreliable and unreasonable during a financial crisis where markets become dysfunctional and the price that one could get for a financial asset can be far below its reasonably expected discounted present value if it were held to maturity. Consequently, it is probably unrealistic to rely on a rules-based approach to determining which financial firms should be taken over. Instead, regulators must be allowed to use their discretion, even though this entails a loss of security of property rights and, hence, possibly of government legitimacy. Shareholders, however, should have the opportunity to contest the regulators’ actions ex post in court.

EU law provides stronger protection for bank shareholders than does US law. Under current EU law, shareholders of firms must vote on acquisitions and mergers and on whether or not the company is to be liquidated. However, during the financial crisis, a need to avoid systemic risk has led some nations to suspend these shareholder rights for financial firms. In the United Kingdom, the Banking Act of 2009 gives the Treasury and the Bank of England wide powers to transfer shares from a failing bank to a government-owned bridge bank or to a private purchaser.

### 4.3. Problems Associated with Multinational Banks

One of the most important and challenging problems in designing a bank resolution mechanism is how to deal with multinational banks. An international banking group’s foreign branches are subject to the resolution regime of the country in which the group is licensed. Its foreign subsidiaries, however, are subject to the resolution mechanism of their host country. As the Lehman Brothers bankruptcy illustrates, conflicts between these mechanisms have the potential to be disastrous.

In addition to legal issues there are technical problems associated with the restructuring of a systemically important multinational financial institution. For example, how does one transfer such a complicated organisation to new ownership over a weekend so that its operations are unaffected? These technical issues are behind the proposals for all systemically significant cross-border institutions to have resolution plans or ‘living wills’.

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6 See Hempton (2009) for a discussion of this.
7 See Kern (2009).
8 It might seem that a possible solution would be to make foreign subsidiaries branches, but many countries dislike the notion that a financial institution located within their borders is regulated and supervised by a foreign nation: the Icesave debacle illustrates why this is so.
5. THE EUROPEAN COMMISSION RESPONSE

The European Commission is addressing the problem posed by systemically important financial institutions with the goal of ensuring that these firms can be allowed to fail without creating significant risk to financial stability or costs to taxpayers. Its 20 October 2011 communication is a careful and sensible assessment of the challenge. It recommends national resolution regimes with well-defined powers and processes, safeguards for the property rights of creditors and resolution plans for financial groups that ‘would require detail on group structure, intragroup guarantees and service level agreements, contracts and counterparties, debt liabilities, custody arrangements, as well as operational information about IT systems and human resources.’ It recognises the difficulties in specifying when the resolution mechanism for a firm is to be triggered. It discusses the design and use of resolution funds. A formal proposal will be made by the Commission in the spring of 2011.

The most serious problem the Commission faces is dealing with cross-border groups. Without a harmonised European resolution regime and a single European regulator, there is no perfect way of dealing with systemically important financial groups with corporate entities in multiple European countries. The existence of financial groups with corporate entities both inside and outside Europe further complicates the issue.

The Commission has made two recommendations for dealing with financial groups operating in multiple EU countries. The first is that ‘resolution colleges’ should be established for financial groups. These colleges would be chaired by the resolution authority responsible for the group’s parent company and would include the resolution authorities responsible for the group’s other corporate entities. Such colleges would provide a forum for exchanging information and discussing coordinated solutions. This appears to be a useful and relatively non-contentious idea, if limited in scope.

The second recommendation is more controversial. Under this recommendation, the relevant authorities – presumably the resolution colleges – would prepare a group resolution plan in advance. In the event of the failure of the group, the resolution authority responsible for the group’s parent company would have the right to decide whether the group resolution scheme is appropriate or whether national resolution regimes would be preferable. This decision would have to be made quickly, but until made the authorities responsible for the group’s other corporate entities would be required to refrain from implementing national measures that would threaten the group resolution scheme. It is unclear whether such a scheme is currently politically feasible.
REFERENCES


Bank and Sovereign Debt Resolution: ‘Never Again’ Meets ‘Not Yet’

