BEARING the LOSSES from BANK and SOVEREIGN DEFAULT

IN THE EUROZONE

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European University Institute

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Financial Institutions Center

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As in the previous years, we would like to thank all the people and institutions that have helped to make the conference and the book possible. Our special thanks go to Tina Horowitz, Christopher Trollen, Elisabetta Spagnoli, the Robert Schuman Centre for Advanced Studies (RSCAS) and the European University Institute. We would also like to thank the Pierre Werner Chair at the RSCAS and the Wharton Financial Institutions Center for financial support.

PREFACE

The European University Institute (EUI) and the Wharton Financial Institutions Center (FIC, Wharton School, University of Pennsylvania) organised a conference entitled "Bearing the Losses from Bank and Sovereign Default in the Eurozone", which was held at the EUI in Florence, Italy, on 24 April 2014. The conference brought together leading economists, lawyers, historians and policy makers to discuss the current economic situation in the Eurozone with particular emphasis on the new regulatory and supervisory architecture in the Eurozone, and loss distribution in the event of default of both banks and sovereigns. The aim was to have an open discussion on these timely and important topics to achieve a better understanding on the future developments of the Eurozone.

The Director of the Robert Schuman Centre for Advanced Studies at the EUI, **Professor Brigid Laffan**, opened the event, which consisted of three panels, a keynote speech and a dinner speech. The first panel, chaired by **Elena Carletti** (EUI), considered the Asset Quality Review in progress within the Eurozone. **Claudia Buch** (Halle Institute) inaugurated the discussion in this panel with an assessment of where the Banking Union stands currently and the issues facing it. **Bart Joosen** (University of Amsterdam) outlined some key legal themes arising out of the AQR to date. **Andrea Resti** (Bocconi University) discussed the supervisory perspective on the stress tests employed by the EBA in previous years and the limitations of risk weighted capital regulation. **Till Schuermann** (Oliver Wyman) gave some insights into the design issues within the AQR. **Thomas Mayer** (Deutsche Bank) broadened the discussion somewhat with a proposal for a safe form of deposit to be employed within the Banking Union.

In the keynote address to the conference, **Miguel Fernández Ordóñez** (former Governor of the Bank of Spain) cast a retrospective look at the crisis and its handling as well as a prospective look at the measures being adopted for the future within the Eurozone and Europe more generally. He emphasised the need to be clear as to the distinction between prophylactic, preventative regulatory and supervisor policy and measures on the one hand, and "exit" policies and measures designed to minimise the costs of crisis and speed up a return to a steady state on the other hand. He stressed the continuing need for vigilance as to both types of measures. He concluded by suggesting that economists and political scientists might usefully consider whether ideas drawn from behavioural economics could explain regulatory behaviour and institutional design in the same way they can explain investor and consumer behaviour.

The speakers participating in the second panel, chaired by **Joanna Gray** (Newcastle University) addressed the related topics of Bail-in, State Aid and Bank Resolution. **Emilos Avgouleas** (Edinburgh University) presented a critical analysis of the advantages and disadvantages of creditor bail-in within the bank resolution regimes of the US and the Europe, arguing that bail-in should not be seen as without problems of its own. **Clemens Kerle** (European Commission) considered the past, present and possible future pattern of burden-sharing under the Commission's State aid framework for aid to banks.

Stefano Miccosi (Assonime) considered in his presentation whether or not the bail-in provisions in state aid and resolution procedures are consistent with the objective of financial system stability. Finally, **Huw Pill** (Goldman Sachs) took a private sector, markets oriented perspective on what he saw as the three main challenges facing the Banking Union at present.

The final panel, chaired by **Erik Nielsen** (Unicredit), returned to the ever present theme in any discussion within the Eurozone of sovereign defaults and banking crises. **Mitu Gulati** (Duke University Law School) highlighted the prevalence of contingent sovereign guarantees within the Euro area and argued that restructuring these contingent liabilities in the future may prove challenging. **Kris James Mitchener** (Warwick University) took a longer view of the "diabolic loop" linking sovereign debt and banking crises asking what lessons can be drawn from these historical precedents of crisis and contagion. **Tolek Petch** (Slaughter & May) applied a legal practitioner's view to the creditor perspective on renegotiating sovereign debt in unchartered legal territory. Finally **Jeromin Zettelmeyer** (German Federal Ministry of the Economy) discussed the need to create a European sovereign debt restructuring regime as a complement to the ESM and the banking union, and put forth several proposals as to how design it.

At dinner **Richard Portes** (London Business School) introduced **Tony Barber** (Financial Times) who argued that uncertainty has been an ever present accompaniment to Europe and the crisis has shown the need to learn to live with and thrive in the face of uncertainty. He urged European policymakers and intellectuals to resist the lure of dogma and fixed orthodoxy, arguing that declining public trust in Europe showed the need to act with humility and imagination in the face of an uncertain future.

The conference follows a 2013 conference "Political, Fiscal and Banking Union in the Eurozone", a 2012 conference, "Governance for the Eurozone: Integration or Disintegration" and that of 2011, "Life in the Eurozone With or Without Sovereign Default." As with all three of those previous conferences, the debate after each panel and guest speakers was lively and thoughtful. We prefer not to take a stance here on any of the issues but simply present all the papers presented and let the reader draw his or her own conclusions. Our hope is once again that this book will contribute to making one step further in finding the right solutions to preserve the achievements that the Eurozone has reached so far.

The e-book (as well as those for the previous events) is available for free download at the following links:

http://www.eui.eu/Projects/PierreWernerChair/Publications.aspx

http://finance.wharton.upenn.edu/FIC/FICPress/bearing.pdf

Franklin Allen, Elena Carletti and Joanna Gray

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Opening Remarks by Brigid Laffan

The Robert Schuman Centre for Advanced Studies is very pleased to host the conference on *Bearing the Losses from Bank and Sovereign Default in the Eurozone* and I congratulate the co-organisers Professors Franklin Allen, Elena Carletti and Joanna Gray for their initiative and putting together such an impressive programme on this very important topic. The crisis in the Eurozone has severely tested the political, economic and policy capacity of the EU and its euro member states. It brought the design faults of the Maastricht Treaty sharply into focus and created a major cleavage within the Eurozone between creditor states and those with troubled economies, the debtor states. The development of a single currency, which centralised monetary policy, and the continuing decentralisation of financial supervision proved to be a serious fault-line in the Eurozone. Banks and sovereigns became linked in a 'doom loop' with serious economic, social and political consequences. The Eurozone crisis impacted more seriously on some countries than others which meant that it was very difficult for the member states to agree responses to the crisis. From spring 2010, the Eurozone struggled to contain the crisis, particularly the potential for contagion while at the same time developing new policy instruments and rules to ensure that Eurozone governance was more robust. The question of 'Bearing the losses' was central to the crisis from the beginning. Should the losses be paid by the private or public sectors and if public, which taxpayers? Europe's tax payers incurred enormous costs in supporting fragile banking systems and Europe's creditor states risked sizeable amounts in prevent sovereign default in the most troubled euro states. For these reasons, a Banking Union was identified as the most important building block for a more sustainable Eurozone. The Banking Union represents a major centralisation (federalisation) of banking supervision with the ECB emerging as a Single Supervisory Authority (SSA). A bank resolution mechanism was the necessary accompanying measure to the centralisation of supervision. As the new system is transformed from paper into a living system, it is very important that the academy provides rigorous theoretical and analytical frameworks in addition to engaging in empirical research on the evolving system. The EUI is committed to research and policy discussion on this important subject. Again I thank the conference organisers for their initiative.

Brigid Laffan

Director
Robert Schuman Centre for Advanced Studies

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Bearing the Losses from Bank and Sovereign Default in the Eurozone[1]

Claudia M. Buch & Benjamin Weigert

I. Overview

Several years into the crisis on European financial markets, signs of acute stress in the markets have dissipated. Market volatility is low, and (sovereign) bond spreads have narrowed. Yet, the crisis is not over. Policymakers have switched from the mode of acute crisis management to tackling the reforms of Europe's institutional structure. The Banking Union is one important element of this reform agenda. Before starting into the Banking Union with European supervisory and restructuring competencies, the European Central Bank (ECB) is performing a comprehensive assessment of banks' balance sheets.

Currently though, legacies from the past are blocking the way towards the new institutional structure – and towards economic recovery. Given that banks have incentives to roll over bad loans, the necessary structural change is delayed. Also, regulatory privileges for investments of banks into government bonds cannot be withdrawn

1 This short paper summarizes our views put forward in previous publications on the role of the Banking Union in the new institutional structure for Europe. For a detailed discussion on the issues addressed in this paper, see Buch and Weigert (2012), Schmidt and Weigert (2012), and Buch, Körner, and Weigert (2013).

easily. The ECB's comprehensive assessment thus aims at reducing uncertainty about the quality of banks' assets by taking stock of the value of banks' assets, stress testing the portfolios, determining the capital shortfalls, and eventually covering capital shortfalls or restructuring banks. The goal is to deal with legacy assets at the national level and *before* the start of the Banking Union.

The results of the comprehensive assessment of banks' balance sheets will soon be published, and decisions will have to be taken of how to deal with banks that cannot close capital shortfalls disclosed by the stress tests in due time. Complex legal reforms have thus to be completed, and difficult policy decisions will need to be taken on how to deal with the fact that Europe is "overbanked" (ASC 2014).

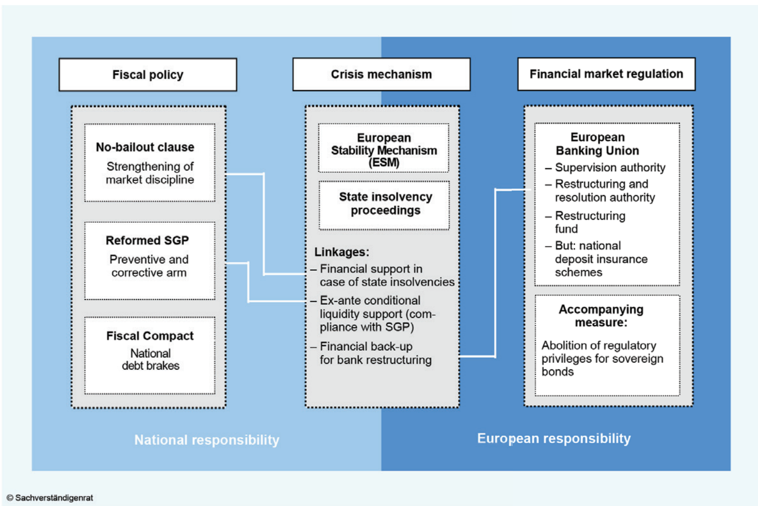
In this paper, we argue that the Banking Union, if properly designed, can be an important step towards enhanced private sector risk sharing in the Euro Area and beyond. We will start our discussion from the concept of the institutional framework of the Euro Area that has been developed by the German Council of Economic Experts (GCEE 2012). We will then sketch the reforms that are necessary to make the Banking Union a success in terms of deepening financial markets in Europe.

II. Reforming Europe's Institutional Structure: Maastricht 2.0

Fixing the shortcomings of the institutional framework for the Euro Area requires following the core principle that liability and control are properly aligned at the same level – either the European or the national level. Liability can be shifted to the European level in an incentive-compatible way only in a full political union with member states giving up most of their sovereignty. Yet, the probability that political union will be on the agenda – and obtain sustained political support – is very small. Therefore, for the foreseeable future, aligning liability and control with national responsibility for fiscal policy, together with improved incentives to adhere to sound fiscal finances is the only sustainable avenue to go.

Based on these principles, the German Council of Economic Experts has proposed a new long-run institutional framework which rests on three pillars (GCEF 2010, 2011; Figure 1): A substantially enhanced Stability and Growth Pact including strict fiscal rules and an insolvency regime for sovereigns, a unified pan-European financial regulation and supervision with a wide range of effective instruments and, finally, a European Crisis Mechanism which is directly linked to the insolvency regime for sovereigns.

Figure 1: Proposal for a Long-term Institutional Structure for the Euro Area

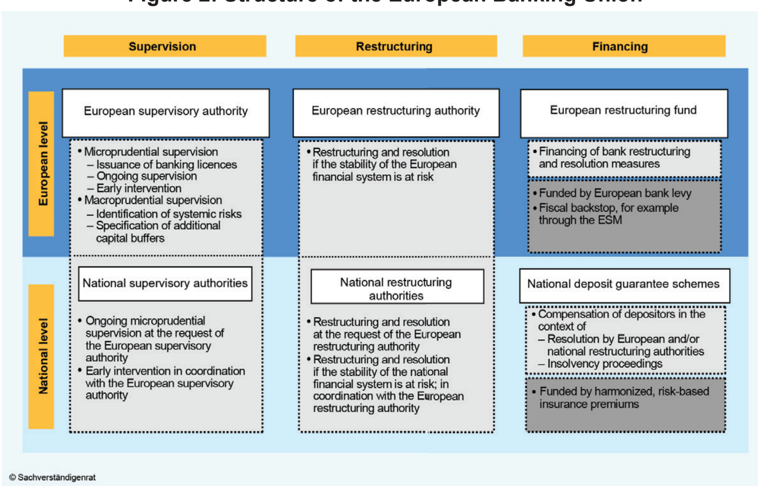


Source: GCEE (2012, figure 41)

The third pillar is the Banking Union – where responsibility will shift from the national to the European level. Assigning responsibility for banking supervision to a European authority is, in fact, a logical complement to monetary union. The problems in Europe's banking sectors and the sovereign debt crisis are not the result of common monetary union per se. But they are the result of regulations which did not contain excessive borrowing, of the ineffectiveness of (national) supervision to contain these risks, together with incentives to shift some of the resulting risks on the central bank's balance sheet. Hence, the principle of aligning liability and control has been violated. Moreover, risks of banks and states have become dangerously intertwined.

These deficits in Europe's institutional structure shall be corrected through the Banking Union which has three elements (President of the European Council, 2012): banking supervision at the European level, a European authority for bank restructuring and resolution financed by a bank resolution fund, and a European deposit insurance fund (Figure 2). An incentive-compatible design of the Banking Union requires coordination between national and European supervisors, while ultimate decision making power would have to rest with the European authorities. In case banks have to be restructured or eventually resolved, financial means have to be available to ensure that orderly resolution is possible. Bank resolution does not necessarily require a European deposit insurance scheme, but national rules and regulations need to be harmonized, and risk-adjusted insurance premia need to be charged.

Figure 2: Structure of the European Banking Union



Source: GCEE (2012, figure 52)

III. Banking Union and Risk Sharing

On their June 2012 summit, the heads of state of the Euro Area have decided upon policy measures towards Banking Union with the aim of breaking the "vicious circle between banks and sovereigns".[2] Since 2012, the elements of the Banking Union have been made more concrete, and legislation has been drafted or already passed:[3] The Single

2 See the concluding statement of the summit of Euro Area heads of state or governments of June 29, 2012.

3 These conditions include direct recapitalizations of banks by the ESM; a common European bank resolution fund (Single Resolution Fund); and further harmonization of deposit guarantee schemes instead of mutualisation.

Supervisory Mechanism as the most advanced pillar will become operational in November 2014; harmonized and centralized competencies in bank resolution have been agreed on; basic conditions for common financing mechanism for bank resolution have been clarified.

The agreement on the Single Supervisory Mechanism (SSM) and on the Single Resolution Mechanism (SRM) constitutes a milestone in European financial integration. Establishing centralized competencies for bank supervision and resolution is a fundamental step away from the original concept of the Single Market where supervision is executed by national authorities (home country control), following harmonized rules (minimum harmonization) and mutual recognition of supervisory decisions.

The Banking Union has often been viewed as the key to increased public sector risk sharing. Given that public finances in many Euro Area countries are strained, national government often lack the means to stabilize distressed banks. Hence, common public backstops could be a way towards increased fiscal risk sharing (de Grauwe, 2013; Goyal et al., 2013). Yet, this argument overlooks that banks in Europe are currently still burdened with significant legacies from the past. Providing a common public backstop would thus de facto imply that these legacies assets are not dealt with under national responsibility. Incentives would thus not be aligned as risks, which have materialized under national responsibility, could be mutualized.

Instead, the Banking Union should be regarded as the key to more private risk sharing.[4] The Banking Union can provide an effective mechanism for the bail in of (domestic and international) private creditors and for the allocation of losses according to the creditor hierarchy. In fact, monetary union of otherwise sovereign states may lead to a situation where effective private risk sharing – the distribution of losses across regions and countries – is limited. As indicated by the recent experience in the Euro area, national supervisors were not able to prevent or to limit the build-up of (cross border) risks in the banking sector before the crisis, and they were not able to coor-

4 See Buch, Körner and Weigert (2013) for details.

dinate effectively during the crisis. The ECB, in turn, has stepped in as a provider of liquidity of last resort, but in its assessment of the solvency of banks, it had to rely on national supervisors.

Establishing clear and harmonized rules for the restructuring and resolution of banks can therefore be an important mechanism for possible losses to be borne by domestic and international bank creditors. For such bail in of private creditors of a systemically important bank to be credible, fiscal backstops will have to be available though at the national level. Ideally, in a systemic crisis, national fiscal backstops together with ex-ante (cross-border) burden sharing agreements are needed. In such cases, deviations from strict bail-in rules might be warranted for reasons of financial stability. As with any public guarantee or back-up facility, clear rules with high hurdles to limit potential moral hazard are needed.

Fiscal backstops thus make the bail-in approach more credible and strengthen the channels of private risk sharing. Consequently, in this setting, financial backstops – common resolution fund and national fiscal backstop – are the last rather than the first resort and are not elements of increased fiscal risk sharing.

To show the potential importance of private channel of risk sharing, consider the following results of empirical studies for existing monetary unions. Estimates of the combined contribution of financial markets (capital market and credit market) to inter-regional risk sharing in the US, Germany, Canada and Sweden are 62% (Asdrubali et al., 1996), 36% until 1994 and 68% after 1995 (Hepp and von Hagen, 2013), 53 % (Balli et al., 2012) and at least 59% (Andersson, 2008), respectively. Moreover, these studies show that there is only a relatively small contribution of fiscal risk sharing to inter-regional risk sharing – 13% in the US, 54% until 1994 and 11,4 % after 1995 in Germany, 27% in Canada and 20% in Sweden.[5] While the exact numbers should certainly be taken with caution, they yet show the potential of risk sharing through financial markets. Integration of credit and equity markets can thus be an important prerequisite to efficient risk sharing in the Euro area (Hoffmann and Sørensen, 2012).

5 See Feld and Osterloh (2013) for a detailled discussion of these studies.

IV. Steps Towards Improved Private Sector Risk Sharing

Banking Union is a comprehensive project which can help paving the way towards deeper integration of financial markets in Europe. Deeper financial integration is often associated with breaking the link between banks and their domestic sovereigns. These links currently make it difficult to introduce clear procedures for dealing with distressed sovereigns and banks. It has also been argued that breaking the bank-sovereign nexus could be achieved only by establishing a large common pool for fiscal resources that can be used to finance the restructuring and potential resolution of banks.

In this short paper, we argue to the contrary that the Banking Union can contribute to enhanced financial integration in Europe not through more public sector risk sharing but through more private sector risk sharing. One of the channels through which this can be achieved is by making creditors accountable for the losses that they assume. Without credible bail in regimes and without applying the creditor hierarchy, ex post risk sharing which is fundamental for the functioning of credit markets will not be achieved.

To achieve these goals, more work is needed though:

With regard to the SSM, establishing the European supervisor under the roof of the ECB has weaknesses. Banking supervision and monetary policy tasks are not sufficiently separated because decisions on supervisory issues are ultimately taken by the ECB Governing Council. This gives rise to potential conflicts of interest. In addition, competencies are currently split between the ECB and national authorities. This entails the risk of diverging supervisory standards and insufficient supervisory powers at the European level. Finally, non-Euro area member countries cannot be integrated into the SSM in a satisfactory manner.

With regard to the SRM, the current legal framework defined by the European Treaties implies that the governance structure in case of bank resolution is highly complex. In particular in crisis times this makes it less likely that swift action will be taken to restructure an ailing bank when it is most needed. The consequence may be that regulators and policymakers shy away from initiating a restructuring process, thereby potentially aggravating the adverse consequences of banking sector distress for the real economy.

The bail-in mechanism is an integral part of an insolvency procedure that seeks to separate elements of a bank with going concern and those with gone concern. In its current form, this mechanism lacks credibility and predictability though. The restructuring authorities have a high degree of discretion whether to use the bail-in instrument and which claims to exclude from the bail in. To provide a level playing field, differences between Euro area and non-Euro members, and between large and small banks should also be minimized.

Going beyond the narrow realms of Banking Union, there are two additional policy areas that need to be addressed:

The first are additional reforms of the microprudential framework for banks. The Banking Union per se leaves the basic regulatory framework for banks unchanged. Yet, in order for the Banking Union to achieve its goals – breaking the bank-sovereign link and making financial integration in Europe more sustainable –, additional steps are needed. The current regulatory framework has several build-in incentives for banks to invest into government bonds. Government bonds from Euro Area countries carry a zero right weight and are exempt from large exposure rules. This incentivises banks to invest into these assets and has contributed to the increasing exposures in particular of home country bonds.

In addition, most of the regulatory reforms that we have seen in Europe since the outbreak of the crisis affect credit markets. Given that excessive credit creation is typically a trigger for financial crises and given the need to make the banking system more resilient to shocks, this focus of reforms has certainly been warranted. In order for financial markets to provide adequate risk sharing, existing explicit and implicit barriers to the full integration of equity markets should be lowered though.

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Legal Aspects of the ECB Asset Quality Review as part of the Comprehensive Assessment

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1. Introduction

With the adoption of the Single Supervisory Mechanism Regulation[2] (**"SSM Regulation"**) one of the main legal foundations of the single supervisory mechanism (**"SSM"**) was completed, effectively creating the basis for the functioning of the European Central Bank (**"ECB"**) as Europe's single supervisory authority for banks[3] established in the

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2 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJEU, L. 287 of 29 October 2013, p. 63-87.
3 In this contribution I will address the subject matter of supervision by the ECB in the SSM framework referring to the commonly used expression "banks", rather than to the legal correct expression "credit institution". Reference is made to the definition of this expression in article 2, section (3) SSM Regulation that in its turn refers to the definition of "credit institution" in article 4 of the Capital Requirements Regulation (Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJEU L. 176 of 27 June 2013, p. 1-348).

Eurozone. The law makers have chosen to draft the SSM Regulation using strong and resolute language as regards the power and authorities of the ECB. This must be seen in the context of the wish of European politicians to empower the ECB in the strongest possible way to exercise its tasks when supervising the European banks comprised in the SSM. The political debate towards the establishment of the SSM as part of the Banking Union was "quickly settled"[4] to base the transfer of powers and authorities from national competent authorities (**"NCAs"**) to the ECB on article 127, paragraph 6 of the Treaty on the Functioning of the European Union (**"TFEU"**)[5].

With this decision, further challenges similar to the application of article 122(2) TFEU as regards the establishment of the European Stability Mechanism have been avoided[6]. A closer look at the provision of article 127, paragraph 6 TFEU suggests that the lawmakers did not envisage at the time of adoption of that provision to establish the far-reaching implications for the role of the ECB in banking supervision. But a discussion on the original intentions of the lawmakers adopting the TFEU provision is, after the adoption of the SSM Regulation, a discussion after the fact of entry into force

4 Sabine Lautenschläger, 'A banking union for Europe: How is it best constructed?', 17 January 2013, www.bundesbank.de.

5 Rene Rapasi, 'Legal issues of the Single European Supervisory Mechanism', 1 October 2012, The Greens in European Parliament; Howard Davies, 'Europe's Flawed Banking Union', Project Syndicate, 18 October 2012; Douglas J. Elliot, 'Key issues on European Banking; Trade-offs and some recommendations'. Global Economy & Development, Working Paper 52, November 2012, Global Economy and Development at Brookings. See for a critical comment: Bundesbank, 'Financial Stability Review 2012', p. 82, http://www.bundesbank.de.

6 See for some contributions to that debate: Bruno de Witte, 'The European Treaty Amendment for the Creation of a Financial Stability Mechanism', European Policy Analysis, Swedish Institute for European Policy Studies European Policy Analysis 2011:6, page 1, www.sieps.se; Antonis Antonadis, 'Debt Crisis as a Global Emergency: The European Economic Constitution and other Greek Fables', (September 1, 2010) in: The European Union and Global Emergencies: a Law and Policy Analysis, Antonis Antoniadis, Robert Schütze, Eleanor Spaventa, eds., Hart Publishing, 2011; Steve Peers, 'Future EU Treaty Reform? Economic Governance and Democratic Accountability', Statewatch ISSN 1756-851X; Boris Ryvkin, 'Saving the Euro: Tensions with European Treaty Law in the European Union's Efforts to Protect the Common Currency', 45 Cornell Int'l L.J. 227 (2012), p. 228-255.

of strong secondary Union law. This regulation undoubtedly forms a solid legal basis for the powers and authorities of the ECB fulfilling its role in the SSM[7]. This does not mean that article 127, paragraph 6 TFEU provides for a comprehensive regulation of all the necessary points needed for the long term institutional organisation of the SSM, particularly if such mechanism would need to be expanded beyond the territories of the Eurozone member states.

The current view is that this treaty provision may need to be amended for a number of reasons. The most important reason being the fact that article 127, paragraph 6 TFEU must be placed in the framework of the role of the ECB for matters concerning the European Monetary Union. The treaty provision falls short of providing sufficiently broad scope to include non-euro area member states of the EU desiring to opt-in for the SSM for banks established in their jurisdiction. Article 127 TFEU also lacks a sound basis for the organisation of the authority of (other) European agencies (not being the ECB) in the context of the other building blocks of the Banking Union (particularly the SSM). It is with a view to these (among other) desirable

7 G. Zavvos, 'Towards a European Banking Union', New York, 18 April 2013, 22nd Annual Hyman P. Minsky Conference, Levy Economics Institute Bard College, noted the following: "The EU's choice to designate the ECB as the European Banking Supervisor was heavily influenced by institutional and legal considerations. Article 127(6) TFEU provides that the Council may unanimously confer specific tasks upon the ECB concerning policies for the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings. The setting up of an agency based on Article 114 TFEU would have been more complex as agencies cannot have discretionary powers according to the Court of Justice of the EU ("CJEU") case-law that are essential for supervision." See further: IMF Staff Discussion Note, 'A Banking Union for the Euro Area', Rishi Goyal, Petya Koeva Brooks, Mahmood Pradhan, Thierry Tressel, Giovanni Dell'Ariccia, Ross Leckow, Ceyla Pazarbasioglu, and an IMF Staff team, February 2013, SDN/13/01, pages 47 and further and Nicolas Véron, 'A realistic bridge towards European Banking Union', Bruegel Policy Contribution, Issue 2013/09, June 2013, Jan Pieter Krahnen, 'Banking Union in the Eurozone? A panel contribution', in: Political, Fiscal and Banking Union in the Eurozone? edited by Franklin Allen, Elena Carletti and Joanna Gray, European University Institute Florence, Italy and Wharton Financial Institutions Center University of Pennsylvania, Philadelphia, USA, Published by FIC Press Wharton Financial Institutions Center, 2013, pages 29 and further and Diego Valiante, 'Framing Banking Union in the Euro Area, Some empirical evidence', CEPS Working Document, No. 388/ February 2014.

changes that the European Commission recommended, in late 2012, amending the treaty provisions in the future[8].

2. Emergency law during the sovereign debt crisis

As the sovereign debt crisis further developed in Europe in the autumn of 2011, European lawmakers where required to address the impact bank failures could have on the deteriorating financial position of certain member states. The agreed upon strengthening of the resilience of banks by increasing the capital base as followed from the Basel III accord[9], was to be introduced at a quicker pace than followed from the ordinary law making process to implement Basel III in Europe. The initial proposals for the CRD IV legislation package were only published a few months before the sovereign debt crisis spun off. The debate on that comprehensive CRD IV proposal of the European Commission was only in an early stage. At the same time, it became clear that banks in the Eurozone (and in other parts of the European Union) faced significant constraints as regards certain sovereign debt positions.

With the introduction in late 2011 of the measures imposed by the European Banking Authority (**"EBA"**) for 70 larger banks in certain member states of the European Union in October 2011, Europe took the step to introduce emergency law circumventing the ordinary legislation processes based on the TFEU. The measures aimed at introducing a "temporary capital buffer against sovereign debt exposures to reflect the market prices" in the midst of the sovereign debt crisis[10]. This measure in the form of a "Methodological Note" clearly qualifies as "emergency law" in all respects. Nowhere in the documentation issued by the EBA to introduce the temporary capital buffer could

8 European Commission Communication, 'A blueprint for a deep and genuine economic and monetary union; Launching a European Debate', 30 November 2012, COM (2012) 777 final/2 (Corrigendum replacing COM (2012) 777 of 28 November 2012).

9 Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems', December 2010 (rev June 2011) www.bis.org.

10 European Banking Authority, 'Capital buffers for addressing market concerns over sovereign exposures; Methodological Note', 26 October 2011, www.eba.europa.eu.

one find references to the legal basis of this measure. The mandate of the EBA as set out in the EBA-Regulation[11] hardly provides for a basis for introducing these direct binding measures on the institutions concerned. The scope of application of the measure to the 70 banks listed in the Annex to the Methodological Note raises questions as to the selection of the group of banks concerned; the group consists of a combination —*bien étonnés de se trouver ensemble*— of larger banks in Eurozone and a non-Eurozone state, but certainly does not represent the group of the largest banks in Europe.

The EBA also had to address the qualitative and quantitative definition of regulatory capital that should be held as temporary capital buffer. Pursuant to the Capital Requirements Directive[12] (**"CRD"**) applicable at the time of the issue of the Methodological Note, neither the desired qualitative elements of bank capital to make it fully eligible as, what we now call "Core Equity Tier 1 capital" (**"CET1"**), nor the severe quantitative measure of 9% CET1 imposed on the 70 banks formed part of the applicable legislative provisions.

Moreover, new rules had to be developed to address the impact of investments in sovereign debt by the banks concerned, and which constituted the main objective for the introduction of this emergency measure. New calculation formulae have been introduced removing prudential filter effects of the available-to-sale portfolio of EEA-sovereign debt and introducing a new valuation technique for the held-to-maturity portfolio of the same asset category. These far-reaching measures set aside the common rules of CRD where sovereign debt issued by EEA-member states had no significant risk weighting measure at all in the standardised approach. For Internal Rating Based-

11 Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, OJ L 331, 15 December 2010, p. 12–47 as amended by Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013, OJ L. 287 of 29 October 2013, p. 5-14.

12 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (Text with EEA relevance), OJ L. 277 of 30 June 2006, p. 1-200.

banks, the own bespoke models could, in theory, address the risk weighting of sovereign debt exposures, but little information is available as to whether or not IRB-banks actually organised such capital measures for sovereign debt. In any event, the Methodological Note required all banks to introduce risk weighting of EEA-sovereign debt, no matter which approach was followed to address credit or market risks.

The Methodological Note contains many parts that suggest an improvisation act of the EBA, referring partly to existing laws and partly to laws that had yet to be adopted at the time of publication of the Methodological Note. But it also contains certain concepts (particularly as regards the computation of exposures in sovereign debt positions) that, at a later stage of development of the formal legislation package for banks, are not reiterated. The political discussion on risk weighting of sovereign debt moved to another direction and final positions as to this subject matter are yet to be developed.

EBA was required to sail between Scylla and Charybdis when introducing this extraordinary measure. It is a clear example of the very particular difficulties for exercising uniform and coordinated banking supervision in Europe in a time where the institutional framework for the Banking Union was not in place yet. European authorities had to find specific solutions to manage the crisis in the markets.

3. ECB Mandate in the SSM Regulation

As noted in the introductory paragraph, the SSM Regulation forms the solid basis for the mandate of the ECB to exercise its role in the SSM. For obvious reasons, the ECB must apply a careful weighting of all its actions based on the mandate provided for in the SSM Regulation. The ECB will not become an effective supervisory authority, if the measures imposed on banks subject to its supervision would be subject to challenges from the outset. The reputational risks that may originate from such challenges to the legal foundation of ECB actions would be every bit as detrimental as in the case where the ECB would be considered responsible for supervision of a bank that, notwithstanding such supervision, would fail and would be made subject to intervention beyond the control of the ECB. In order to manage the latter, the supervision of ECB within the organisation of the Banking Union will only commence, after the performance of the comprehensive assessment. This assessment aims at setting the clock back at zero with respect to the approximately 130 banks comprised in the group in respect of which the ECB will perform direct supervision. In my address held at the conference of 25 April 2014, I have highlighted some of the legal aspects of a part of this Comprehensive Assessment, being the legal framework for the Asset Quality Review (**"AQR"**).

The AQR conducted from late 2013 concerns the selected banks that, most likely, will become subject to direct supervision by the ECB. This exercise intends to review the valuation of certain specific assets held by the banks forming part of the review group. It should ensure that once the supervision of the ECB commences in November 2014, no material re-assessments of asset values would need to take place, requiring an immediate and abrupt recapitalisation of the bank concerned. The organisation of this due diligence of gargantuan proportions is based on specific provisions of the SSM-Regulation providing the ECB with the required mandate.

Although the supervisory tasks of the ECB commence from 4 November 2014, the lawmakers have ensured that the SSM Regulation contains proper provisions to authorise the ECB to conduct the comprehensive assessment of which the AQR forms part. The comprehensive assessment aims to prepare for the exercise of the full authority and powers granted to the ECB in the context of the single supervisory mechanism. The entry into force of the ECB's mandate was the effective date of the SSM-Regulation. It would therefore be incorrect to conclude that ECB's mandate would only have an effective date of 4 November 2014 onwards. The exercise of the authority and powers of the ECB will follow a phased-in approach. There is little explanation to be found on this subject matter in the recitals of the SSM-Regulation, where the only comment is set forth in recital 83:

> *"In order to ensure that credit institutions are subject to supervision of the highest quality, unfettered by other, non-prudential consider-*

ations, and that the negative mutually reinforcing impacts of market developments which concern credit institutions and Member States are addressed in a timely and effective way, the ECB should start carrying out specific supervisory tasks as soon as possible. However, the transfer of supervisory tasks from national supervisors to the ECB requires a certain amount of preparation. Therefore, an appropriate phasing-in period should be provided for."

In further provisions of the SSM Regulation the mechanisms applicable in respect of this phased-in approach are clearer and take away any doubts one could have as regards the authority of the ECB to establish the processes and procedures of the comprehensive assessment, including the AQR.

The most important rule determining the effective date of the powers and authorities of the ECB is article 33 of the SSM Regulation dealing with the transitional provisions. The first sentence of paragraph 2 of this provision determines:

"2. The ECB shall assume the tasks conferred on it by this Regulation on 4 November 2014 subject to the implementation arrangements and measures set out in this paragraph."

This clarifies that the ECB will commence, in principle, the supervisory tasks as provided for in article 4 SSM Regulation from 4 November 2014, subject to the completion of certain procedures. These procedures are listed in the further paragraphs of article 33. Barring a potential recommendation from ECB to delay the commencement date of 4 November 2014 for the single supervisory mechanism, as this is regulated in the article 33, paragraph 2, section 4 SSM Regulation, and barring a potential earlier commencement of the supervision of ECB as regards an individual institution based on the request of the European Stability Mechanism as "a precondition to its recapitalisation" (article 33, paragraph 3, section 2 SSM Regulation), the ECB may not adopt supervisory decisions in respect of any bank before 4 November 2014. This phasing-in of the mandate is, however, without prejudice to the investigative powers conferred to the ECB pursuant to the SSM Regulation (article 33, paragraph 3, section 1 SSM Regulation).

As for the powers and authorities of the ECB (and the NCAs) to conduct the comprehensive assessment, including the AQR, a detailed provision is included in paragraph 4 of article 33 SSM Regulation as follows:

> *"From 3 November 2013, in view of the assumption of its tasks, the ECB may require the national competent authorities and the persons referred to in Article 10(1) to provide all relevant information for the ECB to carry out a comprehensive assessment, including a balance-sheet assessment, of the credit institutions of the participating Member State. The ECB shall carry out such an assessment at least in relation to the credit institutions not covered by Article 6(4). The credit institution and the competent authority shall supply the information requested."*

With this provision, the authority of the ECB to investigate either via the NCAs or directly with the credit institutions (and other entities subjected to the ECB supervision) is regulated. This authority was established with immediate effect and is not following the same postponement of the effective date of 4 November 2014 as outlined in paragraph 2 of article 33 SSM Regulation. This paragraph 4 therefore abridges the period from the entry into force of the SSM Regulation (being 4 November 2013) until 4 November 2014 and is restricted to the power to investigate. There are, however, no restrictions as regards the scope of applicability of the investigative powers as regards the type of the institutions concerned. In other words, it is left to the discretion of the ECB to determine which banks will be subject to the investigations, and therefore to the AQR.

4. AQR; discussion on scope of applicability and AQR Manual

There is some, albeit it not very substantial, evidence that the decisions taken by the ECB in the context of the AQR have been subject to criticism from some of the banks concerned, particularly in France and Germany[13]. In general, the comments made suggested that the institutions concerned disagreed with the selections made as

13 The Economist, 'The asset-quality review; Gentlemen, start your audits', 5 October 2013 and Financial Times, 'ECB to probe €3.7tn of eurozone bank assets', 11 March 2014.

regards the valuation of assets not being valued in a period less than one year. This resulted in an exemption for residential mortgage loan portfolios of German banks, as it was claimed that the stability of the residential property market in Germany did not require revaluation of the assets concerned.

