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3.1 MARKET IMPACT OF ORDERLY SOVEREIGN DEFAULT

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Abstract

The financial crisis led to a severe economic downturn in Europe, culminating in further sovereign debt problems for many euro area governments. The Greek sovereign debt crisis raises important questions about the adequacy of Europe’s sovereign debt default and restructuring process. The paper examines the market impact of an orderly sovereign default, and what type of orderly default arrangements should be established by the EU to facilitate a more efficient restructuring process. The paper argues for a decentralised approach to sovereign debt restructuring based on collective action clauses which facilitates negotiations between creditors and sovereigns and which is based on harmonised EU principles and guidelines and administered by a EU sovereign debt agency.
1. **Executive Summary**

The global financial crisis has led to a severe recession in Europe culminating in sovereign debt problems for many euro area governments. Greece was particularly hard hit because of fiscal mismanagement and unsustainably high levels of public debt, resulting in an extraordinary and unprecedented bailout by euro area governments and the IMF with the creation of the European Financial Stability Facility. The Greek crisis demonstrates the inadequate macro-economic crisis management framework in the EU and the need to establish a more orderly sovereign debt restructuring process.

Europe presently does not have a legal or formal institutional framework to resolve a sovereign debt default or restructuring. Indeed, the Greek crisis and the growing sovereign debt problems of other EU states raise important questions whether EU policymakers should establish a formalised institutional process across the EU to promote more orderly sovereign debt restructurings. The paper analyses a number of corollary questions about how such a process could work without undermining market discipline, and what powers, if any, should be allocated to EU institutions to oversee sovereign debt restructurings and whether this complies with the EU treaties. It further examines what set of principles should guide policymakers in devising such an institutional framework and whether this could help indebted countries avoid a damaging loss of investor confidence and destabilising market volatility.

In addressing these issues, this paper examines two main areas:

1) the market impact of an orderly sovereign default or restructuring and the efficacy of the newly-created European Financial Stability Facility (EFSF), and

2) what type of orderly sovereign default arrangements should the EU establish for its Member States which experience liquidity or solvency problems.

In evaluating the first question, the paper reviews the proposal for a European Monetary Fund and the operational structure of the EFSF. These approaches intend to remove the risk of disorderly default, which is the main risk that countries in a fiscal crisis pose to financial stability in the euro-area. Although the establishment of the EFSF has brought some stability to European financial markets and has resulted in lower spreads on the sovereign debt of Greece and other vulnerable euro-area states, it is intended to be a short-term measure designed to restore investor confidence in euro area sovereign debt.

The paper will also examine the results of the recent EU bank stress test scenarios overseen by the Committee of European Banking Supervisors (CEBS). The stress tests show that 84 of the 91 EU banks are well-capitalised and moreover do not have excessive exposures to sovereign debt investments.\(^{46}\) In fact, most of EU sovereign debt is held by non-bank institutional investors, both regulated and non-regulated alternative investment funds, meaning that a sovereign default would probably not result in an EU banking crisis because of banks’ relatively low level of exposures to EU sovereign debt, but instead would lead to large losses for pension funds, insurance companies and hedge funds with less likelihood of leading to a systemic financial crisis. The chapter suggests that the real risks for most EU sovereigns derives from their assumption of balance sheet risks from their banking sectors which were incurred by the banks during the boom years preceding the credit crunch and which now threaten the viability of the sovereign finances of several EU states.

\(^{46}\) See discussion in Chapter 2.
The second area examines the weaknesses of the existing institutional framework for sovereign debt default and sets forth some principles and guidelines for reform of the sovereign debt restructuring process.

The paper argues that the EU should adopt a decentralised sovereign debt default and restructuring process that emphasises the use of collective action clauses (CAC) to facilitate negotiations and restructuring creditor claims when a sovereign is experiencing financial difficulties. EU legislation should harmonise the principles and guidelines that govern the operation of CACs, but parties should be permitted some freedom to decide certain CAC repayment terms and some of the parameters of the restructuring process. (3.1) Also, EU institutions should create an EU sovereign debt agency (3.2) that would oversee the application of EU principles and guidelines for Member State sovereign debt negotiations and contract formation and would provide market data on sovereign debt markets to market participants and sovereigns. The EU sovereign debt agency could also administer a European Financial Stability Fund that would be created to provide liquidity to states experiencing financial distress if the state in question fulfils the requisite conditions for obtaining support. The Fund would be financed by a small transaction tax on all sovereign bond trading and derivative instruments. (3.2)
2. The Greek crisis and the sovereign debt problem

The Greek crisis

The problems arising from the Greek sovereign debt crisis raise important issues regarding how the EU and the euro area institutions should assist Member States which are experiencing liquidity and/or solvency problems. The EU lacks a fiscal policy dimension to assist states experiencing financial difficulties in crisis situations. Indeed, Article 125 of the Lisbon Treaty (TFEU) prohibits EU institutions from bailing out EU states experiencing fiscal problems. Article 122 TFEU, however, provides the legal basis for EU institutional and Member State support, as it calls for political and financial solidarity with Member States that are in severe difficulties. Paragraph 2 of Article 122 authorises the Council to grant financial assistance from the Union to a Member State if the state in question is in, or seriously threatened with, severe difficulties caused by natural disasters or ‘exceptional occurrences beyond its control’. Although a state facing serious budgetary constraints and financing problems would certainly not qualify for the natural disaster exception, it might qualify for the ‘exceptional occurrences beyond its control’ case on the grounds that a self-inflicted budgetary limitation in combination with a global financial crisis that caused a substantial reduction in the country’s GDP is an exceptional occurrence beyond its control.