NOTE

Karl WHELAN

Abstract

European leaders and the European Commission are to be commended for starting a dialogue on the issue of burden-sharing with the private sector during banking and sovereign debt crises. Current proposals for dealing with bank and sovereign debt problems appear to assume that we can get through the next few years without debt write-downs or a further crisis, so the role of new resolution procedures is to deal with some future crises that will not happen for a number of years. This approach is based on wishful thinking. A future transition to a world in which newly-issued bank and sovereign bonds are treated as junior to previously-issued debt would most likely produce a bigger crisis than the one seen last year. The European Union needs to accept the seriousness of current problems and also that dealing successfully with these problems may require writing down existing debt.
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1. INTRODUCTION

While the euro area economy is now staging a modest recovery, with real GDP in 2010:Q4 up 2% on the same quarter in the previous year, the financial crisis and its accompanying severe recession have left behind a sovereign debt crisis in peripheral countries and a banking system that is in a fragile state. The problems of sovereign and bank debt have become intertwined in various ways over the past year, with the most clear (some might say tragic) example being the role played by the cost of bank bailouts in triggering the Irish sovereign debt crisis. Absent the 20% of GDP that the government set aside in 2010 for recapitalising failing banks, it is extremely unlikely that Ireland would now be reliant on the EU and the IMF for funding. This in turn has pushed much of the risk originally associated with private Irish bank debt on to the international community.

It is now clear that the policy response aimed at containing the financial crisis has left behind a dangerous legacy with widespread agreement that we need to deal with future crises in a different manner. There are various proposals circulating that are aimed at implementing a range of improvements to the EU’s capacity to deal with sovereign and bank insolvencies. In the next two sections of this paper, I discuss some general issues related to dealing with bank and sovereign insolvencies.

The latter part of the paper focuses on the more complex problems related to the current situation that Europe finds itself in. Current proposals for dealing with bank and sovereign debt problem are based on the assumption that we can get through the next few years without debt write-downs or a further crisis, so that the role of the new insolvency or resolution procedures is to deal with some future crises that will not happen for a number of years. Thus, the current policy position could be characterised as uncomfortably caught between ‘never again’ and ‘not yet’.

Unfortunately, this approach is based largely on wishful thinking. In my opinion, a future transition to a world in which newly-issued bank and sovereign bonds are treated as junior to previously-issued debt would most likely produce a bigger crisis than the one seen last year. So, while the wish to avoid upsetting current bond market investors is understandable, the plan to allow haircuts to apply only to bonds issued in the future lacks internal consistency. Those involved in formulating EU policies in this area need to move away from wishful thinking and focus instead on accepting the seriousness of current problems and that resolution of these problems may require writing down existing debt.
2. DEALING WITH BANK INSOLVENCY

This section discusses the legacy left by the interventions during the period after Lehman Brothers and the proposals on bank resolution released by the European Commission.

2.1 A Legacy of Moral Hazard

Financial intermediation via fractional reserve banking plays a crucially important role in the modern economy. In particular, it facilitates maturity transformation: Bank assets have longer average maturities than bank liabilities, meaning depositors have their assets available at short notice, while having loans that can be paid back over a much longer period. This maturity mismatch means that banks require stability and trust: Stability because the fractional reserve model relies on the regularity that only a small fraction of depositors will withdraw funds during any period and trust because bank creditors need to believe that banks will be able to honour their requests despite the maturity mismatch.

This special structure means that the question of how to deal with bank insolvencies is a complex one. Banks are not normal firms and their failure cannot be dealt with via normal corporate insolvency law. Depositors, in particular, require special protection. Given the opaque nature of modern banks, retail depositors cannot be expected to understand the solvency and liquidity positions of the banks they hold their deposits with. For this reason, and to maintain financial stability, it is reasonable for depositors to expect their funds to be insured by governments who, in turn, regulate banks to minimise the risk of this insurance to the taxpayer.

Other providers of funds to banks, such as large institutional bond investors are not eligible for deposit insurance schemes. Unlike depositors, they should be expected to have the capacity to undertake analysis of the solvency and liquidity position of the banks that they lend money to and thus to understand the risks being taken. However, such investors also require stability and predictability and it is important that governments set out clear ‘rules of the game’ for banks that get into difficulty.