When making the choices as regards the scope of the AQR, the ECB clearly made distinctions based on the macro-economic situation in the Eurozone jurisdictions, thereby incorporating the different stages of recovery of the economies in the various countries. Such choices have not been widely debated thus far and it is unlikely that further debate is to spin off. The AQR exercise is, at the time this address has been held, being conducted at an unprecedented pace and thoroughness and the general view is that the institutions concerned are complying in a loyal way with the requirements stemming from this thorough review.

There is little debate whether the ECB had sufficient powers and authority to establish the framework of the AQR and the decisions taken as regards the selection of the assets being made subject to the quality review. There is also little debate as regards the adoption by the ECB of the soft law instruments that determine the process of the AQR, such as the Asset Quality Review, Phase 2 Manual of March 2014 (**"AQR-Manual"**). This AQR Manual did not follow the process of prior public consultation before it was adopted by the ECB, a routine that has been prescribed by article 6, paragraph 7 SSM Regulation for the Framework Regulation[14] regulating the (working) relationship between the ECB and the NCAs after the direct supervision of the ECB commences on 4 November 2014. The public consultation on the Framework Regulation was broader than the requirements imposed on the ECB pursuant to the SSM Regulation, as consultation on this ECB Regulation was only to be made with the NCAs, not the general public. The consultation ended with 36 submissions from different interest parties, of which only 3 were

14 Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17), OJEU L. 141 of 14 May 2014.

submitted by national supervisory authorities and the rest was submitted by private parties. The way the ECB has conducted this process of public consultation, may be seen as the fulfilment of the aim to carefully build up the role that the ECB will assume in the era that it will become the Eurozone exclusive supervisory authority for the supervision of banks.

For the AQR Manual, as noted here above, there was little time to conduct such consultation and perhaps it can be said that the relevant provisions of the SSM Regulation lack clarity as to the need for organisation of a process of consultation before the AQR Manual was adopted. The exact status of the AQR Manual is also not clear, from an institutional perspective. It is neither shaped in the form of an ECB regulation (for which the ECB has authority based on the TFEU), nor any other form of direct binding (Union) law. It is, if this concept is at all relevant in European administrative law, at best to be seen as a clear example of European "soft law".

5. Closing remarks

As emerged from the debate after the panel presentations on 25 April 2014 in Florence, market participants (particularly the large banks with multiple establishments in Europe), are keen to understand how the single supervisory mechanism will work in practice. From that debate, it seemed that (at least some) internationally operating banks may not necessarily pose the greatest resistance to the transfer of their supervision to a single supervisory authority in Europe. There will be a price to be paid for such institutions, particularly with respect to the overall cost of supervision, as the organisation of the single supervisory mechanism will require application of much more sophisticated processes and will require a staffing level at the ECB that will add to its overall costs. The ECB supervision will also be more intrusive, as the ECB will not take any risks as regards its reputation as supervisory authority. Finally, the ECB supervision will result in a shift of the culture of supervision. Local customs and local (perhaps biased) decision making processes in the context of supervision exercised by NCAs will disappear and be replaced by less subjective decision making processes conducted by teams that will be organised in such a way, as to avoid as much as possible national bias. But the overall sentiment seems to be that larger institutions are willing to pay that price. They rather look forward to the establishment of a truly exclusive competent European supervisory authority which will end the period of fragmented supervision by the various NCAs that are thus far authorised to supervise the various parts of the international group.

The mandates given to the ECB in the SSM Regulation do not give cause for concern as regards the legitimacy of the decision making process when exercising supervision after the single supervisory mechanism commences on 4 November 2014. Notwithstanding possible debates on the strength of the foundation in article 127, paragraph 6 of the TFEU, the politicians and lawmakers have taken the courageous step to adopt the SSM Regulation postponing further debates on the treaty provisions to the future. The SSM Regulation is secondary Union law drafted in the strongest possible and resolute language, avoiding further debates as regards the powers and authority of the ECB for the foreseeable future.

In the preparations for the commencement of the single supervisory mechanism, ECB follows where it can (given the time constraints) elaborate procedures to organise as much as possible wide acceptance of the rules made by the ECB in the context of the single supervisory mechanism. Time constraints do, however, put pressure on the organisation of the framework for the comprehensive assessment, such as the AQR, as there is little choice than to proceed with the enormous task and provide the market with the necessary guidance as to how to conduct the comprehensive assessment. It seems that this approach of the ECB remains unchallenged and that there is little debate, which viewed from its immediate perspective has been fortunate, about the appropriateness or legitimacy of the decisions taken by the ECB and rules and soft law adopted in this context.

4
A Safe Deposit for Banking Union

Thomas Mayer[1]

At the end of this year Banking Union will "go live". It consists of a Single Supervisor Mechanism, a function executed by the ECB, and a Single Resolution Mechanism. A common deposit insurance, originally seen as the key component of Banking Union, will not be part of it. The main reason for leaving deposit insurance at the national level is the risk of mutualisation of public debt in case of bank failures. Some governments fear that their tax payers will be held liable when bank failures in other countries exceed the financial ability of these countries to protect the deposits of their residents. However, without common deposit insurance Banking Union can hardly be regarded as complete.

The problem is that a rejection of mutualisation of public debt and full Banking Union are inconsistent in a system of fractional reserve banking. We know from historical experience that fractional reserve banking is prone to suffer liquidity and solvency crises. Central banks have been created to safeguard against systemic liquidity risk and government reinsurance of private deposit insurance has been introduced to safeguard against systemic solvency risk. The problem in EMU is that we do not have a euro area state that could reinsure

1 Thomas Mayer is Senior Fellow at the Centre for Financial Studies at Goethe University Frankfurt This paper is an updated and expanded version of CEPS Policy Brief No. 290, published in May 2013. He wishes to thank Daniel Gros for valuable comments on an earlier draft.

private deposit insurance. Even with maximum bail-in of bank share holders and creditors in case of a systemic banking crisis it is not assured that all deposits of up to EUR100,000 are safe as promised by the EU Directive for deposit insurance. The amounts needed may exceed the common funds available in the Single Resolution Mechanism. Deposits above EUR100,000 are without protection and in fact ought to be bailed-in as a rule to avoid market distortions. Such distortions could arise if governments with a large fiscal capacity were allowed to assure depositors that their deposits are safe in the banks within their territory, regardless of the size of the deposit. In times of crisis, deposits would then flee from countries with smaller to those with larger fiscal capacity. Because of the incompleteness of Banking Union it is highly likely that the ECB will have to deal both with systemic liquidity and solvency crises in the event of their occurrence.

However, the contradiction between national responsibility for public finances and full Banking Union in a fractional reserve banking system can be resolved when we change the system. This paper proposes three simple steps to do this. In step 1, we define as "safe asset" deposits that are fully backed by reserves held with the central bank. In step 2 we create a hierarchy of loss absorbing bank liabilities, and in step 3 we induce banks to divest from government bonds and treat government bonds as "credit".

Step 1: A 100% reserve requirement for safe deposits

We start by defining the risk-free asset for a euro-area resident with short-term and long-term financial liabilities (e.g. living expenses and nominal debt): This is the asset that can be converted into legal tender at face value at any time and under any circumstance. The concept of legal tender is very important in a fiat money system, in which money derives its value from government regulation or law, because it ensures that we can settle debt with almost worthless paper or electronic bits. In a fiat money system the only legal tender is by definition central bank money. Hence, an asset is risk-free if it can be converted into central bank money at any time. It is easy to see that only few assets would qualify as risk-free. Most importantly, the debt of governments that do not control the issuance of legal tender, as is the case in EMU, or deposits of banks that are backed by credit to entities that also do not control the issuance of legal tender, are not risk-free. All these assets are risky because the debtor may not be able to convert them into legal tender at any time and under all circumstances.

Hence, in EMU, where governments have no access to the money printing press of the European Central Bank (ECB), the only risk-free asset is cash issued by the central bank and deposits that are fully backed by central bank reserves held at the central bank. No government sponsored insurance scheme can make deposits risk-free because this scheme cannot guarantee the availability of legal tender under any circumstances. It thus follows that we need to establish safe bank deposits as deposits that are fully backed by banks' holdings of central bank reserves. In other words, we can effectively insure deposits by introducing a 100% reserve requirement for this type of deposits. No industry or state deposit insurance scheme is required. A simple 100% reserve requirement is sufficient.[2]

But would a deposit insurance scheme based on a 100% reserve requirement be at all possible in our present system? The answer, of course, is yes: To back 'insured' deposits created earlier by fractional reserve banking, banks could borrow central bank reserves in the necessary amount and keep them on deposit with the central bank. The cost of these safe deposits for the banks would be determined by the difference between the lending rate for central bank reserves and the deposit rate for central bank money. The cost for the bank customer would be determined by the net cost of central bank funds for the banks and the banks' operating costs for the insured deposits. The benefit for the customer would be to have a safe asset other than only central bank notes, and the ability to use this asset to make non-cash payments.

2 The idea of 100% reserve coverage of deposits is of course not new. As Huerta de Soto has pointed out, it dates back to the school of Salamanca in the 16th century, was taken up in the UK Bank Charter Act of 1844 and is advocated today by followers of the Austrian School of Economics and others (see Jesus Huerta de Soto, "Money, Bank Credit, and Economic Cycles", Ludwig von Mises Institute, Auburn AL, 2012).

A quantitative limit for safe deposits would not be necessary as the central bank could adjust the supply of reserves to the demand for safe deposits. But the central bank could influence the demand for safe deposits by changing the variable costs, which are given by the difference between the cost of central bank reserves and the rate that the central bank pays on deposits. This could be used for stabilisation policy: By influencing the demand for safe deposits relative to other deposits, the ECB would also influence credit extension by the banks.

Assume that customers switch from investor deposits to safe deposits. If the ECB kept the supply of central bank reserves constant, banks would need to reduce credit to free funds for deposit with the ECB as cover for the additional safe deposits. Credit to the non-bank sector would go down, and the credit multiplier, defined as credit relative to central bank money, would fall. Alternatively, if the ECB wanted to accommodate the switch and keep credit to the non-bank sector constant, they could increase the supply by central bank reserves to meet the additional demand. Still the credit multiplier would decline, albeit by less than before, because the central bank money stock would increase. Finally, if the ECB wanted the credit multiplier to remain constant, they could raise the alternative costs of holding safe deposits by lowering the deposit rate. The reduction of the deposit rate needed to achieve the target level of safe deposits could be determined in a reverse refinancing operation, where banks submit bids for the deposit rate they are willing to accept (or pay when the deposit rate is negative).[3]

Step 2: A hierarchy of loss-absorbing bank liabilities

Once we have established reserve-backed deposits as safe assets, all other bank liabilities would of course be risky. We can now define a hierarchy of loss absorption in a bank resolution regime. The first loss would be borne by the equity tranche on the liability side of banks' balance sheets. After having set aside assets pledged to cover secured debt, the second and third losses would be borne by junior

3 Banks in Germany and certain other euro area countries today already hold large amounts of central bank reserves. However, these reserve holdings are motivated by the banks' reluctance to lend to other banks in other euro area countries and are not earmarked to back deposits.

and senior unsecured bank debt. The fourth and last loss would accrue to deposits uncovered by central bank reserves. When all bank liabilities except deposits fully covered by central bank reserves contribute to cover losses on bank assets, taxpayer-funded bank bailouts would become significantly less likely (and will eventually become unnecessary). As long as banks engage in maturity transformation, systemic liquidity crises remain possible and a lender-of-last resort necessary. But the risk of liquidity support turning into support for insolvent banks would be much diminished when there is a clear roadmap for bank resolution. Moreover, the risk of a liquidity crisis could be reduced if the scope for maturity transformation would be limited in the regulatory framework. Finally, when the public fully understands the risk associated with an exposure to banks beyond the reserve-backed safe deposit, it would be up to banks to reassure bank equity investors and creditors that their assets are being managed in a way that makes illiquidity and losses become unlikely.

Step 3: Divest banks from governments by revised regulations for government debt

To be able to fund their assets at reasonable costs, banks would need to have a comfortable equity cushion and a well-diversified and reasonably liquid portfolio of assets. Most importantly, they would have to reduce their exposure to government debt to a level consistent with this debt being subject to default risk. Hence, in the new regulatory regime, government debt would have to be backed by equity and other loss-absorbing bank liabilities, and it would have to be subject to limits for single credit exposure. To allow banks' divestment from government debt, the European Central Bank could buy in a one-off operation the government bonds that banks have pledged to the central bank as collateral for obtaining central bank credit, and place them in a special account that will be wound down over time.[4] As

4 Since government debt presently does not need to be backed by bank equity, is not subject to single credit exposure limits, and is liberally accepted by the ECB as collateral for loans of central bank money to banks, banks have in effect become intermediaries for ECB credit to governments (though this has been camouflaged by keeping government credit on banks' balance sheets). To end this practice, the ECB will have to properly account for its true exposure to government debt by assuming the credit to government presently parked on banks' balance sheets on its own balance sheet.

a result of this operation, risky claims of the banks on governments would be replaced by risk-free claims of the banks on the ECB or, in other words, by central bank reserves. The ECB would of course want to reduce its exposure to government debt over time.

Since it is very doubtful that all highly indebted euro-area countries could repay their debt, governments and the ECB could agree that all income from seigniorage would be used to pay down the government debt held by the ECB in the special account. In practice this would mean that the ECB instead of governments would redeem maturing (or repurchase outstanding) bonds and debit governments' seigniorage account with the costs of the transaction. Since the present discounted value of seigniorage can be very large, reaching several trillion euros in the case of the euro area, depending on interest rates on central bank credit and the growth rate of non-interest-bearing central bank money, it seems likely that this would be sufficient to eventually retire the government debt acquired by the ECB from the banks. The arrangement outlined here has some resemblance to the debt redemption fund proposed by the German Council of Economic Experts. However, an important difference is that in the arrangement proposed above, the ECB would withhold revenue to pay down the debt and would not have to rely on governments to allocate revenue for this purpose.

Part of the reserves obtained by selling government bond holdings to the ECB could be used initially by the banks to back safe deposits. The rest could be released by the ECB into the banking system and the economy at large by setting a rate for central bank deposits below the risk-adjusted bank lending rates. With their debt now subject to default risk, highly indebted governments might encounter difficulties accessing the market at reasonable costs to roll over expiring debt. But market access could be improved if the ECB agreed to assume the status of a junior creditor for the government bonds they have acquired from banks in case of a debt restructuring. Like the orderly pay down of the debt, the costs for such a restructuring could be covered by future seigniorage income. This would represent a partial mutualisation of public debt, but because of its limited character it would probably be acceptable for countries with stronger balance sheets.

Managing the transition

The introduction of a safe deposit within the framework of our present banking system is illustrated in Charts 1-4. The first chart introduces highly simplified balance sheets for a bank and the central bank. The Bank has extended credit in the amount of 99 currency units (CU) and thereby created deposits of the same amount. It holds 1 CU as minimum reserve, funded by a loan obtained from the central bank. The latter holds the bank's reserve and a claim in the same amount on the bank.

Chart 1. Bank and Central Bank Today

Bank

Assets	Liabilities
99 K	99 ID
1 MR	1 ZBC
100	100

Central bank

Assets	Liabilities
1 ZBC	1 MR
1	1

K = Bank credit; ID = Investor deposit + equity caital; MR = minimum reserve; ZBC = central bank credit

Chart 2 shows the separation of the bank's balance sheet into a credit and payments department. Both departments can remain within the same unit, but they operate under separate liability. In particular, the payments department is not liable for any losses of the credit department of the bank.

Chart 2. Separation of bank into credit and payments departments

Bank

Assets	Liabilities
Credit department	
99 K	99 ID
1 MR	1 ZBC
Payments department	
0	0
100	100

Central bank

Assets	Liabilities
1 ZBC	1 MR
1	1

K = Bank credit; ID = Investor deposit + equity capital; MR = minimum reserve; ZBC = central bank credit

Chart 3 shows the creation of excess reserves in the credit department of the bank. The bank borrows 9 CU from the central bank and deposits the funds back to the central bank.

Chart 3. Creation of excess reserve

Bank

Assets	Liabilities
Credit department	
99 K	99 ID
1 MR	1 ZBC
9UR	9 ZBC
Payments department	
0	0
109	109

Central bank

Assets	Liabilities
1 ZBC	1 MR
9 ZBC	9 UR
10	10

K = Bank credit; ID = Investor deposit + equity capital; MR = minimum reserve; ZBC = central bank credit; UR = Excess reserve

Chart 4 shows the decisive step for the creation of the safe deposit. Nine CU are transferred from the account for investor deposits in the credit department to the safe deposit account of the payments department. The safe deposits are fully backed by the simultaneous transfer of 9 CU excess reserves from the credit department to the payments department. At the end of the process, we have 9 CU of completely safe deposits. In case the bank fails and the credit department is wiped out, the safe deposit holders keep their deposits backed by central bank reserves. At the same time, the exposure of the central bank has increased. It has lent 9 CU to the credit department of the bank for the funding of its assets. However, as the exposure is moderate and the ECB is the Single Supervisor in EMU this exposure can be defended. The minimum reserve held by the credit department of the bank is of course now redundant and can be used to repay the corresponding central bank credit.

Chart 4. Transfer of investor deposit to safe deposit

Bank

Assets	Liabilities
Credit department	
99 K	90 ID
1 MR	1 ZBC
0	9 ZBC
Payments department	
9 UR	9 SD
109	109

Central bank

Assets	Liabilities
1 ZBC	1 MR
9 ZBC	9 UR
10	10

K = Bank credit; ID = Investor deposit + equity capital; MR = minimum reserve; ZBC = central bank credit; UR = Excess reserve; SD = safe deposit

Balance sheet effects of safe deposits

Table 1 shows the stylized structure of banks' balance sheets after the introduction of safe deposits. Abstracting from assets earmarked for covered bonds, banks would have central bank reserves and credit on the asset side of the balance sheet, as before. However, central bank reserves would be tied in the payments department to cover safe deposits on the liability side of the balance sheet. All liabilities in the credit department would participate in loss absorption in a clearly defined hierarchy, with equity providing the first layer and investor deposits (not covered to 100% by central bank reserves) the last.

Given our definition of a safe deposit, it corresponds to what are at present called "sight deposits". In April 2013, sight deposits in the euro area amounted to €4.4 trillion, representing about 38% of total deposits or 44% of GDP. Since customers would probably not choose to have all sight deposits in the form of safe deposits, this would represent an upper boundary to the level of safe deposits. In April 2013, banks held €556 billion as reserves with the Eurosystem (€273 billion of which counted as minimum reserves). Hence, the introduction of safe deposits would substantially increase reserve holdings and the Eurosystem's balance sheet (only about €2.5 trillion). But this would only change the mix between inside and outside money and not affect the overall size of the balance sheet of the monetary and financial system.

Table 2 shows the structure of the balance sheet of the ECB. As can be seen from this table together with Table 1, safe deposits, like bank notes in circulation, represent a direct liability of the ECB to the non-banking sector. Against this stands the 'good will' on the asset side of the central bank's balance sheet, which reflects the trust invested by the public in money as a means of exchange and store of value. At first glance, the backing of money by 'good will' in the central bank's balance sheet may look unsound. Proponents of 100% reserve backing of deposits have therefore suggested that the central bank acquire government debt to back safe deposits and issue money against new government bonds when it wants to increase the central bank money stock. But this only camouflages the lack of a material cover of money in a fiat money system and creates circularity in the accounts: The claim of the central bank on the government is neutralized by the government's eventual authority over the central bank. Because of this the government may be tempted to use direct central bank purchases of government debt as an excuse to fund its expenses through the money printing press. The fact is that the only cover of money in a fiat money system is people's trust in money, and this is most honestly accounted for by 'good will' in the central bank's balance sheet.

Table 1. The structure of bank balance sheets in the new regime

Assets	Liabilities
Payments department	
Central bank reserves	Safe deposits
Credit department	
Ring-fenced assets	Covered bonds
Other assets	Investor-deposits* Senior debt* Junior debt* Equity*

* Participating in losses in ascending order.

Table 2. The structure of the central bank's balance sheet in the new regime

Assets	Liabilities
Good will	Deposits of commercial bank reserves to cover safe deposits and banknotes
Other assets	Other liabilities, reserves, and capital

As explained above, the central bank can influence the mix between safe deposits and investor deposits by determining the alternative costs of safe deposits. Since investor deposits fund bank credit, this allows the central bank to influence credit extension by the banking system. Banks can of course still engage in maturity transformation by funding longer-term credit with rolling short-term investor deposits. But holders of investor deposits would be exposed not only to credit but also to liquidity risks associated with maturity transformation. Since they would demand a risk premium as compensation, there would be an economic limit to maturity transformation.

In a growing economy, the central bank may not only want to influence the mix between safe and investor deposits but also the size of the balance sheet of the banking sector. It can do so by writing up 'good will' in its balance sheet and crediting safe deposits with this amount (i.e., paying safe deposit holders something like a dividend). A write-up of 'good will' could be triggered by an increase in the demand for money as a result of an increase in potential GDP. In this case, the price level would fall if no new money was issued. As long as price rigidities exist, this may not seem desirable. Thus, new central bank money would come into existence in a neutral way and would not benefit any sector in particular (as would be the case if the central bank would create new money by buying newly issued government bonds, as suggested by some). Economists of the Austrian school have pointed out that the creation of money via bank credit or government spending benefits those close to the process of money creation and puts at a disadvantage those far away from it. The latter will not obtain new money but may suffer from price increases triggered by the money injection.

A more level playing field

The proposed structure for Banking Union would of course change the way in which banks operate and governments fund themselves. Banks would no longer extend credit and create book money at will. Rather, they would assume the dual role of 1) safe keeper of the risk-free assets, i.e. central bank money, for depositor-savers, and 2) intermediary of funds between investor-savers and entrepreneurs. There would be no need to limit "deposit insurance" to a certain amount, e.g., the EUR100,000 now in force in the euro area, and deny larger depositors, e.g. companies, access to a safe store of value. As safe keepers of the risk free asset and facilitators of non-cash payments banks would of course be entitled to a fee for the services they render, which would become a permanent source of revenue for them. By the same token, banks would receive fees for acting as agents in capital markets and generate income as risk takers when using investor-deposits as a source for credit.

It is possible that bank lending rates would increase in the new regime, but if they do, then only because savers realise that in a fractional reserve banking system bank deposits carry credit risk, unless they are fully backed by banks' holdings of central bank reserves. In fact, the widespread misconception that bank deposits in our present system of fractional reserve banking are completely safe and can be converted into central bank money at any time and in all circumstances represents a subsidy to bank lending rates (and bank profits) from tax payers, who in times of crises are called upon to stabilize banks.

Governments could no longer rely on banks to fund their debt and would have to obtain funding from the capital markets. Borrowing costs could also increase for them as they would no longer be regarded as offering risk-free assets and could no longer benefit from preferential treatment on banks' balance sheets in the form of zero-risk weighting for the calculation of regulatory capital requirements and exemption from single-credit exposure limits. Again, such an increase in borrowing costs would represent the end of a subsidy to government borrowing as a result of special regulatory treatment.

Conclusion

To sum up, "common deposit insurance" could be introduced in the euro area by requiring banks to fully back safe deposits with central bank reserves. This would be the only safe asset in EMU, where, as already noted, governments have no command over the money printing press of the central bank. All other bank liabilities would participate in covering losses on the asset side of banks' balance sheets in a hierarchical order established by the common bank resolution regime in the second step. To help banks divest from government bonds, the ECB could buy these bonds from them, replacing risky claims of banks on governments by risk-free claims of banks on the ECB in the third step. Governments and the ECB could agree to use future seigniorage income to pay down the government debt held by the ECB. With this, Banking Union would be complete.

5
European Supervision And Stress Testing: Beware Of False Friends

Andrea Resti*

1. Foreword

Integrating bank supervision in the European Union is a complex and far-reaching process. In this short note, rather than discussing its general design and trends, I focus on three specific areas.

First, I discuss whether the advent of a Single Supervisory Mechanism (SSM) in the Eurozone, which is generally considered as a major step forward for large European lenders, was well received by investors when it was announced. Second, I look back at past stress tests in Europe, which were often described as ineffective, to see whether such an assessment holds true in light of empirical evidence. Third, since bank supervision in Europe (including the SSM and the next round of stress test) is set to rely heavily on Risk-Weighted Assets (RWAs), I briefly investigate whether regulatory risk weights are as unreliable and disconnected from other risk measures as some authors have claimed.

I deal with these different issues based on a common intent: to see whether conventional wisdom finds support in the empirical evidence or it has rather led to a number of "false" beliefs, which should

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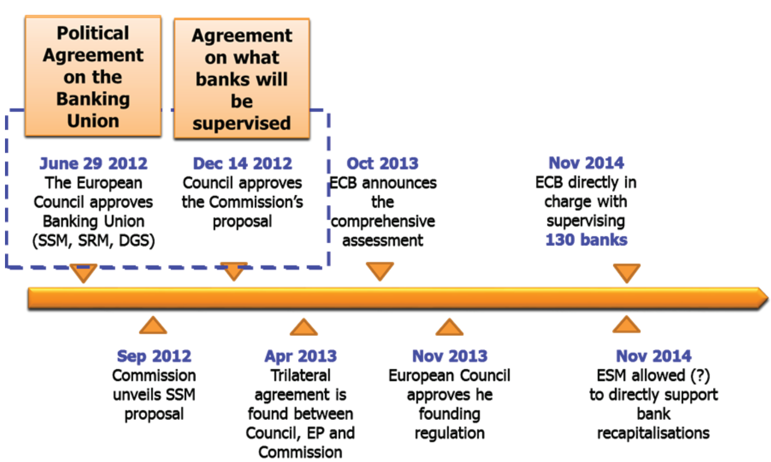
be further assessed but have become hard to challenge in the economic and policy debate.

2. Was the SSM good news for large European banks?

Figure 1 summarizes the key steps in the introduction of the SSM. The two initial dates look especially significant.

The first one is June 29, 2012, when the European Council announced it had reached a political agreement on the so-called "Banking Union", a wide-ranging initiative focused on Eurozone banks, including a single supervisory mechanism (the SSM), an integrated resolution mechanism for ailing banks (the so-called "Single Resolution Mechanism", SRM) and a unified deposit guarantee scheme (DGS). Although the details of the project were still to be defined, a strong political consensus had emerged within the Council on the need of creating a single supervisor. Additionally, a legal procedure had been agreed that would make it possible to assign strong supervisory powers to the European Central Bank (ECB) on the basis of the existing treaties without going through a complex and time-consuming legislative process.

Figure 1: timeline of the key steps in the introduction of the Single Supervisory Mechanism



The second relevant date is December 14, 2012, when the European Council approved an amended version of the SSM rules drafted by the European Commission three months before. Those rules assigned a clear and wide mandate to the ECB, including the direct supervision of about 130 large banking groups. Although no proper list of the latter was released, the approved criteria were clear enough to enable market participants to guess what banks would fall under the ECB's direct control.

In short, while the June 29 statement informed investors about the political willingness to achieve a strongly-integrated model of bank supervision in the Eurozone (within a reasonably short time frame), the December 14 announcement provided details on the ECB's foreseeable powers and on the (directly) supervised institutions. Although the process would involve some more formal steps in the following months, the two key features of the new system had been defined.

Figure 2 shows how equity investors reacted to the two announcements[1]. The values in the table denote Cumulative Abnormal Returns (CARs) on a 5-day event window centered on the event date (-2, +2). The CARs are based on a standard market model where market returns are measured through national stock-market indices (an industry-specific benchmark would have been strongly affected by the returns of the tested banks). Results are provided for several groups of lenders, namely:

- banks to be directly supervised by the ECB according to the criteria approved on December 14;
- banks to be directly supervised by the ECB (as above) *and* based in GIIPS countries (Greece, Ireland, Italy, Portugal and Spain);
- banks to be directly supervised by the ECB and based in *non-*GIIPS countries;

1 Equity values may not be the only tool to assess whether European banks were positively affected by the advent of the SSM. For example, as argued by Galai and Masulis (1976), since shareholders hold a call option on the bank's assets they gain from an increase not only in expected asset returns but also *in their volatility* (something hardly beneficial in terms of financial stability). However, it would be hard to change perspective and compute CARs for debt holders, since for many banks in our sample credit default swaps are not traded actively in liquid markets.

- Eurozone banks to remain under the direct control of national authorities according to the criteria approved on December 14;
- non-Eurozone listed banks.

Since the eligibility criteria for ECB direct supervision were not available yet at the time of the first event date (June 29), we also consider a sub-group of ECB-supervised banks that only includes the largest institutions, i.e., those that could be safely assumed to be falling under the ECB's direct mandate.

Figure 2 – Cumulative Abnormal Returns on two key event dates

Event window: (-2,+2) *Estimation window (-102,-3)*	June 29: Political Agreement					Dec 14: Banks and criteria				
	CAR	Patell	Patell KP	BMP	BMP KP	CAR	Patell	Patell KP	BMP	BMP KP
ECB-Supervised EMU banks	-1.69%	*		*		1.92%	**		**	
ECB-Supervised GIIPS banks	-2.78%	*		**		1.02%				
ECB-Supervised non-GIIPS	-0.75%					2.70%	**	*	**	*
ECB-Supervised - very large	-2.22%	*		**						
NCA-Supervised EMU banks	-1.22%					1.05%				
Non-EMU EU banks	-1.15%					-0.90%			*	

The statistical significance of CARs is tested according to four alternative procedures: a standard Patell test (Patell, 1976), a BMP test accounting for event-induced variance (Boehmer et al., 1991), augmented versions for the Patell and BMP tests based on the Kolari and Pynnonen adjustment for simultaneous announcements (Kolari and Pynnönen, 2010). Stars denote significance at 95% ("*") and 99% ("**").

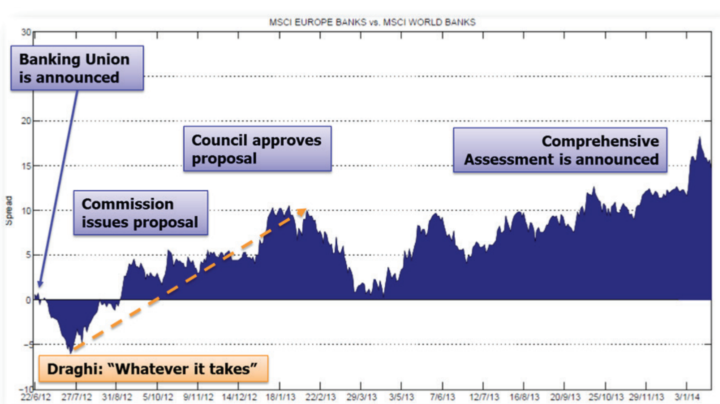
The first announcement appears to have a negative impact for Eurozone banks, especially the largest ones (that could be safely assumed to fall under the ECB's direct mandate) and those based in GIIPS countries.

There are various reasons for this result. While representing an ambitious step towards further financial integration in Europe, the creation of the SSM may have fallen short of investors' expectations. In fact, it does not cover non-Eurozone countries (including the UK, where some of Europe's largest lenders are based) and could be seen as a way to postpone direct intervention in banks by the ESM (European Stability Mechanism) until end 2014 or later. Concerning GIIPS-based banks, a further negative effect may relate to credibility building. As the ECB is completely untested as bank supervisor, it needs to establish a reputation for effective control of bank risk. To that aim, it can be expected to keep a strong grip on the riskiest institutions, many of which are assumed to be headquartered in GIIPS countries.

A positive impact on bank prices is found on the second event date, when strong rules and a credible time schedule for the new supervisory framework were established. Lenders falling under the ECB direct mandate experience significantly positive CARs, unlike their peers remaining under national supervision or based in non-Eurozone countries, where the price impact is virtually nil. The strongest effect emerges for non-GIIPS institutions, which can be assumed to be less affected by reputation-building issues.

To complement the CAR analysis above, Figure 3 looks at long-run impacts. As a measure of price performance, it shows the difference between two stock market benchmarks: MSCI Europe Banks and MSCI World Banks. Positive/increasing values indicate that European banks are performing better than their world counterparties. The starting point is June 22, one week before the announcement issued by the European Council, when the gap is set at zero.

Figure 3 – The long-run impact of the SSM

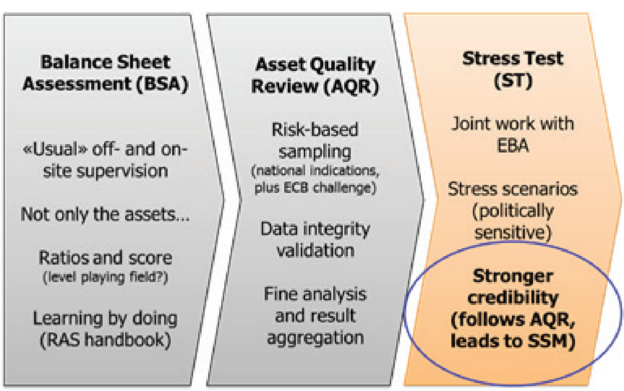


Again, the 29 June event is found to have no positive impact on European bank prices, which keep performing worse than the worldwide benchmark. The turning point is July 26, when ECB's president Mario Draghi delivered the famous speech in London in which he promised to do "whatever it takes" to defend and revive the euro. In the following weeks, however, further steps towards the SSM (together with the introduction of ECB's Outright Monetary Transactions on August 2 and September 6) seem to have contributed to a significant improvement in the relative price performance of European lenders. Additionally, it could be argued that, while not triggering an immediate rebound in stock prices, the first intergovernmental agreement on the SSM provided the political underpinnings for Mr Draghi's straight policy statement a few weeks later.

3. Were past European stress tests really so ineffective?

One key step in setting up the SSM is the so-called Comprehensive Assessment (CA), a 12-month due diligence process on about 130 Eurozone banks started in October 2013 (see Figure 4). The final step in the CA will be a stress test, where the effects of a 3-year downturn scenario on the profitability, liquidity and capitalization of individual banks will be assessed by the ECB, the European Banking Authority ("EBA") and the national supervisors.

Figure 4 – Key steps in the ECB's Comprehensive Assessment



In presenting this stress test, the ECB officials have been keen to affirm that it will differ significantly from similar exercises carried out in the past[2]. According to a widespread belief, in fact, previous European stress tests have been able to neither identify weak institutions nor to convey reliable information to market participants (see, e.g., Acharya et al., 2013).

Regarding the 2011 exercise, carried out by the then newly-established EBA, a widely mentioned “proof” of its ineffectiveness is that Dexia, a large Belgian lender that filed for state support only a few weeks later, had passed the test without any special warning. Things, however, may be slightly more complex.

Dexia’s problems did not originate from a weak capital base but rather from strong liquidity pressures (Acharya and Steffen, 2013). The bank had invested heavily in government bonds issued by GIIPS countries, using them as collateral to raise funds in the wholesale market. Accordingly, when the bonds’ prices dropped and their volatility soared (leading to an increase in repo haircuts), Dexia found it increasingly difficult to refinance its positions and to comply with margin calls.

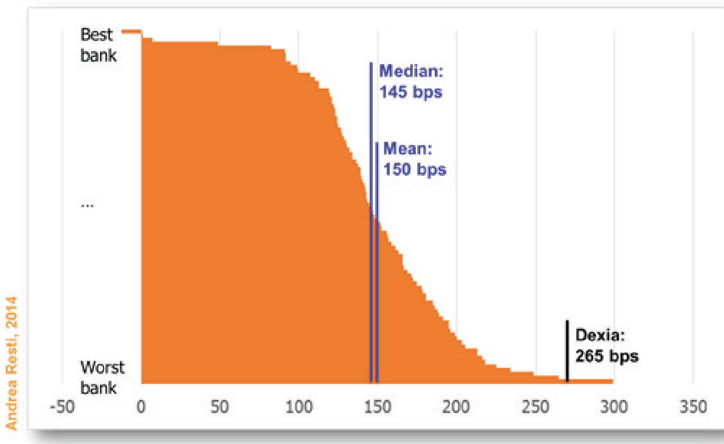
Did the 2011 stress test miss this vulnerability? This is hard to say. In fact, the stress test exercise produced two sets of results: the first one focused on capital and it was disclosed to investors in full detail; the second one concerned liquidity and it was kept confidential because of the fear that its disclosure may trigger panics and self-fulfilling spirals.

Even so, one can use the first set of results to derive a simple measure of liquidity risk: the increase in funding costs under the stress test’s downturn scenario[3]. While this increase can be sustainable, or even moderate, for banks funding themselves on the retail market or through long-term bonds, it becomes more dramatic for institutions relying mostly on short-term wholesale financing, including repos.

2 See European Central Bank (2013), where a press representative asks a top ECB official the following question: “What makes this exercise more credible and effective than the previous two EBA exercises? And I won’t rehearse all the problems or concerns with the previous stress tests. But what makes this different?”
3 Stress tests mostly involve a “baseline” scenario representing the expected evolution of macroeconomic and market fundamentals, as well as a “downturn” scenario involving a more challenging economic context.

Figure 4 shows values (in basis points) for all listed banks participating in the 2011 stress test. As it can be seen, Dexia experiences the second-largest increase, almost double than the sample median. This is strong evidence of a weak funding profile, highly vulnerable to liquidity pressures.