Based on the Treaty provisions, the EU could adopt institutional reforms that provide state guarantees to Member States experiencing serious financial difficulties the causes of which are partly beyond their control. The mismanagement of the Greek economy, exacerbated by the collapse of world trade and hence the collapse of shipping revenues, led to cumulative severe pressures on the bond sales necessary to fund the Greek government deficit. Since Greek government bonds are denominated in euros, investors faced no currency risk. However, they did face increasing fears of default. The reaction in European capitals was to initiate a protracted, indecisive debate on raising the funds for a Greek "bail-out". As vague pronouncements were piled on indecision, the fear of default increased, so that when the €120 billion bail-out was at last agreed, it proved inadequate as a defence against the rising tide of default pessimism. The Greek crisis, along with the recent sovereign debt difficulties of a number of EU states, has defined the shape of necessary institutional and market reforms to be considered in this paper.

Lessons from the Mexican ‘tesobono’ crisis

The confused handling of the Greek crisis stands in stark contrast to the rapid and effective measures taken by the United States Government in the Mexican debt crisis of December 1994, which was very similar in important respects to the Greek crisis. The Mexican government had borrowed billions of dollars of short-term US dollar denominated debt when the economy was growing. When Mexico fell into a severe recession in 1994, it was forced to devalue the peso. This drove up the value of its sovereign bonds or ‘tesobonos’, as they were known. Investors in Mexican government tesobonos faced a complex mixture of currency risk and default risk.

47 Article 125 (1) TFEU excludes the allocation of liability to the Union and the Member States for the commitments of another Member State.
By late 1994, Mexican government finances were collapsing with US$25 billion coming due in a few months while central bank reserves had fallen to less than US$6 billion. In devising a rescue plan, US policymakers and the IMF had not forgotten the Latin American debt crisis of 1982 in which the Mexican government had defaulted on US$80 billion in loans from large – mainly US – banks, creating a contagion that spread rapidly across Latin American countries, causing them to seek emergency refinancing of their US dollar denominated loans from foreign banks. The US government intervened with guarantees for the loans only after defaults led to the near failure of several large US banks: the U.S.’s slow response in providing emergency liquidity support in the form of loan guarantees worsened the crisis and plunged Latin America into a severe recession that stunted its economic development for nearly a decade.

In contrast, during the 1994 Mexican crisis, the Clinton administration, acting with support from the International Monetary Fund, assembled a $50 billion emergency package in a few days, predominantly in the form of guarantees, which stemmed the investor run and rapidly restored confidence. Although the 1994 crisis was smaller than the Latin American crisis of the early 1980s, it could have threatened financial stability throughout Latin America and in other developing countries. Moreover, the growing integration of international trade and financial markets suggests that the negative externalities of financial risk-taking can spread more quickly across borders and threaten global financial stability.

In contrast, if a credible euro area institution had guaranteed Greek bonds at the outset and had imposed adequate fiscal adjustments and facilitated restructuring of bondholder claims, the immediate crisis would probably have been over sooner, at much lower costs. Instead, the euro area’s leading states, Germany and France – dithered and allowed the Greek crisis to worsen considerably. It was not until an emergency meeting of EU finance ministers held on 9 May 2010 where they agreed to adopt an extraordinary rescue package guaranteeing all of Greece’s sovereign bonds and the bonds of other euro area members by establishing an off balance sheet entity which would issue bonds worth up to 660 billion euros (including an IMF 250 billion facility) to banks and other investors which would be fully guaranteed by euro area states. The emergency rescue package essentially bailed out the banks and other creditors who had purchased Greek sovereign debt and it imposed the burden of adjustment almost entirely on the taxpayers of Greece and indirectly on the taxpayers of all euro area states. The Greek rescue package will have the effect of increasing moral hazard for the creditors of EU sovereign states by incentivising them to make more and riskier loans to euro area states with the cost of any adjustment borne by the debtor state and indirectly by European taxpayers.

The confusion and delay in putting together the guarantee fed the flames of volatility and it is now not clear that even this sum will be enough. A more damaging sequence of events would be difficult to imagine, but worse may come. Having at last chosen to follow a sensible guarantee strategy, the euro area governments plan to resuscitate the Stability and Growth Pact. The euro area was and continues to be gripped by deficit hysteria, with all governments being forced to commit to massive cuts in public expenditure. It appears that the path to recovery may be paved with higher unemployment and bankruptcy.