How to deal with non-deposit creditors has become a major issue since the financial crisis that occurred after the US government’s decision to allow Lehman Brothers to go into bankruptcy. Many have chosen to interpret the financial chaos that followed the US government’s decision not to save Lehman as evidence that governments need to protect non-deposit bank creditors even if this inflicts severe costs on taxpayers.9

In my opinion, this view of the consequences of Lehman’s insolvency is incorrect. Rather than proving that non-deposit creditors must also benefit from government guarantees, the Lehman incident shows that governments need to stick with consistent pre-specified rules when dealing with troubled financial institutions. During September 2008, very few financial market participants could explain why Bear Stearns had been saved from insolvency with the help of the Federal Reserve while Lehman was not or why AIG was saved while Lehman was not.

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9 Living in Ireland over the last few years, I can attest that this message was communicated regularly to the Irish public in recent years by our Minister for Finance, Brian Lenihan, as a justification for the almost-blanket government guarantee for bank liabilities adopted by the Irish government in September 2008.
The absence of a clear understanding of which financial institutions might be saved and which might not led to a severe curtailment of interbank financial markets, which had profoundly negative effects on financial intermediation and the real economy.

- The period after Lehman saw a very quick retreat across the world from the line-in-the-sand on moral hazard that Hank Paulson intended with his decision not to save Lehman. The situation in Europe was made particularly complicated by the existence of different regulatory systems across countries, differences in standards for dealing with insolvent banks, a lack of clarity about how to deal with multi-country financial groups, and a lack of co-ordination among EU policy makers on how far to go in offering help to banks. The result was something of a free-for-all as governments in Europe moved to offer a wide range of supports to keep banks afloat, including using public funds to recapitalise banks and government guarantees for bank creditors.

In addition, the European Central Bank (ECB) provided unprecedented amounts of liquidity funding and much of it, we now know, allowed banks that had severe solvency problems to pay off their liabilities to the private bond market. For example, the Irish banks have paid off most of the bond liabilities that they owed at the start of the financial crisis and, in the absence of private investors willing to lend to them, they now owe almost EUR 150 billion to the ECB and the Central Bank of Ireland. Despite a massive financial crisis caused by reckless investment decisions by banks all across Europe, senior bank bond holders have not suffered losses.

These policy responses, while well-intentioned, have left a very significant legacy of moral hazard in relation to the financing of banks.

2.2 The Future of EU Bank Insolvency

With fiscal belts being tightened all across Europe, there is a growing political realisation that many Member States cannot afford a further round of expensive bank bailouts and, indeed, that such bailouts would not be acceptable to the public. For these reasons, the past year has seen an ongoing debate about how to deal with troubled banks with the most controversial issue being how to treat the senior debt of insolvent banks. The most important proposal on the table is the European Commission’s January consultation document on an EU-wide resolution regime.10

Harmonisation and Early Intervention

The key priorities of any regime for dealing with troubled banks must be the maintenance of financial stability and minimisation of financial cost to the taxpayer. Many of the Commission’s proposals relate to harmonising the procedures adopted in relation to failing banks, particularly when dealing with banks trading across multiple Member States. When bank insolvencies are dealt with in a systematic and orderly manner, they are less likely to cause a financial crisis due to contagion driven by fear or uncertainty. So the proposals are to be commended as likely to make progress in ensuring the maintenance of financial stability and they should be implemented as soon as possible.

The Commission report emphasises the need for timely and pre-emptive intervention to deal with failing banks, with the diagnosis based on realistic stress tests and a more intrusive supervisory approach.

One reason this approach is required is that the failure to appropriately diagnose bank insolvency has left the European taxpayer on the hook for potentially large losses due to the lending activities of the ECB.

The ECB is not a bank supervisor. As long as supervisory authorities deem a bank solvent, the ECB will view the bank as an eligible counterparty, provided they have sufficient qualifying collateral. Indeed, this is the classic prescription of how a central bank should honour its ‘lender of last resort’ function: Lend against good collateral to banks that are solvent but have liquidity problems. If we are to avoid in the future the possibility of the ECB making large credit losses on its open market operations, bank resolution will have to be a significantly faster and more efficient process.

**Bail-In Proposals**

In relation to protecting the taxpayer, the most contentious aspect of the Commission’s consultation document is its proposal that write-downs of senior debt should be an element of a future approach to dealing with insolvent banks. The report proposes two different, though possibly complementary, approaches. The first approach, ‘the comprehensive approach’, gives regulatory authorities the power to write down or convert to equity the fraction of senior debt that is deemed necessary to bring the bank back to a target level of solvency. The second approach, ‘the targeted approach’ would require banks to issue a required amount of debt which could be ‘bailed in’ in the form of write-downs or a conversion to equity if the bank’s solvency position reached a specified statutory trigger.