Figure 5 – 2011 EBA Stress Test: change in funding costs under the downturn scenario



Another widespread belief regarding the 2011 stress tests is that market sentiment was unaffected by the results. In a sense, this is largely correct, as the long-run decline of bank prices did not end after the stress test results were announced. However, it is hard to see how a stress test alone could have changed investors' beliefs that banks were able to cope with a negative market outlook. Unlike its US counterpart, the 2009 SCAP, the European stress test was not accompanied by an announcement that governments were ready to stand behind ailing banks and offer to inject high levels of capital as often as needed. In this sense, the EBA was missing a "big bazooka" to convince investors that no banks would be left without adequate capital (Onado and Resti, 2011).

However, if one looks at the way individual bank stocks reacted when the stress test results were announced, about 60% of the abnormal returns can be explained by a small set of indicators that could be derived from the EBA data file. Table 1 (abridged from Petrella and Resti, 2013) shows that investors rewarded banks that:

- started from a higher Tier 1 ratio (including additional rights issues carried out in preparation of the stress test);
- experienced a smaller increase in the “total coverage ratio” (loan loss provisions over total loans, including performing ones) under the downturn scenario;
- posted a stronger rise in the coverage ratio for defaulted exposures (loan loss provisions over bad loans) under the downturn scenario;
- suffered a lower increase in funding costs (see Figure 5) under the downturn scenario.

Overall, the results in Table 1 show that bank prices have adjusted to stress test results. This result may have been modest or short-lived, but it may be unfair to say that market participants did not care.

Table 1 - Drivers of individual Cumulative Abnormal Returns when the 2011 stress test results were announced

	Coefficient (p-value)
Intercept	-0.03
	(0.07)
Current Tier 1 capital ratio (including additional capital issues)	0.57
	(0.00)
Change in total coverage ratio (including performing loans) under stress	-0.89
	(0.00)
Change in coverage ratio for defaulted exposures under stress	0.07
	(0.01)
Change in funding costs under stress	-0.11
	(0.05)
Adjusted R-Square	0.58

Source: Petrella and Resti (2013)

In short, the 2011 European stress test did not overlook Dexia’s vulnerabilities and did exert an impact on market prices. It may therefore be unwise to carry out the 2014 stress test without keeping the effects of the previous test in mind. Indeed, the 2011 test represents a useful benchmark, especially in terms of transparency and comprehensiveness of the information released to investors.

4. Should we distrust RWAs?

The CA relies heavily on Risk Weighted Assets (RWAs), as does the whole regulatory architecture that resulted from the Basel accords.

In short, bank assets are converted into a minimum capital charge through a system of coefficients known as "risk weights." Since 2004 ("Basel II"), large banks have been increasingly allowed to replace standard regulatory weights with tailor-made coefficients linked to their own internal ratings. While the latter should, in principle, be more accurate and risk sensitive than standard weights, they are increasingly seen as a means to "tweak" or "optimize" (some would say "squeeze") capital requirements, thus artificially supporting capital ratios.

Policy reports and research papers from academics, supervisors and supranational institutions (Cannata et al., 2012; Le Leslé and Avramova, 2012; Mariathasan and Merrouche, 2013; Vallascas and Hagendorff, 2013) are increasingly casting doubts on the reliability of RWAs (which apparently stands for "Random, Worthless and Arbitrary"). Some large rating agencies have always computed bank capital through their own proprietary risk-weights, rather than using coefficients generated by internal models (de Longevialle et al., 2008). The Economist magazine, in a widely-cited editorial, defined RWAs as "do it yourself capital" (The Economist, 2012).

Figure 6 shows the average risk weights ("risk weight densities"[4]) for a sample of 50 large European lenders in 2008-2012[5]. The riskiness of bank assets *decreases* over time, even when the real economy and financial markets experience negative trends. While some banks may have shifted their asset mix towards safer investments, it looks unlikely that all European institutions have de-risked their balance sheets.

Table 2 refers to the same sample (50 lenders for 5 years) and shows how risk weights correlate with a number of variables proxying for the banks' business models, risk management models, risk and capital levels. As a robustness check, we use two different measures of the "average risk weights": the former ("RWATA") is computed as the ratio of RWAs to total assets; the latter focuses on credit risk and divides RWAs (for credit risk only) by the bank's own estimate of

4 See Le Leslé and Avramova (2012).

5 The data in Figure 6 and Table 2 draw on preliminary results of a joint research project with Brunella Bruno and Giacomo Nocera.

"Exposure At Default" (EAD), an aggregate that, unlike total assets, accounts for off-balance sheet items.

Figure 6 – Change in the average risk weight in 2008-2012. Data for the 50 largest European banking groups. Individual results are reported only for countries having at least 3 banks in the sample.

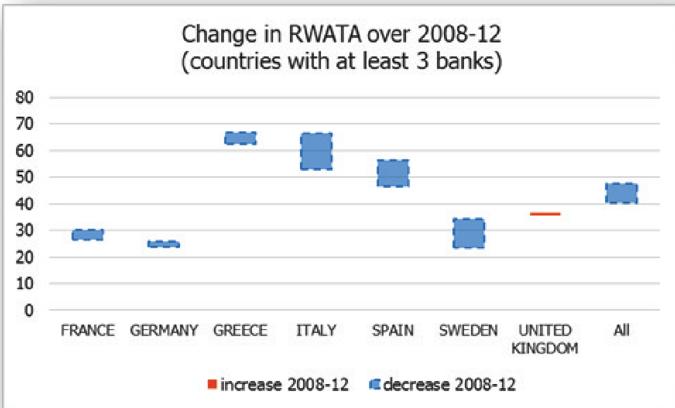


Table 2 –Risk Weights and Bank Characteristics (univariate analysis)

							Correlation with	
	Mean	Median	Max	Min	Sigma	Obs	RWATA	RWAEAD
(I) - Business models								
Log of Total Assets	12.5	12.5	14.7	10.3	1.3	250	-65.4%***	-52.5%***
Deposits / TA	48.6	48.7	94.7	4.0	15.2	250	45.3%***	37.5%***
Loans / TA	53.9	59.3	81.7	12.2	17.8	250	74.4%***	57.6%***
Retail / total loans	30.8	32.1	58.8	0.0	11.9	239	23.2%***	15.8%**
Corporate / total loans	35.2	34.7	54.9	6.3	9.2	239	7.8%	11.9%*
Institutions / total loans	12.1	9.8	48.2	0.9	9.5	239	-29.0%***	-27.1%***
Governments / total loans	12.2	11.9	28.6	0.0	5.9	239	-23.1%***	-22.3%***
(II) - Risk models								
Standard / total loans	45.0	37.3	100.0	1.9	30.6	250	74.2%***	69.6%***
IRB / total loans	55.0	62.7	98.1	0.0	30.6	250	-74.2%***	-69.6%***
FIRB / total loans	10.5	0.0	92.0	0.0	18.1	250	-9.9%	-12.0%*
AIRB / total loans	43.5	47.7	98.1	0.0	30.7	250	-67.1%***	-61.0%***
(III) - Capital and risk								
Stock return volatility	3.4	3.1	10.3	1.0	1.5	240	1.6%	5.9%
CDS spreads	278.8	154.0	2494	17.0	366.4	205	30.6%***	18.1%***
WACC	3.9	3.6	13.4	0.4	2.1	240	25.1%***	23.5%***
Impaired loans / Total loans	5.8	4.4	32.6	0.4	5.3	250	33.8%***	30.1%***
Tier 1 / RWA	11.0	10.8	21.3	-6.7	3.5	250	-55.5%***	-55.2%***

*Note: * = significant at 10%; ** = significant at 5%; significant at 1%.*

Institutions with larger risk weights tend to be smaller (see Panel I), more focused on the traditional loans-and-deposits business, more exposed to retail and, to some extent, corporate portfolios (as opposed to governments and financial institutions).

Low risk weights involve a more widespread usage of Internal Ratings-Based (IRB) models, especially advanced ones (Panel II). This was expected, since Basel II allows banks to use IRB on a voluntary basis (subject to supervisory approval). As a result, only institutions that foresee significant capital savings are willing to invest extensively in internal models.

Risk weights correlate significantly (albeit not perfectly – see Panel III) with some market-based risk measures, namely the CDS spreads and the weighted average cost of capital (WACC, as estimated by Bloomberg). This marks an improvement over previous empirical tests (Vallascas and Hagendorff, 2013), based on pre-crisis data, where no significant link has emerged. Our sample, including years of financial distress that triggered considerable variance across banks and over time, may make it easier for different risk indicators to convey similar signals. Furthermore, banks with higher risk weights also show a more significant level of ex post credit risk, as measured by the ratio of impaired loans to total loans.

Finally, risk-weights correlate inversely with risk-weighted capital. As a result, banks that trim down their RWAs to unusually low risk levels are apparently required (by supervisors, investors or both) to hold a larger cushion of excess capital. Arguably, institutions can obtain supervisory/market approval for more "aggressive" risk weights only by holding extra capital above the regulatory minima. This could mean that banks (and, again, supervisors and investors) are bound by some sort of un-weighted capital ratios, where the product between a bank's risk-weighted Tier 1 capital and its average risk weight cannot overly deviate from some "optimal" target level.[6]

5. Conclusions

This note examined widely-shared beliefs about three topics in the recent policy debate. First, it is generally agreed that the Banking Union should rebuild investors' confidence in Eurozone banks.

6 This, however, does not rule out the risk that "banks with higher capital buffer […]may be undercapitalized in spite of holding capital above the minimum requirements" (Vallascas and Hagendorff, 2013), consistent with the theoretical underpinnings provided in (Allen et al., 2011).

We saw that the introduction of the SSM did not trigger positive market reactions, although in the following months – as the new supervisory mechanism and its implementation schedule were set out in detail – it certainly helped revive bank prices, lending momentum to the ECB's "whatever it takes" stance.

Second, previous European stress tests are sometimes dismissed as ineffective. We showed that this is not necessarily the case, and that the work done by EBA in the past may still represent a meaningful benchmark, in terms of transparency and comprehensiveness of results.

Finally we saw that, although over the past five years, some banks may have used RWAs to reach seemingly higher capital levels, risk-weights are not absent from market-based risk measures. In addition, a negative relationship was found between a bank's risk density and the amount of capital it holds in excess of the regulatory minimum. In sum, regardless of what we may think of the appropriateness of un-weighted capital requirements, some kind of plain leverage ratio seems to exist already.

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6
Prevent or Exit? A Policy Dilemma: Policies to *Prevent* Future Crisis vs. Policies to *Exit* Current Crisis

Miguel Fernández Ordóñez

The dreadful fall of Lehman Brothers and the immediate collapse of nearly all financial markets fortunately provoked a flood of reactions of unprecedented geographical and historical dimensions both in the fields of research and policy. A large number of academicians, politicians and regulators have worked and continue to work very hard on this task. National governments, parliaments, supervisors and central banks, new international institutions like the G20 and the FSB, or older ones like the International Monetary Fund, the Basel Committee or the European Commission have dedicated and continue to dedicate much time and resources to satisfy a strong public opinion demand: "This cannot happen again".

Virtually all the keys have been touched: regulatory and supervisory policies; monetary, budgetary, fiscal and structural policies, and many more. Today I will not discuss any of these policies; I will not judge their efficacy or efficiency. My purpose today is to attract your attention towards the potential tradeoffs between preventing the next crisis and exiting from an ongoing crisis. The simple point I want to make is that whenever we are analyzing, designing or implementing any type of policy, we should question ourselves whether we want to adopt "prevention policies" or "exit policies"

I call "prevention policies" those decisions that tried to respond to the huge clamor that emerged at the end of 2008 when most markets and many banks collapsed and prompted the worst recession since the(Great Depression of the 1920´s. I call "exit policies" those that aim to exit from the crisis, those that aim to reduce the costs of the economic downturn and to shorten the period of adjustment.

To be more precise, the distinction I want to stress today is not between policies but between the effects of different policies, whatever their declared purposes are. The specific idea is being aware of two effects of our decisions: on the one hand, their properties to prevent the next crisis and, on the other hand, their contribution to exit, to get out, from this crisis.

So, why is it important to consider both, prevention and short term macroeconomic impacts? Because there are policies that aim to prevent future crisis without harming, in principle, the exit from the current crisis. For example, setting remuneration criteria for bank executives, serves to avoid or at least to smooth out the next crisis without harming, in principle, the exit from this crisis. In the other way, labor market reforms - where needed- help both to fight this crisis and to prevent the next crisis.

But it is not always so easy. Sometimes good policies to prevent the next crisis, if they are implemented during the crisis, not only do not serve to alleviate the present crisis but they can even aggravate it, or delay the recovery.

Today I will start by reflecting on three cases where policies adopted to prevent future crisis by improving incentives, actually worsened the crisis. These three examples are the decision to let Lehman Brothers go, the Greek debt restructuring and the Eurogroup agreement on the Cyprus crisis.

In theory, these decisions were taken to ensure that, in the future, agents will act much more responsibly and therefore to prevent the appearance of similar crises in the future. But their short term impact was harmful.

The decision to let Lehman go bankrupt is a clear example of a policy that had both kinds of effects. On the one hand, it had an impact on the economy. It triggered an extraordinary cascade of negative effects on many financial firms which increased the depth and duration of the crisis. On the other hand, the decision was presented as a step forward in fully playing the market discipline mechanisms.
The destructive effect on the world economy of the Lehman decision is not discussed today by anybody, even if we accept that not all the costs incurred since then would have been avoided if Lehman had been bailed out. The costs paid during the crisis came not only from bad decisions in managing the crisis but also from the needed adjustments of imbalances accumulated during the bubble, independently of how the crisis was managed.

What happened with the second intended effect, the discipline effect to prevent future crises? At best, this effect was null since it ended up being anecdotal, because neither before Lehman nor after Lehman, no exemplary "bail in" policy was applied to any other big financial institution. The immediate bail out of AIG confirmed forever the realism of the "Too Big to Fail" assumption.

The second decision is the Eurogroup agreement imposing rebates to all the deposits of Cypriot banks. In fact, there were two decisions because the first one was amended in the following meeting of the Euro group. This was another case in which the objective to prevent a future crisis predominated over the objective to help to exit the current crisis[1]. It is clear that the first decision, the one to hit the insured deposits was one that brutally harmed confidence without bringing any other benefit. It even demolished the trust of insured depositors which is the pillar on which confidence is built in a financial system. But even the second decision (haircut only the uninsured deposits) is questioned by many analysts who also ask themselves if the discipline effect has been worth the cost, taking into account the depression that has the Cyprus economy has been suffering since then.

1 "We have a new "template "to solve the banks crisis" was said at that time.

A third example, although more difficult to analyze, is what is now denominated the "Deauville Agreement " by which the President of the French Republic and the German Chancellor announced to the world that the Greek sovereign debt should be restructured. The effects of that decision taken on a beautiful beach have been without any doubt very harmful, but we should not quickly draw to the conclusion that the decision to restructure the Greek debt was inadequate. Restructuring is a useful tool to deal with excess leverage. The negative effects did not come from restructuring but mainly from its announcement. In the old times of fixed exchange rates, everybody knew that you should never announce currency devaluation until after it is done.

The three examples mentioned so far refer to decisions that aimed, above all, to discipline economic agents. When these decisions were adopted they were defended arguing that, by penalizing their behavior, the agents (banks or countries) would in the future engage in less irresponsible behavior. But these decisions had negative consequences regarding both "exit" and prevention objectives. Regarding the "exit" objective these decisions damaged confidence which aggravated the crisis or delayed the recovery. But they have also been useless at preventing irresponsible behaviors because either the decision was eventually quickly turned back, or the incurred huge recession costs sent a message to the market that authorities will rescue all institutions afterward.

These three examples could open a very interesting debate: how to set up regulations to prevent moral hazard and how to treat it during crisis resolution. Is a declaration of no bailout enough? Is a compromise of no bailing out big institutions credible? Should financial regulations contain provisions to avoid moral hazard? All these issues are important and they are at the center of this seminar, but they are not the subject of my speech, centered exclusively in assessing the prevention and exit effects of our decisions.

The three examples I have presented so far are also examples of decisions adopted in the heat of the crisis and could open a debate about the problems of deciding under serious public opinion pressure. This is also a very interesting issue but again it goes beyond the topic of my speech.

Lehman, Cyprus and Deauville were just particular examples that illustrate my general point: the necessity to distinguish between the effects on preventing future crisis and the effects on helping to exit from this crisis. Next, I will give you some other examples of decisions that show how this general argument can be applied to other decisions, how the same trade off emerges in decisions that do not have to do with moral hazard, decisions not adopted in the heat of a crisis and decisions not even related to banks resolution or sovereign debt restructuring.

I will start by giving you an example of regulatory decisions where it is equally necessary to evaluate costs and benefits of "preventing" and "exiting". Specifically, I refer to some decisions taken to increase banks´ capital requirements during the crisis.

Rafael Repullo, who is Director of CEMFI, a research center created and supported by the Bank of Spain and that many of you know, made an interesting presentation last fall in London explaining how the decisions to increase the requirements of regulatory capital are, without a doubt, a necessary and correct policy in order to have (promote) safer institutions. But, at the same time, he showed that, by increasing those requirements during the crisis, the problems generated by the crisis were amplified. This case equally shows the importance of assessing the two different effects and they have nothing to do with moral hazard or market discipline.

Certainly some of you know that the Bank of Spain was one of the regulators that, before the crisis, during the years of the bubble, introduced countercyclical regulations. The Banco de España required the constitution of dynamic provisions with no other basis than the credit growth, independently of the quality or performance of the granted credits. At that time Spain was criticized for this particular regulation and Spanish bankers complained that they were forced to make more provisions than banks of other countries. Even the European Commission threatened Spain with beginning a sanction procedure if these provision requirements were not scrapped. One of the few satisfactions brought by the crisis was that this negative view on counter cyclical regulations dramatically changed and finally Basel III accepted the idea of building a regulatory scheme that compensated the pro cyclical character of financial firms and financial regulation, although, to avoid accounting problems, it was finally decided not to solve this problem through additional dynamic provisions but through the constitution of counter cyclical capital buffers. Researchers at the Banco de España have always been very sensitive to the need to adapt regulatory policies to the cyclical situation of the economy and I want to recognize my debt to them when I selected the topic of this speech.

Let me continue with this fourth example. The 2008 Great Collapse raised a wide consensus on the necessity to increase regulatory capital above the requirements of Basel I and Basel II. The problem emerges when you ask banks to comply with this increased requirement before the crisis is over. The problem is that, when a higher capital requirement is introduced in the middle of the crisis, the effect is a reduction of the credit supplied by banks. This happens because it is not easy for banks to raise equity at those moments while reducing credit is relatively easy; consequently when you introduce the requirement to increase the ratio of capital, banks tend to reduce the denominator, that is, banks end up reducing credit. To comply with the new regulatory ratios, banks will restrict credit even more than they would due to the fall in economic activity. And the greater the fall of credit, the deeper will be the intensity of the economic crisis. The solution to this trade-off might come from requiring greater capital ratios only when the economy starts to recover but this should not be done at the worse moment of the crisis.

There is no easy solution to this trade off because a greater exigency of capital may not come exclusively from the regulators and supervisors trying to avoid a similar crisis in the future. Markets themselves could ask for a capital increase because, whether we like it or not, markets often act with pro cyclical behavior. Those who proposed to increase the regulatory capital in the middle of the crisis claimed that the ratios of capital before the crisis were already low and, therefore, to allow an additional reduction in capital would increase the distrust of those who finance the banks and this would have negative effects on credit and growth. Thus, the argument goes, unfortunately we were not in a situation in which we could accept calmly and comfortably a reduction in capital.

My intention is not to give simple solutions that could be generally applicable but to emphasize that the problem exists and, therefore, it must be considered when taking these decisions. My point is that before taking these decisions, we should not just analyze them from the point of view of preventing a similar crisis. This is a long term and fundamental objective and to which logically we must dedicate a lot of our efforts, but we should also make an assessment of the effects of our decisions on the present crisis we are suffering, that is, to what extent that decision helps or hinders the exit of the crisis.

Let us reflect on another example that it has nothing to do with either the resolution of a banking crisis or with financial regulations. I am referring to the Euro zone budgetary policy. As you surely know, this policy has undergone three violent zigzags during the crisis. In the first place, international organizations demanded the different national governments to increase public expenditure to the maximum to avoid the depression. Soon the theory shifted to require an immediate and serious return to austerity. The targets of public deficit or national debt that were correct for a normal situation were demanded during the crisis without considering the position of the economy in the cycle. Today, after a second recession in the Eurozone, everybody recognizes that it was a huge mistake demanding sudden and large expenditure cuts and rapid increases in taxes because it worsened the recession and, consequently, not only there was no improvement in deficit and debt figures but they even got worse. A balanced budget is another example of how reasonable policies thought to avoid a future crisis could have negative effects on the duration and depth of the present one if the timing is not appropriate and fiscal restraint is required suddenly, in the midst of the crisis.

Some of the problems I have mentioned – for instance, capital requirements increases - were correctly identified at the appropriate moment, and regulators tried to correct these potential problems establishing timetables for implementation. The problem was that, in some cases the authorities themselves altered these timetables.. In other cases, markets themselves demanded more capital and regulators did not react by issuing other regulations that tried to offset this pro cyclical tendency of the markets.

We know that decision making, especially in real time, is a difficult task. And I do not think that doing, before deciding, a cost-benefit analysis on the effects of decisions on prevent and exit from the crisis will be a panacea. In some cases it would continue to be difficult to solve the trade-off, but in many other cases we could spare ourselves wrong decisions resulting not from an inadequate evaluation of different effects but simply because there was no assessment at all.

The idea is that until the crisis is not over should we carefully consider what effects the decisions that we are taking on the evolution of the crisis have. We should ask if our decisions serve to alleviate the crisis, if they are neutral or even if, as it has happened in some cases, they could aggravate it. And while the crisis is not over, the objective of exit from the crisis must predominate over preventing the next one. Preventing is important, it is very important, and, if it does not have effects on the exit of the crisis, prudential regulations must be adopted as soon as possible. But, if they have negative effects on the economy we must think twice. Or, if you prefer, we must wait a little. Costs of postponing a prevention framework exist and must be considered, but usually they are not very important in the short run because crisis induce prudent behavior in the agents themselves, that help to delay a new crisis. Peoples' - borrowers and lenders - behavior is always pro cyclical. They make procyclical decisions in good times but equally in bad times. They risk too much in good times but they fly away from risk and they are extremely prudent in bad times.

All in all, the work done during the last five years, has been very positive. I mentioned to you only the examples of wrong decisions but I could give you other important examples where the exit objective predominated over the prevention objective. Probably the best example is the Monetary Policy applied since Lehman collapsed. You surely know the view of the critics on Quantitative Easing or on many other unconventional monetary policies implemented up until now. These critics go as far as saying that this policy not only will not prevent the next crisis but even, they say, it is planting the seeds of the next crisis. Of course central bankers have entered in unchartered waters and their decisions are not without risks. But they have been crucial in avoiding a new Great Depression.

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I am not naive. I do not believe that just by demanding that authorities assess costs and benefits, we will immediately get authorities to always act rationally. They will continue to act irrationally as other humans. To understand their decisions and to avoid irrational decisions we should apply social psychology to their behavior. Unfortunately there has been little progress in studying the cases when national authorities or international institutions have not adopted rational decisions in contrast with the significant advancement of behavioral economics over the last decades. Thirty years ago Economics was based on welfare maximization under the central assumption that economic agents act rationally. But throughout those three decades economists like Kanehman, Akerloff, Schiller and many others made a lot of progress in analyzing irrational behavior of consumers, executives, investors and all economic agents. The result of this work is that the paradigm of Economics has changed significantly today.

Although we now widely accept that investors and consumers can act irrationally, we continue assuming that authorities and international organizations act rationally. We have learned that investors may act as a herd, we discern all kinds of cognitive bias, etc., but we do not yet dare to apply these theories to the economic authorities.

7
A Critical Evaluation of Bail-in as a Bank Recapitalisation Mechanism

Charles Goodhart* & Emilios Avgouleas**

Abstract

Many of the world's developed economies have introduced, or are planning to introduce, bank bail-in regimes. Both the planned EU resolution regime and the European Stability Mechanism Treaty involve the participation of bank creditors in bearing the costs of bank recapitalization via the bail-in process as one of the (main) mechanisms for restoring a failing bank to health. There is a long list of actual or hypothetical advantages attached to bail-in centered bank recapitalizations. Most importantly the bail-in tool involves replacing the implicit public guarantee, on which fractional reserve banking has operated, with a system of private penalties. The bail-in tool may, indeed, be much superior in the case of idiosyncratic failure.

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Nonetheless, there is need for a closer examination of the bail-in process, if it is to become a successful substitute to the unpopular bailout approach. This paper discusses some of its key potential shortcomings. It explains why bail-in regimes will fail to eradicate the need for an injection of public funds where there is a threat of systemic collapse, because a number of banks have simultaneously entered into difficulties, or in the event of the failure of a large complex cross-border bank, except in those cases where failure was clearly idiosyncratic.

A. Introductory Remarks

The scale of losses flowing from bank failures is initially independent of the identity of those upon whom the burden of meeting that loss falls. But, such losses also can then entail critical externalities. These have traditionally justified the public bailouts to avoid the systemic threat that the failure of any bank beyond a certain size carries with it.

Nevertheless, public bailouts of banks are a source of moral hazard and they undermine market discipline. One of the key principles of a free market economy is that owners and creditors are supposed to bear the losses of a failed venture. Bailouts can also have a destabilizing impact on public finances and sovereign debt, with UK and Irish finances being held as illustrative examples of the impact of such costs.[1]

These concerns have given rise to reforms to internalize the costs of bank failure of which the foremost is the drawing up of bank creditor bail-ins. Essentially, bailing in bank creditors constitutes a radical rethinking of who bears the ultimate costs of the operation of fractional reserve banking.

A great momentum has built up for basing resolution on bail-in, which sometimes resembles a 'chorus' (wording used in McAndrews, et al, (2014), p. 14). The regulatory authorities in most of the

1 This is a nearly undisputable argument against bailouts and is fully endorsed in this paper. However, bailout costs cannot be accurately measured unless the costs of the alternative potential instability are also counted (Dewatripont, 2014).

world's developed economies have developed, or are in the process of developing, resolution regimes that allow, in principle, banks to fail without resorting to public funding.

The bail-in approach is intended to counter the dual threat of systemic disruption and sovereign over-indebtedness. It is based on the penalty principle, namely, that the costs of bank failures are shifted to where they best belong: bank shareholders and creditors. Namely, bail-in replaces the public subsidy with private penalty (Huertas, 2013) or with private insurance forcing banks to internalize the cost of risks, which they assume.

In these new schemes, apart from the shareholders, the losses of bank failure are to be borne by ex ante (or ex post) funded resolution funds, financed by industry levies, and certain classes of bank creditors whose fixed debt claims on the bank will be converted to equity, thereby restoring the equity buffer needed for on-going bank operation.

This is an important development, since in the past banks' subordinated debt did not provide any cover when bank liquidation was not an option, which meant that subordinated creditors were bailed out alongside senior creditors by taxpayers (Gleeson, 2012). This led to creditor inertia.

Turning unsecured debt into bail-in-able debt should incentivize creditors to resume a monitoring function, thereby helping to restore market discipline. For example, as the potential costs of bank failure would fall on creditors, in addition to shareholders, such creditors should become more alert about the levels of leverage the bank carries (Coffee, 2011), limiting one of the most likely causes of bank failures and the governance costs associated with excessive leverage (Admati et al. 2013; Avgouleas and Cullen, 2014b). Normally, shareholders have every incentive to build leverage to maximize their return on equity (Admati et al. 2012; Avgouleas and Cullen 2014a).

Such monitoring might, in turn, reduce the scale of loss in the event of a bank failure: creditors could force the bank to behave more cautiously, especially where the bail-in regime allows for earlier intervention and closure than a bail-out mechanism. It should also, in principle, eliminate the 'too-big-to-fail' subsidy enjoyed by bigger banks.

Essentially, bail-in provisions mean that, to a certain extent, a pre-planned contract replaces the bankruptcy process giving greater certainty (Coffee, 2011) as regards the sufficiency of funds to cover bank losses and facilitating early recapitalisation. Moreover, the bail-in tool can be used to keep the bank as a going concern and avoid disruptive liquidation or dis-membering of the financial institution in distress.

But the idea that the penalty for failure can be shifted onto an institution, such as a bank, is incorrect. Ultimately all penalties, and similarly benefits, have to be absorbed by individuals, not inanimate institutions. When it is said that the bank will pay the penalty of failure, this essentially means that such penalty is paid in the guise of worsened terms, by bank managers, bank staff, bank creditors or borrowers. The real question is which individuals will be asked to absorb the cost.

The goals of the bail-in process are not the same in every jurisdiction. In the United States the process through which bail-in and subsequent conversion of creditor claims takes place for SIFIs is imbedded in the mechanics and architecture of the resolution process that is applied to systemically important institutions, the so-called Orderly Liquidation Authority (OLA) of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. This means that triggering the bail-in process under Title II aims at providing with sufficient capital the entities that will emerge following liquidation of the resolved parent institution (see section B below).

In the European Union, on the other hand, the doom-loop between bank instability and sovereign indebtedness has left Eurozone governments with a major conundrum. The traditional route of a public bailout is increasingly ruled out, not only due to a principled adherence to the avoidance of moral hazard, but also due to its potential impact on already heavily indebted countries. To answer this challenge, the Eurozone has established the European Stability Mechanism (ESM) to act, amongst other purposes, as an essential component of the European Banking Union (EBU). Both the ESM statute and the new EU Resolution regime based on the forthcoming EU Bank Recovery and Resolution Directive (BRRD) require the prior participation of bank creditors in meeting the costs of bank resolution. This means that either the bank remains a going concern and the bail-in process is triggered to effect bank recapitalization to restore it to health ("open bank" bail-in process) or in conjunction with the exercise of resolution powers treating the bank as gone concern ("closed bank" bail-in process). This contrasts with DFA's approach to SIFI resolution, discussed in section B(1) below, where only the second approach is used. This bifurcation is likely to prove problematic.[2]

Similarly, the intention is that intervention will be sooner (forbearance less), so that losses will be less, but whether that hope will be justified is yet to be seen. We discuss this further in section C below.

The desire to find an effective way to replace the public subsidy and the unpopular bailout process is entirely understandable and can lead to welfare enhancing outcomes. At the same, time, there is a danger of over-reliance on bail-ins, in part owing to the growing momentum for its introduction. In placing bail-in at the heart of bank resolution regimes, legislators and regulatory authorities ought not to overlook some important shortcomings attached to this approach. This paper sets out to discuss these shortcomings and to explain why, arguably, bail-in regimes will not remove, in the case of resolution of a large complex cross-border bank, (unless the risk is idiosyncratic, for example fraud), or in the event of a systemic crisis, the need for public injection of funds. In our analysis we particularly focus on BRRD's distinction between the resolution of banks that have be-

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2 Notably, although both the US and the European authorities are moving simultaneously towards reliance on bail-in mechanisms, we are struck by how little attention appears to be paid in each to the detail of what the other is doing. It is instructive that in the FRBNY Special Issue on 'Large and Complex Banks' (2014), the papers by McAndrews, et al, and Sommer hardly mention Basel III, the BRRD or any European initiative. Equally much of the discussion within Europe on its own resolution mechanisms ignores the DFA, and looks inwards.

come bankrupt ("gone concern"), from the recapitalization (also as part of the resolution regime) of banks that have become so fragile as to need intervention and recapitalization, but are not (yet) bankrupt, ("going concern"). Although this distinction is hallowed in the literature, we argue that it may be less clear-cut in practice than is sometimes suggested.

B. The Architecture of the Bail-in Process

1. Bank resolution and Bank Bail-in under the Dodd Frank Act (DFA)

(a) Overview

Under section 204(a) (1) of the Dodd Frank Act creditors and shareholders bear all the losses of the financial company that has entered OLA. This is in accord with one of the Act's explicit aims, as stated in its preamble: "to protect the American taxpayer by ending bailouts." To this effect, Title II of the Dodd-Frank Act provides the FDIC with new powers to resolve SIFIs. Under OLA, the FDIC may be appointed receiver for any U.S. financial company that meets specified criteria when resolution under the U.S. Bankruptcy Code (or other relevant insolvency process) would be likely to create systemic instability.

In order to make group resolution effective and to minimize systemic disruption, the FDIC has decided that it will follow the Single Point of Entry approach (SPOE) (FDIC, 2013), which is the final step in the implementation of the "source-of-strength" doctrine (enshrined in section 616(d) of the DFA). In the event of bank failure the top-tier holding company will have to enter into receivership and attendant losses will be borne by the holding company's shareholders and unsecured creditors. Section 210(a)(1)(M) of the Act provides that the FDIC, as the receiver for a covered financial company, succeeds by operation of law to all the rights, titles, powers, and privileges possessed by, inter alia, the creditors of the resolved and all rights and claims that the stockholders and creditors of the resolved institution may have against its assets are terminated, but for their right to receive payment under the provisions of section 210. The FDIC would then form a bridge holding company ("Newco") and transfer the failed holding company's ownership of healthy operating subsidiaries into it, leaving the holding company shareholders and creditors behind in the estate of the failed holding company. Operating subsidiaries that face no solvency problem will be transferred to the new solvent entity or entities (NewCo).[3]

Section 210 requires the FDIC to conduct a claims process and establish a claims priority pyramid for the satisfaction of claims against the resolved entity without the use of taxpayer funds. At the conclusion of this process claims against the receivership would be satisfied through a debt-for-securities exchange in accordance with their priority under section 210 through the issuance of debt and equity in the new holding company.

Prior to the exchange of securities for claims, the FDIC would determine the value of the bridge financial company based upon a valuation performed by the consultants selected by the board of the bridge financial company. Yet the FDIC has stated that it expects "shareholders' equity, subordinated debt and a substantial portion of the unsecured liabilities of the holding company—with the exception of essential vendors' claims— to remain as claims against the receivership." (FDIC, 2013).

This is essentially the bail-in process under Title II, which aims at giving the NewCo what is essentially a clean bill of health rather than turning unsecured creditors into NewCo shareholders. OLA's bail-in process will be utilized to resolve the holding company ("closed bank" process), although the operating subsidiaries remain unaffected, and, thus, it differs from the BRRD approach that provides, in addition, the option to use an "open bank" bail-in process.

By establishing the bridge financial company with significant assets of the parent holding company and many fewer liabilities, it is hoped that the bridge financial company would have a strong balance sheet

3 "The term 'bridge financial company' means a new financial company organized by the Corporation in accordance with section 210(h) for the purpose of resolving a covered financial company." (Dodd-Frank, Title II, Sec. 201 (3)).

that would put it in a good position to borrow money from customary market sources. The FDIC has indicated that contingent value rights, such as warrants or options allowing the purchase of equity in the new holding company or other instruments, might be issued to enable funding the transition/resolution (FDIC, 2013). If there are shortfalls or these sources of funding are not readily available, the SPOE approach offers the benefit of FDIC's access to the Orderly Liquidation Fund (OLF), provided that borrowings from the fund can be fully secured and repaid. Any costs incurred by the FDIC as the appointed receiver or other public authority which cannot be covered by the above will be recovered from the industry.

The bail-in approach is not new in US bank resolution practice. For example, in 2008, the FDIC exercised its existing powers and resolved the part of the Washington Mutual group that was not sold to JP Morgan Chase, mainly claims by equity holders and creditors, under the least-cost resolution method. It imposed serious losses on the unsecured creditors and uninsured depositors (deposit amount above USD 100,000).[4] OLA further expands the resolution authority of FDIC, including its power to cherry-pick which assets and liabilities to transfer to a third party, (though these will be subject to strict conditions to be further detailed by the FDIC) and to treat similarly situated creditors differently, e.g., favouring short-term creditors over long-term creditors or favouring operating creditors over lenders or bondholders. This discretion is curbed by the introduction of a safeguard that creditors are entitled to receive at least what they would have received if liquidation had taken place under Chapter 7 of the Bankruptcy Code (comparable to the "best interests of creditors" test under the Bankruptcy Code).

(b) Evaluation

Although TARP and other forms of direct bank capitalization by the US Treasury during the 2008 crisis did not prove to be loss-making, the issue of moral hazard and principled opposition to a private company receiving public assistance in bankruptcy means that one of

4 FDIC Press Release, 'Information for Claimants in Washington Mutual Bank' 29 September 2008, available at http://www.fdic.gov/news/news/press/2008/pr08085b.html

DFA's key rationales is exclusion of bailouts. Thus, as mentioned earlier, OLA treats the holding company as a bankrupt (gone) concern. There may, however, be some caveats.

First, the dismemberment of the parent holding company, in order to provide the necessary funding for the recapitalization of the operating banking subsidiary(ies) may have reputational impact on the entire group, including the (seemingly unaffected) operating subsidiaries.

Could the subsidiary bank, with help from the authorities, really handle the reputational fall-out?[5] Historical evidence of reputational contagion, e.g. in the case of certain solvent subsidiaries of BCCI, would suggest that this could be a real danger. If such depositor flight should then occur, the Central Bank (or in the USA the Orderly Liquidation Fund) might have to pump in large amounts of liquidity. While this would be protected by seniority and collateral, the previous buffer represented by the holding company's capital would, at least initially, no longer be there. So a large portion of the operating company's continuing liabilities might come either from the Central Bank (or OLF) or be backed by the deposit insurance fund, with some potential call on public support.