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48 As Alan Greenspan recounts in his autobiography: "Mexico ended up using only a fraction of the credit. The minute confidence was restored, it paid the money back-the United States actually profited $500 million on the deal". Greenspan (2007).
49 The North American Free Trade Agreement had liberalised much of cross-border finance and trade between Mexico and the U.S. with the result that the two economies were increasingly integrated and exposed to the economic and social problems which both experienced.
50 As the Financial Times leader argued on 25th May 2010:
European Monetary Fund

The absence of an EU sovereign debt restructuring framework and sovereign default mechanism has led to a proposal for a European Monetary Fund which could provide financial support to EU states which have already adopted the euro. The proponents of the EMF, such as Daniel Gros and Thomas Mayer, argue that a sovereign default mechanism is necessary for the following reason:

*The strongest negotiating asset of a debtor is always that default cannot be contemplated because it would bring down the entire financial system. This is why it is crucial to create mechanisms to minimise the unavoidable disruption resulting from a default. Market discipline can only be established if default is possible because its costs can be contained.*

The idea of the EMF is premised on the notion that sovereign defaults are good economic policy if a state has assumed unsustainable debt and that an orderly default can be permitted because its costs can be contained. This is an important assumption that drives the EMF proposal. The proposed EMF has been supported by the German Finance Minister and the IMF Managing Director.

The EMF proposal is an important development in the debate over whether to establish a centralised sovereign default support mechanism in the EU. Under the proposal, it would be operated by the euro area states but is open to participation by all EU states if they satisfy the requisite conditions. Serious legal concerns have been raised about whether the EMF can be established through the enhanced cooperation framework of Article 236ff TFEU and whether it violates the no-bailout prohibition of Article 125 TFEU and qualifies for the exceptions in Article 122 TFEU. It is submitted that in addition to the legal concerns, the adoption of the proposed EMF would represent a substantial centralisation of EU institutional authority to provide guarantees to ailing EU sovereign debtors without an adequate market-based framework to encourage or facilitate negotiations between creditors and sovereigns over the restructuring of sovereign debt. Nevertheless, the EMF proposal is under serious consideration by EU policymakers and will continue to play an important role in the debate over a reformed sovereign default mechanism in the EU.

*"growth is a precondition for stability, not something to be traded off against it. Putting countries on the rack of debt deflation will not stabilise their economies, only destabilise their politics".*


52 The mechanics of the EMF proposal are analysed in a compilation of papers published by the European Parliament and will not be discussed further in this paper. For further analysis, see generally *Intereconomics – Forum* (2) pp. 64-95.

53 Dominique Strauss-Kahn, IMF Managing Director, Lecture at King’s College, Cambridge, Institute for the New Economics Teaching (INET) conference, (10 April 2010).

3. Market impact of sovereign debt shocks

EU Bank Stress Tests

The EU Council mandated the Committee of European Bank Supervisors (CEBS) to conduct a second EU-wide bank stress test in July 2010 in cooperation with the European Commission, the ECB, and EU national supervisory authorities. The stress test’s overall objective was to provide policymakers with information to assess the robustness of the EU banking system against adverse economic developments and the ability of individual EU banks to absorb potential shocks to their balance sheets, including sovereign debt risks.

EU regulators announced the results of the stress tests on 23 July 2010 that showed that 84 of the 91 tested EU-based banks did not need additional capital under an adverse or worst-case scenario of a financial crisis. Investor reaction to the stress test results was positive, as bank shares increased sharply and the costs of insuring their bonds against default declined significantly. With only 7 of the tested banks needing capital support under an adverse scenario, the results suggested that EU banks are recovering from the credit crunch and withstanding the economic downturn. It should be emphasized, however, that the results of the stress test exercises do not provide forecasts for the EU and euro area economies, but instead provide ‘what-if’ scenarios with plausible but extreme assumptions which are not likely to occur.

Under the hypothetical adverse scenario which includes a sovereign debt shock, the bank capital ratios of the 91 banks would fall mainly because of credit impairment losses of 472.8 billion euros over a two year period and trading losses of 25.9 billion euros over this period. Moreover, losses associated with a sovereign default involving one or more sovereigns would reach 67.2 billion euros over a two year period, of which 38.9 billion euros would be valuation losses of sovereign exposures arising from the trading book. Total impairments and trading losses under the adverse scenario, including the sovereign debt losses, would be 565.9 billion euros.

Under the adverse scenario which included a sovereign debt shock, the impact on bank capital levels was not severe. To demonstrate this, Appendix A contains a sample of large banks based in six representative EU countries and shows the impact on bank balance sheets of, respectively, credit impairments, trading losses and sovereign debt shocks. The important point for this analysis is that the reduction in bank capital levels because of a sovereign debt shock was small relative to the reduction because of credit impairments and trading losses. For example, under a normal scenario, Deutsche Bank would hold 13.2% tier one regulatory capital, but under an adverse stress testing scenario which excluded a sovereign debt shock it would suffer additional credit impairments and trading losses which reduced its tier one capital to 10.3%. However, if the adverse scenario includes a sovereign debt shock, its tier one capital only falls another 0.6% to 9.7%.

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55 The Council Decision was based on the ECOFIN decision at its 2 December 2009 meeting. See http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111706.pdf. The first EU bank stress tests were conducted in 2009 and were reported to the September 2009 Financial Stability Table of the Economic and Finance Committee of the EU Council (EFC) and then to the October 2009 meeting of the ECOFIN. The EFC then requested CEBS to carry out a second test in 2010 that would assess the overall resilience of the EU banking sector to shocks and the ability of individual banks to absorb shocks on credit and market risks and their dependence on public sector support. See CEBS, ‘Aggregate outcome of the EU wide stress test exercise coordinated by CEBS in cooperation with the ECB’ (23 July 2010) p. 10.
58 See CEBS, above n. 54.
59 Similar results were found for other large, systemically important banks in different EU states. BNP Paribas held tier one capital of 11.4% under normal conditions, which dropped to 9.7% under stressed conditions excluding a
The results of the stress tests for the 91 banks demonstrate that sovereign debt shocks are not a significant source of banking instability in the EU. The 91 EU banks that were stress tested had relatively low exposures to sovereign debt which suggests therefore that any sovereign debt losses arising from default or restructuring would not directly threaten the stability of the banking system.

