

Insolvency Procedures and Market Discipline for Banks and Euro Area Countries

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The role of market discipline

The global financial crisis triggered by the subprime mortgage debacle in the US has led to a large number of proposals for reform of financial regulation. Most of the proposals have in common a presumption that the crisis was evidence that markets cannot be relied upon to exert discipline on risk taking of banks and other financial institutions. In order to remedy assumed imperfections in financial markets more intrusive regulation and supervision of the financial sector has been advocated.

Since its first statement in 1998 the European Shadow Financial Regulatory Committee (ESFRC) has been stressing the role of market discipline as a pillar for a safe and efficient financial system. We do not agree that the recent crisis justifies a weakening of the reliance on market discipline but argue that the large market failures that occurred in the run up to the crisis were caused to a substantial extent by an inappropriate institutional framework that made bail outs of financial institutions inevitable.

The fundamental institutional deficiency of the pre-crisis legal and regulatory framework for European banks was far-reaching implicit protection of banks' unsecured creditors caused by a lack of predictable procedures for allocation of losses of banks in distress. This implicit protection of unsecured creditors (causing so-called moral hazard) has been exacerbated by actions taken by EU governments during the crisis.

The lack of clear and credible procedures for allocating banks' losses to groups of creditors has compelled governments since the start of the crisis to issue a safety net behind all creditors of banks in order to pre-empt runs that could threaten the stability of the financial system as a whole. The ESFRC has raised this issue in several previous statements and recommended procedures for "Structured Early Intervention and Resolution" or "Prompt Corrective Action" in combination with rules for restructuring or closing insolvent banks with a minimum amount of contagion.

Market discipline in the euro area

The lack of ability to deal with distressed financial institutions in Europe has been the main *raison d'être* for the recent massive 750 billion euro European Financial Stability Facility aimed at preventing contagion of the Greek crisis to other EMU countries.

Unless the conditionality associated with the Facility is highly credible, it could weaken the incentives of euro zone governments to exert fiscal discipline.

Until recently, there was widespread perception that all government bonds issued by EMU members were subject to nearly identical risk. The currency union removed differences of inflation as a cause of interest rate differentials. Moreover, the remaining risk difference related to governments reneging on debt servicing was considered negligible until early 2008 when the interest rates on EMU members' government bonds started to diverge. The large deficits created by the stimulus packages in response to the severe recession and by low, sometimes even negative, growth rates have amplified the debt-service problems of some countries and made market participants aware that they may be economically or politically unable to service their debts.

Just like banks are encouraged to shift risk to tax payers when bank debt is guaranteed, EMU governments are encouraged to shift risk to other EU member states when there is a perception that there is an EMU guarantee of individual countries' debt. Market discipline on individual governments' fiscal policies fails when each government is able to "free ride" on the credit rating of EMU governments as a collective.

The ESFRC considers it of utmost importance that market-based incentives on financial institutions to manage risk and on governments to exert fiscal restraint are strengthened. The two incentive problems are actually intertwined since the inability to deal with distressed banks can become a motivation for bailing out governments, as we have recently seen.

The European Council, having taken the major decisions of setting up a substantial macroeconomic adjustment package for Greece and a huge financial safety net for other euro area countries possibly affected by contagion, has recently turned its attention to a future monitoring system that should reduce the risk of future sovereign debt crises within the euro area. So far, the work of the Task Force chaired by the President of the European Council has focused on designing how to monitor fiscal positions and competitiveness indicators in an effort to strengthen the Stability and Growth Pact. The challenge now is to develop a more constructive and timely interaction between policy rules and their monitoring on the one hand, and market discipline on fiscal policies on the other.

Although some governments have argued for "a procedure for orderly state insolvencies," it seems that the Task Force has so far not dealt with this issue. Such procedures could strengthen the incentives for sound fiscal policies by governments and for prudent lending by financial markets to sovereigns. Financial market participants seem to be calling for more guidance on such procedures.

Restructuring sovereign debt

Sovereign debt is different from corporate debt. Creditors of corporations can rely on formal legal procedures for allocation of a corporations' remaining wealth to creditors while creditors of sovereigns face political uncertainty with respect to governments' ability and willingness to service debt. Formal insolvency procedures are helpful in reducing the costs of default by specifying how the residual ownership of corporate

assets is shifted from shareholders to creditors as soon as the value of the firm's assets fall below the value of the firm's liabilities.