The second question is about the speed of rebuilding the capital structure of a new holding company ("HoldCo") after the bankruptcy of the initial holding company. While bail-in is not taken in isolation but is part of a restructuring process under which management is replaced and group business restructured, if the new HoldCo's capital structure is not rapidly rebuilt, one would be left with an initially thinly capitalized operating bank (Sommer, 2014) plus large public sector liabilities. The government cannot force private sector buyers to purchase new equity and (subordinated) debt in a new HoldCo, and the prior experience would make private buyers wary. Of course, the authorities could massively expedite the process by injecting new capital into a new HoldCo, (with the aim of selling off such equity later back to the private sector), but that would just be another form of bail-out.

5 No doubt the resolution would have to be accompanied by a careful communication strategy, but the example of Northern Rock shows how this can go wrong.

The third question is about costs to the rest of the sector of rolling over maturing bail-inable debt, once it has been announced that losses have been imposed on the original failed holding company's holders of bail-inable debt in the event of that bank's failure. The cost of such debt could spike and the HoldCos might be tempted to let their own buffers slip below the required level. Of course regulatory authorities could impose sanctions in such cases. But in doing so they will have to consider the impact of rising funding costs to the sector, both in terms of operating costs and in terms of solvency if such intervention takes place, as is likely, in a recessionary economic climate or worse during a generalized bank asset crisis.

The fourth question relates to the interaction between the DFA approach and the Basel III capital requirements, which appear to necessitate an earlier intervention approach than DFA's OLA. Under the latter, the authorities should intervene to resolve a bank whenever its core tier 1 equity falls below 4½% of Risk Weighted Assets. A bank with CT1E between 0 and 4½% is not formally insolvent, i.e., it is still "going", rather than "gone", concern. It is to be hoped that regulators would intervene in a failing bank before the formal insolvency point is reached. But then they would not be able to bail-in senior unsecured debtors under the "no creditor worse off" (NCWO) condition. Either all the debt in the HoldCo, comprising subordinated debt or contingent capital instruments (Co-Cos), would have to be designated as bail-in-able, which could have a considerable effect on bank funding costs, or the authorities could just not take preemptive action, disregarding the Basel III requirement. Either route might prove problematic.

2. The FDIC-BoE Approach to Resolving G-SiFIs and Bail-in

Dodd-Frank explicitly authorizes coordination with foreign authorities to take action to resolve those institutions whose collapse threatens financial stability (Title II, section 210, N). A heat-map exercise conducted by US regulators determined that the operations of U.S. SIFIs are concentrated in a relatively small number of jurisdictions, particularly the United Kingdom (UK) (Gruenpeng (Chairman, Federal Deposit Insurance Corporation) 2012). Thus, the US and

UK authorities proceeded to examine potential impediments to efficient resolutions and on a cooperative basis explored methods of resolving them (Tucker, 2014).

This culminated in the joint discussion paper published by the Bank of England (BOE) and the Federal Deposit Insurance Corporation (FDIC) titled, *Resolving Globally Active, Systemically Important, Financial Institutions* comparing the resolution regime established by Dodd Frank Act Title II to the resolution powers of the UK's Prudential Regulation Authority (PRA). To this effect the two authorities have proposed that they will adopt the single point of entry" (SPOE) approach, when appropriate,[6] in the resolution of G-SIFIs.

Although initially a group taken into resolution would be "owned" by the FDIC (in the US) or, perhaps, under a trustee arrangement (in the UK), the intention is that the group would be returned to private ownership, with the creditors whose debt is converted into equity becoming the new owners of the group. Both the BRRD and the UK Financial Services (Banking Reform) Act 2013, implementing government's plans to introduce, with modifications, the Vickers' Report recommendations, include requirements that banks have sufficient capital and debt in issue to make them resolvable using bail-in or other resolution tools.

Under the HoldCo approach the continuity of critical economic activities is preserved because – in most cases – the subsidiaries of the holding company should be able to continue in operation, either because they have remained solvent and viable, or because they can be recapitalised through the writing down of intra-group loans made from the holding company to its subsidiaries. A subsidiary would need to be resolved independently only where it had suffered large losses.

Under the FDIC-BoE joint paper, in the UK the equity and debt of a resolved holding company would be held initially by a trustee, though the BRRD now provides alternative methods as well (Arts

6 The joint Paper recognizes that multiple point of entry (MPE) may be more appropriate in some cases of complex cross-border banks.

47, 48, 50). The trustee would hold these securities during a valuation period. The valuation is undertaken to assess the extent to which the size of the losses already incurred by the firm or expected to be incurred can be ascertained in order to determine the extent of required recapitalization. Namely, valuation of losses determines the extent to which creditor claims should be written down and converted. During this period, listing of the company's equity securities (and potentially debt securities) would be suspended.

Once the amount of required recapitalisation requirement has been determined, an announcement of the final terms of the bail-in would be made to the previous security holders. On completion of the exchange the trustee would transfer the equity to the original creditors. Creditors unable to hold equity securities (e.g. because they cannot legally hold equity shares) will be able to request the trustee to sell the equity securities on their behalf. The trust would then be dissolved and the equity securities of the firm would resume trading.

3. The European Approach

Bail-in is a pre-condition for bank resolution in the EU and for (ultimately) ESM implemented bank recapitalization within the Eurozone. In a nutshell before a Member State is allowed to tap ESM resources for direct recapitalization of a failing bank, a round of bail-in and national contributions must have taken place. National regulators must first impose initial losses representing at least 8% of the bank's liabilities on shareholders and creditors (Art. 38 and 39 of the BRRD (as finalized by EU Council Decision, Dec. 2013)) before they can use the national resolution fund to absorb losses or to inject fresh capital into an institution, and then only up to 5% of the bank's liabilities. In the event that bank losses exceed 13% of its liabilities, a further bail-in round may take place in order for the residual losses to be absorbed by creditors and non-guaranteed and non- preferred depositors before public money and then ESM funds are used. These conditions make ESM assistance an absolute last resort in order both to counter moral hazard and to allay any fears of de facto mutualization of liability for bank rescues in the Eurozone.[7] It is clear that the EU holds high hopes about the effectiveness of this mechanism, an approximation to which has already been tried in Cyprus in March 2013[8] and for the restructuring of the Spanish banking sector.[9] It is also hoped that bail-in will nullify the need for state aid for the banking sector across the EU and not just within the confines of the Eurozone (Angeloni, Lenihan, 2014).

Yet the legal entity by legal entity approach raises its own set of difficult issues. In the case of non-EBU groups, resolution colleges might smooth co-ordination issues but a bail-in decision has distributional consequences, potentially with clear losers. So in some cases it might even create a crisis of confidence in a member state's banking system, and strong disagreements are bound to arise as to which subsidiary is bailed-in and which is not. Where there are subsidiaries in non-EBU European countries such disagreements could even go as far as creating serious problems in the relationship of the EBU with non-EBU European countries, especially where losses are bound to fall unevenly. The obvious solution is to follow a group-based resolution approach and aggregate all losses to the group entity in accordance with the US model, but that would seem to us to reinforce subsidiarisation, which goes against the operating principles and constitutional freedoms underpinning the single European market.

C. Problems of Bail-in for a "going concern" bank

1. Effective Resolution Substitute?

While OLA provides for the liquidation of the bank holding company, it uses bail-in to leave operating subsidiaries unaffected. The EU, on the other hand, has an "open" bank resolution process that is reliant on the successful bail-in of the ailing bank. So both jurisdictions

7 See Arts 1-3 of ESM Guideline on Financial Assistance for the Recapitalisation of Financial Institutions.

8 While the authorities would say that the Cypriot case was very different, given the absence of the resolution tools provided by the BRRD, we feel that its implementation gave important further momentum to the adoption of bail-in processes.

9 See Bankia Press Release, 'BFA-Bankia expects to culminate recapitalisation in May' March 2013, available at http://www.bankia.com/en/communication/in-the-news/news/bfa-bankia-expects-to-culminate-recapitalisation-in-may.html

view the bail-in process as a substitute to liquidation of either the entire group or of parts of the group, combined of course with the use of other resolution tools. This is not an unreasonable approach, especially in the case of a largely idiosyncratic cause of failure, e.g., fraud. But there are four essential conditions that have to be met when using the bail-in process as a resolution substitute: timing, market confidence, the extent of restructuring required, and accurate determination of losses.

First, the issue of when to trigger the bail-in process, taking also into account the requirements of early intervention regimes (e.g., Art. 23 et. seq. BRRD), is a matter of cardinal importance. Identification of the right time and conditions to trigger the bail-in tool in a process that extends conversion beyond specially designed bail-able debt will be one of the most important for any bank supervisor. The reasoning leading to supervisors' decision will much resemble first and second order problems in mathematics and logic. If the supervisor triggers bail-in early, then the full measure of losses may not have been fully revealed, risking further rounds of bail-in. But if the supervisor determines to use the bail-in tool at a later stage, when the full scale of losses to be imposed on creditors is revealed, they risk a flight of bank creditors who do not hold ex ante specifically designed bail-inable debt, defined hereinafter as D bail-inable debt.

Moreover, speed of resolution/recapitalization (albeit at the expense of flexibility) is one of the reasons for the popularity of bail-in among regulators (Sommer, 2014). Yet, we doubt whether the adoption of bail-in regimes would lead to earlier regulatory intervention than under the bail-out regimes. The aforementioned paper by McAndrews, et al, reinforce our view that legal concerns about imposing potentially large losses on private creditors could unduly delay resolution, perhaps until the last possible minute. By then the liabilities needed to be written down could extend beyond HoldCo's specially designated bail-inable debt. Bail-out, being undertaken by the authority of the government, is, we would argue, somewhat less liable to legal suit than bail-in. On the other hand, bail-in of bank liabilities that extends beyond D bail-inable debt affects a wider range of creditors; there are more parties to the negotiation, and hence that may be more protracted. In our view, the more delayed will be the onset of Resolution, the more essential it will be to put more emphasis on an earlier Recovery phase.

There are also other concerns. In the absence of a fiscal backstop for other parts of the financial system, if bail-in is triggered before measures have been taken to buttress the rest of the financial system a creditor flight from other banks will be certain, spreading the tremors throughout the financial system, even if those banks retain sufficient amounts of D bail-in able debt.

Secondly, market confidence in the bailed-in institution would have to be quickly restored in order to preserve franchise value and repay official liquidity support (Sommer, 2014). As mentioned in section B(1)(b) above this is mostly dependent on how fast the capital structure of the requisite bank (or the new bank in the event of a "closed" bank process) is rebuilt. If the institution has entered into a death spiral with customers, creditors and depositors fast disappearing reversing the trend would doubtlessly prove a task of daunting proportions.

Thirdly, triggering the bail-in process will prove unsuccessful if bank losses are not properly identified in some finite form. The determination of bank losses including unrealized future losses must be accurately determined in order to avoid successive rounds of bail-in losses accruing to bank creditors. This might in fact prove a challenging task. For example, bank losses in the recent crisis have consistently been underestimated.

Normally bank failures occur when macro-economic conditions have worsened, and asset values are falling. Bank failures during boom conditions, e.g. resulting from fraud, such as Barings, are easier to handle with less danger of contagion. In the uncertain conditions of generalized asset value declines, the new (incoming) accountants, employed by the resolution agency, are likely to take a bad scenario (or even a worst case) as their base case for identifying losses, to be borne by the bailed-in creditors, partly also to minimize the above-mentioned danger of underestimation leading to further calls on creditors. Previously the accountants of the failing bank itself will have been encouraged (by management) to take a more positive view of its (going concern) value. Thus the transition to bail-in is likely to lead to a huge discontinuity, a massive drop, in published accounting valuations. This could put into question amongst the general public the existing valuations of other banks, and lead, possibly rapidly, to a contagious crisis, on which we add more below.

Moreover, restructuring should extend to the underlying business model, which led the bank to bankruptcy in the first place, to avoid several bail-in rounds in the future.

2. Who Meets the Burden?

(a) Overview

In general, banks have three types of creditors:
banking creditors, including retail and wholesale depositors, needing to use the provision by the bank of payment and custody services;
investment business creditors, including swap counterparties, trading counterparties, and those with similar claims from trading activity such as exchanges, clearing systems and other investment business counterparties (including repo counterparties);
financial creditors, comprising long term creditors of the bank, including bondholders and other long-term unsecured finance providers (Clifford Chance, 2011).

When banking groups are resolved, only the third type of creditors should be affected by bail-in, since banking creditors and investment business creditors will most likely hold claims against unaffected operating subsidiaries. This is, however, not the case where, under the EU approach, resolution is undertaken at the legal entity level. Under the BRRD business creditors may be exempted, through pre-designed "carve-outs". It is not inconceivable that this exemption may be utilized to shift disproportionately the burden of bail-in onto other classes of creditors such as bondholders and unprotected depositors.

Arguably, in contrast to bail-outs, where all the taxpayers are, in some sense, domestic constituents, an advantage of bail-in is that some creditors may be foreign, but this is an elusive and possibly false advantage. The aim to penalise Russian creditors of Cypriot banks might have played a significant role in the way that "rescue" was structured. Similarly the treatment of the creditors of Icelandic banks was organised in such a way as to give preference to domestic depositors over foreign bondholders[10]. But the foreign investors would, of course, realise that they were in effect being targeted, so that they would both require a higher risk premium and flee more quickly at the first sign of potential trouble. The result is likely to be that a larger proportion of bank bondholders will be other (non-bank) financial intermediaries of the same country, providing a further small ratchet to the balkanization and nationalisation of the banking system. In any case, the BRRD disallows discrimination between creditors on the basis of their nationality or domicile, eradicating this mis-conceived advantage of bail-ins over bailouts.

With a purely domestic bank, the effect of shifting from bail-out to bail-in will, therefore, primarily transfer the burden of loss from one set of domestic payers, the taxpayers, to another, the pensioners and savers. It is far from clear whether, and why, the latter have broader backs and are better placed to absorb bank rescue losses than the former. One argument, however, is that savers, and/or their financial agents, have made an ex ante choice to purchase the claim on the bank, whereas the taxpayer had no such option, and that, having done so, they could/should have played a monitoring role. While this is a valid point, the counter-argument is that charities, small or medium size pension funds, or individual savers, e.g., via pension funds, do not really have the expertise to act as effective bank monitors. Thus, forcing them to pay the penalty of bank failure would hardly improve bank governance. On the contrary it would only give rise to claims that they were "tricked" into buying bail-in-able debt.[11] Arguably, BRRD's provisions (Art. 37(3)(c)(iii) and

10 See S. Goodley, "Bondholders may take legal action against Iceland over failed banks Bondholders may take legal action against Iceland over failed banks", *The Guardian*, 7 November 2010, available at http://www.theguardian.com/business/2010/nov/07/iceland-banks-bondholders-legal-action

11 Would such bail-in able debt be a suitable investment for pension funds, charities, local authorities and individuals? The Pensions Regulator, the Department for Communities and Local Government, the Charities Commission and the FCA may need to consider whether further rules in this area would be necessary.

Recitals 48(a) and 78(a)) reflect these concerns by giving resolution authorities the power to exempt (in "exceptional circumstances"), from the application of the bail-in tool, liabilities held by individuals and SMEs beyond the level of insured deposits. The chief rationale for this discretionary exemption is avoidance of contagion, a very plausible concern. If it is applied in a wider context, this safe harbour could provide adequate protection to vulnerable segments of savers' population. These are, in general, weak bank governance monitors and, at the same time, stable sources of cheap funding. Such wider (albeit ad hoc) protection would reinforce the confidence of these parts of society and economy in the banking system.

3. Governance

The treatment of bailed-in creditors, especially where creditors will be issued new securities rather than having their claims written-down, is likely to be complex, time-consuming and litigation intensive. Faced with such costs the original creditors are likely to sell out to those intermediaries that specialise in such situations, e.g. "vulture" hedge funds. So, as already seen in the case of the Co-op Bank, ownership may fall into the hands of a group of such hedge funds[12]; the same would probably have happened had there been creditor bail-in in Iceland and Ireland. In Cyprus creditor bail-in has given a large share of ownership to big Russian depositors.[13] In theory, this problem could be resolved by placing caps on how much bail-inable debt different creditors could hold. In practice, however, such caps would encounter legal constraints, at least, under EU law. In addition, if caps are very strict, they would restrict the liquidity of the market for bail-inable debt and could lead to banks having to hold insufficient amounts of bail-inable debt, increasing the need for a public bail out.

In spite of their numerous disadvantages, bail-outs do give governments the power to direct and specify who is to take over the running

12 See M. Scuffham, "Co-op to cede control of bank to bondholders", Reuters, 21 Oct. 2013, available at http://uk.reuters.com/article/2013/10/21/uk-coop-bank-bondholders-idUKBRE99K05O20131021

13 A. Illmer, 'Russia's rich dominate Cyprus' largest bank', Deutsche Welle, 18 Oct. 2013, available at http://www.dw.de/russias-rich-dominate-cyprus-largest-bank/a-17146540

of the rescued bank. That is not the case with some versions of the bail-in approach. In the USA the role of the FDIC as "trustee" of the resulting bridge company should, however, deal with this point. But elsewhere the resulting governance structure could become unattractive to the authorities and public. While there is a safeguard that the new managers have to be approved by the regulatory authorities, nevertheless the ethos, incentives and culture of a bank, whose ownership is controlled by a group of hedge funds, for example, is likely to differ from that of a bank rescued by a bail-out.

4. Legal Costs

While there might be a few jurisdictions such as the UK where bail-in regimes can be established by contract, elsewhere this route would lead to a stream of litigation (Gleeson, 2012). As a result, in most jurisdictions, including the UK, bail-in regimes are given statutory force (e.g., Art. 50(2) of the BRRD). Yet this does not mean that litigation will be avoided when the bail-in process is triggered. Bail-in regimes that extend beyond D bail-inable debt clearly encroach on rights of property, which remain entrenched in countries' constitutions and international treaties. Legal claims will be raised both by shareholders who will see their stakes wiped out and creditors who will see the value of their claims reduced or diminished[14] and it is unlikely that the "no creditor worse off" principle, which both Dodd-Frank and the UK's Banking Act and the BRRD (Art. 29(1)(f)) have adopted as a creditor safeguard under the bail-in process, will deter the expected stream of litigation. In fact, the principle could make litigation even more likely. Therefore, where the result of government action is that bailed-in creditors receive a demonstrably lower return than they would have done had the bank proceeded to disorderly liquidation, they should be compensated (Gleeson, 2012), but by whom and in what form? Would that be in the form of shares in the NewCo or of the recapitalized operating subsidiary? Even so, rapid restoration of public confidence is the only way to make creditors' converted stakes valuable.

14 E.g., see "Russian depositors begin seizing property of Cypriot banks", Russia Today, 12 April 2013, available at http://rt.com/business/laiki-cyprus-banks-arrest-765/

Moreover, a significant proportion of the costs of bank resolution could involve settling conflicts of interest among creditors (IMF, 2013). This is particularly likely to be so in so far as bail-in will concentrate ownership amongst "vulture" hedge funds, whose métier is the use of legal means to extract large rents. Shifting the burden of meeting the costs of recapitalisation from a small charge (on average) imposed on the generality of taxpayers to a major impost on a small group of creditors, easily capable of acting in unison, is almost bound to multiply the legal costs of such an exercise manifold, however much the legal basis of this process is established beforehand.

This is easily explainable. In the case of taxpayer-funded bail-outs, everyone's tax liabilities go up a little, (and the relative burden has, in a sense, been democratically reviewed and decided); in the case of creditor bail-in, a few will lose a lot, and will, therefore, have stronger incentive to protest and litigate.

5. Funding Costs

There are two aspects to this, a static and a dynamic one. There have been numerous quantitative studies of the "subsidy" provided by the implicit government bail-out guarantee to the larger banks which are too-big-to-fail (Santos, 2014; Morgan and Stiroh, 2005; Ueda and Weder-Di Mauro, 2011; Li et al. 2011). There is sufficient evidence to show that Too-Big-To-Fail banks are prone to take much riskier assets than other banks (Afonso et al. 2014; Brandao et al. 2013; Gadanetz et al. 2012, Gropp et al. 2011).

Such a subsidy is also criticised as undesirable and unfair distortion of competition. Taking advantage of lower funding costs, larger banks cut margins aggressively to edge out smaller competitors (Hakenes and Schnabel, 2011). Thus, the subsidy distorts the pattern of intermediation towards larger banks and away from smaller banks and non-bank intermediation, including peer-to-peer channels. But there is a counter-argument. Shifting intermediation to smaller banks or to other parts of the financial system will take it from safer, better regulated and more transparent banks (including bigger banks) to riskier, less regulated, and less understood channels. In addition, dependent on the state of competition between banks, much of that subsidy will have gone to providing better terms, primarily in the shape of lower interest rates, to bank borrowers. Controversially, perhaps, size improves banks operating costs (Kovner et al. 2014).

Funding costs may not be a major concern in the case of bail-inable debt but there might be an issue of adverse selection. First, another facet of the same, static question is by how much funding costs of (large) banks have to rise if they have to hold specifically bail-inable debt. There are a range of views about this. As in the case of equity (Miles et al., 2011, and Admati et al. 2011), if we compare one otherwise identical equilibrium with another, when the sole difference is that some categories of bank debt become bail-inable, it is doubtful whether the overall cost of bank funding would rise by much, say 10-30 bps. Moreover, with a rising proportion of bank creditors at risk from bank failure, there should be a greater benefit, in terms of lower funding costs, from a patently safer overall portfolio structure. As explained in Section A above, one of the fundamental rationales of bail-in, is that creditors at risk will have an incentive to encourage bank managers to pursue prudent policies, a counter-weight to more risk-seeking shareholders.

Secondly, bail-inable debt may affect banks' choice of assets. If institutions are required to issue a minimum amount of bail-inable liabilities expressed as a percentage of total liabilities (rather than as a percentage of risk weighted assets), critically, this will impose higher costs on institutions with large amounts of assets with a low risk weighting (such as mortgages). Such institutions typically hold relatively small amounts of capital as a proportion of their total liabilities. In addition, institutions will face constraints on their funding models and higher costs if they are required to hold bail-inable liabilities in specific locations within a group (for example at group level when their funding is currently undertaken by their subsidiaries).

That bail-in regimes will provide some ex ante incentive to more prudent behaviour seems undisputable. Yet market discipline failed to operate effectively ahead of the current financial crisis and holders of bail-inable liabilities will face the same difficulties as other stakeholders in assessing the health and soundness of bank balance sheets (See on complexity as a monitoring barrier Avgouleas and Cullen, 2014a).

In addition, if bank(s) nevertheless run into trouble, then utilization of the bail-in process will give another twist to pro-cyclicality. With bail-in, the weaker that banks become the harder and more expensive it will be for them to get funding. In this respect high trigger Co-Cos would perform better than bail-in-able bonds. While, in principle, increased creditor monitoring could translate into greater focus on prudence and caution for the individual banker, in the face of a generalised shock, a sizeable proportion of the banks in a given country will seem weaker. Thus a shift away from bail-out towards bail-in is likely to reinforce procyclicality. The ECB has been cautious about bailing-in bank bondholders for such reasons.[15]

Of course, should the sovereign be in a weak fiscal condition, bail-out costs will give another twist to the "doom loop" of bank and sovereign indebtedness. But if the costs of recapitalising the banks in a given country are so large, does it help to shift them from the taxpayer to the pension funds, insurance companies and other large domestic investors, and also on the surviving banks? No doubt the crisis would take a different shape, but would it be any less severe? It could be (politically) worse if people began to fear that their pensions were being put at risk?

6. Liquidity Concerns

Once the bail-in process has been triggered, it is highly likely that the financial institution would only be able to continue conducting business with the 'lifeline' of emergency liquidity assistance. But the amount of liquidity support that could be provided by central banks

15 Reuters, "Draghi asked EU to keep state aid rules for banks flexible", Milan, 19 Oct 2013, available at http://www.reuters.com/article/2013/10/19/us-banks-bondholders-draghi-idUSBRE99I03B20131019

and resolution funds (such as the Orderly Liquidation Fund in the US) may be constrained by a lack of sufficient high quality collateral, and by restrictions on any support that might result in losses falling on taxpayers. This would be accentuated if a number of major financial institutions had to be resolved at the same time. Critically, liquidity could be limited to supporting critical economic functions while other parts of the business are resolved.

Naturally, central banks and resolution funds will be reluctant to pre-commit to provide liquidity support in all circumstances. They will want to ensure that a "plan B" option is in place, including the immediate winding down of a failing financial institution through rapid sales and transfers, without liquidity support, which again would depend on a resolution plan drawn up in advance (KPMG, 2012). However, implementation of such plans would negate one of the biggest advantages of ("open bank") bail-in regimes, namely the continuation of the resolved entity or of operating subsidiaries as a going concern.

7. Bank Creditors' Flight and Contagion

A desideratum for a revenue raising mechanism is that the taxed cannot easily flee. It is difficult to avoid taxation, except by migration, which has many severe transitional costs. In contrast it is easy to avoid being hit with the costs of creditor bail-in; you just withdraw or sell your claim. Consequently, triggering the bail-in process is likely to generate a capital flight and a sharp rise in funding costs whenever the need for large-scale recapitalisations becomes apparent. Creditors who sense in advance the possibility of a bail-in, or creditors of institutions that are similar in terms of nationality or business models will have a strong incentive to withdraw deposits, sell debt, or hedge their positions through the short-selling of equity or the purchase of credit protection at an ever higher premium disrupting the relevant markets. Such actions could be damaging and disruptive, both to a single institution (Randell, 2011). and potentially to wider market confidence, a point that is also highlighted by proponents of the bail-in tool (Micossi et al. 2014, p. 9). In our view, market propensity to resort to herding at times of shock means

that it is not realistic to believe that generalised adoption of bail-in mechanisms would not trigger contagious consequences that would have a destabilizing effect.
Where the ceiling of guaranteed deposits is set low a significant number of large depositors might migrate to other schemes such as Money Market Funds or even Investment funds that offer higher interest rates, as in the example of contemporary Chinese shadow banks. It would certainly take a lot of explaining to justify why weakening the liquidity of the regulated banking sector and increasing its funding costs in order to boost liquidity levels and lower the funding costs of the unregulated shadow banking sector is a measure to strengthen financial stability. On the contrary, a lack of Lender of Last Resort type of liquidity support in the unregulated sector could make bank-type runs inevitable, increasing the possibility of psychological spill-overs into the regulated sector and generalized panic, (as occurred in the USA in 1907).

It is, of course, true that equity holders and bond holders cannot run in the same way that depositors can, but financial counterparties can easily do so and will do so if they do not immediately see a hefty capital cushion in the bailed-in bank (Sommer, 2014). If these flee then equity and bond holders would certainly follow and in their attempt to do so they would drive asset values sharply down to an extent that would make the option of raising new money, or rolling over existing maturing bonds, unattractive or virtually impossible. In such circumstances, bank credit extension would stop, amplifying the downturn, lowering asset values yet further and putting the solvency of other banks at risk. Excluding depositors of all brands from bail-in might reduce the danger of contagion but would not remove it.

8. International Coordination

The resolution of G-SIFIs with bail-in is examined in Appendix A. However, some thoughts are apposite here to provide a fuller evaluation of bail-in advantages and disadvantages. In our view, the top-down SPOE approach adopted by the US regulators is conceptually superior. Assets and liabilities at the operating subsidiary level are

not part of the painful debt restructuring bail-in exercise and may continue operations regardless. There are however four clear disadvantages in implementing this approach in the case of G-SIFIs.
First, the (unaffected by resolution) operating subsidiary might, nevertheless, suffer a flight due to reputational contagion, which triggers an irrational but quite likely panic, regardless of parent's ability to sufficiently recapitalize the operating parts of the group through conversion of bail-in-able liabilities. Secondly, apart from closely inter-related banking markets like the UK and the US, where the level of trust between national authorities is high, it is doubtful if any form of non-binding bilateral arrangements, including MOUs, would hold in the event of a cross-border banking crisis, involving a transfer of funds from one jurisdiction to another (Sommer, 2014). The gulf between regulators will become even deeper, if the majority of a certain form of group level funding (e.g., tripartite repos) is booked with a specific subsidiary that is not based in the same place as the HoldCo being resolved (Skeel, 2014). Thirdly, it is arguable that when the subsidiary is ring-fenced the regulators may expect the subsidiary creditors, as well as shareholders like the HoldCo, to bear the cost of bail-in. Fourthly, the top-down approach could increase scope for arbitrage and regulatory forbearance. In most cases it will be the home country regulator that will have the final word as regards the level of D bail-inable debt to be held by the HoldCo. But D bail-inable debt could prove more expensive than other subordinated debt. Thus, a home regulator concerned about the health of banks in its domestic market would be much less keen on increasing the cost of funding of its banks, unless legally bound to do so through bilateral or multilateral arrangements with host authorities. In fact, the absence of such arrangements could trigger multiple races to the bottom meaning that many HoldCos might not have a sufficient level of D bail-able debt to recapitalize the group subsidiaries. In addition, there could also be circumstances where home resolution authorities are reluctant to use the bail-in tool because of its adverse impact on specific groups of creditors (KPMG, 2012).

A host resolution authority might be tempted to trigger its own resolution and bail-in powers if it was concerned that it might not receive sufficient support from the new bridge holding company to meet losses at, and/or to preserve critical economic functions in, its local subsidiary. Art 87 of the BRRD explicitly extends this power beyond subsidiaries to branches of institutions from outside the EU. By means of this provision, EU member states can apply resolution tools, including bail-in, to such branches to protect local depositors and to preserve financial stability, independent of any third country resolution procedure, if the third country has failed to act. Similarly, subject to a number of conditions and on the basis of EU financial stability concerns, the BRRD (Art. 86) gives the right to European resolution authorities to refuse to enforce third country resolution proceedings over EU-based subsidiaries.

Accordingly the kind of international cooperation required to allow a top-down approach to operate effectively is unprecedented and it might well form the most challenging aspect of cross-border implementation of bail-in recapitalisation in the case of G-SIFIs.

Conclusion

> *"As the emerging-market crises and the entire history of financial crises made clear, imposing haircuts on bank creditors during a systemic panic is a sure way to accelerate the panic"* [16]

While we fully understand the revulsion from too-big-to-fail banks and the (political) cost of bailouts, we are worried that the development of a bandwagon may conceal from its many proponents some of the disadvantages of the new bail-in regimes. While bail-in may, indeed, be much superior in several contexts, notably in the case of idiosyncratic failure, the resort to bail-in may disappoint unless everyone involved is fully aware of the potential downsides of the new approach.

A bail-in mechanism used for the recapitalisation of a bank as going concern has the following advantages, vis-à-vis a bail-out approach:-

- Lower levels of moral hazard
- Better creditor monitoring
- Protects taxpayers

16 Geithner, 2014, p. 214.

- Places the burden more fairly
- Should improve ex ante behaviour of bank management
- Mitigates the Sovereign/bank debt "doom-loop"

But the bail-in process may also have some important disadvantages over bailouts, as it could prove to be:-

- more contagious and procyclical
- more litigious
- slower and more expensive as a process
- requiring greater subsequent liquidity injections
- leading to deterioration of governance
- requiring higher funding costs to banks
- providing a worse outlook for bank borrowers
- worsening ex post outcomes

That the second list is longer than the first is no indication of which approach should be favoured. This paper is not intended to claim that the proposed reforms will make the process of dealing with failing banks necessarily worse. Its purpose is, instead, to warn that the exercise may have costs and disadvantages, which, unless fully appreciated, could make the outcome less successful than hoped. The authorities will no doubt claim that they have already, and fully, appreciated all such points, as and where relevant. But we would contend that many advocates of moving to the latter do not mention such disadvantages at all, or only partially. Perhaps the choice should depend on context.

The bail-in process seems, in principle, a suitable substitute to resolution (whether liquidation of a gone concern, or some other form of resolution in a going concern bank) in the case of smaller domestic financial institutions. It could also be used successfully to recapitalize domestic SIFIs, but only if the institution has failed due to its own actions and omissions and not due to a generalized systemic crisis (Gleeson, 2012). Otherwise, a flight of creditors from other institutions, i.e., contagion, may be uncontainable. Even so, successful bail-in recapitalization would require rapid restoration of market confidence (Sommer, 2014), accurate evaluation of losses, and successful restructuring of the bailed in bank's operations to give it a sound business model to avoid successive rounds of bail-in rescues.

It could, of course, prove very hard for regulators to secure all those pre-requisites of a successful bail-in recapitalisation in the event of a systemic crisis.
Moreover, generic structural, governance, legal, and other risks and costs associated with a cross-border resolution of a G-SIFI make the use of the process highly uncertain in its outcome, unless failure was clearly idiosyncratic, for example, as a result of fraud.

Given these shortcomings and costs of bail-in bank recapitalisation, orderly and timely resolution of a G-SIFI would still require fiscal commitments. These could be established by means of ex ante burden sharing agreements, concluded either independently or by means of commitments entrenched in G-SIFI living wills (Avgouleas, Goodhart, Schoenmaker, 2013). Moreover, over-reliance on bail-in could deepen the trend towards disintegration of the internal market in the EU (CEPS, 2014), while providing uncertain benefits. So, effective recapitalization of ailing banks may still require a credible fiscal backstop. In addition, a fiscal backstop may be essential to avert, in the case of deposits held in the same currency across a common currency area, a flight of deposits from member states with weaker sovereigns to the member sates with solvent sovereigns (Schoenmaker, 2014). This is more or less a Eurozone specific risk, unless the current strictures on the use of ESM funds are gradually loosened. EU policy-makers ought to continue their efforts to build on this instead of relying on the unproven thesis that the bail-in process can resolve the recapitalization challenges facing the Eurozone banking sector.

Finally, achieving the goal of making private institutions responsible for their actions would be the best policy in an ideal world where financial "polluters" would be held responsible for their actions. But, in practice, it might prove an unattainable goal. If this turns out to be the case then developed societies might have to accept that granting some form of public insurance is an inevitable tax for having a well functioning banking sector. At the same time, other forms of regulation like structural reform and cycle adjustable leverage ratios (plus more emphasis on the prior Recovery stage), if they prove to make banks more stable, should come to the forefront with renewed force.

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Burden-sharing Under State Aid Rules: Evolution, State of Play and the Way Ahead

Clemens Kerle[1]

1. Introduction

This article provides an overview of the burden-sharing rules of the Commission's Banking Communication ("the Communication")[2] of 10 July 2013. The Communication is the latest adaptation of the Commission's State aid framework for aid to banks, which is based on the so-called "Crisis Communications"[3].

1 The views and expectations expressed in this article are those of the author and are not necessarily those of the European Commission.
2 Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis of 10 July 2013, OJ C 2013 216/1.
3 Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis ('(first) Banking Communication') (OJ 2008 C 270/8); Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ('Recapitalisation Communication') (OJ 2009/C 10/2); Communication from the Commission on the treatment of impaired assets in the Community financial sector ('Impaired Assets Communication') (OJ 2009 C 72/1); Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules ('Restructuring Communication') (OJ C 2009 C 195/9); Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis ('2010 Prolongation Communication') (OJ 2010 C 329/7) and Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis ('2011 Prolongation Communication') (OJ 2011 C 356/79).

The Communication establishes the principle that should a Member State want to grant capital-enhancing aid to banks, i.e. recapitalisations or impaired asset measures, these will be authorised only once a restructuring or liquidation plan has been approved by the Commission. Perhaps most importantly, the Communication also raises the minimum requirements for burden-sharing. Banks intending to resort to State aid should first undertake all possible capital raising measures by private means, based on a capital raising plan agreed with the supervisor and accepted by the Commission. If those measures are not sufficient, then shareholders, hybrid capital and subordinated debt holders have to contribute to reduce the capital shortfall to the maximum extent before State aid can be granted. Such contribution can take the form of either a conversion into CET1 or a write down of the principal of the instrument, depending on the capital position of the bank.

This article will elaborate on these new burden-sharing requirements, after firstly providing some background on the evolution and rationale underlying the concept of burden-sharing. It will then attempt to sketch out what the near future may hold for burden-sharing and bail-in, in particular by explaining the likely interplay between the burden-sharing rules of the State aid framework and the Banking Union's bail-in regime.

2. The rationale and evolution of burden-sharing until August 2013

Burden-sharing can in essence be understood as a contribution of the stakeholders of a bank to the cost of its restructuring along with public resources, in order to, on one hand, limit the aid to the minimum necessary, and on the other hand, address moral hazard. In a wider sense, burden-sharing results from the Commission's obligation to ensure that any aid it approves is necessary, appropriate and proportionate. It is by no means a new concept - certain minimum burden-sharing requirements were part of the first Crisis Communication[4]. Throughout the crisis, during which 72 banks

4 Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis ('(first) Banking Communication') (OJ 2008 C 270/8).

representing approximately 25% of total banking assets in the EU have been restructuring in accordance with State aid rules, it formed one of the main pillars of the Commission's assessment of aid to banks.

However, until 1 August 2013, bank restructuring in the EU has, with some exceptions, remained characterised by public bail-outs, including notably to the benefit of subordinated debt holders. Due to concerns relating to financial stability and jeopardising a bank's access to the senior funding market, Member States accepted to bear the cost of bank restructuring instead of, inter alia, subordinated debt holders, at the expense of public finances. Notwithstanding this, the Commission introduced at the outset of the crisis – and gradually increased over the past years – minimum requirements for burden-sharing, so as to avoid that the bail-out of banks came as a free lunch for all stakeholders.