Nevertheless, it should not be forgotten that financial crises do not have to arise from bank defaults: in the period leading up to the credit crisis in 2007 banks were over-capitalised and it was the loss of liquidity in the wholesale capital markets which caused the securitisation markets to fail. Wholesale capital markets can go into panic mode without a bank failure and when economic fundamentals appear to be sound. Investor behaviour can sometimes be irrational and focus on events that can trigger a crisis but which do not appear to the rational investor to affect the health of the financial system. A sudden loss of investor confidence in sovereign bonds could happen because of what average investor opinion believes average investor opinion to be ad infinitum in a Keynesian sense. Moreover, the impact on market stability of bank exposures to sovereign debt is not the only way that sovereign debt problems can threaten financial stability. In fact, the assumption by sovereigns of banking sector liabilities and assets in the recent crisis, either through direct guarantees of bank liabilities or by taking an ownership interests in banks and/or assuming the risks of their toxic assets, has created another channel whereby financial sector instability and bank fragility can seriously weaken the balance sheets of sovereigns. This has been the case not only for euro area states experiencing financial difficulties such as Greece, Portugal, Spain and Ireland, but also for states such as Germany whose stronger economic growth has been accompanied by surging fiscal deficits arising in part from the assumed liabilities of bailed-out German banks.

If the stressed conditions included a sovereign debt shock, however, the bank's capital only fell another 0.1% to 9.6%. Similar, the results for Barclays plc show that it held tier one capital of 15.8% under normal conditions which fell to 13.9% with credit impairments and trading losses excluding sovereign debt shocks. Its capital level fell only 0.2% from 13.7% to 13.5% with the sovereign debt shock. See Appendix A.

See JM Keynes, The General Theory of Employment, Interest and Money [1935](1964 ed.,) (Harcourt Brace: Orlando) chap. 12, analogising investor decision-making to the British newspaper beauty contests of the 1930s in which readers selected winners based on what average opinion believed average opinion to be and not on whom they actually believed to be, or should be, the winner.

See Munoz and Enrich, above n. 55, C2, providing data on how Irish sovereign bond spreads are growing significantly, in part, because of the government's assumption of liabilities of the largest Irish banks; see also, Boughey, above n. 56, p. 27, providing data on the extent of the Irish government's liabilities and toxic assets assumed from partial nationalisation of the largest Irish banks. Also, the extent to which the German government's deficit has surged in 2010 is due, in part, to its assumption of the liabilities and toxic assets of some large German banks.

See Geoffrey T. Smith, 'German deficit surges despite strong growth', WSJ, (25, Aug. 2010) p. 4, stating and supporting with data from the German Federal Statistics Office, Destatis, '[t]he deficit figures are a stark reminder of the cost of bailing out some German banks after they racked up disastrous losses during the financial crisis.'
The European Financial Stability Facility (EFSF)

The European Financial Stability Facility (EFSF) was approved by Council on 10 May 2010 to provide funding support to euro area states who are in financial difficulties.63 Euro area states (excluding Greece) pledged 440 billion euros to the fund that will be guaranteed by these 15 states according to their respective contributions to the capital of the European Central Bank.64 To enhance its creditworthiness, the fund has a cash reserve of 20% in addition to the amount pledged by each member. It is designed to be a short-term financing arrangement that will last for only three years, after which, the fund will be dissolved if no member has drawn on it.65

The EFSF relies for most of its operational support from the German Debt Office and the European Investment Bank. It is an off balance sheet special purpose vehicle that will issue bonds to the market.66 Before a euro-area member receives assistance, the Eurogroup must ask the IMF, the European Commission, and the European Central Bank to analyse the request of the country seeking assistance. The IMF and the EU institutions can then deliberate before making the final decision to authorise the euro-area finance ministers to approve the EFSF to raise money. At that point, the German Debt Office will work closely with the EIB to issue the bonds as agent for the EFSF.67

Diagram A: The European Financial Stability Facility (EFSF)

![Diagram A: The European Financial Stability Facility (EFSF)](image)

Source: The German Debt Office

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63 Council Regulation No. 9606/2010. See also Decision of the 16 euro area Member States (7 June 2010)(Luxembourg). The EFSF has a basic securitisation structure but with no tranches. Unlike other securitisations, there is no actual exchange of collateral

64 For example, Germany’s pro rata share of the fund is 122.85 billion euros, while France’s share is 92.3 billion euros, and Italy’s has a 81 billion share.

65 The EFSF will close down in three years on 30 June 2013, unless there is a financial operation in which a euro area state draws on the fund, in which case the EFSF’s existence would be prolonged until the last obligation was fully repaid.