In my opinion, the comprehensive approach should be emphasised. While ‘bail-in-able’ debt, such as contingent capital securities, are an attractive theoretical solution to the problem of minimising the public cost of banking crises, in practice there has been little appetite among investors for these instruments. (One could argue that they lack the certainty that bond investors desire but are also unattractive to equity investors since they only turn into equity in the case of a bank that has effectively failed.) These instruments are likely to be costly for banks to issue and there would be strong lobbying from bankers against the requirement to issue a fixed amount of these securities. In this sense, while regulators may wish to encourage the issuance of contingent capital, the comprehensive approach proposed by the Commission is likely to be more effective.

**Limiting Knock-On Effects**

As a stand alone proposition, most people would be in favour of steps to transfer the costs of failing banks away from taxpayers and towards non-insured private investors who chose freely to give their money to banks that were poorly managed. However, like all areas of economics, there is no free lunch here. In many cases, the decision to allow senior bank creditors to take haircuts will result in losses for other financial institutions which could also threaten their insolvency. Such knock-on effects could threaten financial stability and trigger a crisis.

The ultimate decision as to whether to bail in senior debt and, if so, the size of the haircut being imposed will always have to take into account the systemic importance of the debt instruments being considered. However, there is much that can be done to make the financial system more robust to such shocks.

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11 I am simplifying here what is, in fact, quite a complex area. The ECB’s operational guidelines allow it to ‘suspend or exclude counterparties’ access to monetary policy instruments on the grounds of prudence.’ This ability of the ECB to make its own decision about which parties it declines to do further business with undoubtedly featured in the various negotiations related to the Irish request for funds from the EU and the IMF. But, in general, the point remains that the ECB will be expected to lend to banks that national supervisors deem to be solvent.
Regular stress tests should give regulators a better sense of large counterparty exposures and thus the likely knock-on effects from a bank failure. More importantly, there is a need for higher capital ratios and higher quality capital to absorb more losses. Unfortunately, the Basel 3 agreements probably do not go far enough in this direction (and do not get implemented quickly enough) to be of sufficient help in the coming years. Ultimately, authorities will never be able to rule out having to use public funds to limit the knock-on effect of senior bank bond defaults, but they can be much better prepared to respond to and deal with these knock-on effects than they have been in the past.

**The Need for Bail-In Mechanisms**

Proposals for ‘bail ins’ of senior bank debt are already proving controversial. However, the current position is simply unsustainable. The *de facto* current position of the European authorities is that senior bank bond defaults cannot be countenanced, even if taxpayers must come up with the funds to fully compensate these bondholders.

Proof that this is the current position has been provided during the negotiations over the Irish loans from the EU and the IMF. European Commission officials have told investors on conference calls that the need to pay back all senior bank debt is ‘integral’ to the Irish programme. In fact, there is no mention of senior debt whatsoever in the official programme conditionality, which suggests that this requirement is more of a ‘backroom’ agreement. Irish officials and politicians have pointed to the ECB as also insisting that all senior bank bonds be repaid, so this backroom agreement most likely involves the ECB in some capacity, suggesting that repayment of senior bank bonds is somehow a *quid pro quo* for the ECB’s agreement to continue providing funding to the Irish banks.

Two of the Irish banks that owe senior debt (Anglo Irish Bank and Irish Nationwide Building Society) are widely accepted to be insolvent and recently had their deposits transferred to other institutions. These banks have cost the Irish taxpayer over 20% of GDP so far. So this is where we are now. EU Member States are being urged to use taxpayer funds to honour bank debts, no matter how insolvent the banks are or how much strain a country’s public finances are under.

Continuation of this policy would amount to a blank cheque to European banks from the taxpayers. Furthermore, such a policy would discourage the process of bond markets providing discipline for bank management and would put all the pressure to avert crises back on regulators who have failed before and may fail again. Rather than arguing about whether we can afford to deal with senior bank bond defaults, we need to think about whether we can afford to live in a world where there are no such defaults.

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3. SOVEREIGN INSOLVENCY

In some ways, the question of how to deal with sovereign debt problems is simpler than dealing with bank debt, while in other ways, it is more complex.