The first step towards today's burden-sharing regime was to request adequate remuneration for State interventions, for guarantees[5] and recapitalisations.[6] In 2011, the pricing requirements for State recapitalisation in the form of ordinary shares, and hence the degree to which existing owners have to be diluted when the State intervenes, was also clarified.[7] The Commission also decided to prohibit recapitalisation in the form of hybrid instruments with coupons which can be waived.[8]

Related to this, the Commission increasingly restricted discretionary payments of a bank to its stakeholders, so as to ensure that State aid is kept in the bank to accompany the restructuring, rather than flow out to investors. First, as of October 2008 the Commission requested dividend bans before approving capital enhancing aid[9], and then, as of December 2008, that banks under restructuring are prohibited from paying coupons on hybrid capital instruments if they were not contractually obliged to do so.[10]

5 Cf. Banking Communication and Prolongation Communications.
6 Cf. Recapitalisation and 2011 Prolongation Communication.
7 Cf. 2011 Prolongation Communication at point. 8 et seq.
8 Cf. 2011 Prolongation Communication at point 13.
9 Commission Decision of 13.10.2008 in case N 507/2008, OJ 2008 C 290/2.
10 See for example Commission Decision of 18.12.2008 in case N 615/2008 OJ 2009 C 80/5.

It then launched its policy of imposing some of the losses on stakeholders: Banks under restructuring were banned from freeing up reserves to avoid that hybrid capital instruments have to participate in the coverage of losses,[11] and could not exercise calls on hybrid capital instruments anymore.[12] In the same vein, those banks were only allowed to perform buy-backs of hybrid capital instruments if this strengthened the capital position of the bank whilst imposing some of the losses on hybrid debt holders.[13]

Whilst these gradually evolving burden-sharing requirements prevented the use of State aid to shelter certain stakeholders from bearing losses (and an "abuse" of public funds for that purpose), the quantitative impact of these burden-sharing requirements was limited and could not avoid large bail outs.

The onset of the sovereign crisis began to change the perception of how the costs related to bank restructuring should be distributed. The previous bail-outs had in several cases begun to undermine the fiscal sustainability of States altogether, forcing the Eurogroup, through EFSF and ESM, to lend money to these weakened Member States. The Communication describes this development (e.g. in the cases of Ireland and Spain)[14] in point 18: *"Some Member States had to go beyond minimum requirements under State aid rules and by introducing new legal frameworks enforce stricter […] burden-sharing requirements. […] Such differences in the approach to burden-sharing between Member States have led to divergent funding costs between banks depending on the perceived likelihood of a bail-in as a function of*

11 Commission Decision of 12.5. 2009 in case C 43/08, OJ 2009/L 345/1.

12 See Buybacks of hybrid securities by banks under restructuring, Explanatory note by staff of the European Commission's Directorate-General for Competition of 13 June 2012, available at: http://ec.europa.eu/competition/recovery/buyback_conditions_en.pdf.

13 See Buybacks of hybrid securities by banks under restructuring, Explanatory note by staff of the European Commission's Directorate-General for Competition of 13 June 2012, available at: http://ec.europa.eu/competition/recovery/buyback_conditions_en.pdf.

14 See Commission Decision in case of SA.33433, second Restructuring of Bank of Ireland, OJ 2012/C 246, and Memorandum of Understanding on financial sector polity for Spain, available at: http://ec.europa.eu/economy_finance/eu/countries/pdf/mou_en.pdf.

a Member State's fiscal strength. They pose a threat to the integrity of the single market and risk undermining the level playing field which State aid control aims to protect."

3. New burden-sharing requirements

In response to the observed divergence in the approaches that Member States took to burden-sharing and the resulting divergent market pricing of the risk of bail in, the Communication aims at introducing a new, higher minimum standard for burden-sharing for all banks, its owners and certain creditors, so as to re-establish a level playing field, and to accompany the transition to the Banking Union. The three key requirements (capital raising measures, bail-in of subordinated debt, measures to prevent the outflow of capital) which need to be complied with before State aid can be approved are described in turn:

a. Capital raising measures

The Communication provides in point 35 that the bank should identify all possible measures which would improve the capital base of the bank in a capital raising plan. It also provides a non-exhaustive list of such measures, including rights issues, liability management exercises (should be 100 % capital generating) and capital generating asset sales.

During this capital-raising phase, the bank and its owners can try to convince holders of hybrid capital instruments to agree to being converted into in equity, which would probably require the shareholders to offer a rather favourable conversion rate. Accordingly, point 35 b) allows for voluntary conversion of subordinated debt instruments into equity on the basis of a risk-related incentive.

b. Bail-in of subordinated debt

If a bank does not manage to raise sufficient capital, the Communication establishes a sort of "burden-sharing waterfall", obliging Member States to seek contributions from shareholders and junior creditors first. As indicated above, this was not required systemically before, mainly due to financial stability concerns, which were greatly reduced by the experiences in Spain, Ireland and the Netherlands[15] demonstrating the feasibility and compatibility with financial stability of imposing loss-participation on subordinated creditors.

Points 41 thus reads *"after losses are first absorbed by equity, […] [h] ybrid capital and subordinated debt holders must contribute to reducing the capital shortfall to the maximum extent. Such contributions can take the form of either a conversion into Common Equity Tier 1 or a write-down of the principal of the instruments."* Contrary to the Banking Union's bail-in regime, this is where the "waterfall" stops, as point 42 sets out that *"[t]he Commission will not require contribution from senior debt holders (…) as a mandatory component of burden-sharing under State aid rules […]."*

The Communication then specifies how burden-sharing should be applied in two sets of circumstances – one in which the bank in question has a capital ratio above the regulatory minimum, and one in which it is below:

First, when the capital ratio of the bank remains above the EU regulatory minimum (situation 1) but below the threshold set by the competent supervisory authority or resolution authority (e.g. pillar 2 requirements, for example in the context of a stress test), the bank should normally be able to restore its capital position on its own, through private capital raising measures. This is in essence the so-called "precautionary recapitalisation" situation, for which also the Bank Recovery and Resolution Directive[16] ("BRRD") provides a specific provision in Article 32 (4)(d)(iii). If there are no other possibilities, including any other supervisory action such as early intervention measures or other remedial actions to overcome the shortfall

15 Commission Decision 22.2.2013 in case SA.35382, SNS Reaal, OJ 2013 C 104/3.

16 Directive of the European Parliament and the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, not yet published.

defined, then hybrid capital and subordinated debt holders must be converted into equity before State aid is granted. Shareholders contribute to burden sharing through dilution.

Second, when the bank no longer meets the minimum regulatory capital requirements (situation 2), equity, hybrid capital and subordinated debt must fully contribute to offsetting the losses through write down and/or conversion before State aid is granted.

The above distinction is mainly a result of a legal concern, which alleges that bail-in, also of subordinate debt, might infringe fundamental property rights. In this context, it should first and foremost be recalled that even constitutionally enshrined property rights are not absolute. Given a sufficiently strong public interest, proportionate interference with property rights can be justified, in particular when there is no economic disadvantage resulting from the interference. In the Communication, property rights related considerations are taken account of by the so-called "no creditor worse-off principle" (cf. point 46): "In the context of implementing points 43 and 44 […] subordinated creditors should not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted."

Whether or not burden-sharing could lead to an unjustifiable infringement of property rights is thus predominately a question of the counterfactual, and it is for this reason that the Communication distinguishes between the above situations.

In situation 2, it is assumed that the bank would not be able to cover the shortfall and the counterfactual of the failing bank would be insolvency; this is the classic "failing bank" scenario. In this counterfactual, in the absence of a state intervention, the subordinated debt holders would most likely have lost their entire claims. A bail-in (here: conversion or write-down) of the junior debt should not put its holders in a situation that is worse than it would have been in the case of insolvency.

For situation 1, the Communication does not foresee a write-down (which is normally meant to cover a loss). To see what the counterfactual in situation 1 could be, it is worth recalling the reasons for which a supervisor would want to raise the capital ratio above the minimum regulatory requirements. One of them might be that the competent supervisor wants to ensure that the bank could also weather a prolonged phase of economic difficulties – the stress case. Against this background, two potential counterfactual situations can exist, and it can be assumed that the property rights of creditors are respected in each of them. First, if the stress conditions were to materialise, the additional capital would be necessary, and would offset the losses. In these cases, the converted creditors would be in the same situation than those under situation 2 and would thus need to face the same consequences.

If however the stress does not materialise, the converted subordinated debt holders will recoup the value of their investment in their capacity as shareholders. In this context it should be considered that for bank meeting regulatory requirements the capital contribution from a conversion of subordinated debt should be in some cases sufficient to cover the shortfall, and the newly converted equity holders would own a part of the bank as a result of the conversion.

It should also be recalled in this context, as indicated above, that the Commission can only approve aid that is necessary (and proportionate). Regarding precautionary recaps, this means that the Commission could not approve such a measure unless it is clearly shown that in the absence of this measure the bank at hand could not continue to perform "business as usual". In other words, the counterfactual of situation 1 would have to be rather disadvantageous for the bank and the circle of stakeholders potentially affected by burden-sharing for the Commission to be in a position to authorise a measure that would avert the materialisation of that counterfactual.

Finally, the Communication also allows for exceptions, which the Commission will assess on a case by case basis. Point 45 explains that "*[t]his exception could cover cases where the aid amount to be received is small in comparison to the bank's risk weighted assets and the capital shortfall has been reduced significantly in particular through capital raising measures*". That is to say that bail-in might not be required where the aid amount required is small in proportion to the initial capital shortfall, and is meant to provide an incentive for banks to primarily rely on their own efforts to overcome capital shortfalls.

As for the risks to financial stability, the cases of Spain and Slovenia in which such burden-sharing has taken place simultaneously in significant parts of the domestic banking sector show that adequate legislation can address the potential contagion channels so that no dangers to financial stability should arise.

It thus should be noted that so far the conversion/ write down of retail holders of such instruments and the implementation of such measures to large parts of the banking sector of a Member State (Slovenia, Spain) at the same time have not been considered as justifying exceptions.

c. Preventing capital outflows

In addition to the capital raising measures and bail-in described above banks at risk to require State aid are also obliged to preserve all capital in the bank for the restructuring, according to point 47 of the Communication: "*from the time capital needs are known or should have been known to the bank, the Commission considers that the bank should take all measures necessary to retain its funds: […]*". The rationale of this provision is to ensure that the capacity to reduce a capital shortfall is not decreased by prior action of the bank.

What exactly is required from such banks is illustrated by a list of non-exhaustive measures that reflect mostly the experience from previous case practice as mentioned above, such as coupon and dividend bans, and the prohibition of buy-backs.

For cases of non-compliance, point 48 stipulates that *"[…] at a point in time when its need for additional capital should have been evident to a well-run business, the Commission will, for the purpose of establishing the required measures to limit distortions of competition, add an amount equivalent to the outflow of funds to the aid amount."* This provision reflects case practice[17] and intends to incentivise banks in good faith to fill the capital shortfall by themselves but to be mindful to prevent behaviour that could increase the potential need for State aid.

d. Application of the Communication so far and going forward

The Communication came into force in August 2013, and since then, Member States have notified no further classic bail-outs.[18] The only new recapitalisations that the Commission assessed and approved from this date onwards were those regarding the Slovenian banking sector, which were however accompanied by the implementation of burden-sharing in line with the Communication. In spirit, the Communication was also applied in cases in which the Commission did not have to assess and authorise anything, because no State aid was necessary (and hence none notified): For example, Hellenic Bank filled a capital shortfall through the conversion of its subordinated debts into contingent convertible bonds and a small capital raise. Similarly, the British Co-op bank filled a capital shortfall of GBP 1.5 billion through a conversion of debt in equity.[19] In both cases, the historical shareholders were nearly fully diluted by the converted subordinated debt. In other words, subordinated debt holders accepted to be converted only if they got a large shareholding in the banks and not merely shelter the existing shareholders.

The importance of putting the necessary legal frameworks in place in all Member States has been politically recognised in the meanwhile. The ECOFIN Council has agreed on the need for Member States to equip themselves with the necessary tools to enable burden-sharing in line with State aid rules in the run up to the balance sheet assessment by the SSM and next EBA stress test at the end of 2014.[20]

17 Commission Decision of 18.11.2009 in case C 10/2009,ING, OJ L 274/139.

18 Decisions taken in the end of 2013, such as decision of 27.11.2013 in Case SA 36175, MPS, not yet published, have been notified before 1 August 2013.

19 Cf. http://www.bbc.co.uk/news/business-25414153.

20 ECOFIN statement on backstops at point 9, 15.11.2013, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/139613.pdf.

5. The interplay of the new burden-sharing requirements with the BRRD

After the initial phases of the banking crisis, as the fiscal cost of resolving it made it evolve into a sovereign crisis, the necessity to limit the cost of bank restructuring for tax payers to the minimum has become increasingly apparent. The second main component of the Banking Union – BRRD and the Regulation establishing a Single Resolution Mechanism[21] ("SRM) are based on the principle that banks, their owners and creditors shall in the future bear or at least participate in the cost of bank restructuring and resolution.

The BRRD will come into force on 1 January 2015. The question arises as to whether State aid rules for aid to banks will, and if so to what extent, still be relevant then.

In that context, it should firstly be recalled that pursuant to Article 32(4)(d)(iii) of the BRRD, certain ("precautionary") recapitalisations do not automatically trigger resolution, this being an exception to the BRRD's rule that any form of extraordinary public support would require the responsible resolution authority to resolve a bank. Whilst this provision should probably be read restrictively (cf. the numerous requirements that have to be met in order to qualify a measure as "precautionary" in the sense of the BRRD), it is clear that a certain margin remains for Member States to grant aid to banks in difficulty without triggering, and therefore "outside", resolution. Such measures would then have to comply with the burden-sharing regime of State aid rules as described above.

Second, as for the legal framework applicable in cases of resolution (which also entail public recapitalisation), the periods as of 1 January 2015, and as of 1 January 2016, have to be distinguished.

The BRRD comprises an Article 59, applicable as of 1 January 2015, which sets out a requirement to write down and convert *capital*

21 Regulation of the European Parliament and the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council, not yet published.

instruments when the conditions for resolution have been met; i.e. when such a write down or conversion would restore the bank's viability within a reasonable timeframe, or when a public support has been provided, other than in case of a precautionary recapitalisation as defined in article 32(4)(d)(iii).

This means that public recapitalisations in the context of resolution will also automatically trigger the write down and conversion of capital instruments under Article 59 of the BRRD. Article 59 does not foresee any exceptions. In such circumstances, both State aid rules and BRRD provisions apply, which means that after the Member State has written down and/or converted capital instruments as required by the BRRD and if there is still a capital shortfall to be covered by State aid, subordinated debt instruments, which are not considered as a capital instrument under Article 59 BRRD, have to be written down and/or converted according to State aid rules. In such a case the possible exceptions to the burden-sharing requirements provided for in the Communication are no longer applicable for the capital instruments covered by Article 59, as these exceptions are not included in the BRRD.

Going forward, the main change compared to the previous period (from 1 January 2015 until 31 December 2015) will be the entry into force of the provisions related to the bail-in tool. If the conversion or write down of capital instruments under Article 59 BRRD is not sufficient to fill a capital shortfall, the other debt instruments up to and including uncovered depositors will be subject to bail-in. When and before any public resources are used, the absorption of losses by shareholders and creditors must amount to a minimum of 8% of total assets (including own funds) of the institution under resolution. All liabilities are subject to bail-in with the exception of secured, collateralised and guaranteed liabilities, covered deposits and some specific unsecured liabilities, as defined under Article 44 (2).

This means that as of 1 January 2016, the burden-sharing requirements of State aid rules will only be of substantial relevance for resolution cases in the rare circumstances in which all capital instruments have been bailed-in (as per Article 59 BRRD) and the total bail-in has reached 8% of total liabilities but certain subordinated debt instruments which are not considered as a capital instrument under Article 59 BRRD remain untouched. These would then also have to be converted or written-down, so as to comply with State aid rules as explained above.

6. Conclusion

Before the full BRRD bail-in regime enters into force, it will be the burden-sharing rules of the Communication that define the minimum level of bail-in in 2014, and, having regard to Article 59 of the BRRD, to a substantial degree in 2015. When the ECB will engage into its balance sheet review and EBA oversees another EU-wide stress test towards the end of 2014, before the ECB assumes its role as SSM, the burden-sharing regime of the Communication hence determines the essential rules of the game for a bank and its stakeholders if this exercise reveals a capital shortfall.

The above brief overview of the interplay between State aid rules and the BRRD has been based on an analysis of the former as they stand today. It remains to be seen if and how the State aid regime has to be adapted to the new regulatory landscape that has emerged - a review is foreseen in point 93 of the Communication. In any event, the State aid framework for bank restructuring will most probably remain a safeguard going forward to ensure that private contributions precede bail-outs, which even after the BRRD will have entered into force, will remain possible, at least under certain and narrowly defined circumstances.

9
Bail-In Provisions in State Aid and Resolution Procedures: Are They Consistent with Systemic Stability?

Stefano Micossi, Ginevra Bruzzone and Miriam Cassella*

1. Introduction

In July 2013, the European Commission adopted a new Banking Communication – the seventh since the inception of the financial crisis – updating its criteria for the evaluation of state aid in the banking sector in response to the evolving economic and institutional environment.[1] Under this Communication, any credit institution in need of recapitalization or 'impaired asset' measures will be required to submit a plan for restructuring or orderly winding down of the bank before any further action can be taken. Moreover, whenever there is a capital shortfall, the Commission will require that, not only shareholders – as has been the case until now – but also junior

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1 Communication from the Commission on the application from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ("Banking Communication") (2013/C 216/01), 30 July 2013.

creditors, write down or convert into equity their claims on the bank before any public funds can be granted. This rule applies regardless of whether the bank is under resolution, so as to minimize the need for state aid.

Subsequently, the Council and the European Parliament have adopted a directive (BRRD[2]) and a regulation (SRR[3]) establishing uniform rules for the resolution of banks. For member states participating to the Single Supervisory Mechanism (SSM), these rules will be applied within the SRM, which will be supported by a resolution fund (the SRF). Both the BRRD and the SRR contain rules for the bail-in of shareholders and creditors, either on a stand-alone basis or as a part of the resolution procedure. The adoption under the BRRD or the SRR of a resolution scheme entailing state aid or resort to the SRF is made conditional on the European Commission's approval under state aid rules.

The pre-conditions and the scope of burden-sharing by creditors under state aid control and resolution procedures differ. Therefore, it is necessary to determine whether the two sets of rules can work together. In addition, questions have been raised as to whether the guidelines on state aid to banks take sufficient account of systemic stability considerations when imposing the conversion or write-down of creditor claims.

This issue is especially important because of the ongoing comprehensive assessment of the quality of banks' balance sheets and business models by the European Central Bank (ECB), in preparation for the start of the SSM. This may require substantial capital injections

2 Directive 2014/59/EU of the European Parliament and the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 of the European Parliament and of the Council.

3 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

to meet the enhanced prudential requirements, and possibly public support in certain cases. As may be recalled, the publication of the new Banking Communication in July 2013 led to a lively exchange of letters between Commissioner Joaquin Almunia and ECB President Mario Draghi (the letters were leaked to the press but never officially published). Mr. Draghi reportedly feared that the Commission Communication could be read as an announcement that all banks in need of public support would be preventively subject to a bail-in of junior creditors, regardless of circumstances, potentially aggravating the funding difficulties of individual banks and the banking system as a whole. A similar issue of systemic stability may also arise in connection with the new resolution framework when bail-in is applied before the start of resolution, as will be described.

The following analysis concentrates on the mutual consistency of the two sets of rules, how they are coordinated and how they address the question of systemic stability when creditor claims are bailed in. It does not address the broader issue of the potential impact of bail-in on investors' confidence under distressed market conditions, which is a feature of the current transition to full banking union; on this issue, readers may usefully refer to Avgouleas & Goodhart (2014). Our conclusion is that by and large the two sets of rules are mutually consistent and that they already contain sufficient safeguards to address systemic stability concerns when confronted with a single bank's crisis (i.e. barring systemic banking crises). However, the sensitivity of investors to policy announcements in still-fragile financial conditions may require further efforts to clarify state aid policy regarding prudential bank recapitalizations in the transition to the SSM.

2. The role of state aid control in governing bank restructuring at EU level

Since 2008, the European Commission has adopted a number of decisions under Articles 107-109 TFEU on the compatibility of state aid measures for banks. Article 107 permits to consider compatible with the common market aid measures that appear necessary and proportionate in order to address market failures and thus leaves the Commission sufficient flexibility to adapt the state aid policy in particular market conditions. When identifying the market failures resulting from the financial crisis of 2008, the Commission had to proceed by trial and error. As soon as the Commission began to recognize the systemic nature of the crisis, it resorted to article 107, paragraph 3, letter b, of the Treaty as a legal basis for the temporary adoption of exceptional measures. This part of the Treaty allows it to be to be considered compatible with the common market measures needed to "remedy a serious disturbance in the economy of a Member State". It was understood, however, that once the financial system returned to normal, the standard criteria for the control of state aid would once again be applicable.

Since 2008, the Commission has adopted seven Communications setting out the special criteria to be used in assessing the compatibility of state aid in the financial sector under Article 107, paragraph 3, letter b (the first Banking Communication of 2008 has been entirely replaced by the Communication of July 2013; the others have been partially updated).[4] Initially, the emphasis was on state guarantees; it later shifted to recapitalization measures and the treatment of impaired assets. In the belief that the peak of the crisis was past, the three 2009 Communications focussed on restructuring aid and its three principles: that the aid recipient must be viable in the long term, with no need for further aid; that bank owners must contribute to restructuring costs (burden sharing); and that the possible effects on competition resulting from state aid must be minimized through

4 Communication from the Commission — The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (2008/C 270/02); Communication from the Commission — The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (2009/C 10/03); Communication from the Commission on the treatment of impaired assets in the Community banking sector (2009/C 72/01); Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules (2009/C 195/04); Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis (2010/C 329/07); Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis (2011/C 356/02); and, finally, the "Banking Communication" of July 2013.

adequate remedies (divestitures and behavioural measures such as the prohibition of aggressive commercial conduct). In 2010, as funding conditions normalised, the Commission tightened its requirements, notably by considering state aid for recapitalization and impaired assets as compatible with the internal market conditional on the recipient submitting a restructuring plan.

In general, the criteria set out in the Guidelines were applied flexibly, always with due consideration of the specific features of each case. For example, whereas in HypoBank the Commission required a substantial dismissal of assets, in ABN Amro it only required the bank to abstain from aggressive commercial conduct, since the need for state aid was considered unrelated to the need for restructuring.

In 2011, financial conditions worsened again in the eurozone, with the emergence of a perverse 'doom loop' between the sovereign and bank crises; the Commission reacted by extending the application of the crisis communications. In its conclusions of 22 October 2011, the Ecofin Council acknowledged that state aid control was the only coordination instrument available at the EU level to maintain financial stability and a level playing field in the internal market by encouraging distressed banks to restructure and return to viability.[5]

In 2012, the European Council launched the banking union project, which was intended to break the vicious circle between sovereign and bank debt, overcome the fragmentation of financial markets, and eradicate moral hazard by bankers through strengthened supervision, a new banking resolution procedure at the EU level[6] and beefed-up deposit insurance rules. The Commission argued that, while waiting for the banking union to be established, it still needed to play a temporary role in order to ensure the orderly restructuring of the banking sector. In this context, its 2013 Communication can be seen as a transition, or a "bridge," communication which will have to adapt to new changes in the banking regulatory framework.

The Commission has always stressed that its primary goal in the control of state aid in the financial sector is that of ensuring financial

5 See European Commission, Report on Competition Policy 2011.
6 Micossi S., Bruzzone G., Carmassi J. (2013).

stability. This includes preventing spill-over effects that might result from the failure of a bank and ensuring that the banking system as a whole continues to provide adequate lending to the real economy, while minimizing state aid and distortions of competition.

In order to foster financial stability and minimize reliance on taxpayers' resources in bank bailouts in the future, the latest Guidelines require timely and decisive restructuring plans to restore the bank to long-term viability or, alternatively, ensure its orderly wind-down. These restructuring plans will be reviewed in close cooperation with the competent supervisory authorities. Moreover, state aid will be authorized only subject to burden-sharing involving junior creditors. Rescue aid before a restructuring plan is approved is only allowable when the competent supervisory authority confirms it is necessary to preserve financial stability. On the other hand, the main support for banks not experiencing a capital shortfall, should be guarantees on new liabilities.

Recapitalization or impaired assets measures will be deemed compatible only if the member state demonstrates that all attempts to minimize the need for state aid have been undertaken, notably by:

i) submitting a plan to raise capital before or as part of the restructuring plan (including issues of new rights, voluntary conversion of subordinated debt, asset sales, earnings retention);

ii) replacing management and adopting strict executive remuneration policies until the end of the restructuring period;

iii) preventing the outflow of own funds, by, among other things, restricting dividends, buy-backs of hybrid capital instruments, acquisitions, etc.; and

iv) ensuring adequate burden sharing: losses should be first absorbed by equity; hybrid capital and subordinated debt holders must then contribute to reducing the capital shortfall as much as possible through conversion or write-down of the principal of their instruments.

The Communication envisions two scenarios for burden-sharing: i) the bank does not meet the minimum regulatory capital requirements or, ii) the minimum capital requirements are met and a capital shortfall is still identified by a competent supervisory authority, e.g. as the result of a stress test (precautionary recapitalizations). In the first case, state aid can only be authorised after equity, hybrid capital and subordinated debt have fully contributed to covering the losses (through write-down or conversion). In the second case, the Commission requires that in the event that there are no alternative remedies for the shortfall, 'in principle' subordinated debt must be converted into equity before granting state aid. Writing-down debt is not taken into consideration. This strengthened burden-sharing, involving junior creditors, is the primary new feature of the July 2013 Communication.

During the crisis, some member states have applied burden-sharing involving creditors (e.g. in cases involving Irish, Dutch and Danish banks). The Troika has imposed burden-sharing as a condition for gaining access to financial assistance programmes in Spain and Cyprus.[7] After the adoption of the new Banking Communication, the Commission has also required it for the approval of state aid in the restructuring of the main Slovenian banks.

In order to ensure compatibility with the protection of property rights, the Communication endorses the "no creditor worse off" principle (point 46): subordinated creditors should not receive less in economic terms than what their instrument would have been worth if no state aid were granted.

For completeness, it may also be recalled that state aid policy also places some constraints on the Emergency Liquidity Assistance (ELA) procedures by national central banks (under ECB control): Point 62 of the 2013 Banking Communication specifies in this regard that "dedicated support to a specific credit institution (commonly referred to as ELA) may constitute aid" unless certain condi-

7 For general background to bail in and a description of precedents see DG Internal Market (2011); Financial Stability Board (FSB) (2011); Dűbel (2013).

tions are met.[8] In turn, ECB rules for ELA are fully consistent with state aid policy and, in addition, the ESCB Statute assigns the Governing Council the power to restrict such operations when they may "interfere with the objectives and tasks of the Eurosystem" (Article 14.4). Since ELA normally does not constitute state aid, the application of burden-sharing and bail-in cannot come into play.

3. Write-down and conversion in the resolution framework

The objective of the BRRD and the SRR is to manage and resolve bank crises through common administrative procedures, the application of which to member states participating in the SSM will be entrusted to a new EU authority, the Single Resolution Board (SRB). The resolution objectives are: to ensure the orderly unwinding of a failing bank while preserving the continuity of critical functions (e.g. the payment system), protecting financial stability and depositors, as well as minimising reliance on extraordinary public financial support (Article 12 of the Regulation). This last provision is meant to bar any future public support of failing banks – from bail-out to bail-in – thus severing one link between banking and sovereign risks.[9] As may be seen, there is a significant overlap with the objectives of the 2013 Banking Communication.

Under the "General Principles" for bail-in in Article 13 of the SRR (and in Article 34 of the BRRD), the shareholders of the institution under resolution will bear first losses; creditors will bear losses after them, in accordance with the reverse order of their priority claims under national insolvency law; and no creditor shall incur greater losses than would have been incurred if the entity had been wound up under normal insolvency proceedings (the 'no creditor worse off' condition[10]). Thus, the list of creditor claims that may be called in

8 The credit institution, albeit temporarily illiquid, must be solvent; the liquidity provisions occur in exceptional circumstances and are not part of a larger aid package; the facility is fully secured by collateral with appropriate haircuts; the national central bank charges a penal interest rate; and the measure is taken at the central bank's own initiative, without any counter-guarantee of the state.
9 There is another link that remains, stemming from banks' exposure to sovereign securities held in their balance sheet.
10 Article 34.1.g of the BRRD.

is broader than that under the 2013 Banking Communication, potentially extending to senior uncovered bonds and, down the line, uninsured deposits (those above 100.000 euro, under the Deposit Insurance Directive).

The SRB has the power to write down and convert liabilities of the credit institution both on a stand-alone basis and within a resolution procedure, by activating the bail-in tool. Article 18 states that the write down and conversion of capital instruments shall be exercised by the Board when:

i) the entity will no longer be viable unless the capital instruments are written down or converted into equity; and

ii) public aid is required by the entity or group, with the exceptions provided for by Article 16.3.d (described below).

When the exercise of the write-down and conversion powers is sufficient to recapitalise the bank, the Board may use them without placing the bank in resolution; otherwise, the write down and conversion of capital instruments will take place within the resolution procedure, before any other resolution action is taken.

The conditions for initiating a resolution procedure, according to Article 16 of the Regulation, are that:

i) the entity is failing or likely to fail;

ii) there is no reasonable prospect that an alternative action (including the write-down or conversion under Article 18) would prevent its failure within a reasonable timeframe; and

iii) a resolution action is necessary and proportionate in the public interest (as defined in Article 12) to ensure the continuity of critical functions, maintain financial stability, minimize the burden on public resources, protect depositors and client funds and assets.

The entity is deemed to be failing or likely to fail when one or more of a set of circumstances listed in paragraph 3 of Article 16[11] are met; among these is the receipt of extraordinary public financial support (i.e. state aid). The determination of the condition (i) above shall be made by the ECB, after consulting the SRB; the SRB will decide on the presence of conditions (ii) and (iii). In this case, the SRB will adopt a resolution scheme detailing the use of resolution tools and that of the Fund, and send it to the Commission. The resolution scheme will enter into force if no objections have been raised by the Council or the Commission (on the grounds of public interest listed in Article 16 paragraph 6) within 24 hours after transmission of the scheme by SRB.

As mentioned, an escape clause in Article 16.3.d provides that financial support to the bank by national authorities or the Fund does not imply that the institution is failing or is likely to fail, when it involves state guarantees to back liquidity facilities provided by central banks (Article 16.3.d.i), state guarantees of newly issued liabilities or recapitalizations (injections of a bank's own funds, Article 16.3.d.ii), and purchase of capital instruments that do not confer an advantage upon the entity (Article 16.3.d.iii).[12] The three exceptions will only apply to solvent entities and are, in all circumstances, conditional on the approval under state aid rules. In practice, these measures shall be acceptable when they are of a precautionary and temporary nature and proportionate to remedy the consequences of a serious exogenous disturbance. The exception in Article 16.3.d.iii concerning recapitalizations is limited to capital shortfalls established following the stress tests, asset quality reviews or equivalent exercises.[13]

In sum, if the entity requires state aid (with the exception of state guarantees and aid for recapitalization at market prices, aimed at solvent companies), it is deemed to be failing or likely to fail and the Board may use its powers to write down and convert its liabilities (bail-in) when this is deemed necessary to meet the public interest objectives of the new rules. If a broader resolution action is needed, these powers will be exercised within the resolution procedure and

11 Paragraph 4 of Article 32 of the BRRD.
12 See also Article 32.4.of the BRRD.
13 See also Article 32.4 of the BRRD.

may be associated with the use of other instruments (e.g. sale of business tool, bridge institution tool, and asset separation tool) and resort to the resolution Fund, as described by the resolution scheme prepared by the Board. The resolution scheme will enter into force only if no objection has been raised by either the Council or the Commission within 24 hours from its transmission by the Board.

All of this is without prejudice to the application by the Commission of the state aid framework.[14] More specifically, the SRR provides that when public aid (either state aid or aid from the Fund) is present, the Board shall act in conformity with the decision on that public aid taken by the Commission.[15]

4. Coordination of resolution procedures with state aid control

Article 16a of the regulation coordinates the action of the Board relating to the resolution procedure (Article 16) and that of the Commission in the exercise of its powers for the control of state aid. The use of the Resolution Fund is treated as state aid and therefore is subject to prior control by the Commission under Article 107 TFEU, under the same procedures. Although the resources of the SRF will be collected with fees charged on banks, they result from a compulsory contribution established by the law and therefore are treated as if they were public resources. The rationale for this provision is to ensure equal treatment of those member states participating in the SSM and those that are not participating when their banks are supported with public funds.

Under Article 16a, when the resolution action involves the granting of public aid, the adoption by the Board of the resolution scheme "shall not take place until such time as the Commission has adopted a positive or conditional decision concerning the compatibility of the use of public aid with the internal market" under Article 107 TFEU. This regulation recalls the principle of the BRRD (Article 3.3) that states that institutions should ensure the operational independence between their function in the resolution framework and

14 Article 44.12 of the BRRD.
15 Article 16.8 of the SRR.

their other functions. For the Commission, this entails that the performance of the institutional tasks related to public aid control will have to be clearly separated, also from an organizational perspective, from the Commission tasks in vetting the SRB resolution proposal under Article 16 of the regulation.

When the Board decides that resolution measures may constitute public aid, it will invite Member States to notify the Directorate General for Competition of the European Commission, and it will notify directly measures involving the use of the Fund. If the Commission takes a negative decision on the compatibility of public aid, the Board shall have to reconsider its resolution scheme and revise it. It is also envisaged that the Commission may amend its initial decision, following a recommendation by the Board or on its own initiative, if the implementation of resolution tools and actions departs from the criteria on which it has taken its original decision. This opens the way to the exercise of some flexibility, in case of unforeseen developments related to financial stability.

It is also important to recall that the Commission's decisions on public aid will always be based on the resolution scheme prepared by the Board (which includes information on the exercise of bail-in powers). Therefore, its decisions, which will be taken under the state aid perspective, will not need to be extended to the design of burden-sharing arrangements which will be applied to shareholders and creditors. The Commission will only have to assess whether the proposal made by the Board under the resolution rules satisfies the requirement of a sufficient burden-sharing under state aid rules. While this may entail some room for discussion between the competition and resolution authorities, there does not seem to be an inherent contradiction.

5. In conclusion: how to improve the public communication of competition policy goals

Our analysis shows that the new resolution framework is fully consistent with state aid policy. Indeed, coordination of the two sets of provisions is explicitly provided for by the SRR, since all decisions entailing public aid will be preliminary vetted by the Commission under state aid rules, and the relationship between the two procedures is well designed. Once the SSM and the SRM will be in full force, the task of limiting moral hazard and the use of public funds through appropriate bail-in measures will clearly fall to the SRB, although the Commission may express its view in the exercise of its competences in the control of state aid.

As for the relationship between bail-in under the two procedures and concerns of financial stability – meaning that the expectation or fear of bail-in may engender a run on a bank or the banking system by (uncovered) depositors and investors – the following conclusions apply. First, when a bank is failing or likely to fail and therefore likely to be placed under resolution, the essential requirement to preserve financial stability is speed of the decision, which under normal circumstances should take place within a weekend following the ECB communication that the relevant circumstances have been met. Here bail-in is just one component of the general process and does not involve specific consequences or raise special concerns. As has been described, it is also possible for the resolution authorities to write down and convert unsecured liabilities into equity on a stand-alone basis. But again, this may only happen when the bank is no longer viable and therefore already under special care by the resolution authorities. Therefore, a separate adverse impact of bail-in on investors' expectations is not likely. Moreover, under the BRRD and SRR, bail-in is excluded for viable entities when public support is of a temporary and precautionary nature and is proportionate to remedy the consequence of a serious exogenous disturbance.

Thus, the possible destabilizing effects deriving from the fear of bail-in seem mainly to arise for solvent institutions in need of public support to raise capital, and thus mainly from the application of state aid rules. In this regard, the Banking Communication already contains a number of safeguards and exceptions that may help dispel these fears. These notably include the following:

i) the provision that an exception can be made when implementing the Communication would endanger financial stability or lead to disproportionate results (point 45);

ii) the provisions specifying that when applying state aid rules to individual cases, the Commission shall take account of the macroeconomic environment; the specificities of each credit institution and each member state; the fact that the need for state aid has not been the result of excessive risk-taking; the need for a coordinated approach when recapitalization measures involve a large portion of the financial system, taking into consideration the aggregate effects of restructuring on individual institutions at the sector level and on the economy as a whole; and the feasibility of burden-sharing measures and their impact on market structure (points 9-11); and

iii) the 'no creditor worse off' principle, whereby subordinated creditors should not receive less in economic terms than what their instrument would have been worth if no state aid were to be granted (point 46).

On the basis of these criteria, it is reasonable to expect that the prudential recapitalization of a solvent bank, following a stress test, would not entail the risk of losses for junior creditors even when, due to general market conditions, there is need for some temporary public support.

However, this reassuring balance of the elements underpinning the Commission's decisions on individual cases may not be clear to bank creditors and potential investors in financial markets. The impression of an unneeded rigidity on this very sensitive issue has been heightened by various official statements that over-emphasize that each case under competition rules will be assessed individually, thus feeding the impression that the systemic dimension of the issue is being underestimated.

Therefore, some further clarification by the Commission may be needed on how the various criteria will be applied during the ongoing transition to banking union. This may be achieved through a new communication completing the state aid framework for banks in view of the adoption of the new resolution rules, without calling into question that public aid has to be kept at a minimum, both for distressed banks and for banks that are fundamentally sound, and that the availability of public aid should not give rise to moral hazard and distortions of competition.