66 It is not clear yet whether it will receive a Triple-A rating. The EFSF argues that the Triple-A rating is justified based on the 20% reserve fund it will have in addition to the amounts contributed by each euro area state.

67 The EFSF can guarantee bonds up to 440 billion euros but in actual fact this will be less because the guarantee applies to 120% of the value of the bonds based on the 20% excess cash reserve which is designed to enhance the creditworthiness of the bonds for a Triple-A rating.
Much uncertainty surrounds the fund: little is known about who will buy the bonds it issues, nor how it will operate, or what will happen if more than one country attempts to draw on it.68 The fund has attracted criticism as 'an attempt to resolve the crisis with imaginary money rather than providing real money and having to find it somewhere.'69 Moreover, if several countries seek assistance at once, there is a risk that the fund could be exhausted, but fund proponents argue that this is unlikely because foreign investors are returning to the sovereign debt markets.70 Euro-area states can also use the fund to bail out their banks. The recent problems of August 2010 involving Irish state-owned banks suggest that tapping the fund will be a real possibility for Ireland in the near future.

The creation of the EFSF initially brought some stability to European financial markets and restored some investor confidence in Greek sovereign debt and in the debt of other vulnerable euro area sovereign debtors. EU bank stress test results also had the effect of calming concerns about the health of EU banks by showing that, under certain stress scenarios, EU banks were not inadequately capitalised nor dangerously exposed to a sovereign debt default. Nevertheless, EU financial markets remain fragile: Ireland’s state-owned banks continue to report growing pre-tax losses in August 2010 which has increased the costs of the country’s credit default insurance (CDS) by 36% since 1 August 2010. The renewed troubles with Ireland’s state-owned banks suggest that the newly-created EFSF and the bank stress tests have not sufficiently eased investor concerns about EU financial institutions and by extension have rekindled fears about the solvency of some deeply indebted EU sovereigns, such as Greece, Ireland, Portugal and Italy. These concerns have led financial institutions in these countries to increase significantly their borrowing from the European Central Bank as recently as July and August 2010. Moreover, as part of its emergency programme begun in May at the height of the Greek crisis to purchase euro area sovereign bonds, the ECB announced on 12 August that it would purchase short-dated Irish bonds in an effort to reduce growing volatility in the Irish bond market based on investor concerns that the government will have to continue massive public support for Ireland’s weakened banking sector. These developments suggest that volatility is returning to EU sovereign debt markets and that investor concerns have not been allayed by the much-heralded bank stress tests and the creation of the EFSF.

4. Reforming Sovereign Debt Restructuring in the EU

This chapter argues that a reformed institutional structure at the EU level to oversee sovereign debt restructurings and, in exceptional circumstances, sovereign defaults should be established based on a coherent set of principles that are linked to a new decentralised EU institutional structure with clear lines of responsibility and decision-making to facilitate negotiations between creditors and sovereigns during periods of financial distress. The desirability of a level playing field in the EU internal market suggests that such an approach can be based on a harmonised set of principles and guidelines across EU states that govern the application and operation of this sovereign debt restructuring process.

68 The EFSF is incorporated and domiciled under Luxembourg law and as of July it has 12 employees including Klaus Regling who was appointed as chief executive on 1 July. In an interview with the Financial News (19 July 2010), he stated that the EFSF will obtain Triple-A status in August 2010. He also said that the EFSF had not received any requests for funding by its Member States but that, if it did so, funds could be made available within one month.
70 See comments of EFSF CEO Klaus Regling, citing the Chinese foreign exchange department’s announcement in July 2010 that it would buy more Spanish government bonds. The Financial News, ‘Special purpose vehicle set on rescue mission’, p. 9.
A Decentralised EU Institutional Approach

The recent sovereign debt crisis and ongoing financial turbulence in global and European financial markets demonstrates the need for a more coherent and rational sovereign debt default and restructuring process. Such a process could reduce the uncertainty and thus the moral hazard for states to reach unsustainable debt levels by creating a more predictable sovereign debt restructuring process. A clearer procedural framework and set of principles applicable throughout Europe would lead to improved and more timely sovereign debt management decisions, thus reducing the likelihood of crises occurring and mitigating the associated costs. The aim for creating a more orderly sovereign debt restructuring process in Europe would be to increase the incentives that sovereigns have to pay their debts in full and on time. This will allow sovereigns to have continued access to capital at reasonable interest rates. To achieve this, a clearer EU legal and institutional framework should be established to reduce the uncertainty that now surrounds sovereign defaults and restructurings.

Recent proposals as discussed above for a European Monetary Fund or the creation of a new EU agency with powers to arbitrate and resolve sovereign debt disputes would probably require amending the EU Treaty, which may not be a feasible political proposition at present. Instead, this section suggests that EU policymakers should consider the following principles and rules to provide more certainty to sovereign debt risk management for both sovereigns and investors. These would not necessitate Treaty changes, but would be feasible within the existing legislative instruments.

Collective Action Clauses (CACs)

CACs – also known as majority action clauses - allow a super majority of, for example, bondholders holding a particular class of bond contracts to vote to restructure the financial or repayment terms of the bond. The bond contract could provide, for instance, that 75% of creditors – rather than 100% - of a certain creditor class vote to restructure the financial and repayment terms (ie., lower the interest rate or extend the maturity of the debt, respectively). The super-majority’s decision would bind the minority bondholders of the same class, thus preventing a small minority from delaying or otherwise disrupting a restructuring agreement, thereby making the restructuring process more predictable.

