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Bank and Sovereign Debt Resolution: 'Never Again' Meets 'Not Yet'

Briefing Note

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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AUTHOR

Karl WHELAN
University College Dublin

RESPONSIBLE ADMINISTRATOR

Doris KOLASSA
Policy Department Economic and Scientific Policies
European Parliament
B-1047 Brussels
E-mail: poldep-economy-science@europarl.europa.eu

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ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its monthly newsletter please write to: poldep-economy-science@europarl.europa.eu

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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.

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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.[1]

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. 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

[1] 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.

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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.[2]

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.[3] Indeed, this is the classic prescription of how a central bank should

[2] European Commission (2011), http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

[3] 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.

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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.

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.

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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.[4] 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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[4] See www.independent.ie/business/european/bondholders-safe-even-if-opposition-win-election-2454031.html.

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.[5]

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 renege 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.

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

[5] See, for instance, Blundell-Wignal and Slovik (2010).

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Lorenzo Bini-Smaghi, give speeches and interviews declaring that a Greek default is 'not an option.'[6]

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.[7]

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.

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[6] For one example, see www.ft.com/cms/s/0/660edbae-3468-11e0-993f-00144feabdc0.html.
[7] Gianviti et al (2010).

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.[8]

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.

[8] 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.

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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.[9]

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.

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.

[9] 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.

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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

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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.

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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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