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10
Banking Union – Challenges and Consequences

Huw Pill[1]

For Britons of a certain age, bonfire night is redolent of Guy Fawkes, the Gunpowder Plot, baked potatoes and, above all, fireworks.

This year, bonfire night – the fifth of November – may be memorable for other reasons. It marks the first day of Europe's banking union, when the ECB becomes the single supervisor of the Euro area banking sector (and assumes direct responsibility for supervising the largest European banks).

Will this be an occasion for fireworks, as some predict? Or will it prove to be a damp squib?

Challenges – Improving stability, overcoming segmentation, exiting crisis

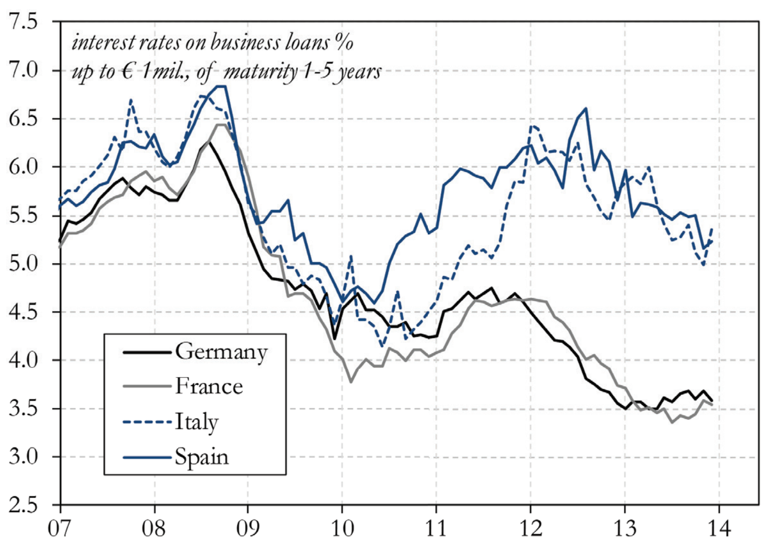
It has become conventional wisdom to identify the segmentation of Euro financial and banking markets as central to the Euro area's persistent economic weakness and disinflationary dynamics.[2] With

1 This note was prepared for the conference 'Bearing the losses from bank and sovereign default in the Eurozone' which took place at the European University Institute on 24 April 2014. The opinions expressed are those of the author and should do not necessarily reflect the position of Goldman Sachs.
2 See Giannone et al. (2011) for a discussion.

market fragmentation, the accommodative monetary policy stance established by the ECB – with risk-free, short-term market rates anchored close to zero – is not transmitted uniformly to all parts of the Euro area. Indeed, the impact of segmentation is perverse: financial conditions facing the private sector are tighter in the periphery (where monetary stimulus is most needed) than in the core (where – arguably – the German economy is starting to overheat).

As illustrated in Chart 1, such segmentation has a particular impact on borrowing by small and medium-sized enterprises (SMEs) in the periphery. ECB data demonstrate that bank lending rates on loans to SMEs show considerable cross-country heterogeneity within the Euro area, even across the big-4 economies.[3] Since the intensification of the European financial crisis in 2011, rates in Italy and Spain have stubbornly remained around 200bp higher than equivalent rates in Germany and France, even as sovereign spreads have narrowed. Given the importance of the SME sector as a source of growth, the European periphery's recovery has been hamstrung by financial fragmentation.

Chart 1 – Heterogeneity of bank lending rates to small and medium-sized enterprises



Source: ECB

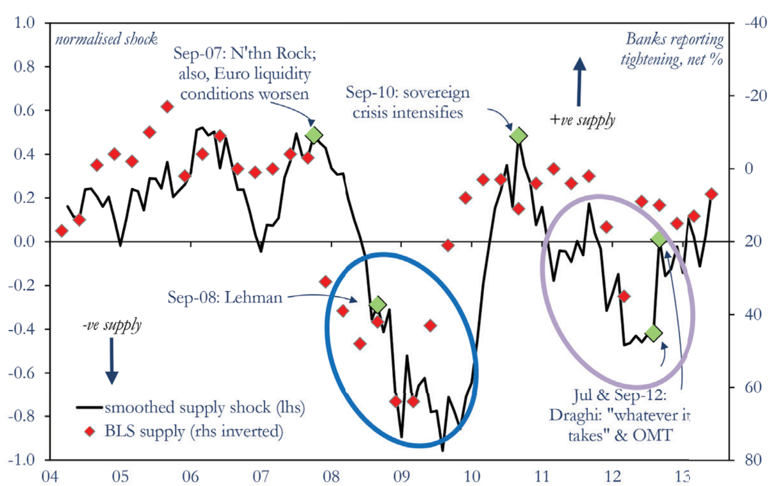
3 See Pill (2013) for a richer discussion of the behavior of bank lending spreads within the Euro area and an attempt to construct a synthetic indicator of developments in such spreads.

Of course, such analysis faces a 'chicken-and-egg' problem: higher lending rates in the periphery may reflect higher corporate credit risk in a difficult macroeconomic environment, rather than being a cause of the economic weakness underlying that environment. In practice, causality will operate in both directions.

To distinguish the effect of fragmentation from the macroeconomic situation, we attempt to identify credit supply and credit demand shocks in a simple structural VAR model using sign restrictions.[4] Such techniques are not definitive. But reassuringly the results we obtain – summarised by the time series of smoothed credit supply shocks shown in Chart 2 – are corroborated by the independent perspective provided by responses to the ECB's bank lending survey.

Chart 2 shows two periods of negative credit supply shocks: (1) following the failure of Lehman Bros. in 2008-09, when the Euro money market threatened to seize up; and (2) following the intensification of the European sovereign crisis in 2011-12, when peripheral banks faced severe funding problems and (in some cases) wholesale deposit flight.

Chart 2 – Identification of area-wide credit supply shocks



Source: ECB, Goldman Sachs Global Investment Research

4 The methods used are essentially those proposed by Uhlig (2005). The details of the approach together we further results are described in Pill and Wan (2013).

Chart 3 – which shows the contribution of credit supply and credit demand shocks to developments in the spread of bank lending rates over policy rates – offers a cross-country perspective on this issue. In the post-Lehman phase of the crisis, negative credit supply shocks appear symmetric across Euro area countries: German banks are equally as adversely affected as Italian banks. By contrast, during the later sovereign phase of the crisis in 2011-12, Italian banks are significantly affected, whereas German banks are largely immune (and at the margin may have benefited from a flight-to-safety effect).

These empirical results help us to describe the challenges faced by the European policy authorities.

Three stand out.

Challenge 1:
Improving stability and resilience of the European financial sector as a whole.

The symmetric post-Lehman impact of adverse credit shocks across Euro area countries (and indeed also across other jurisdictions, including the US and UK) demonstrates the vulnerability of the global financial sector as a whole to the excessive leverage, complexity and credit risks that built-up in the financial system during the first decade of the millennium. By acting to align incentives and manage systemic risks, better regulation and governance can improve the stability and resilience of the entire global financial system, obviously including its European component.

Challenge 2:
Overcoming intra-Euro area cross-country heterogeneity.

While improving financial resilience is a problem facing many jurisdictions, experience of market segmentation within a single currency zone is unique to the Euro area. A common explanation for such segmentation is the emergence of the *Teufelskreis* (or "diabolical loop") between sovereign and bank balance sheets: banking problems weaken sovereign balance sheets given the (often implicit) government guarantees provided to the financial sector, while banks typically hold a significant portfolio of domestic sovereign debt, such that a weakening of the sovereign balance sheet may raise concerns about the solvency of banks. Breaking this link and thereby establishing a 'level playing field' for Euro area banks independent of their domicile and links to specific sovereigns is seen as an essential support for financial stability, better integrated markets and effective monetary policy transmission.

Challenge 3:
Exiting the crisis by dealing with legacy balance sheet problems.

In addition to improving the incentives and environment facing European financial institutions in an attempt to avoid future calamities, measures are needed to strengthen existing balance sheets that suffered damage in the financial crisis and its macroeconomic aftermath. Legacy problems cannot simply be wished away. Ensuring that the bank sector has sufficient capital, liquidity and risk-taking capacity to restore the supply of credit to SMEs (and the wider economy) remains a central conjunctural concern, independent of the design of any new steady-state regime intended to govern the financial system in the future.

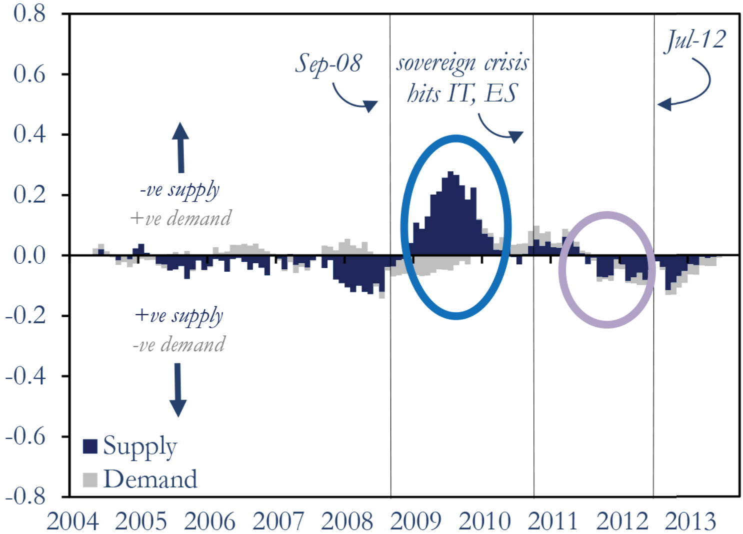
To illustrate the potential benefits of banking union, consider the possible implications of the SSM for the Euro area banking sector. Unifying responsibility for bank supervision at the ECB offers scope both: (1) to raise the average quality of supervision (e.g., by spreading best practice and/or breaking the capture of regulators by 'national champions'); and (2) to ensure common application of standards and rules across Euro area countries (e.g., by imposing common definitions of non-performing loans). Moreover, the on-going ECB/European Banking Authority (EBA) "comprehensive assessment" of Euro area bank balance sheets (consisting of an asset quality review and stress test exercise) is intended to clarify the extent of legacy programs and allow them to be dealt with ahead of the SSM coming into operation.

These three challenges are themselves significant. But the situation is further complicated by trade-offs that emerge in pursuing them.

Chart 3 – Cross-country heterogeneity in impact of adverse credit shocks

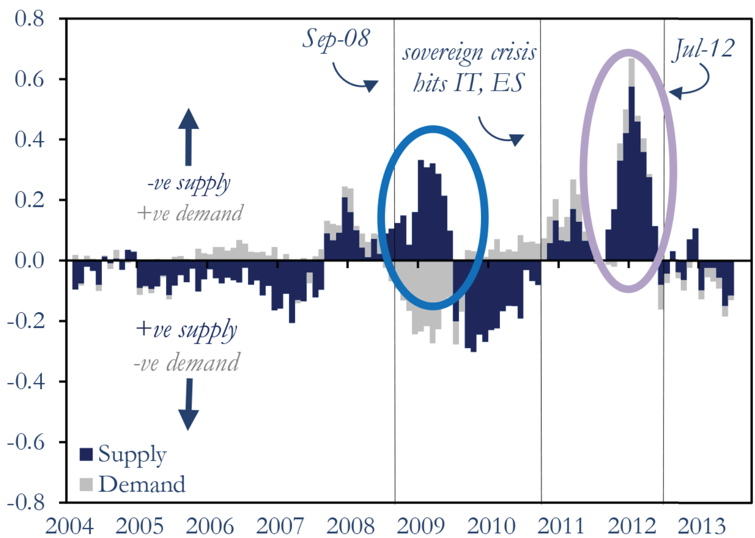
Germany

contribution of shock to interest rate spread, pp



Italy

contribution of shock to interest rate spread, pp



Source: Goldman Sachs Global Investment Research

Trade-off 1:
Improving the quality of the playing field vs. ensuring the playing field is level.

In the European context, the danger always exists that attempts to establish a level playing field deteriorate in the direction of accepting the 'lowest common denominator' across participating countries, rather than ensuring uniform adoption of best practice across jurisdictions. Politically and practically, harmonising on the basis of what has already been achieved is easier than upgrading national practices to best in class. As a result, potential for a trade-off exists: establishing a level playing field may come at the cost of the average quality of the regime established. At a minimum, improving the overall quality of the financial institutional environment is likely to be more complicated in the European context relative to more unitary jurisdictions (such as the US).

Trade-off 2:
Dealing with time consistency issues.

Trade-offs are also likely to emerge between measures intended: (1) to establish the new 'steady-state' regime for the financial sector, with better alignment of private incentives with social demands for systemic stability and appropriate risk taking; and (2) to support escape from the current crisis and overcome existing legacy problems in the banking system. In other words, tensions may exist between exit (from the recent crisis) and prevention (of a future crisis).

For example, requiring higher levels of capital in the banking system is desirable in the new steady-state since it provides more loss absorbing capacity and encourages bank stakeholders to demand better risk management. But in the short term where banks are weak following the crisis, demands to reduce leverage ratios may lead to aggressive deleveraging that weakens that macroeconomic environment, and threatens a vicious cycle of non-performing loans and tighter credit supply conditions.

In short, a time consistency problem may emerge. The authorities seek to design a new financial regime that will be more stable than that which preceded (and ultimately triggered) the recent crisis. But the rules that govern this new regime may be 'too strict' to allow banks to recover from the travails they currently face as a consequence of the crisis. In this context, a 'one-off' relaxation may be desirable for banks to escape legacy problems. But of course markets and the banks themselves understand that the authorities will face incentives to repeat this supposedly 'one-off' relaxation if a new crisis emerges in the future. Thus the credibility of the new regime's stricter rules will be weak – and their desired impact on private incentives (which is intended to reduce the likelihood of a future crisis) will be undone. From the literature on monetary policy and the 'expectations-augmented' Phillips curve, central bankers have a good appreciation of how to address such time consistency problems. Building institutions that bolster the credibility of commitments to the stricter regime even in the face of short-run incentives to deviate from those incentives is crucial. This is one aspect of what banking union is intended to achieve.

Market responses to the announcement and introduction of banking union

Reflecting the trade-offs described above, much commentary on the emerging European banking union has been sceptical: the transition to a new common bank resolution fund is too slow; the proposed size of the fund is too small to deal with systemic problems; the transitional arrangements (which have to respect national fiscal sovereignty, as the common fund will only be established over time) are too complex and time-consuming to function well in a crisis, etc.

These practical concerns are probably well judged. But there is a danger that focusing on such commentary 'misses the wood for the trees'. Because the reaction of market pricing and financing to the banking union has been very positive. Funding access and costs for peripheral banks have improved significantly, as has their ability to raise private capital.

What are the sources of this positive market sentiment, even in the face of scepticism about the details?

First, one has to recognise the **broader market environment**. In a world where advanced economy central banks have established a flat risk-free yield curve anchored very close to zero at the short-end and where equity prices are at or close to all-time highs in many jurisdictions, the 'search-for-yield' will inevitably push many investors into riskier assets that offer positive returns or seem under-priced on a valuation basis. Peripheral banks' funding and equity liabilities fit the bill.

Second, **market participants have famously short investment horizons**. The critical events of the past few years seem like a 'once-in-a-(working)-lifetime' event. From this standpoint, another crisis is a long way off. To quote published research by my colleagues working on the European financial sector: *"From an investor perspective, … it is important to recognize (pragmatically) that banks do not face the level of turmoil experienced in the 2007-13 very frequently. … Investable banks are on very stable footing."*

Third, **market participants have focused on the opportunities offered by the creation of banking union**. ECB President Draghi and his colleagues have repeatedly emphasised that the creation of European banking union involve the abolition of any intra- Euro area barriers to the flow of bank liquidity and capital. To quote: *"With a European supervisor, borders will not matter. Issues such as protecting national champions or supervisory ring-fencing of liquidity will not be relevant"*.

Again drawing on the work of my colleagues, three consequences emerge:

- in the short run, the fungibility of bank liquidity and capital will permit a rationalisation of bank balance sheets. In simple terms, following banking union higher yielding corporate loans in the periphery (see Chart 1) can be funded using cheap liquidity in the core. This will expand bank interest margins, sustaining bank profitability, bolstering bank capital and supporting bank funding and equity prices.

- in the medium term, the profits deriving from wider interest margins will prompt greater competition, influencing loan and deposit pricing in the Euro area.

- at longer horizons, market structure will evolve to the new regime, as bank business models respond to the new environment. Consolidation – involving M&A activity in pursuit of broader cross-border banks – is a likely result.

With particular emphasis placed on the first of these implications given the short horizon of market participants, banking union has received a positive market response.

The authorities have every incentive to acquiesce in this market behaviour. At the turn of the year, significant concern surrounded the soundness of the Italian banking sector (in particular, the regional banks that were central to the financing of the SMEs in northern Italy central to the country's corporate performance). With the fiscal capacity of the Italian state to address solvency issues revealed by the ECB/EBA comprehensive assessment in question (e.g., the Italian authorities had expressed scepticism about launching a 'bad bank' to warehouse non-performing assets), negative surprises were feared. But now that markets are supportive of bank funding and equity issuance in the current favourable environment, these concerns have abated.

Nevertheless, there is a strong case that, at least to some extent, market pricing has become detached from underlying fundamentals. Moreover, the search-for-yield dynamic threatens to embody a self-sustaining momentum (e.g., as investors underweight in peripheral assets underperform their benchmarks and are 'stopped in' to purchases of peripheral debt by the fear of redemptions).

All this has led to concerns that a "bubble" may be emerging in peripheral assets. Certainly the gap between market pricing and fundamentals and the self-sustaining nature of market momentum are two common features of bubble-like phenomena. But all is not necessarily lost. Two interpretations of recent events are possible.

On the one hand, a positive interpretation is that favourable market conditions have created the "breathing space" in which necessary, but difficult, reforms to the financial sector can be implemented. Going further, one might argue that the improved conditions for bank funding and capital raising allow the authorities to "boot strap" the Euro area banking system into a better, more sustainable position. Improved financial conditions resulting from easier bank credit supply will support the macroeconomic recovery that improves credit performance and thus validates the bank's less risk averse attitude to credit expansion. Either way, fundamentals will improve over time to validate current market pricing, which anticipates those improvements. Moreover, this approach offers a neat way out of the time consistency problem described above: it is market (over)optimism, rather than a relaxation of new rules, that is allowing banks to work their way out of legacy problems.

On the other hand, a negative interpretation would suggest that ultimately market prices will correct to levels more consistent with fundamentals. And if the institutional framework in which the financial sector operates has not been made more resilient and robust through reform, the danger exists that such a correction could overshoot and/or trigger the vicious downward spirals that underlay the crisis of 2007-12. Adding to this pessimism, one could argue that the benign market environment induces complacency on the part of both the authorities and the banking system, such that necessary but painful changes to fundamentals are neglected. Moral hazard may emerge. In this context, market prices will correct towards stagnant or deteriorating underlying fundamental levels.

Concluding remarks – No slackening of reforms and a cautionary tale from the 1990s

It is premature to come to a definitive view in which of the two preceding descriptions is more appropriate.

Current market behaviour appears to be driven by the expectation that ultimately banking union will be made to work at the Euro area level: today's pricing follows by backward induction of this view. Such an assumption contrasts with the view – common at the peak of the European sovereign crisis – that the Euro area would fragment. Convertibility and other attendant risk premia have been largely eliminated.

A common narrative supporting this positive interpretation is as follows. If the banking sector behaves in a manner that assumes full fungibility of bank capital and liquidity within the Euro area, in the event of a future crisis the cross-border entanglements among banks will be so extensive that only a unified approach to crisis management and resolution would be possible. Therefore, whatever the state of banking union's institutional development, in the end the authorities would have to deliver. Implicitly, the assumption is that the lessons of 2007-12 have been learnt. In the context, one should not worry about complexity of transitional arrangement or incompleteness in the final regime.

The self-referential nature of this equilibrium is immediately apparent. And, as is typical when such self-referential behaviour emerges, other equilibria exist. Not least, one can easily envisage a situation where, in the event of crisis, markets re-fragment once it becomes apparent that there is no functional common area-wide backstop or resolution regime in place. After all, this is what happened during 2007-12. In the context of such multiplicity, the shift from one equilibrium to the other can induce large and rapid shifts in market pricing and behaviour.

Even the positive interpretation is open to substantial risks. In this respect, history offers a cautionary tale. Following the ERM crises of 1992-93, few believed that a single currency was feasible by the end of the decade. But the reaffirmation of political commitment to monetary union at the Madrid European Council in 1995 spurred a reversal of market sentiment. It was the 'convergence play' of the latter part of the decade that narrowed sovereign spreads and made the introduction of the Euro possible in 1999. But support from the benign market environment of that period resulted in a complacency on the part of the authorities: fiscal consolidation and structural reform at the national level were insufficient, and – admittedly with the considerable benefit of hindsight – area-wide governance and integration were not pursued with sufficient purpose. In the end, EMU took flight – but in a form that was not robust enough to manage the rigours of the financial crisis a decade later.

Parallels can be drawn with banking union. Are the European authorities now relying on a 'convergence play' in bank funding markets? Is that breeding complacency and slowing necessary reform and institution building?

History will be the judge. At this stage, we need to see progress in building a concrete, rather than just a virtual, banking union in Europe. As the central bankers now becoming responsible for area-wide supervision know well from their experience with monetary policy, it is through building credible institutions that the time consistency problems inherent in current and future policy challenges can be managed.

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11
Restructuring a Euro Area Sovereign Guarantee

Lee C. Buchheit and G.Mitu Gulati*

As of this writing, in May 2014, market sentiment appears to be that the Euro area sovereign debt crisis is over. Spreads are converging to pre crisis levels and even countries like Greece are finding their bond issues oversubscribed. One of the techniques used by a number of sovereigns to extract themselves from the crisis, however, has produced a problem that may yet need to be dealt with. Specifically, in the course of trying to support their banking sectors during the crisis years, sovereigns turned to the issuance of large numbers of sovereign guarantee bonds. One advantage of issuing these types of bonds for a sovereign trying to escape a crisis is that they typically do not show up on the country's already bloated balance sheet. The disadvantage is that if the crisis hits again, these bonds can be difficult to restructure.

In every situation where a sovereign lends its credit support to facilitate a borrowing by a third party, the sovereign will have had a choice. The alternative to guaranteeing the debt of the third party is for the sovereign to borrow the money in its own name and on-

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lend the proceeds to that entity. The difference is that a direct liability appears on a sovereign's own balance sheet; a contingent liability probably will not. In the last five years, as the need to finance Great Recession stimulus measures has swollen the debt-to-GDP ratios of many developed countries, sovereigns have sought to camouflage the true extent of their liabilities by resorting to the issue of contingent, rather than direct, obligations.[1]

I. Sovereign Comfort

A benignant sovereign may bestow its credit support to a third party in a variety of ways.

(a) Explicit sovereign guarantees

At one end of the spectrum will be an explicit contractual guarantee by the sovereign expressed in words like these:

> The Republic hereby unconditionally and irrevocably guarantees (as primary obligor and not merely as surety) the punctual payment when due, whether at stated maturity, by acceleration or otherwise, of all obligations of the Obligor now or hereafter existing under this Agreement….

Such an explicit guarantee will sometimes come with all the trappings of an independent, separately enforceable, legal obligation on the part of the sovereign guarantor -- representations, covenants, waiver of sovereign immunity, choice of foreign governing law,

1 *See, e.g.*, *A Note of Caution in Greek Banks' Seeming Recovery*, Landon Thomas Jr., N.Y. TIMES, May 7, 2014; *State Debt Guarantees That are Hidden Add to Worries in Europe*, N.Y. TIMES, Feb. 5, 2013; Christopher Spink, Contingent Sovereign Liabilities a 'Landmine', INT'L FINANCING REV., May 26, 2012; David Reilly, *Time to End the Fiction of 'Frannie'*, WALL ST. J., Aug. 21, 2012. Mr. Reilly, in his piece, writes:

> That [a new requirement that Fannie Mae and Freddie Mac pay all of their profit to the U.S. Government as a dividend] bolsters the argument that Fannie and Freddie should be included on the government's balance sheet. Of course, that is politically unpalatable: The inclusion of their combined $5.3 trillion in liabilities would balloon the nearly $16 trillion in total federal debt outstanding and breach the debt ceiling.

submission to foreign court jurisdiction and appointment of an agent for service of process abroad.

Explicit sovereign guarantees may also be extended by operation of law. Some (but only some) deposit insurance schemes benefit from the full faith and credit of the host sovereign. In some countries, certain state-owned enterprises will by law carry the full faith and credit of their sovereign in their borrowing activities.

(b) Implicit sovereign assurances

The other side of the spectrum of sovereign credit support consists of nothing more than a background shadow; a figurative -- perhaps even a literal -- wink, nod and reassuring smile to the prospective investor. These are normally situations in which the primary obligor is so closely associated with the sovereign in the mind of the market (such as a political sub-division or an important state-owned enterprise) that lenders to the primary obligor are passively encouraged in the belief that the sovereign could never tolerate a circumstance in which the primary obligor tarnishes the reputation of the sovereign by defaulting on its debts. Nothing is ever said openly about sovereign credit support in these situations, but the perceptive investor is expected to see the warm arm of the sovereign wrapped in a reassuring manner around the shoulder of the debtor.

(c) In between

Between these two extremes of unambiguously explicit sovereign guarantees and gauzily implicit sovereign reassurances are many gradations. These include:

- partial guarantees -- the sovereign agrees to cover only a portion of the amount payable by the primary obligor;

- indemnities -- the sovereign agrees to indemnify the creditor for any residual loss but only after all efforts to recover the debt from the primary obligor have been exhausted;

- keepwells -- the sovereign's promise to the lender is limited to an undertaking that the primary obligor will at all times have a positive net worth (often expressed as a nominal amount), but the sovereign is free to achieve this objective of solvency in any way it wishes (by recapitalizing the primary obligor, assuming or paying some of its debts, lending money to the primary obligor, etc.); and

- comfort letters -- an aptly-named instrument, the comfort letter, in its most innocuous form, merely assures the lender that the sovereign is aware that the primary obligor is borrowing the money, that the sovereign does not object to the transaction and that the obligor continues to enjoy the affections of the sovereign.

The remainder of this paper will deal only with explicit sovereign guarantees. For obvious reasons, it is impossible to identify or quantify implicit guarantees because they exist only in the eye of the beholder.[2]

II. Contingent Charms

The principal charm (for the guarantor) of a contingent obligation lies precisely in its contingent nature; no one can be sure, at the time the debt is incurred, whether it will be paid by the primary obligor without recourse to the guarantor. This feature allows guarantors, with the blessing of the accounting profession, to treat the resulting liabilities as off balance sheet unless and until something happens in the future that makes it probable that the guarantee will in fact be called. For sovereigns already struggling under dangerously bloated debt-to-GDP ratios, this accounting treatment allows the sovereign

2 This vagueness about whether a particular loan does or does not enjoy the credit support of the sovereign carries its own risks. In a distressed debt context, a lender that thinks itself the beneficiary of an implicit sovereign guarantee is apt to protest if the sovereign orphans the primary obligor and allows the loan to go into default. The United Arab Emirates, burnt by just this reaction during the Dubai financial crisis of 2009, subsequently changed its policy to ensure that there would be no future misunderstandings about which loans to state-linked enterprises did, and which did not, enjoy government support. *See* Camilla Hall, *Abu Dhabi Tightens Rules for Debt Issued to State-Linked Businesses,* FIN. TIMES, Oct. 23, 2012 at 15.

to continue to raise capital on the strength of the sovereign's credit standing while not visibly increasing the size of the sovereign's own stock of debt. The only catch is that the loans must be directed in the first instance to a third party (the primary obligor) under the cover of the sovereign guarantee. That third party may be related to the sovereign (a state-owned enterprise for example), or it may be a private sector entity whose activities the sovereign wishes to encourage. A construction project undertaken by a private sector entity in the tourism industry is a good example.

Accounting standards differ somewhat in how they describe the circumstances which allow a guarantor to keep a contingent liability off of its own balance sheet. For corporate borrowers, the International Accounting Standards Board (IAS 37) directs that if a present obligation "may, but probably will not, require an outflow of resources" from the guarantor, it need not be "recognized" on the balance sheet of the guarantor, but should be disclosed in financial statements as a contingent liability.[3] Where the likelihood of an outflow of resources from the guarantor is "remote", even the need for financial disclosure is omitted.[4]

The general principle established by Eurostat (the statistical office of the European Union) for presenting the accounts of EU member states is broadly similar. As long as a state guarantee is not called by beneficiary, the liability is recorded only on the balance sheet of the primary obligor, not the sovereign.[5] Eurostat recognizes a "special case" exception to this general principle in situations where the need for the government to make debt service payments on the loan is open and notorious from the outset. The Eurostat Manual describes the circumstances in these terms:

> Even though the liability is issued by the enterprise itself, it may be right away considered with certainty as an actual government liability if the following conditions are fulfilled:

3 IASB Guidance on implementing IAS 37, Tables, *Provisions and Contingent Liabilities.*

4 *IAS* 37, para. 28

5 Eurostat, ESA95 Manual for Government Deficit and Debt (2002 ed.), II.4.3.2(1).

— the law authorizing issuance of the debt specifies the government's obligation of repayment.

— the budget of the State specifies each year the amount of repayment.

— this debt, issued by the enterprise, is systematically repaid by the State (interest and principal).

The liability must then be recorded directly -- as soon as at issuance -- in the government financial account and balance sheet, and not in the enterprise's. Its amount must be taken into account in the government debt.[6]

A Note on the Database

The statistical information in this paper is based on our survey of sovereign guaranteed bonds issued between January 1, 1965 and July 1, 2013, as those bonds appear on three publicly-available databases (Dealogic, Perfect Information, Thomson One Banker).[7] The prospectuses and offering circulars for a total of 885 sovereign guaranteed bonds appearing on these databases were reviewed.

This is not the total universe of sovereign guaranteed bonds. The databases we use are commercial and therefore usually include only those bonds that the database operators believe will be of interest to paying customers. Our information suggests that those customers tend to be foreign rather than local investors (domestic investors are often less concerned with legal terms, having other mechanisms to police and monitor the behavior of their sovereign). In other words, what we report on is probably both a small and biased (towards the interests of foreign investors) subset of the universe of sovereign guaranteed bonds, the exact size of which is entirely a matter of speculation.

We nevertheless believe that our results reveal the general trends in the issuance of these instruments over time, particularly in the areas of greatest relevance to the subject of this paper -- number of issuances (relative to direct sovereign bonds), governing law, submission to court jurisdiction and waiver of sovereign immunity.

6 *Id.*, II.4.3.2(2)

7 We also examined the bonds available from Bloomberg, a fourth data source. However, there were no bonds there that we had not already accessed from one of the other databases.

III. The Explosion of 2008 - 2012

The data we have reviewed suggests that there was literally an explosion in the number of sovereign guaranteed bonds issued after the onset of the financial crisis in 2008, particularly in Europe. Using publicly-available information (see box -- "A Note on the Data Base"), the results are shown on Figure 1:

Figure 1: Number of Bonds with Sovereign Guarantees
Jan, 1 1965 - July 1, 2013 (n=885)

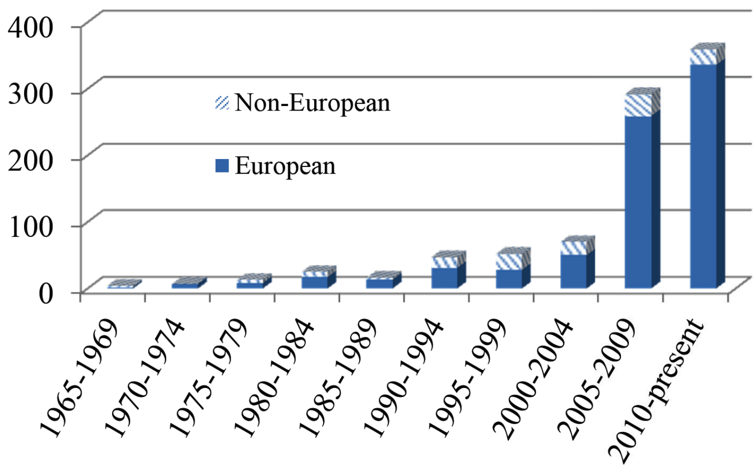
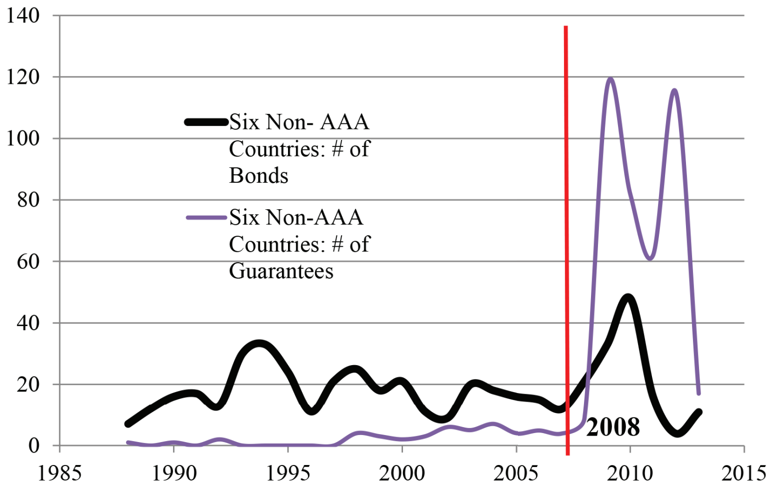


Figure 2 reports a different, but equally striking, perspective -- it focuses on the bonds and guarantees for the six euro area nations that were generally perceived to be at the heart of the crisis starting in late 2009 – Greece, Italy, Ireland, Portugal, Spain and Belgium. These are also the six early entrants to the European Monetary Union who have not traditionally been AAA rated (in contrast to, for example, Germany and France). For these six nations, Figure 2 reports both the numbers of sovereign bonds and guaranteed bonds issued during the quarter century between January 1, 1988 and July 1, 2013. As the European crisis worsens during the 2009-2012 period, the issuance of guaranteed bonds, particularly in comparison to regular sovereign bonds, mushrooms.

Figure 2: Numbers of Bonds versus guaranteed Bonds for Six Non-AAA Early Euro Area Entrants (Jan 1, 1988 - July 1, 2013)



An excellent study released by Houlihan Lokey in May 2012[8] concluded that sovereign loan/bond guarantees in Europe as of end-2010 (a category that did not include other forms of sovereign contingent exposure such as umbrella guarantees or deposit insurance schemes) represented, on a GDP-weighted average, 13.1% of European GDP. In some countries, contingent exposure approached 30 percent of GDP. The trend noted in the Houlihan study was upward; the aggregate size of guarantees outstanding in 2013 is undoubtedly significantly larger than it was in 2010.

There are two explanations for this dramatic rise in the popularity of contingent sovereign obligations. The first, as discussed above, is the desire of over-indebted developed countries to minimize further strains on their debt-to-GDP ratios. The off balance sheet accounting treatment of contingent obligations permits this. The second explanation relates to the methods by which the European Central Bank has been prepared to provide liquidity assistance to banks in the Eurozone. A bank in need of liquidity may either borrow money

8 Houlihan Lokey, *The Increasing Risks Posed by Contingent Liabilities: How to Measure and Manage Them*, Presentation at the 2012 Meeting of the Private Sector with the Paris Club and with Representatives of Non Paris Club Bilateral Creditors, available at http://www.iif.com/emp/dr/

directly from the ECB's discount window by posting eligible collateral for the loan, or the bank may borrow the funds from its own central bank through the Emergency Lending Assistance ("ELA") program. ELA funds, however, are ultimately also sourced from the ECB and the Eurosystem and require the posting of eligible collateral by the borrowing bank.

Peripheral European banks that had exhausted their store of eligible collateral for these programs came up with an ingenious solution -- they manufactured eligible collateral.[9] The bank issues a debt instrument to itself (there is no third party purchaser of the instrument), takes the instrument to its local ministry of finance and obtains a government guarantee, and then uses the instrument as collateral for a new borrowing from ECB's discount window or the ELA.[10]

In July 2012, the ECB is reported to have grown alarmed at the size of the manufactured collateral that it was accepting at its discount window. The ECB accordingly capped the amount of "specially tailored bonds" that could be used for this purpose by Eurozone banks at the level each bank had outstanding at the time the new policy was announced.[11]

IV. Precedents

One of the remorseless laws of sovereign debt management is that size brings risk. If a component of a sovereign's debt stock is of neg-

9 The Cypriot Ministry of Finance charmingly refers to instruments issued for the sole purpose of ECB/ELA discounting as "collateral for liquidity extraction from the European Central Bank." Republic of Cyprus, Ministry of Finance, Public Debt Management Annual Report 2011 (March 2012) at 35.