First, sovereign debtors and investors should agree henceforth to incorporate CACs into sovereign bond contracts or sovereign loan contracts (ie., bank loans) governed under the law of an EU state. Although investors and sovereigns are increasingly using CACs in their sovereign bond contracts following the Argentine default, significant differences in the structure of these contracts still exist, thus increasing uncertainty regarding the renegotiation of repayment terms and how the overall restructuring process would operate. Sovereign bond contracts issued by EU states should have harmonised legal templates governing their overall structure but would allow the parties to agree on some of the specific repayment terms.

71 See discussion in Häde, 'Legal Evaluation of a European Monetary Fund', above n. 53.
72 The financial terms of the contract would generally include the rate of interest (the coupon rate), the amount of the principal, and related financing terms, while the repayment terms would include the date of periodic payments and the means and place of payment, the loan’s maturity date, and in some cases what amount of interest and principal would be included in each payment.
73 CACs are in all sovereign bonds issued under English law and are increasingly being used under New York law sovereign bond contracts, which by tradition required unanimity or 100% of creditors of the same class to vote to restructure the financial or repayment terms of the bond contract.
Although a growing number of EU sovereign bond contracts contain CACs, the majority does not, which means that for most EU sovereign bond contracts the consent of 100% of the bondholders of a particular class of bonds are necessary to change the repayment terms of the bond.\(^{74}\) As a result, a small minority of bondholders can prevent a restructuring that the majority believe to be in their best interests. Rather, EU directives and regulations should require that all sovereign bond and loan contracts contain majority action clauses, but allowing the parties to agree on certain repayment terms, such as specifying the percentage of creditors holding a certain value of the debt (e.g., 85%, 75% or 65%) to approve a change in payment terms (e.g., lower interest rate). EU law should also require that sovereign bond or loan contracts contain a clause describing the process through which sovereign debtors and creditors negotiate if a restructuring event were to occur. This clause would specify how the creditors would be represented and by whom and on what date, or within what period of time, the debtor must provide financial and other information to the creditors’ representative. The representative would be authorised to act on behalf of the creditors in the negotiations and have discretion to act based on the instructions of creditors with a specified percentage value of claims.\(^ {75}\)

Another important area concerns how the sovereign would initiate a restructuring. EU law could require that this could be provided in a clause describing what period of time — for example, four weeks — for creditors to come together to obtain the relevant information regarding the sovereign’s financial situation, choose a representative, and decide a timeline for the negotiation process.

The notion of a ‘cooling off’ period or automatic stay on creditor action against non-sovereign corporate or individual debtors is already recognised in the insolvency laws of some countries, such as Chapter 11 of the US Bankruptcy Code.\(^ {76}\) The contract would be required to state when the ‘cooling off’ period would begin, for example, the date when the sovereign notifies its creditors that it wants to restructure its payments and/or the date that the creditors appoint their representative. The duration of the cooling off period would be mandated by EU law at, say, 60 or 75 days. During this period, a temporary suspension or deferral of payments would be required and enforced by an EU court of law. EU law should mandate that the bond or loan contract should provide for the possibility of a suspension or deferral of payments and provide for damages or penalties for any creditor who violates the provision by seeking to enforce its claim without prior court approval.

\(^{74}\) See Elmar B. Koch, *Challenges at the Bank for International Settlements: An Economist’s (Re)view*, pp.56-60, stating ‘[t]raditionally, CACs were included in sovereign bonds governed by English, Japanese and Luxembourgian law. Sovereign bonds issued under US, German, Italian and Swiss law did not include CACs’ and thus required unanimous approval by bondholders of a particular class of bonds to change repayment terms. Ibid, pp. 60-65, providing data of the value of sovereign bond issuance with CACs.

\(^{75}\) The specified percentage value of claims would be provided in the repayment terms of the contract. Moreover, the representative, and not individual creditors, would have the authority to initiate litigation for breach of the bond or loan covenants, but only with the approval of creditors with a specified value of claims.

\(^{76}\) Although Chapter 11 of the US Bankruptcy Code does not apply to sovereign debt default or restructuring, Chapter 9 of the US Bankruptcy Code does provide insolvency proceedings and an automatic stay against creditor claims against a municipal or county government debtor while the sovereign debtor is formulating a repayment plan for judicial and creditor approval. While the automatic stay is in effect, secured creditors can petition the court for adequate protection of their collateral rights in eligible property owned or possessed by the debtor. In chapters 9 and 11, the automatic stay can remain in effect for up to a six month period to allow the debtor an opportunity to negotiate with creditors and devise a comprehensive payment plan.
Implementation

The decentralised approach that relies on regulating EU sovereign bond and loan contracts so that they contain CACs is not the only option that has been proposed for reforming the sovereign debt restructuring process. Of course, the IMF staff had proposed an international sovereign debt restructuring mechanism (SDRM) in 2002 that attracted much attention but was not approved because of US opposition. The SDRM would have provided a more centralised approach that would have involved amending the IMF Articles of Agreement in order to create a legally binding arbitration process in which a designated IMF tribunal would have mediated and approved any disputes regarding the restructuring of sovereign debt. The IMF’s SDRM was criticised on the grounds that it was insufficiently market-oriented and required too much centralised authority at the international level by concentrating too much power in the IMF. These same criticisms are perhaps also applicable to recent proposals to create an EU Monetary Fund (1.3) that would provide guarantees on sovereign debt and liquidity assistance for ailing EU sovereign debtors while negotiating creditor claims, or the creation of the EFSF, which also provides liquidity support and issues guarantees for euro area sovereigns having financial difficulties.