3.1 Dealing with a Sovereign Debt Restructuring

One sense, in which sovereign debt restructuring is simpler, is that sovereign governments are not financial intermediaries so if sovereign bonds are restructured, there are no depositors ranking *pari passu* with bondholders that need to be dealt with.

Another sense in which sovereign debt restructurings are simpler is that they involve a smaller number of debt instruments and it is easier to figure out the potential knock-on effects of haircuts on the banking system. Europe has lots of banks and they issue many debt instruments of varying levels of complexity. It can be hard at any point in time to assess the likely second round effects of the failure of a particular bank or group of banks. In contrast, as last year’s CEBS stress tests illustrated, it is possible to figure out the extent of sovereign debt holdings of the leading European banks. While the execution of the CEBS stress test lacked credibility (due to its assumptions that there would be no sovereign defaults over the next few years even in a stress scenario and due to its somewhat arbitrary distinction between banking books and trading books) it did provide sufficient information for analysts to assess the exposures of various banks to risky sovereign debt.13

These stress tests should be repeated on a regular basis, thus allowing supervisory authorities and national governments to be in a position to respond swiftly to potential banking problems that could occur if the sovereign debt of a euro area government was to be restructured. In the meantime, European bank supervisors should actively discourage excessive holdings of sovereign debt issued by a bank’s national government unless such debt has a high debt rating. The more dispersed are the holdings of the sovereign debt being restructured, the smaller the disruption to financial stability will be.

3.2 Sovereign Restructuring in the EU: Why and How?

In the context of euro area Member States, the complex questions in relation to potential sovereign defaults are less to do with how to deal with the knock-on effects and more to do with how a default might happen and the role that should be played by the European Union.

As the widely-cited work of Reinhart and Rogoff (2009) has emphasised, sovereign defaults have been occurring for hundreds of years and have come in many different flavours. In some cases, governments have decided to renge on debt obligations even when markets were still willing to lend to them. In the European Union of today, it is unlikely that any Member State would chose such a route. Rather, sovereign defaults in Europe are likely to occur as the result of a ‘buyers strike’ in which a country cannot issue new bonds and thus fails to come up with the cash to honour existing bond obligations.

In the absence of European Union and IMF intervention, it is likely that this situation would have already occurred in Greece and would perhaps be about to happen in Ireland. However, the EU and the IMF have intervened and their decision to do so echoes the classic debate about how central banks should treat troubled financial institutions.

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13 See, for instance, Blundell-Wignal and Slovik (2010).
The EU’s current position on Member States with sovereign debt problems is that these are problems of liquidity rather than solvency. For example, while financial markets firmly believe that a Greek default is highly likely, European policy-makers, such as the ECB’s Lorenzo Bini-Smaghi, give speeches and interviews declaring that a Greek default is ‘not an option.’

It is possible, of course, that the markets will come around to such a viewpoint and decide in a few years time that, despite a debt-GDP ratio of about 150%, Greek sovereign debt represents a good investment. But what if they do not? One possibility is that the EFSF’s proposed permanent successor, the European Stability Mechanism (ESM), will just continue to lend to those countries shunned by the market, with ever-greater proportions of their sovereign debt being owed to the EU. This is unlikely to be an attractive option to the principle funders of the ESM. If a restructuring is ultimately required, the longer the delay, the more the burden will fall upon other EU Member States.

In reality, if Member States cannot return to borrowing from financial markets after a multi-year adjustment programme supported by loans from the international community, then there may be a need to accept that effectively this country’s government is financially insolvent. Thus, the ESM must be given the powers both to restructure sovereign debt in programme countries and also to provide gap financing until the countries can regain access to sovereign debt markets. The most well-articulated proposal as to how this mechanism would work is the recent paper from the Bruegel think-tank which updates the IMF’s Sovereign Debt Crisis Resolution Mechanism proposal in arguing that all euro area sovereign debt should contain collective action clauses (CACs) that would facilitate an orderly restructuring if necessary.

In deciding on the scale of any restructuring, there would be a need to balance the needs of the debtor country and those of the wider EU. The debtor country has to balance off the requirement to restore debt sustainability against the damage done to its future reputation by a substantial haircut on its sovereign debt. Consideration of European financial stability concerns would suggest a preference from the EU for a ‘light touch’ restructuring involving maturity extensions and interest coupon deferrals, thus minimising the write-down of principal. However, in return for such an approach and continued adherence to a strict macroeconomic adjustment programme, the ESM should provide gap financing on concessionary terms that improve the country’s chances of a return to the market.