10 *See* Sonia Sirletti & Elisa Martinuzzi, *Italy Banks said to Use State-Backed Bonds for ECB Loans*, BLOOMBERG, Dec. 21, 2011, available at http://www.bloomberg.com/news/2011-12-20/italian-banks-are-said-to-use-state-guaranteed-bonds-to-receive-ecb-loans.html

11 *See* Marc Jones, *ECB Caps Use of State-Backed Bonds as Collateral,* REUTERS, July 3, 2012, available at http://uk.reuters.com/assets/print?aid=UKBRE8620V920120703; Joseph Cotterill, *ECB Collateral Shift* Du Jour, FT ALPHAVILLE, July 3, 2012, available at http://ftalphaville.ft.com/2012/07/03/1070271/ecb-collateral-shift-du-jour/. As of early 2014, however, the practice of banks appears to be continuing at least in some Euro area countries. See Christopher Spink, *Greek Banks Confront Liquidity Issues*, INT'L. FINANCING REV., June 13, 2014.

ligible size, that component can sometimes escape a debt restructuring. For example, with only a couple of exceptions, sovereign bonds were not restructured in the 1980s debt crisis. The reason? Emerging market sovereign bond issues were rare in the period before the crisis began in 1982 and the cost/benefit analysis weighed heavily in favor of exempting those few bonds from the restructurings that engulfed commercial bank loans and bilateral credits in that decade. But by the late 1990s, bonds had replaced bank loans as the main component of the debt stocks of many emerging market countries. Bond restructurings therefore became inevitable in countries with insupportable debt loads.

If this remorseless law is indeed remorseless, it suggests that any country carrying a significant stock of contingent sovereign obligations will eventually need to address those liabilities if a generalized restructuring of the country's debt becomes necessary. Unfortunately, there are few historical precedents to guide such an exercise.

In the sovereign debt restructurings of the 1980s, the aggregate number of sovereign guarantees was small. This allowed them to be ignored in the debt workouts of that era. The normal approach was to include a contingent liability in the restructuring only if the beneficiary called on the guarantee before the restructuring closed. But no pressure was placed on beneficiaries to call on their guarantees. This set a precedent that has been followed in most sovereign debt restructurings of the last thirty years.[12]

One notable exception was Grenada's restructuring in 2005 where the government's contingent exposure equaled about 10% of its direct liabilities. Grenada warned in the disclosure document for its restructuring that any contingent obligation called by a beneficiary after the restructuring closed would be settled by the delivery of consideration having a net present value equal to what the lender would have received had the guarantee been called in time to be included in the main restructuring.[13]

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12 *See* Lee C. Buchheit & G. Mitu Gulati, *The Treatment of Contingent Liabilities in a Sovereign Debt Restructuring*, in FINANCIAL CRISIS CONTAINMENT AND GOVERNMENT GUARANTEES (J. LaBrosse, R. Olivares-Caminal, & D. Singh eds., 2013).

13 *See* Lee C. Buchheit & Elizabeth Karpenski, *Grenada's Innovations,* 2006 J. INT'L BANKING AND REG., at 227, 231.

The most recent precedent, Greece in 2012, is mixed. Although the Hellenic Republic had hundreds of outstanding state guarantees at the time it announced its debt restructuring in February of 2012, only 36 of those instruments were made eligible for inclusion in the workout.[14] The distinguishing characteristic of the included instruments was that they fell within Eurostat's "special cases" exception to the general rule of off balance sheet treatment.[15] In effect, Eurostat had already concluded that the liabilities were central government debt and had to be shown as such for Eurostat reporting purposes. Accordingly, they were also made eligible for the restructuring of the central government's direct debt.

Interestingly, although the main Greek debt restructuring was facilitated by Greek legislation which retrofit a collective action mechanism on that portion of the debt stock governed by Greek law (93% of the total), this legislation did not attempt to sweep in the Greek Government guarantees of the guaranteed bonds that were declared eligible for the restructuring, nor did the Greek legislature attempt to pass separate legislation dealing with the Government's local law guarantees. The Greek authorities therefore avoided the legal and operational complications (described below in Part VI of this paper) that would have attended an attempt to restructure sovereign guarantees in a more coercive way.

V. <u>The Restructurer's Dilemma</u>

If a country that is forced to restructure its outstanding (direct) indebtedness also has a significant amount of contingent obligations coming due during the period covered by that restructuring, there are a limited number of options:

(i) hope that the primary obligor will have the resources to pay the debt without a call on the guarantee;

(ii) hope that the beneficiary of the guarantee will voluntarily roll over the debt at maturity;

14 Twenty series of these guaranteed bonds (totaling €4.88 billion) were governed by Greek law; the other sixteen series (totaling €4.97 billion) were governed by foreign law.
15 See text accompanying note 5 above.

(iii) honor the guarantee if it is called by paying the debt in full; and

(iv) dishonor the guarantee and attempt to restructure the liability when it matures.

Option (i) is, of course, the sovereign's preferred choice. But a natural selection process is always at work in guarantees. Had the primary obligor been perceived as fully creditworthy on its own, it would not have needed sovereign credit support in order to raise capital at a tolerably low interest rate. The very presence of a sovereign guarantee is thus a sign that the primary obligor might not be good for the money when it comes due.

Option (ii), a voluntary rollover, is the sovereign's second best choice. Naturally, this requires the cooperation of either an indulgent, or a captive, beneficiary. The "liquidity extraction bonds" (see footnote 9 below) that have been issued by European banks for the purpose of accessing the ECB's discount window or the ELA program presumably fall into the category of "captive beneficiary". Demanding repayment of the loan to the discounting bank on its maturity date would, in most of these situations, be pointless. Demanding payment from the sovereign guarantor of the guaranteed bonds pledged to secure the loan would be inconsistent with the official sector's bailout program for the country. The result is a captive beneficiary that has little choice but to roll over the loan and the accompanying collateral for the loan.

Option (iii), pay up, can have several problems. The first, of course, is money, a commodity that is rarely in abundant supply when a sovereign is compelled to restructure its debts. Even if the cash is available, paying in full the beneficiary of a state guarantee while all of the sovereign's direct creditors have been forced to take losses will naturally delight the former and enrage the latter. Finally, it is unlikely that the financial predicates underlying the restructuring will have assumed payment in full of maturing contingent liabilities during the adjustment period. If those contingent liabilities are of a significant size, a policy of paying them may torpedo the entire program.

Option (iv), attempt an ad hoc restructuring of a contingent liability when it matures, raises the predicable issues of feasibility, cost and intercreditor equity. It would also inevitably prolong the perception that the country remains mired in a debt crisis.

The restructuring of a contingent obligation is more complicated than the same exercise for direct sovereign debt. For one thing, until the guarantee is called by the beneficiary, it remains contingent; the guarantor is rarely in a position to force such a call. This gives the beneficiary the option of attempting to ride out the sovereign's restructuring of its direct obligations in the hope that after that main restructuring closes, the sovereign will be reluctant to plunge back into another debt crisis by dishonoring a call on the guarantee.

Moreover, even if beneficiaries can be persuaded to call upon their guarantees, they are in a fundamentally different position from the sovereign's direct creditors. By definition, the holder of a sovereign guaranteed bond benefits from the credit of both the primary obligor and that of the sovereign guarantor; in the jargon, the creditor is holding "two-name paper". Giving such a creditor the same deal as that offered to direct creditors of the sovereign would effectively attribute no value to the credit of the primary obligor. But any attempt to sweeten the terms of the restructuring for contingent sovereign creditors in order to compensate those holders for the surrender of their claim against the primary obligor requires someone to put a monetary value on that second credit risk. This could be a delicate and politically sensitive task when the primary obligor is a state-owned or controlled enterprise.

In short, the restructurer's dilemma is that contingent liabilities, if they are of any material size, cannot safely be left *out* of a sovereign debt restructuring, nor can they easily be included *in* a sovereign debt restructuring. This problem wasn't a problem for so long as contingent liabilities represented only a small part of the debt stocks of affected countries. But for many countries, that period ended with the commencement of the financial crisis in 2008. The problem will therefore be unavoidable in at least some of the sovereign debt restructurings yet to come.

In the bankruptcy of a corporate borrower in the United States (let's call it Acme Corporation), the value of any contingent claims against Acme that are not expected to be crystalized before the bankruptcy proceeding ends may be estimated for purposes of allowing the beneficiary's claim to be filed in the insolvency proceeding. (See U.S. Bankruptcy Code § 502(c)(1).) This is done to avoid unduly prolonging the administration of Acme's estate or forcing the administrator to establish a reserve against the claim. If it appears that the primary obligor will be able to pay the debt out of its own resources (without requiring a call on Acme's guarantee), then the beneficiary's claim in Acme's bankruptcy may be estimated at zero or close to it.

VI. Restructuring Sovereign Contingent Obligations

How hard would it be to cast the net of a sovereign debt restructuring wide enough to catch the sovereign's contingent obligations?

(a) Voluntary offers

If the debt restructuring is conducted as a purely voluntary exchange (that is, no use of CACs, embedded or retrofit), and involves delivery of new debt instruments of the sovereign in exchange for outstanding sovereign guaranteed bonds, the holders of contingent sovereign paper can be expected to ask for a sweeter deal than that offered to the direct creditors. The justification will be that this additional consideration is needed to compensate for the creditors' surrender of a claim against the first name (the primary obligor) of their two-name paper. Apart from the politically delicate job of deciding whether the incremental credit risk of a parastatal on a debt instrument is worth a nickel or a dime or something more, different values would logically need to be assigned for each of the primary obligors, a tedious and possibly controversial task.

The alternative would involve restructuring each guaranteed bond in a manner that maintains the primary obligor as the first name on the paper. This could be done either by exchanging each old guaranteed bond for a new guaranteed bond with the same parties, or else attempting to modify the terms of that old bond within its four corners (no exchange). This approach would address the concern about the loss of the creditor's claim against the primary obligor, but it could significantly complicate the mechanics of the restructuring. For one thing, it would be tantamount to a separate restructuring for each guaranteed bond. Because the primary obligors would continue as a credit risk on the restructured debt instruments, the securities laws in many jurisdictions would require separate disclosure for each of those primary obligors in the exchange offer. Instead of issuing a single series of sovereign bonds for exchange with existing debtholders, the restructuring would involve the issuance, listing and administration of multiple series of bonds, each corresponding to an underlying guaranteed debt instrument.

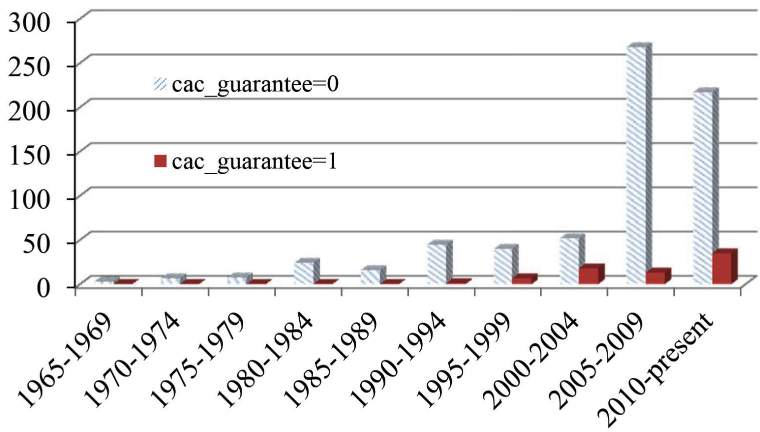
(b) Less-than-voluntary offers

A debt restructuring that does not rely exclusively on persuasion to bring creditors into the deal will face its own set of problems with contingent sovereign obligations.

<u>Collective action clauses (CACs)</u>. One immediate question will be whether the terms of the guarantee will need to be amended separately from, or in parallel with, a modification of the terms of the underlying debt instrument. If the underlying instrument does not include a collective action clause of some kind, its amendment -- and the corresponding amendment of the related guarantee -- would presumably require the unanimous consent of each debtholder. Even where the underlying debt instrument contains a CAC, however, the related sovereign guarantee almost certainly will not. Our research suggests that CACs are almost never incorporated in sovereign guarantees.

Somewhat more common, but still quite rare, is for the CAC appearing in the underlying bond to permit changes to the accompanying sovereign guarantee. As Figure 2 shows, of the guaranteed bonds with CACs in our database, fewer than 10% permitted modifications by a supermajority vote of creditors to both the underlying bond <u>and</u> the accompanying guarantee.

Figure 3: Number of Sovereign Guarantees with CACS mentioning Guarantee Modification (Jan 1, 1965-2013 - July 1, 2013)



Why should contract drafters who were cautious enough to put CACs in their bonds have felt it unnecessary to incorporate a similar feature in the accompanying guarantees? The most plausible explanation is that the drafters simply didn't see the need to do so. The guarantee promises payment of the bond on the dates and in the amounts due. If the creditors agree to amend the terms of the bond, this argument goes, the terms of the guarantee will automatically wrap around those modified terms.

This assumption may be a bit too facile. For one thing, the wording of the guarantee could be crucial. For example, a Republic of Turkey sovereign guarantee in our database recites that:

> The intention and purpose of this Guarantee is to ensure that the Bondholders . . . shall receive the amounts payable as interest and principal as and when due and payable according to the Issue Terms . . . [16]

No mention is made of a possible modification to the original Issue Terms. It is therefore not clear whether an amendment to the terms of

16 The Central Bank of the Republic of Turkey, DM200,000,000 7% Deutsche Mark Bearer Bonds of 1987/1992, *irrevocably and unconditionally guaranteed by the Republic of Turkey*, (emphasis added).

the underlying bond would automatically result in a corresponding amendment to the accompanying guarantee. More importantly, the amendment of a sovereign guaranteed bond through the use of a collective action clause is still an unusual event and would raise novel legal issues.

If a supermajority of bondholders can alter the terms of an underlying bond through a collective action clause, but no similar contractual flexibility exits to modify the terms of the related sovereign guarantee, can a disaffected minority of bondholders insist on payment by the guarantor of the amounts originally due under the bond? The argument <u>against</u> permitting such a claim focuses on the words of the guarantee promising payment "when due" of the primary obligor's obligations under the bond. If those obligations are extended or reduced in a manner permitted by the terms of the bond (through the exercise of the CAC), the argument goes, the guarantee should automatically wrap around the amended terms.

The argument in <u>favor</u> of allowing those disgruntled creditors to insist on strict performance of the guarantee has several components. First, these guarantees are often deliberately set up to be free standing, separately enforceable instruments; the guarantor is frequently described as being liable as a "primary obligor and not merely as surety" of the underlying obligation. If a supermajority of bondholders wish to modify the terms of the underlying obligation, the presence of a CAC may allow them to sweep along a disaffected minority at that level. But absent a CAC in the guarantee, the consent of each beneficiary of the guarantee would appear to be required to effect a parallel amendment of that instrument. Second, had the drafter of the guarantee wanted to permit its terms to be modified with less than the unanimous consent of the beneficiaries, this would have been easy to do. Under normal principles of contract interpretation a court would not read such a modification clause into the document. Finally, many guarantees contain language similar to the following:

> The liability of the Guarantor hereunder shall be absolute and unconditional irrespective of any change in the time,

> manner or place of payment, or any other term of, the [underlying obligation].[17]

This situation (a conflict between a "collective action" amendment of an underlying obligation and the modification of an accompanying guarantee) is not well developed in U.S. law for the simple reason that collective action modification clauses fell out of favor in corporate debt instruments in the United States in the 1930s, and have only recently (since 2003) begun to appear in sovereign debt instruments governed by the law of a U.S. jurisdiction. In a traditional U.S. amendment clause requiring the unanimous consent of all creditors for a change to payment terms, the issue does not arise; by definition, every holder will have consented to the change.

Governing law. A sovereign fortunate enough to have its guarantees governed by its own law may (subject to constitutional constraints) be able to encourage holders of its contingent obligations to accept a restructuring by threatening to pass domestic legislation containing a sentence along these lines:

> All guarantees issued by the Republic of Ruritania in respect of debt obligations of third parties that are eligible to participate in the [Ruritanian restructuring] shall, if called by the beneficiary at any time after the closing of the [Ruritanian restructuring], be satisfied and discharged in full by delivery to the creditor of consideration equivalent to that offered in the [Ruritanian restructuring].

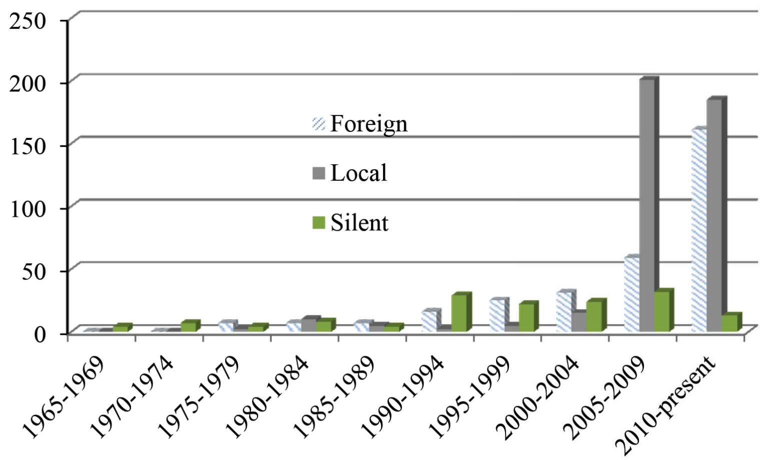
The effect of such a provision would be to remove any incentive on the part of the beneficiary of a state guarantee to refrain from calling

17 This language is included in a guarantee to ensure that the guarantor is not released if the lender agrees to vary the terms of the underlying obligation. *See* Raymer McQuiston, *Drafting an Enforceable Guaranty in an International Financing Transaction: A Lender's Perspective,* 10 INT'L TAX AND BUS. LAWYER 138, 156 (1993) ("Common law courts have ruled consistently that a variation or change in the terms of the underlying loan agreement without the guarantor's consent … justifies a release of the guarantor from its obligations.") That said, a bondholder might argue that the language could equally be seen as preserving a bondholder's claim against the guarantor to perform the unamended terms of the underlying instrument unless that lender has also agreed to amend the guarantee.

on the guarantee at the time of the main restructuring. It is thus a statutory expression of the warning that Grenada gave in 2005 to the holders of its contingent obligations (see text accompanying footnote 13 above). In a debt restructuring, a local law guarantee thus provides the sovereign with considerable leverage.[18]

One of the most startling conclusions of our empirical research has been the split between the law chosen to govern underlying debt instruments and the governing law of the related sovereign guarantee. Figure 3 suggests that until 2010, a significant number of sovereign guarantees were governed by local law (the law of the sovereign's jurisdiction), even where the underlying bond was governed by foreign law.

Figure 4: Number of Sovereign Guarantees by Law of Guarantee (Jan 1, 1965 - July 1, 2013)



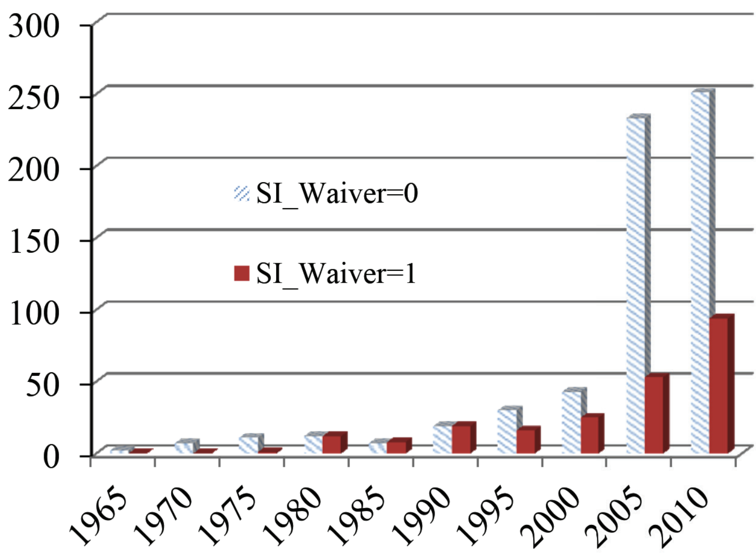
This practice shifted abruptly starting in 2010, probably because the Greek crisis highlighted the added risks for the holders of debt instruments governed by local law. Post Greece, bondholders were no longer as willing to allow their guarantees to be governed by the

18 At least one attempt to use the local law advantage to strip a sovereign guaranteed bond of the guarantee has already begun. *See* Christopher Spink, *Plan to Remove Guarantees from Hypo Alpe-Adria's Bonds Ruffles Market*, INT'L. FINANCING REV., July 4, 2014.

sovereign's own law.[19] This is, we believe, a particularly vivid example of documentation practices in cross-border debt instruments responding almost immediately to the market's perception of a new -- or in this case, an overlooked – legal risk.

Waiver of immunity. All creditors of sovereigns face the daunting challenge of enforcing their claims against a recalcitrant debtor, but most benefit from an express waiver by the sovereign of any entitlement that the sovereign (or its property) may enjoy based on sovereign immunity. Figure 5 suggests, however, that such express waivers of immunity are far less common in sovereign guarantees than one might have thought.

Figure 5: Number of Guaranteed Bonds with Waivers of Sovereign Immunity (Jan 1, 1965 - July 1, 2013)



The absence of an express waiver of immunity does not make it impossible to enforce a guarantee against a defaulting sovereign, but it will make the enforcement process more difficult. Sovereigns can be expected to remind the beneficiaries of their guarantees of this

19 The Greek Parliament retrofit a collective action mechanism on its local law debt stock in early 2012 in order to facilitate a restructuring of those obligations. *See* Jeromin Zettelmeyer, Christoph Trebesch & Mitu Gulati, *The Greek Debt Exchange: An Autopsy*, Duke Law School Working Paper (Sept. 11, 2012 draft), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2144932

likely difficulty as a means of encouraging those beneficiaries to join a general restructuring.

VII. Conclusion

Our conclusions are --

- In a number of important countries, sovereign guarantees have become so prevalent that they cannot be ignored in any future debt workouts that may be needed for those countries.

- Exactly how the contingent portion of a sovereign's debt stock is to be addressed in such a restructuring remains a mystery. There are very few precedents and no good precedents.

- For a while at least (until existing bonds mature and are replaced by new issues with more pro-creditor provisions), some sovereigns will benefit in a debt restructuring from the prelapsarian innocence shown in the contract drafting patterns that prevailed before 2010 in areas such as governing law and waiver of immunities.

- One thing seems certain: the presence of a significant number of contingent liabilities in a sovereign's debt stock will present major complications for the architects of a debt restructuring for that country. Not the least of these will be psychological. The need to address contingent liabilities will force everyone -- creditors, official sector sponsors and citizens -- to watch with alarm as heretofore off balance sheet liabilities come rushing on to the sovereign's balance sheet, just in time to be restructured.

12
The Diabolic Loop: Precedents and Legacies

Kris James Mitchener

I. Background

Commentators have used a variety of terms, including the "diabolic loop," the "doom loop," and the "vicious cycle," to describe how distress in the banking sector and sovereign bond markets fed off each other during the recent European crisis, exacerbating macroeconomic problems and fueling political unrest. Strained banks suffering from "toxic" assets and declining property values placed pressure on states to assist them and ward off failure. Sovereigns responded with publicly-funded bailouts, which then weakened their fiscal position at a time when declining aggregate demand and falling tax revenues were already straining states' balance sheets. Debt markets reacted by "punishing" sovereigns, selling bonds, driving up risk premiums, and making it difficult for states to obtain rollover funding. Financial institutions had been tacitly encouraged to hold sovereign bonds since regulatory standards in Europe effectively gave them a risk weight of zero. Hence, banks' balance sheets in turn worsened as sovereign bonds were downgraded by rating agencies and/or prices of debt fell in the secondary market. These balance sheet effects raised further doubts about bank solvency, in turn driving up their rates for borrowing as well, and raising the specter of the need for more public-sector assistance.

Two prominent examples of this vicious cycle are Greece and Ireland. Greek banks faced insolvency due to the virtual default of the sovereign, whose bonds they were holding. Ireland, which despite a relatively low debt-GDP ratio prior to the crisis, experienced a withdrawal of funding as debt markets become concerned about a possible government-funded bailout of banks. The prospect of further bailouts of banks by sovereigns acted as a lethal embrace between "conjoined twins" (in the words of George Soros) that dragged both down and has prevented economic activity from restarting in Europe.

II. Historical Precedent?

A. Frequencies

A better understanding of how common diabolic loops have been throughout history as well as what factors have induced them are likely to be useful for formulating appropriate policies and institutions aimed at combating future crises, including determining who bears the burden of the losses during such crises – foreign creditors, domestic creditors, taxpayers, etc. Many of the characteristics of this crisis, including funding bonanzas, credit booms, balance-sheet effects, and implicit and explicit government guarantees are features of past crises (Bordo and Eichengreen, 2002; Reinhart and Rogoff, 2009; Eichengreen and Mitchener, 2002). In this essay, we focus on whether vicious cycles between sovereigns and banking systems emerged in earlier eras, and what their experience might help us understand about the recent European crisis.

It is no secret that sovereigns and banks have maintained very close relationships for a very long time. Banks receive their charters from sovereigns, often lend back to them, and sometimes even act as their fiscal agents. States monitor bank note issuance closely since they have an incentive to control or extract the rents from seigniorage. There is also a long history of mutual aid in times of crisis. During wars, banks aid sovereigns by absorbing new domestic debt issues. In turn, banks often receive emergency funding (e.g., liquidity support by a central bank) or direct capital infusions from states when in need. As a result, balance sheets of sovereigns and banks often become comingled.

Of course, the support of banks has not prevented sovereigns from defaulting; they have repeatedly done so at least since the time of Phillip II of Spain. Moreover, large banks (in modern parlance, SIFIs) and/or lots of banks have failed regularly throughout history, wreaking havoc on both developing and developed economies. It is certainly possible, then, that these two crises have worked in conjunction to worsen recessions of the past. To examine whether there is evidence of diabolic loops, a database of crises of different sorts (banking crises, sovereign debt crises, stock market crashes, hyperinflations, and exchange-rate crises) was assembled for two periods of history that most closely resemble the conditions of the recent European crisis.[1] Pressure from external creditors is a feature of the diabolic loop seen in Europe, so examining eras when there were active secondary markets for sovereign debt (in order to gauge prices and yields in crisis periods) seems like a necessary condition for comparison. Moreover, the fact that Eurozone countries were the ones experiencing the diabolic loop suggests that hard pegs likely constrain policy choices, and made the diabolic loop particularly pernicious. Hence, focusing on eras when hard pegs were widely employed also seems like a relevant starting point for comparison. The analysis thus focuses on 1870-1913 and 1920-35, periods when (1) large numbers of countries issued sovereign bonds and their issues actively traded on international capital markets and (2) countries adhered to hard pegs (the classical and interwar gold standards). There are other periods when governments borrowed heavily and defaulted, but in some cases lending was done by banks (the Latin American debt crisis of the 1980s) or the defaults occurred when banks were of little consequence due to the country's level of development (the new Latin American republics of the early 19th century). Focusing on these two periods of high capital mobility will give us a fair assessment of conditional probabilities (the likelihood of the dual loop in the event

1 For comparability, we employ the same crisis definitions as in Reinhart and Rogoff (2009). For example, banking crises occur when a large numbers of banks face runs or significant banks (in terms of size measured in assets) fail. Sovereign defaults occur when a payment on principal or interest is missed. The database on crisis dates and frequencies, however, utilizes additional sources to obtain a complete record for our sample period. These include the Annual Reports of the Corporation of Foreign Bondholders, the Annual Reports of the Foreign Bondholders Protective Council, Mitchener and Weidenmier (2008, 2010), and Bordo et. al. (2001).

of a crisis), but, of course, may lead to an undercount of the total number of episodes.

Crises were fairly common in these two periods of high capital mobility. 52 countries or colonies experienced some sort of macroeconomic crisis (inflation, exchange-rate, sovereign debt, or banking) in the first era, and 59 occurred in the shorter, tumultuous interwar period. Table 1 shows that 27 countries defaulted on their sovereign debt during the first era of globalization (1870-1913) while 23 did so during the interwar period (1920-35). Banking crises were slightly more common than external debt crises, with 29 in the classical gold standard era and 26 in the 1920s and 1930s. More than 50 percent of countries experiencing any sort of crisis during these two eras had a banking crisis.

Table 1. Frequencies of Sovereign Debt and Banking Crises, 1870-1913 & 1920-35

Period	Countries with Sovereign Debt Crises	Countries with Banking Crises	Countries with any type of crisis	Share with sovereign debt crises	Share with banking crises
1870-1913	27	29	52	52%	56%
1920-1935	23	26	59	47%	53%

The definition of a diabolic loop implies a coincidence in the timing of the two types of crises within a country, so how frequently did this happen? We first identified windows during which both events occurred relatively near to each other. As seen in the recent crisis, banking problems can manifest themselves before or after a formal or virtual default on debt, so we consider both possibilities. Moreover, since crises take time to unfold, we defined a coincidence in timing liberally to provide a better estimate of an upper bound, and used three-year and five-year windows as the periods of overlap. Windows much longer than this would begin to call into question whether the two crises are causally connected, although we acknowledge it is a possibility. It turns out that using either the three-year or five-year windows makes little difference in frequencies. If a country defaulted on its sovereign debt, the chances of having a banking crisis three to five years after the default was 30 percent during the first era of globalization and 35 percent during the interwar period. If a country first had a banking crisis, then the chance of it defaulting on its external debt in the subsequent three to five years was 28 percent for the classical gold standard era and 31 percent for the interwar period.

In both the first era of globalization and during the interwar years, there were eight countries that experienced banking crises and sovereign debt crises within three or five years of each other.[2] Perhaps it is not surprising, but most of these coincidental crises were concentrated in periods of widespread distress – the 1870s, the 1890s, and, especially, the 1930s. From 1870-1913, 6 percent of countries with any kind of crisis had a twin sovereign-banking crisis. From 1920-35, 16 percent of countries with any kind of crisis experienced a twin sovereign-banking crisis.

B. Doom Loops from Earlier Eras

We used contemporaneous newspapers and annual reports of sovereign creditors to gain additional perspective on the 16 historical twin crises. The narrative evidence suggests that six of them have features that broadly resemble recent diabolic loops.[3] Of these six, two occurred in the first historical era, one in Peru and the other in Argentina. In the eyes of international creditors, Peru had a well-diversified export base in the 1870s, which made it an attractive recipient of new lending. Its guano deposits, sugar, cotton and nitrate production allowed it to contract two huge foreign loans in 1870 and 1872 for the purpose of constructing railroads and improving internal

2 For the first period, and with the start date located in parentheses, these are: Argentina (1890), Austria (1868), Brazil (1897), Mexico (1883), Parguay (1890), Peru (1872), and Uruguay (1891). For the interwar period, they are: Austria (1931), Brazil (1929), China (1919), Greece (1931), Mexico (1929), Poland (1931), Romania (1931), and Turkey (1931).

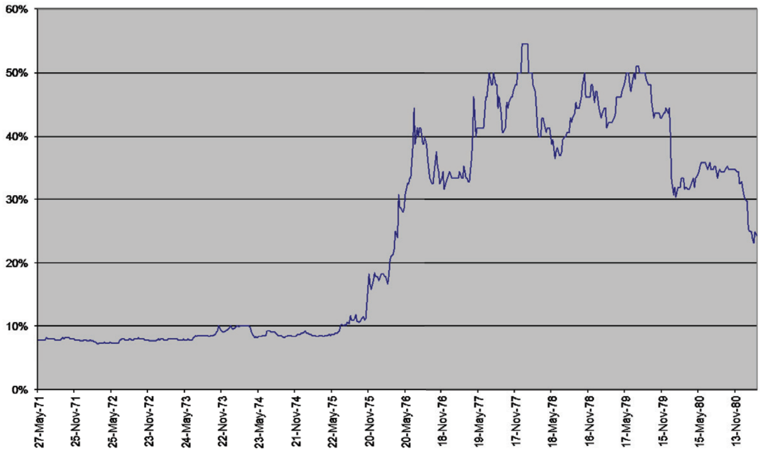
3 The main primary sources consulted were the *Economist*, and the annual reports of the Corporation of Foreign Bondholders (British organization), and the annual reports of the Foreign Bondholders Protective Council (American organization).

transportation networks for the movement of goods and people. The income obtained from guano exports was directed primarily for the payment of interest, but exports of guano began a decline and fiscal deficits grew in the early 1870s. Fiscal demands were initially met by a growing international demand for Peru's exports of nitrates, but debt- servicing costs continued to grow. Eventually, it made a deal with Dreyfus Fréres of Paris, which promised to cover the debt service in exchange for the guano monopoly; however, the firm warned Peruvian officials in July 1875 that it would not pay interest on the debt if guano sales remained depressed.[4]

On August 1, 1875, Banco Nacional del Peru, a private institution with close ties to the government, became insolvent. To prevent a widespread banking panic, the government allowed other banks of issue to increase their note issuance if they in turn lent these paper notes to the government (primarily to meet internal debt obligations). Further, the government intended to employ these banks as local consignees of nitrate production in its drive to nationalize the nitrate industry and then to use the revenues from nationalization to pay off external debt claims. The nitrate producers balked at the government's nationalization program, which included land for government-bond swaps. Figure 1 shows Peruvian yields began to rise in late 1875. Facing insufficient revenues, the country suspended its interest payments on its external debt on January 1876. Foreign bondholders were informed that due to differences among the guano contractors and the Peruvian authorities no further payments would be forthcoming. The country did not resume payments on its external debt for more than a decade.

4 See Marichal (1989, 2014) and Vizcarra (2009).

Figure 1: Peruvian Sovereign Bond Yields, 1871-1880 (1870 6% issue)



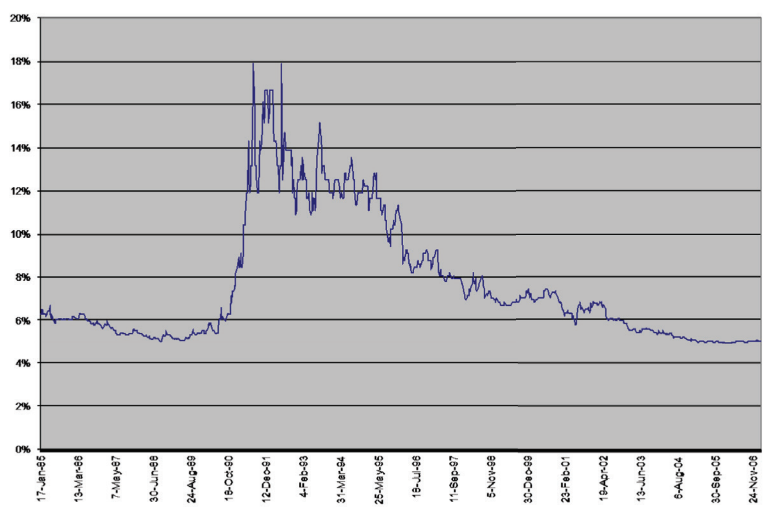
Argentina's problems of the 1890s are perhaps more widely known than Peru's earlier difficulties. Europeans began financing an Argentine land and construction boom in the 1880s. The country borrowed from abroad to finance investment projects with long-term maturities, such as railways and land improvements. Domestic credit expanded rapidly during this decade. An important institutional change occurred in 1887 when a banking law authorized commercial banks to issue paper notes (a new government liability) backed by gold bonds. Loans were then floated in Europe to purchase gold bonds. From 1884-1890, the monetary base grew at an annual average rate of 18 percent (driven by the issuance of paper currency emissions), inflation averaged 17 percent, and the paper peso depreciated at an average rate of 19 percent per year. By 1890, the country's economic fortune depended on export earnings and foreign borrowing to finance consumption (60 percent of imports) and debt service (40 percent of foreign borrowing). If foreign borrowing ceased, it would likely result in a default, a serious contraction in imports, or both.

Signs of trouble became apparent when the government broke its legal obligation and paid off some gold liabilities with the massively depreciated domestic currency. The investment house of Baring then failed to float a 25 million gold peso loan in London, and runs on the banks of issue, Banco Nacional and the Banco de la Provincia de

Buenos Aires, began in 1890. Panicky depositors feared a "sudden stop" in the supply of foreign capital, a situation that would put the government and banks (tacitly linked to the government) at risk. Banks were making loans to the government in exchange for short- and medium-term government bills, but these were not readily tradable in the stock market. Banks had put these on their balance sheets, in part, because they believed a public bail out would take place if the bills became illiquid.[5]

Fearing widespread panic, the government intervened when the first bank runs occurred, and authorized new paper notes to meet deposit withdrawals. Since no capital controls were simultaneously implemented, these actions were inherently incompatible with long-term maintenance of an exchange rate pegged to gold. Argentina's fiscal position continued to worsen and its yields on sovereign bonds spiked (Figure 2). It then defaulted on its external obligations, and the country eventually agreed to a debt-restructuring plan in January 1891, the provisions of which included the cessation of monetary emissions and no lifelines to banks of issue. Banks of issue were allowed to fail, and Argentina departed the gold standard, abandoning its commitment to a hard peg.