On the other hand, one can question the viability of the decentralised approach on the grounds that there are multiple legal systems of contract law in the EU and that this might be difficult to harmonise in order to facilitate sovereign debt negotiations and restructurings. Another question concerns what is the scope of the debt subject to the CACs. In theory, there would be no reasonable justification on economic grounds to restrict the scope of such clauses to bond contracts. For instance, Taylor (2002, 4) observes that ‘[i]t would be appropriate, for example, to include such clauses in bank debt along with bonded debt’. It is observed that such clauses are already incorporated in many syndicated bank loans. Another question concerns whether during a restructuring all the claims of different bond issues should be consolidated into a single class of creditors or, alternatively, whether all the claims of bondholders should be consolidated with the claims of other creditors (ie., bank loans). Market-based practitioners appear to prefer an approach that consolidates the CACs and other clauses into debt on an issue-by-issue or loan-by-loan basis.

Any inconsistency in legal terms or requirements created by different types of issues or jurisdictions should be resolved by arbitration provided in the contracts or by an EU agency established (as discussed below) to apply the EU principles and guidelines governing sovereign debt restructuring.

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Finally, the EU must have the institutional capacity to monitor the implementation of such debt contracts to ensure that vital data is communicated to creditors and debtors and that the parties negotiate terms and conditions with full access to relevant information. An EU sovereign debt agency could be created by regulation to exercise such a function and would have authority to collect data and perform surveillance of sovereign debt markets and report market developments to the European Commission, Parliament, and market participants. The responsibilities of a EU sovereign debt agency could include overseeing EU Member State sovereign debt practices and providing data to the market regarding the risks that certain bond and loan contracts pose and to make recommendations and, if necessary, ‘name and shame’ states which appear to be developing unsustainable debt positions.

The agency could also exchange information with the ECB, the European Supervisory Authorities, and the European Systemic Risk Board regarding financial stability issues in the sovereign debt markets. Moreover, it would clarify the process how market participants could enforce their rights and obligations under the debt contracts in a court of law of an EU state, especially to ensure that any restructuring process is occurring according to contractual requirements.

**EU Financial Stability Fund**

The proposed EU sovereign debt agency with responsibility for overseeing the implementation of the CAC approach to sovereign debt restructuring based on harmonised EU principles and guidelines could also administer the establishment of a EU ‘stability’ fund to which EU states experiencing short-term funding problems would have access for short-term funding during financial distress and crises until they regain access to capital markets. The EU ‘financial stability’ fund would be paid for by a small transaction tax on all sovereign bond sales. The tax could be imposed at a very low level – ten basis points/0.10%, or five basis points/0.05% - so as not to distort significantly the sovereign bond market and it would be easily implemented by requiring the intermediary banks who execute the transactions to deduct the tax at the point of purchase and sale and pay on to national treasuries who would then have an obligation to pay the sums into the fund. The tax could also apply to sovereign debt derivative instruments (ie., sovereign credit default swaps) or other instruments which use sovereign debt as a referenced asset. The tax would apply uniformly to all EU sovereign bond issuance and could even be extended to include a tax on bank loans to EU governments. The tax could provide a sustainable source of finance to assist EU sovereigns experiencing sovereign liquidity problems and help assist the implementation of any restructuring plans. In return for accessing the fund, states would be required to implement appropriate fiscal adjustments in order to bring their sovereign debt to sustainable levels over the medium term.

If instead the country is not merely illiquid, but insolvent, more drastic measures should be taken and the EU stability fund would continue to be available, but needs to be supplemented by a mechanism for determining collective guarantees. These should be offered on the basis of strict conditionality, in which the state in question may be required to undertake significant structural reforms to, for example, the fiscal system, the structure of macro-economic management, or the labour market. Short-term austerity measures may be a necessary component of a rescue package.


80 This means that EU authorities should adopt criteria for determining whether a state is either illiquid or insolvent; or, if it is illiquid, at what point does it become insolvent?.

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But their impact should always be assessed against the needs of medium term recovery. This also means that the rules of the Growth and Stability Pact that have so conspicuously failed should be reconsidered and possibly replaced.

The approach suggested above would involve a major re-think of the political economy of the EU in general and the euro area in particular. It would require a significant change of direction in fiscal policy, including a harmonised EU framework consisting of principles and guidelines to govern the restructuring and default of a sovereign debtor. The absence of an EU regime governing the restructuring of sovereign debt has resulted in an under-pricing of the true costs of sovereign debt, as it creates a moral hazard for investors to take on too much sovereign debt because they perceive that euro-area states in particular will always bail them out to prevent a collapse of the euro area. This has led to an under-pricing of sovereign debt which means that the full cost of sovereign debt has not been internalised by those who invest in it, thereby resulting in too much of it being issued. Moreover, investors would be able to price sovereign debt more efficiently if they had more certainty regarding the rules of debt renegotiation and the ability to coordinate their claims collectively with other creditors in a crisis and to obtain relevant information from sovereigns. Whether such an EU agency could be constructed to facilitate such negotiations and generate relevant information for creditors is a policy matter and legal issue that is beyond the scope of this brief study.
5. Conclusion

This paper argues that any institutional or legal reform for a more orderly EU sovereign debt default process should not be further centralised in EU institutions but rather should be based on a set of harmonised principles enshrined in EU legislation (3.1) and implemented by EU states with verification of implementation confirmed by an EU sovereign debt agency (3.2).