While some may worry about the moral hazard precedent such concessional funding might create, it should be kept in mind that a sovereign default of a euro area Member State would completely change the subsequent approach taken by sovereign bond markets. The market disciplines that failed to discourage some Member States from running excessive deficits in the past would be far more effective after a sovereign default than they would be if other EU states continuously intervened to prevent any defaults on European sovereign debt.

14 For one example, see www.ft.com/cms/s/0/660edbae-3468-11e0-993f-00144feabdc0.html.
4. WILL THE ‘NOT YET’ POLICY WORK?

The discussion in the previous sections has paralleled recent discussions in official circles and think-tanks in its focus on the pros and cons of bank and sovereign debt resolution and on the mechanics of how new systems for dealing with debt crises might work. More importantly, however, it also parallels the official discussion in placing little focus on a crucial question: When should these proposals be implemented and which debt instruments should be eligible?

The answers to these questions in official circles have been ‘not yet’ and ‘only to debt instruments issued after some date in the future such as January 2014’. This official view is based on the belief that we can spend the next few years debating the necessary procedures for new mechanisms to restructure sovereign and senior bank debt and once these procedures are agreed upon, then the new rules can apply to debt issued after this point.16

I do not believe these are satisfactory answers. The approaches they suggest are not appropriate for dealing with serious existing European sovereign debt problems, while the banking proposals would face severe implementation difficulties and could trigger the type of crisis they are intended to prevent.

4.1 Motivation for the ‘Not Yet’ Proposals

The motivations for the ‘not yet’ proposals are understandable:

- In relation to sovereign debt, European Member States are still running large budget deficits and do not wish to scare off the bond market investors that are financing these deficits. The approach of telling financial markets that haircuts will only be applied to future investors, raises the comfortable prospect of obtaining a few years of breathing space to get deficits down and then implementing new procedures at a time when states are not so dependent on the bond market.

- Similar considerations apply to the market for bank bonds. There are still widespread concerns about the health of the European banking system. The European bank bond market has not fully recovered and the ECB is still being relied on to provide large amounts of funding. One can understand the reluctance to introduce new procedures for haircutting senior bank bonds at a time when we are hoping for increased funding from this market.

- Finally, there are legal concerns. In relation to bank debt, there is the problem that most senior bonds carry pari passu clauses and those who hold them can appeal on legal grounds against being singled out amongst unsecured creditors. For sovereign debt, there is the complexity that the debt instruments of various Member States have been issued in different jurisdictions with some being easier to restructure than others. Enshrining the ability to restructure sovereign and bank debt in law and then issuing debt with clear statutory clauses that allow such restructuring could be considered attractive as it would avoid the messy legal issues associated with haircutting debt instruments issued under current law.

16 So, for example, the foreword to the excellent Bruegel proposal on a Sovereign Debt Restructuring Mechanism concedes that the proposal ‘does not address any of the short-term discussions on the situation within the euro area. Rather, the focus is on the principles and the main tenets of a permanent system.’ Unfortunately, the short-term problems are likely to prove hard to ignore before a long-term policy structure is put in place.
4.2 Problems with the ‘Not Yet’ Proposals

There are a number of key problems with these proposals. First, the proposals underestimate the severe problems associated with transitioning from the current regime to the new regime. Second, they suffer from what macroeconomists call time-inconsistency, i.e. policy makers may settle on a policy delaying action until tomorrow but when tomorrow arrives, they may again wish to delay the action further.

Sovereign Debt

Consider first the somewhat simpler question of sovereign debt. The reason the question of sovereign defaults is under discussion is because of the serious debt problems in countries such as Greece and Ireland. Both countries are now reliant on official support from the EU and the IMF and the international agencies concede that, even after the implementation of adjustment programmes, Greece will have a debt-GDP ratio of around 150% in 2013 while the Irish debt ratio will be over 120%.