In theory, a similar approach could be adopted for sovereign debt in the euro area. Several proposals have been developed for orderly sovereign debt restructuring that would enhance market discipline. Already in 2002, the IMF proposed a formal debt restructuring mechanism for sovereign debt. Many difficulties associated with such a mechanism were pointed out in the debate. As a result, an operational proposal was never implemented.

In the euro area, for lack of appropriate resolution mechanisms, member states are likely to regard the short run consequences of a member state's default as so severe that a bail out will be preferred. Therefore, it is unlikely that creditors will require a risk premium to compensate for anticipated losses on a member state's debt.

In 2010, in the wake of the euro area turmoil, several proposals have emerged with the objective of creating greater predictability with respect to recognition and allocation of losses on sovereign debt. For example, Daniel Gros and Thomas Mayer suggest that a European insurance fund should be created by contributions from individual countries in proportion to their excessive debt and deficit performance. The fund would be used to buy sovereign bonds at a point when a country is considered unable to service its debt. Holders of sovereign debt would have to take a haircut in order to make the potential for losses on sovereign debt credible and predictable.

Furthermore, Jacques Delpla and Jakob von Weizsäcker propose to separate sovereign debt into a safe component ("blue bonds") and a risky component ("red bonds"). The blue bonds would be guaranteed by all euro area member states within a maximum of 60 percent of a country's GDP. The red bonds would have junior status and the losses to bondholders would be determined by "sound procedures for orderly default". An attractive aspect of this proposal is that it offers countries a relatively low interest rate on the safe part of the debt while the countries would have to pay a disciplining risk premium on increases in debt beyond the safe part.

Most recently, four German economists (Clemens Fuest, Wolfgang Franz, Martin Hellwig and Hans-Werner Sinn) published an article proposing that bondholders take a five percent haircut per year from the time a country rescue package is agreed upon until the time the rescue operations are no longer needed. The relatively small haircut per year is motivated by a concern with panic in the market for the country's bonds. Correspondingly, the ex ante contribution to market discipline is relatively limited. This disadvantage is compensated for by other proposed measures such as a major strengthening of the Stability and Growth Pact.

While we recognize that these proposals all have considerable merit we think that, in the spirit of the "blue bond-red bond" proposal, a more effective and simple approach to the creation of market discipline for sovereigns in the euro area is feasible. Specifically, it may be sufficient to include an explicit contractual covenant that the issuing country has the right not to service its sovereign debt above a certain debt-GDP ratio (the "red bond" tranche) to provide incentives for holders of sovereign debt to exercise monitoring and demand a risk premium. In order to make it unlikely that the issuing

country will renege on its “red bond” debt, it is essential that the “blue bond” ceiling for the country could be lowered.

There are several reasons for making this right not to service debt explicit. First, having the option of non-payment spelled out in the contract would facilitate its exercise by preventing litigation and avoiding investor loss of confidence about the binding character of contracts. Second, the presence of explicit contractual covenants would allow “gatekeepers” such as auditors, credit rating agencies or supervisory authorities to require creditors to mark their sovereign debt holding to “fair value”, which in turn would increase creditors’ monitoring incentives. Third, explicit contractual covenants would reduce the backlash of foreign public opinion towards indebted states, should interest not be paid or debt not be repaid, as voters’ anger in this case would become directed at imprudent creditors to a greater extent rather than primarily at the profligate debtor.

Credibility of sovereign and bank insolvency procedures

All the above proposals are intended to enhance market discipline on governments’ fiscal behavior. However, to be credible any mechanism for allocation of losses on sovereign debt requires that financial institutions holding sovereign debt are not in need of government protection. Thus, we return to the issue of credible procedures for resolving distressed financial institutions.

As noted above, and emphasized in previous statements from the ESFRC, credible rules for allocation of banks’ losses to shareholders and creditors must be in place if a no bail out policy is to be credible. These rules must include a system of “Structured Early Intervention” based on trigger points for a leverage ratio, as well as legally mandated procedures for restructuring or closing severely distressed financial institutions. These rules must be designed with the objective of unwinding the distressed institution without severe systemic consequences and without offering a bailout of unsecured creditors and shareholders.