Although EU bank stress tests reported in July 2010 calmed concerns about the health of EU banks by showing generally that EU banks were not inadequately capitalised nor dangerously exposed to sovereign debt, EU financial markets remain fragile. The renewed troubles with Ireland’s state-owned banks and Greece’s persistent sovereign debt problems suggest that the results of the stress tests have not sufficiently eased investor concerns about EU financial institutions and by extension have rekindled fears about the solvency of some deeply indebted EU sovereigns, especially Greece, Ireland, Portugal and Italy. (2.1)

These developments suggest that volatility is returning to EU sovereign debt markets and that EU policymakers should consider whether Europe needs a formal EU sovereign default process to incentivise states to manage more effectively their sovereign debt and to promote a more orderly resolution of creditors’ claims. This paper examined a number of options, including the newly-created European Financial Stability Facility (2.2), and suggests that European policymakers should focus reform efforts on adopting a decentralised sovereign debt restructuring process that emphasises the use of collective action clauses to facilitate negotiations and information flow between creditors and sovereigns regarding sovereign debt risks. EU directives and regulations, not necessitating Treaty changes, should harmonise the principles and guidelines that govern the operation of CACs, but parties should be permitted some freedom to decide the parameters of CAC negotiations and some aspects of the restructuring process. (3.1)

An EU sovereign debt agency should be created to facilitate such negotiations and to serve as an information warehouse for creditors and sovereigns to obtain data on market developments relevant to the pricing of sovereign debt risk. (3.2) The EU sovereign debt agency could also administer a European Financial Stability Fund that would be created to provide liquidity to states experiencing financial distress and undergoing a restructuring if the state in question fulfils the requisite conditions for obtaining support. (3.2) The EU Financial Stability Fund would be financed by a transaction tax on all EU sovereign bond issuance, credit default swaps and other derivative transactions that reference EU sovereign bonds. The tax would be at a very low rate so as not unduly to limit the market and to raise adequate revenue to assist states with temporary liquidity problems.
6. References

- Auerback, R.M. ‘Sovereign default and restructuring of debts owed to private creditors’, Journal of International Banking Law and Regulation.’
- Committee of European Bank Supervisors, ‘Aggregate outcome of the EU wide stress test exercise coordinated by CEBS in cooperation with the ECB’ (23 July 2010), London.
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7. Annex A – Selected results of EU stress tests

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>France</th>
<th>Italy</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DEUTSCHE BANK AG</td>
<td>BNP SOCIETE</td>
<td>INTESA SANPAOLO</td>
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<tr>
<td></td>
<td>HYPO REAL ESTATE</td>
<td>GENERALE UNICREDIT</td>
<td></td>
</tr>
<tr>
<td></td>
<td>HOLDING AG</td>
<td></td>
<td></td>
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<tr>
<td>Total Tier 1 Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>after Benchmark</td>
<td>41527</td>
<td>71769</td>
<td>45918</td>
</tr>
<tr>
<td>(mln Euros for all</td>
<td>6211</td>
<td>39415</td>
<td>33934</td>
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<tr>
<td>except the UK)</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Total Tier 1 Ratio</td>
<td>13.2%</td>
<td>11.4%</td>
<td>10.0%</td>
</tr>
<tr>
<td>after Benchmark (%)</td>
<td>7.8%</td>
<td>11.9%</td>
<td>9.8%</td>
</tr>
<tr>
<td>Total Tier 1 Capital</td>
<td>38987</td>
<td>66932</td>
<td>38334</td>
</tr>
<tr>
<td>after Adverse</td>
<td>4898</td>
<td>36520</td>
<td>33326</td>
</tr>
<tr>
<td>Total Tier 1 Ratio</td>
<td>10.3%</td>
<td>9.7%</td>
<td>8.1%</td>
</tr>
<tr>
<td>after Adverse (%)</td>
<td>5.3%</td>
<td>10.2%</td>
<td>8.8%</td>
</tr>
<tr>
<td>Total Tier 1 Ratio</td>
<td>9.7%</td>
<td>9.6%</td>
<td>7.8%</td>
</tr>
<tr>
<td>after Adverse+Sovereign (%)</td>
<td>4.7%</td>
<td>10.0%</td>
<td>8.2%</td>
</tr>
<tr>
<td>-Additional Impairment losses</td>
<td>-411</td>
<td>-988</td>
<td>-1200</td>
</tr>
<tr>
<td>-Additional losses on sovereign exposures in the trading book</td>
<td>-362</td>
<td>-576</td>
<td>-928</td>
</tr>
</tbody>
</table>

Source: CEBS (http://www.c-ebs.org/EuWideStressTesting.aspx)