The current proposals envisage these countries returning to the bond market in 2014 to issue bonds that will contain clauses singling them out as first in line to receive haircuts from a ESM if these countries end up defaulting. When one looks at the large risk premia that current Greek, Irish (and indeed Portuguese) sovereign bonds carry, it seems clear that there would be no market for such bonds. Or equivalently, one that the interest rate such bonds would need to bear would be so high as to rule out debt-sustainability for these countries.\(^{17}\)

These considerations illustrate the lack of coherence in the current European approach to sovereign debt problems. While one can legitimately debate whether financial markets have misunderstood the Irish and Greek situations and argue that these countries could pull through their current sovereign debt problems, it stretches credulity to expect them to achieve this goal in 2014 by issuing bonds that maximise the risk to purchasers if these countries subsequently default.

This is where the time-inconsistency of the current proposals is exposed. Today, European governments want bond markets to feel safe when lending to them, so official policy is that other investors, guys from the future, will take the hit if there is a default. However, we can safely predict that when the future arrives, it becomes the present and the incentive will be to again postpone the proposal to allow for CACs or other rules that facilitate orderly restructuring.

In particular, while Member States with low debt/GDP ratios may be able to survive a transition to bonds with CACs with a relatively small increase in their cost of borrowing, those with high debt ratios may be more dramatically affected. While I have argued that Greece and Ireland could be forced into sovereign default by such a transition, countries such as Portugal, Spain, Italy and Belgium could also be significantly affected.

\(^{17}\) As the recent IMF paper by Ghosh et al discusses, one cannot simply assume that debt investors will just add on a risk premium in response to an increase in the riskiness of sovereign debt. Bond investors also need to assess whether public debt is sustainable at the prevailing interest rates and if it is not, this can lead to default.
At this juncture, European governments will be better served by adopting the position that sovereign haircuts, if they ever occur, will be allocated evenly across all classes of existing bonds. The risk spreads on peripheral sovereign debt suggest that markets do not believe that the proposals that are currently circulating have, in fact, shifted risk away from bonds already issued. So one cannot argue that the abandonment of the ‘not yet’ policy will upset sovereign debt markets because it is clear that they already do not believe this policy will come to pass.

There is little doubt that a commitment to haircut all existing debt would make the future work of the ESM more complicated than envisioned by those who see it only dealing with future bonds issued with CACs. And it would be hard to avoid complex legal cases. I am not a legal expert but it seems to me that these problems can be overcome. Sovereign defaults have happened before and they will happen again, even if they are often accompanied by messy legal cases. The role of the ESM should be to make the default as orderly as possible, to provide gap financing and to seek to minimise the financial stability implications.

Note that I am not arguing against proposals that future bonds contain a common type of CAC that would facilitate restructuring by the ESM. I am all in favour of such proposals. Indeed, I believe a commitment to haircutting existing sovereign debt in any restructuring will be a necessary requirement for there to be any market for bonds with CACs issued by peripheral European countries.

**Senior Bank Debt**

Many of the considerations that apply to the proposal to only haircut sovereign bonds issued in the future also apply to the European Commission’s proposals on senior bank bond write-downs because the Commission does not envisage applying these measures to currently-issued debt.

As with distressed sovereigns, it is hard to see there being a strong market for supposedly senior debt that, in reality, is subordinate to all existing senior debt. In particular, those banks that are currently finding it difficult to obtain bond market funding (or can only do so at expensive rates) may find it impossible to raise such funding after the introduction of legal powers to haircut such debt in an insolvency situation.

Consider the stylised example of a bank that has EUR 100 million in senior debt, with EUR 20 million each issued over the past five years, and for which there is a 10% probability of an insolvency which could see the bank having a net value of minus EUR 10 million after subordinated creditors had been dealt with. In the case where all senior debt shares equally in any haircut that occurs on insolvency, risk-neutral bond investors would apply a premium of 1% to such debt (based on a 10% probability of a 10% haircut).
Now suppose, in contrast, there is a commitment to haircut only senior debt issued after 2013. The bank will go to the bond market in 2014 looking to raise the EUR 20 million required to pay off debt issued five years earlier. Investors would now view this EUR 20 million bond as having a 10% probability of delivering a return of -50%. Risk-neutral investors would now request a premium of 5% for such debt, which would be highly expensive for the issuing bank. In practice, traditional risk-averse bond investors would have little interest in such an instrument. While alternative investors such as hedge funds may take an interest in this kind of bond, it is questionable whether there would be enough demand for these instruments to meet the requirements for the large quantities that would have to be issued by banks all across Europe.

The Commission’s consultation document shows some awareness of the potential problems created by a transition to a new regime. The document states ‘It is important to note that this consultation concerns possible future legislative changes which would be subject to a full impact assessment, appropriate transitional provisions and transitional periods of sufficient length and designed in such a way so as to avoid any market instability or unintended consequences.’

It is not clear, however, that this is a problem that can be solved via careful transitioning of the new regime. Going back to the stylised example, suppose, for example, that regulatory authorities requested that only EUR 5 million of the bank’s debt issuance in 2014 be eligible for a statutory write-down. In this case, the ‘bail-in’ bonds would be viewed as having a 10% chance of delivering a return of -100%, requiring a premium of 10% from risk-neutral investors. In other words, the longer the transition period, the more risky the initial ‘bail-in-able’ bonds will be and the less likely it is that the transition be successful.

So, as with sovereign debt, my preference is for a mechanism that will see all senior debt of an institution written down or converted to equity once the institution reaches a specified insolvency trigger. This approach will, of course, be more complex to implement because it requires making decisions about how to deal with depositors in these institutions.

- One approach to protecting depositors would be to apply haircuts to both deposits and senior bonds, thus respecting pari passu, use resolution powers to immediately transfer the written-down deposits to new institutions and then use public funds from deposit guarantee schemes to compensate depositors. If done swiftly, over a weekend for example, the depositors involved will barely notice the haircut that was applied.

- A second, perhaps more controversial, approach would allow European governments to adopt resolution powers to retrospectively change the terms and conditions of senior debt if the institution involved is sufficiently insolvent that senior creditors would lose out significantly in the absence of government support for the bank.

Whichever approach is taken, these steps should be combined with the introduction of the European Commission’s proposals that would see future bond issuance subject to write-downs if banks reach statutory triggers for insolvency. As with sovereign debt, the ability to share such write-downs with pre-existing debt would allow the market for such bonds to develop far more effectively than if these bonds are viewed as ‘first in line’ for haircuts.
**Anglo and Irish Nationwide: A Good Place to Start?**

When considering using resolution procedures to apply haircuts to senior bank bonds, a couple of obvious test cases propose themselves: Anglo Irish Bank and Irish Nationwide Building Society. Recapitalising these two banks is projected to cost the Irish taxpayer at least EUR 35 billion, an amount that exceeds 20% of current Irish GDP and which far exceeds the initial equity and subordinated debt risk capital of these institutions. These banks still owe about EUR 4 billion in unsecured senior debt issued prior to September 2008 and which is not guaranteed by the Irish state. Consider the following three points in relation to these two financial institutions:

(a) The scale of insolvency of these institutions far exceeds any statutory triggers that will be agreed in future.

(b) Both organisations had what could most charitably be called ‘serious corporate governance issues’ at the time the currently outstanding bonds were issued.

(c) Depositors in these institutions have already had their funds moved to other banks.

Taken together, these points suggest that these institutions are clearly well over the line that will be set for applying future haircuts to senior bonds.

Rather than viewing write-downs of the senior debt of these institutions as an outcome that would threaten the European financial system via some sort of contagion mechanism, European leaders should view these organisations as exactly the place to start when laying down a marker for future policy on bank resolutions.
5. CONCLUSIONS

European leaders (in particular the German authorities) and the European Commission are to be commended for starting a dialogue on the issue of burden-sharing with the private sector during banking and sovereign debt crises. The issues that are faced in dealing with these problems are considerable but the status quo, which rules out sovereign defaults and places most of the cost of bank failures on the taxpayers, is simply not sustainable.

It is understandable that the initial proposals that have emerged in this area give in to the tendency that often emerges with difficult problems to ‘kick the can down the road.’ Given the scale of current peripheral sovereign debt and bank debt problems, there is a natural urge to reassure financial market participants that bond write-downs are events that will happen to other people at some point in the future. However, it is precisely because the problems are so big that the ‘not yet’ policy approach simply will not work.

It is time for European leaders to accept that, in some cases, write-downs of senior bank debt are necessary and to begin preparations for potential Euro area sovereign defaults that would involve restructuring of existing debt. Well-managed and orderly restructurings can be achieved without endangering financial stability. In contrast, the current path of policy risks another round of financial crises.
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