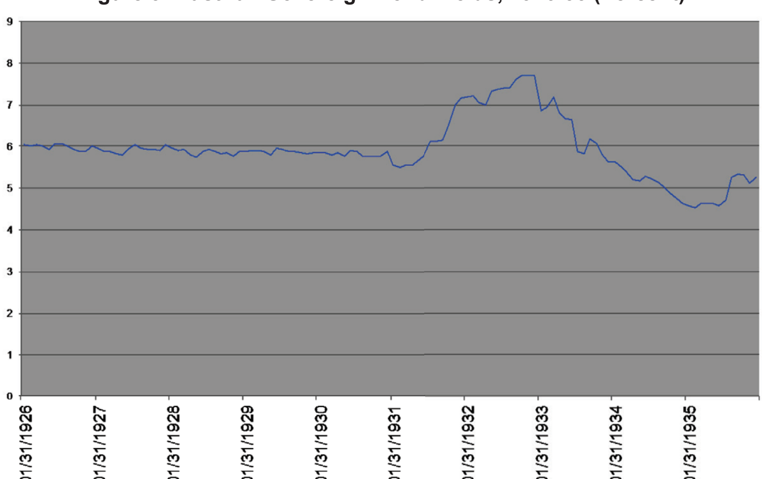
Figure 2: Argentine Sovereign Bond Yields, 1885-1906 (5% 1884 issue)



5 See della Paolera and Taylor (2001).

Four countries experienced crises in the 1930s that also bear a broad resemblance to modern diabolic loops: Austria, Greece, Romania, and Poland. In Austria, short-term indebtedness was large for a country of its size, with much of it taking the form of liquid deposits of Viennese banks. By May of 1931, the Credit Anstalt, an important Austrian bank holding 55 percent of the assets of the six other largest Viennese banks, had realized large losses on its loan portfolio. Its liabilities were greater in size than the Austrian government's budget. Having agreed to absorb a troubled bank in 1929 at the government's behest, it viewed its position as one in which it could receive a bail out from the government. Policymakers responded to the SIFI's distress with a plan to recapitalize the bank. In order to purchase the shares of the Credit Anstalt and provide support to other distressed banks, the central bank increased note circulation by 25 percent. Moreover, the government effectively pledged an unlimited state guarantee to the troubled bank, but this was not enough to stop deposit withdrawals. Central bank emissions placed pressure on the exchange rate, and policymakers eventually responded by imposing capital controls. Yields on Austrian sovereigns rose (Figure 3) and Austria suspended its payments on its external debt. With the crisis subsiding by 1933, Austria was able to resume payments on its long-term obligations.

Figure 3: Austrian Sovereign Bond Yields, 1926-35 (Percent)

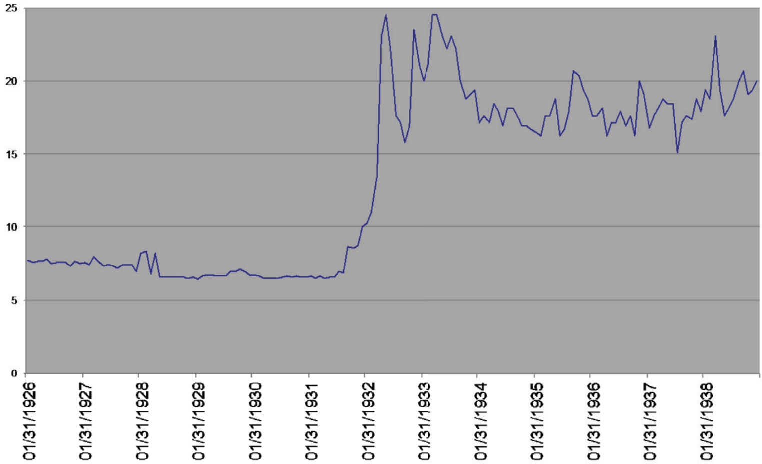


Greece also appears to have experienced a doom loop in the 1930s. Due to the legacy of World War I and the Greco-Turkish war, the country was running high inflation rates and had accumulated an enormous amount of government debt relative to GDP in the early 1920s. Greek officials wanted to borrow abroad to fund public investment projects, but the country lacked the macroeconomic credibility to do so. It thus created a central bank and joined the gold standard in 1928 to bolster its image, but like many countries, it adopted a peg at its pre-war rate vis-à-vis the UK – a rate that made its exports uncompetitive in global markets. These institutions were meant to convey price stability and credible policymaking, but unlike the country's experience shortly after it entered the Eurozone, bond markets appear to have thought otherwise. Greek sovereigns still traded at 215 basis points over the UK consol.

When England abandoned gold in May 1931, Greece did not immediately follow. The government continued to pursue what it called a "strong drachma policy" for the rest of that year, maintaining its peg to gold. Despite a small budget surplus in 1931, even the left-wing party was encouraging the government to pursue austerity and cut public consumption further. Street protests followed as did bank runs. The central bank provided liquidity to cash-starved firms, but did so by opening new branches rather than aiding banks directly.[6] Foreign exchange reserves continued to decline (with the liquidity injections encouraging capital flight) and sovereign yields rose (Figure 4). Greece appealed to England and the League of Nations for debt assistance on it foreign obligations, proposing a five-year moratorium on debt service and a new 12.5 million (pound sterling) loan to finance infrastructure projects and enhance growth. The League, however rejected this proposal. Greece exited the gold standard in April 1932 and defaulted on its external debt. Foreign bondholders eventually accepted a 70% haircut, but Greece's political problems persisted for the rest of the decade (four national elections and four coup d'etat) further undermining the state's fiscal position. Only when Greece joined the Sterling Area in 1937-38 did its rates on sovereign debt begin to decline.

6 See Christodoulakis (2012).

Figure 4: Greek Sovereign Bond Yields, 1926-35 (Percent)



The failure of the Credit Anstalt in Austria triggered panicky depositors to pull their funds out of financial institutions in in other parts of Europe, not unlike what happened in East Asia during its crisis of the late 1990s. Romania was one such country to experience massive banking withdrawals and capital flight shortly after the collapse of the Credit Anstalt. The central bank (the National Bank of Romania) responded by nearly doubling its discounts to distressed banks between May and November of 1931. Banknotes in circulation rose by 26 percent. Meanwhile, Romania had gone to capital markets to borrow for a "development loan," a new sovereign bond issued in France at a rate of 7.5 percent. Much of the borrowing was not used for its stated purpose, but instead for covering a budget deficit, for supporting ailing banks, and for maintaining convertibility of the currency. It turned out to be an insufficient measure to stop a full-blown crisis. Three major banks defaulted: Banca Generală a Ţării Româneşti (in June 1931), Banca Berkovits (in July 1931) and Banca Marmorosch Blank (October 1931).[7] These failed even in spite of direct bail out assistance from the government. By December, the gold cover ratio had fallen dangerously close to its legal limit of 35 percent, and in May 1932, Romania effectively ended convertibility of its currency by imposing capital controls. Lacking sufficient exchange, it eventually suspended payments on its external sovereign

7 See Blejan et. al. (2009).

debt in August 1933, and commenced debt negotiations with foreign creditors.

Poland is a final case that deserves consideration for inclusion in the list of countries experiencing doom loops during the 1930s, although the timing of the default and banking crisis are five years apart, putting it at the far end of our window of coincidence. As in Romania, banks faced runs subsequent to the failure of the Credit Anstalt. In particular, the Warsaw Discount Bank experienced severe depositor withdrawals in June 1931. Overall, commercial bank deposits fell by more than 30%. Assistance in Poland took a different form from central bank support. The Polish government, which had begun to nationalize the banking system as early as 1925 (during an agricultural crisis), responded to the 1931 runs by taking over more banks. By 1934, commercial banks held only 20% of Polish deposits and investments. Poland defaulted on its sovereign debt in July 1936, five years after the banking crisis. A workout was achieved by December 1937.

III. What about the future?

We set out with the task of gaining a long-term perspective on the incidence of doom loops, and identified at least six historical episodes that broadly resemble the recent crisis. It is more than likely the case that we have undercounted the incidence of diabolic loops, at least if we consider the modern period as a benchmark, since the definition employed excludes cases where default did not occur but where bond prices nevertheless spiked. As noted in the introduction, such episodes would more closely resemble the modern Irish rather than the Greek experience. Deciding on a sensible methodology for including historically similar cases to the Irish case is a logical next step for extending the analysis presented here. Having offered some preliminary evidence on the likelihood of a country experiencing a diabolic loop, we close with some thoughts on how the past may have differed from recent experience and perhaps made it less prone to diabolic loops, acknowledging that these conjectures are speculative and therefore represent avenues for future research.

First, in contrast to the past, the European diabolic loops occurred when the political commitment to maintaining a fixed exchange rate transcends a single country experiencing the vicious cycle. European policymakers are concerned with potentially large political and economic externalities associated with exits from the Eurozone. By contrast, when the going got tough in the past, countries simply abandoned their pegs. This was especially true for developing countries in the 19th century (Mitchener and Weidenmier, 2009) as well as for the interwar period (Eichengreen and Sachs, 1985). Briefly consider the Swedish interwar experience to make this point clearer. The country faced a banking crisis in 1932 after Skandinaviska Kreditaktiebolaget failed, a bank that had close ties to the government. But by this point in time, Sweden had already left the gold standard and was able to provide liquidity to other banks and limit the domestic fall out. This approach was commonplace in earlier eras. By contrast, other countries within the Eurozone thought "Grexit" would set a dangerous precedent within the Eurozone and that its exit from the Euro area was worth avoiding at significant domestic political and economic costs to the crisis country.

A second factor that may influence an economy's susceptibility to a diabolic loop is the likelihood that governments will react by rescuing banks. In the 19th century, banks failed often and governments chose not to intervene. Indeed, in many countries, they lacked institutions (i.e., central banks) that might help banks. By contrast, modern central banking encourages emergency lending to banks in need of liquidity and explicit guarantees (like deposit insurance) as well as implicit guarantees (such as "too big to fail" doctrines) suggest markets will even rescue insolvent banks. As we have seen during the European debt crisis, markets respond vigorously and quickly, driving up sovereign bond yields on the expectation that government bailouts and explicit/implicit commitments to banking systems will take place. To examine whether markets punished sovereigns similarly in the past, we analyzed our sovereign debt series for structural breaks around the time at which banking crisis occurred. Bai-Perron tests suggest that structural breaks in bond yields came six to 12 months after banking crises began in Argentina, Peru, and Austria. Only in Greece did yields move significantly around the time of the banking crisis – just two months after runs started. This suggests that markets may react more strongly today and that the link between sovereigns and banks is more diabolical.

The flip side of the sovereign-bank relationship reveals a third possible way circumstances may have changed. Today, European banks are holding significant amounts of sovereign bonds in their portfolios, in part encouraged by the zero-risk weighting they have received by regulators. Historical accounts of debt workouts from these earlier eras suggest that external debt was held by foreign creditors. Reports do not mention domestic banks as a major player in negotiations of sovereign debt settlements. As a result, the feedback between sovereigns and banks operating through balance sheet effects we have seen recently may have operated more weakly in the past, thus reducing the incidence or severity of doom loops.

Finally, it is possible that rollover risk was smaller in the past. Most sovereign bonds of the 19th century had long-term maturities, and countries aspired to terms similar to the British consol, which was issued as a perpetuity. Longer maturities may help countries avoid having to dip into financial markets at inopportune times and face the shock of higher refunding as Ireland did. It may be the case that repeated defaults by sovereigns have, over time, changed creditors' preferences for the maturities of sovereign bond issues.

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13
A Perspective on Renegotiating Sovereign Debt in Unchartered Legal Territory[1]

Tolek Petch

> *"In the light of eternity, we have allowed a financial system to develop for sovereigns that assumes a more or less perpetual state of benignity – in the debtor country, in the region, in the global economic and political environment, and even in the natural world. A disturbance in any of these areas, if it frightens investors sufficiently, risks interrupting the expectation of refinancing that defines sovereign creditworthiness. Many sovereign borrowers would last only a few month, some only a few weeks, if shut off from the ability to refinance their debts. Denied continued market access, they would burn through their reserves with frightening speed. The last step is, for the fortunate borrowers, an official sector bailout and for the unfortunate, a debt restructuring".*
>
> *Lee Buchheit*[2]

1 Tolek Petch, Solicitor, Slaughter and May. All views are personal and do not reflect the opinions of Slaughter and May or its partners.
2 *Sovereign Debt in the Light of Eternity* in RM Lastra and L Buchheit, Sovereign Debt Management, Oxford UP, 2014, ch. 28 para 28.18.

Introduction

This paper considers sovereign debt enforcement once a sovereign has been forced to restructure its existing body of debt. It is therefore concerned with the second of the situations referred to by Lee Buchheit, although it should be noted that even in the case of a sovereign bailout debt restructuring may be necessary as a condition of IMF or other official sector assistance where the borrower's debt is on a non sustainable trajectory. The question of debt sustainability itself is outside the scope of this paper and readers are referred to the relevant materials published by the IMF and ESM.

The first part of this paper considers the legal nature of sovereign debt as well as the differences from other commercial debt. The second part analyses the mechanics for restructuring sovereign debt focussing on the use of a tender offer. The third part considers specific strategies that may be adopted for minimising holdout creditors. The fourth part looks at strategies holdout creditors have developed to resist restructuring focussing on the interpretation of the *pari passu* clause invariably found in foreign law governed bonds. Finally the conclusion draws together some potential lessons for the future.

Sovereign Debt and Sovereign Immunity

Looked at purely in terms of drafting, sovereign debt issued under foreign law resembles other forms of commercial debt. The full faith and credit of the issuer will be pledged for the repayment of the debt. There will be provision for the payment of interest and the repayment of principal at maturity. Moreover, in the modern era, the contract will be legally enforceable, although this was not always the case as sovereign immunity would have previously precluded enforcement in many cases.

Today most developed countries have adopted the restrictive theory of sovereign immunity under which it is confined to *acta jurii imperii*. English law reached this position in a trilogy of cases in the 1970s and 1980s.[3] The matter is now regulated by statute.

3 *The Philippine Admiral* [1977] A.C. 373*; Trendtex Trading Corp. v. Central Bank of Nigeria* [1977] Q.B. 529 *and Playa Larga (Owners of Cargo Lately Laden on Board) v. I Congreso del Partido (Owners)* [1983] 1 A.C. 244.

The State Immunity Act 1978 applies to proceedings in respect of matters that occurred on or after November 22, 1978. The Act applies to any foreign or Commonwealth state other than the United Kingdom. According to section 2(2) of the State Immunity Act 1978, "[a] State may submit after the dispute giving rise to the proceedings has arisen or by a prior written agreement; but a provision in any agreement that it is to be governed by the law of the United Kingdom is not to be regarded as a submission". It follows that if the bonds contain a waiver of sovereign immunity then the issuer will not be immune.

The scope of this was recently considered by the Supreme Court in *NML Capital v. Republic of Argentina*[4]. Argentina declared a moratorium in December 2001 and subsequently restructured most of its sovereign debt. However, a portion of the debt was acquired by vulture funds which sought to recover the full nominal amount outstanding together with interest. The bonds were governed by New York law and the claimant had obtained a judgment against Argentina in New York which it sought to enforce in England. The relevant bonds contained the following submission to jurisdiction:

> "To the extent that the republic … shall be entitled, in any jurisdiction … in which any … other court is located in which any suit, action or proceeding may at any time be brought solely for the purpose of enforcing or executing any related judgment, to any immunity from suit, from the jurisdiction of any such court … from execution of a judgment or from any other legal or judicial process or remedy, and to the extent that in any such jurisdiction there shall be attributed such an immunity, the republic has hereby irrevocably agreed not to claim and has irrevocably waived such immunity to the fullest extent permitted by the laws of such jurisdiction … solely for the purpose of enabling the fiscal agent or a holder of securities of this series to enforce or execute a related judgment".

The Supreme Court unanimously held that this amounted to a submission to the jurisdiction of the English courts in order to enforce the US judgment.

4 [2011] 2 A.C. 495.

Section 3(1) of the State Immunity Act 1978 may also be relevant. This section provides:

> "A State is not immune as respects proceedings relating to (a) a commercial transaction entered into by the State; or (b) an obligation of the State which by virtue of a contract (whether a commercial transaction or not) falls to be performed wholly or partly in the United Kingdom".

Section 3(3) provides that a 'commercial transaction' means (a) any contract for the supply of goods or services; (b) any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation; and (c) any other transaction or activity (whether of a commercial, industrial, financial, professional or other similar character) into which a state enters or in which it engages otherwise than in the exercise of sovereign authority. The reference to 'any loan' would provide an exception to sovereign immunity in respect of bonds issued on the capital markets. However, given that not all states accept the restrictive approach to sovereign immunity[5] it is customary for sovereign bonds to include an express waiver of immunity.

The State Immunity Act 1978 therefore creates two avenues for creditors to enforce sovereign debt: either they may rely on an effective waiver of sovereign immunity or may claim that that the debt is a commercial transaction. Both lead to the result that the contract will be enforceable. What the State Immunity Act 1978 does not do is to confer *in personam* jurisdiction over a foreign sovereign.

The rules on jurisdiction differ depending on whether Council Regulation (EC) No. 44/2001[6] (the 'Brussels Regulation') applies,

5 We understand that Austria, Belgium, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Lithuania, Luxembourg, the Netherlands, Portugal, Slovakia, Spain, Sweden and Switzerland apply the restrictive theory. Bulgaria, the Czech Republic, Poland, and Romania are understood to follow the absolute theory, although the Czech Republic, and Romania have signed the UN Convention on Jurisdictional Immunities of States and Their Property which, when it enters into force, will apply the restrictive approach. The Convention will enter into force once 30 states have ratified it. At the time of writing there are 16 ratifications and 28 signatories.

6 [2001] O.J. L12/1 16.1.2001.

although for the reasons that follow this is unlikely to matter much in practice[7]. The Brussels Regulation applies to claims in respect of a 'civil or commercial matter'. The Lugano Convention applies similar rules in respect of EFTA states. The meaning of this concept has been explored in a series of judgments by the European Court of Justice[8]. However, there is no prior decision determining whether a claim against an EU member state for non-payment under a sovereign bond is a 'civil or commercial matter'. Case law[9] has drawn a distinction between claims arising out of the exercise of public powers (which are outside the scope of the Brussels Regulation[10]) and other civil law claims. Borrowing money is a civil or commercial matter, and in litigation regarding interest rate swaps it was not disputed that the liability of a local authority to make restitution in respect of *ultra vires* derivatives transactions was a civil or commercial matter[11]. However, it may be argued by a sovereign defendant that the character of sovereign borrowing should be distinguished from other commercial debts, as it is incurred for public purposes and repayment is dependent on refinancing, the proceeds of future taxation or the sale of public assets. In our view such an argument should fail as while taxation is a governmental act, repaying a loan voluntarily contracted does not involve any exercise of public power.

If the Brussels Regulation applies then the following bases of jurisdiction may be available against a sovereign defendant:

7 When it comes to establishing jurisdiction. However, if leave of the court is required to serve the defendant out of jurisdiction then the court has discretion whether or not to permit service of proceedings: Practice Direction 6B, para. 3.1. In deciding whether or not to give leave the court will consider whether England is the natural forum: *Amin Rasheed Shipping Corp. v. Kuwait Insurance Co.* [1984] A.C. 50 and *Spiliada Maritime Corp. v. Cansulex Ltd* [1987] A.C. 460.

8 See e.g. Case 29/76 *Lufttransportunternehmen GmbH and Co. KG v. Eurocontrol* [1976] E.C.R. 1541; Case 814/79 *Netherlands State v. Reinhard Rüffer* [1980] E.C.R. 3807; Case C-172/91 *Volker Sonntag v. Hans Waidmann, Elisabeth Waidmann and Stefan Waidmann* [1993] E.C.R. I-1963; Case C-271/00 *Gemeente Steenbergen v. Luc Baten* [2002] E.C.R. I-10489; Case C-433/01 *Freistaat Bayern v. Blijdenstein* [2004] E.C.R. I-981; Case C-265/02 F*rahuil S.A. v. Assitalia SpA* [2004] E.C.R. I-1543.

9 See n. 8 *supra*.

10 See e.g. Case C-292/05 *Irini Lechouritou and others v. Dimosio tis Omospondiakis Dimokratias tis Germanias* [2007] E.C.R. I-1519 (state liability for the actions of armed forces in wartime is not a civil or commercial matter).

11 Case C-346/93 *Kleinwort Benson Ltd v. City of Glasgow District Council* [1995] E.C.R. I-615.

(a) Article 23 – if the bonds contain an exclusive or non-exclusive jurisdiction clause in favour of the courts of the United Kingdom provided that one of the parties is domiciled in an EU member state;

(b) Article 5(1)(a) – if the claim relates to a contract[12] and the place of performance of the obligation in question (i.e. payment under the bond) is in the United Kingdom;

(c) Article 5(3) – if the claim is in tort[13] and the place where the harmful event occurred[14] is within the United Kingdom; or

(d) Article 24 – if the sovereign enters an appearance (i.e. does not object to proceedings being brought in the United Kingdom).

Regulation (EC) No. 44/2001 will be replaced from January 10 2015 by Regulation (EU) No. 1215/2012. The substantive rules will be the same except for the elimination of the requirement that a party be domiciled in the EU before reliance can be made on an exclusive or non-exclusive jurisdiction clause.

If the Brussels Regulation does not apply, then leave of the court would be required to serve the defendant state outside the jurisdiction. This is now governed by Part 6 of the Civil Procedure Rules together with Practice Direction 6B. The grounds on which a court

12 An autonomous meaning applies: Case 34/82 *Martin Peters Bauunternehmung GmbH v. Zuid Nederlandse AV* [1983] E.C.R. 987; Case 9/87 SPRL A*rcado v. Haviland S.A.* [1988] E.C.R. 1539; Case C-26/91 *Jakob Handte & Co. GmbH v. Traitements Mécano-chimiques de Surfaces S.A.* [1992] E.C.R. I-3967.
13 Again, an autonomous meaning applies: Case 189/87 *Athanasios Kalfelis v. Bankhaus Schröder, Münchmeyer, Hengst & Co.* [1988] E.C.R. 5565; Case C-364/93 *Antonio Marinari v. Lloyds Bank plc and Zubaidi Trading Company* [1995] E.C.R. I-2719; Case C-167/00 *Verein für Konsumenteninformation v. Karl Heinz Henkel* [2002] E.C.R. I-8111.
14 Case law holds that the expression is to be understood as permitting a claimant to choose to sue in the courts of the place where the damage occurred or in the courts of the place of the event giving rise to that damage: Case 21/76 *Handelskwekerij GJ Bier B.V. v. Mines de Potasse d'Alsace S.A.* [1976] E.C.R. 1735.

may permit service out of the jurisdiction are essentially the same as those referred to in connection with the Brussels Regulation[15].

It follows that establishing jurisdiction over a foreign sovereign that has submitted to the jurisdiction will be relatively easy. However, this is where the problems facing creditors start. It is one thing to obtain a judgment. It is another thing to get paid, and even if the judgment is enforceable in other jurisdictions (as the judgment obtained by NML was held to be enforceable in the United Kingdom) that will not assist unless there are realizable assets that the judgment can be enforced against.

If enforcement proceedings are brought in England, the State Immunity Act 1978 places limitations on the assets that can be subject to those proceedings[16]. Subject to the exceptions below:

(a) relief shall not be given against a state by way of injunction or order for specific performance or for the recovery of land or other property; and

(b) the property of a state shall not be subject to any process for the enforcement of a judgment or arbitration award or, in an action in rem[17], for its arrest, detention or sale[18].

However, section 13(2) of the State Immunity Act 1978 does not prevent the giving of any relief or the issue of any process with the written consent of the state concerned; and any such consent (which may be contained in a prior agreement) may be expressed so as to

15 Section 12 State Immunity Act 1978 contains special rules on the service of process which must be transmitted through the Foreign and Commonwealth Office to the ministry of foreign affairs of the state concerned. However, this requirement *"shall not be construed as affecting any rules of court whereby leave is required for the service of process outside the jurisdiction"*: section 12(7).

16 In Case C-292/05 *Irini Lechouritou and others v. Dimosio tis Omospondiakis Dimokratias tis Germanias* [2007] E.C.R. I-1519, 1539, Ruiz-Jarabo Colomer AG considered that "the issue of State immunity from legal proceedings must be settled before considering the Brussels Convention since, if proceedings cannot be brought, the determination of which court can hear the action is immaterial". The Court did not rule on this point.

17 E.g. over a ship.

18 Section 13(2) State Immunity Act 1978.

apply to a limited extent or generally. Written consent will usually be given in the terms and conditions of the bonds.

Section 13(4) of the State Immunity Act 1978 does not prevent the issue of any process in respect of property which is in use or intended for use for commercial purposes. Commercial purposes are defined in section 3(3) as meaning: …

(b) any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation; and

(c) any other transaction or activity (whether of a commercial, industrial, financial, professional or other similar character) into which a State enters or in which it engages otherwise than in the exercise of sovereign authority.

The question of when a debt was property in use for commercial purposes was the subject of the decision of the Supreme Court in *SerVaas Incorporated v. Rafidain Bank*[19]. Following a debt cancellation agreement under the auspices of the Paris Club (as to which see below), Iraq proceeded to negotiate the restructuring of its commercial creditors as well as the creditors of specified Iraqi entities including the defendant bank. In 2005 Iraq issued an invitation to creditors to tender claims for cash. Afterwards, Iraq took assignments of certain debts owed to the defendant's creditors. Rafidain bank was placed into liquidation in the United Kingdom and subsequently the court sanctioned a scheme of arrangement to distribute its assets to its creditors including Iraq. SerVaas, which was a creditor of Iraq, sought to attach Iraq's right to receive a distribution from Rafidain under the scheme of arrangement. It argued that as Rafidain was a commercial bank its assets arose from commercial transactions and were therefore liable to attachment under section 13(4) of the State Immunity Act 1978. The UK Supreme Court disagreed. The expression "in use for commercial purposes" should be given its ordinary and natural meaning having regard to its context. It would not be an ordinary use of language to say that a debt arising from a transaction is 'in use' for that transaction. The UK Parliament did not intend

19 [2013] 1 A.C.595

a retrospective analysis of all the circumstances which gave rise to property, but an assessment of the use to which the state had chosen to put the property[20]. It was not sufficient that the property related to or was connected with a commercial transaction[21]. SerVaas had failed to show that Iraq's claims against Rafidain were property in use for a commercial purpose.

The practical problem with the exceptions to state immunity is that sovereigns do not as a general rule accumulate assets abroad. This applies a *fortiori* in the case of sovereigns that are contemplating default or have a history of prior defaults. It follows that a creditor may have a perfectly valid claim and right of enforcement but no assets against which to levy judgment. It may be objected that the state is likely to have other assets, such as the assets of the central bank or of publicly owned companies. However, such entities are treated as separate legal entities and are not liable for the obligations of the state (as opposed to for their own obligations). Indeed Section 14(4) provides that the property of a state's central bank or monetary authority shall not be regarded as in use for commercial purposes and where such a bank is a separate legal entity from the state (which will usually be the case) the central bank will be immune from enforcement. A state may also seek to place its reserves beyond the reach of its creditors as Argentina did through depositing assets with the Bank for International Settlements in Switzerland[22].

Differences between Sovereign Insolvency and Corporate Insolvency[23]

Sovereign immunity is not the only difference between sovereigns and corporates when it comes to insolvency. All modern countries have well developed regimes specifying the procedures that are followed when a company gets into financial difficulties. Generally, the trend is to favour the survival of (part of) the undertaking as a going

20 *Ibid.*, 607 para. 16.
21 *Ibid.*, 607 para. 17.
22 See D Devos *Special Immunities: Bank for International Settlements* in RM Lastra and L Buchheit *Sovereign Debt Management*, Oxford UP, 2014, ch. 10.
23 PR Wood, Corporate Bankruptcy Law and State Insolvencies in RM Lastra and L Buchheit, *Sovereign Debt Management*, Oxford UP, ch. 24.

concern where this is possible. In other cases, the assets of the insolvent company will be realized and distributed to the creditors of the company in accordance with their entitlements. Generally there will be some procedure for the involvement of creditors such as creditors' committees.

In England the main insolvency proceedings are administration and liquidation. The objective of administration is to ensure the survival of the undertaking as a going concern where possible and where not a more advantageous realization of the assets than would be possible in a winding up. A liquidation results in the dissolution of the company after its assets have been got in and distributed to creditors. Both procedures take place under the supervision of the court which has the power to give directions and to remove an administrator or liquidator for cause. Detailed statutory provisions exist to adjust prior transactions that are detrimental to creditors (preferences, transactions at an undervalue, transactions in fraud of creditors, etc.). As an alternative to administration or liquidation the creditors of an insolvent company may also agree a creditors' voluntary arrangement. This is in essence a statutorily enforced contract and will depend on the terms that can be agreed between the company and its creditors. Generally, the objective will be to ensure the survival of the company in the interests of the creditors and members, although the interests of the former will predominate.

The contrast with sovereign default could not be clearer. There is no legal framework for sovereign insolvency and no bankruptcy court with jurisdiction over sovereigns. The proposal made by the IMF for a sovereign debt restructuring mechanism ("SDRM") came to nothing for a variety of reasons including opposition from the United States (which has a blocking vote on amendments to the IMF's Articles of Agreement), concerns of a potential conflict of interest in locating the SDRM within the IMF and a fear on the part of certain sovereigns that the SDRM would drive up borrowing costs. Sovereigns that default are required to negotiate with their creditors with a view to agreeing a mutually acceptable outcome. The history of sovereign defaults has demonstrated the difficulty of reconciling creditor and debtor interests in the absence of a neutral arbiter. Moreover, since the end of gunboat diplomacy there has been no coercive way of enforcing claims for repayment as a state cannot be dismantled and its population divided up amongst creditors.

Unlike corporate insolvency there is no also moratorium on the payment of interest or principal or a cut-off date for the payment of interest. Instead, the debt can (subject to questions of limitation) continue to compound interest onto principal for years or decades resulting in the ultimate amount owing constituting a multiple of the original amount originally owed[24]. In a corporate context the making of the winding-up order generally constitutes a cut-off point with post-winding-up interest payable only to the extent that there are available funds after all creditors have been paid.

Once a state defaults there is no control over the state's financing absent conditionality under an IMF or other international bail-out. In effect, the state is free (subject to questions of *pari passu* considered below) to decide which payments to prioritize and which to leave outstanding. States that default on their external debt may remain current on their internal debt, and are likely to continue to meet their obligations to international financial institutions where their support is being sought as part of an international bail-out.
Although creditors may seek to organize themselves there is no equivalent to the mechanism for creditors' committees under corporate insolvency law. This exacerbates collective action problems, particularly where the creditors are widely dispersed. This is most likely to be a problem with bonds as bondholders often have great practical difficulties identifying one and another organising a response to the default. In the case of loans it is less difficult as committees of lead lenders may be formed – such as the London Club, considered further below – to negotiate with the sovereign. Where the sovereign seeks official debt forgiveness from developed countries there is an existing forum through the Paris Club to facilitate negotiations.
Assuming the negotiations succeed, there will be no formal discharge of the debtor. Unless the terms of the bonds include collective action clauses (CACs – which are considered below) there are in fact

24 *Donegal International Limited v. Republic of Zambia* [2007] EWHC 197 (Comm).

no means of imposing a settlement no matter how beneficial to the general body of creditors or the size of the majority accepting the restructuring. Instead, dissenting creditors will be able to hold out ('holdouts') and seek repayment in full. This creates obvious collective action problems where a negotiated settlement is in the objective interests of all the parties but where certain creditors may opportunistically hold out for payment in full at the expense of those creditors agreeing to negotiate a haircut.

Sovereign Debt Restructuring in a Legal Void

Given the above difficulties it may be wondered how sovereigns are able to restructure their debt. Yet sovereigns are and in recent years many sovereigns have been able to negotiate significant reductions in the net present value of their obligations culminating in the February 2012 Greek default under which Greece was able to secure a 74.5% reduction in the net present value of its private debt.

Sovereigns are able to restructure their debt in a legal vacuum because they usually have significant leverage over creditors. We have seen how, under the modern approach to sovereign immunity, creditors can relatively easily obtain money judgments against defaulting sovereigns. However, unless there are assets readily available outside of the jurisdiction of the sovereign, such money judgments will provide scant comfort for creditors seeking repayment. Creditors are in practice generally forced to negotiate if they wish to recover some of the value of their investment. In certain cases this has been abused by sovereigns to become serial debtors. For example, Argentina and Greece have been in default for nearly half of their modern history. In such cases the only effective sanction might be for bond market investors to refuse to lend further sums. Argentina has been frozen out of international lending markets since defaulting in December 2001. However, Greece was able within two and a half years of the largest sovereign default in history to sell new 5 year bonds at a yield of 4.95%.

How is sovereign debt restructured? This depends on the nature of the debt. Official loans owed to developed countries have historically been restructured through the Paris Club. The Paris Club is an informal group of official creditors whose role is to find solutions to payment difficulties experienced by debtor countries, usually through debt rescheduling or cancellation[25]. The Paris Club operates on the basis of five key principles:

(a) decisions are made on a case-by-case basis having regard to the debtor country's individual situation;

(b) decisions are reached by consensus among the participating creditor countries;

(c) debt restructurings will only be agreed with countries that need debt relief, have implemented and are committed to implementing reforms to restore their economic and financial situations and have a demonstrated track record of implementing reforms under an IMF programme;

(d) members of the Paris Club agree to act as a group in their dealings with a given debtor; and

(e) a debtor country that reaches an agreement with Paris Club creditors should not accept less favourable terms than those agreed with the Paris Club from non-Paris Club creditors. In many cases this has taken the form of the Bank Advisory Committee (the London Club) process[26].

Loans have historically been restructured through a lead committee of lenders negotiating the terms of new lending. The London Club is an informal group of commercial banks that join together to negotiate their claims against a sovereign debtor. The debtor initiates a process in which a London Club "Advisory Committee" is formed. The Committee is chaired by a leading financial firm and includes representatives from other exposed firms. Upon signing of a restructuring agreement, the Committee is dissolved.

25 Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, Russia, Spain, Sweden, Switzerland the United Kingdom and the United States are permanent members of the Paris Club. ,

26 L Rieffel, *The Bank Advisory Committee (London Club) Process* in *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery*, Brookings Institution Press, 2003.

As has been mentioned, the process of restructuring of bonds is different as these tend to be widely dispersed making organised negotiations of the form carried out by the Paris and London Clubs impractical. The procedure therefore takes the form of a tender offer under which holders are invited to tender their bonds for new bonds. In order to provide debt relief the terms of the new bonds will inevitably be less advantageous than the original bonds. Possible changes include longer maturities, lower interest rates, the postponement of payment of interest, a lower principal amount, etc. The intention is to reprofile the debt so as to be sustainable while ensuring the preservation of some value for the original bondholders.

In principle the exchange will benefit both parties. The state will face a debt burden that it is capable of sustaining, while holders will receive payments that the state is able to make. Whether this is in fact the case depends on the terms of the exchange, and given the asymmetries in information between states and bondholders, as well as the collective action problems the latter face in organising themselves into a group capable of negotiating with the state, achieving a fair balance may in some cases be elusive. The one strength that bondholders have (absent CACs) is that they can always refuse to participate in the debt exchange and hold out for payment on the original terms. This poses problems for the sovereign as well as for bondholders tempted to accept the tender as they risk taking a haircut while holdouts refuse to do so and seek by litigation to enforce their original contractual rights. We return to this strategy later in this paper.

The previous paragraph raises a threshold question. Why would bondholders ever agree to a tender offer? After all they have a legally enforceable contract. Part of the answer is that faced with a sovereign prepared to default they have few good options. It is therefore always possible to frighten bondholders by actually defaulting or threatening to do so. In the former case the default will usually be a precursor to a subsequent tender offer. An example may be provided by the Argentine default in 2001. In 2005 Argentina announced a 'take it or leave it offer' of a 70% haircut on Argentina's existing obligations. At the same time Argentina announced that it would pass legislation (the 'Lock law') precluding the state from reopening the tender offer. The risk factors in the offering document stated[27]:

> "Eligible Securities that are not tendered may remain in default indefinitely. Eligible Securities not exchanged pursuant to the offer will remain outstanding. Argentina has announced that it has no intention of resuming payments on any Eligible Securities that remain outstanding following the expiration of the Offer. Consequently, if you elect not to tender your Eligible Securities pursuant to the Offer there can be no assurance that you will receive any future payments in respect of your Eligible Securities".

Threats are not the only means of persuading bondholders to tender their bonds. Lee Buchheit[28] has identified a number of "carrots" that can be used to make the terms of the tender offer more attractive to bondholders. These include:

(a) offering a menu of restructuring options catering to the preferences of individual classes of creditors. This was used extensively in the Brady restructurings[29].

(b) structural documentation improvements[30]. For example, following the Greek default, bonds issued under local law were substituted by new bonds issued under English law to prevent the Greek legislature from being able to modify the terms of the new bonds in the future. The new Greek bonds were also linked to a co-financing agreement with the EFSF meaning that any default under the new bonds would be accompanied by a default to the EFSF – something, it was taken, that Greece would be keen to avoid.

27 Cited by L Buchheit, *Minimizing Holdout Creditors: Sticks* in RM Lastra and L Buchheit, *Sovereign Debt Management,* Oxford UP, 2014, ch 2, para 2.12.
28 L Buchheit, *Minimizing Holdout Creditors: Carrots* in RM Lastra and L Buchheit, *Sovereign Debt Management,* Oxford UP, 2014, ch 1.
29 *Ibid.* para 1.14.
30 *Ibid.* para 1.15.

(c) Loss reinstatement features[31]. This is a technique used by sovereigns where there is a fear that one debt restructuring may be succeeded by another. Essentially, creditors are promised that should there be a second restructuring the amount of the creditors' claim will balloon back up to more or less the status quo.

(d) Value recovery rights[32]. The intention is to provide the creditor with a stake in the recovery of the borrower and was used by countries issuing Brady bonds. In the case of Greece, bondholders were offered GDP warrants that would be triggered if the Greek economy recovered faster than expected.

Minimizing Holdouts

It has been seen that an option commonly open to bondholders who do not like the terms on offer is to refuse to tender their bonds and to 'hold out' from the debt restructuring. While it can be a perfectly legitimate commercial strategy, holdouts tend to stir strong emotions. Often they will have bought distressed debt in the secondary market and will be seeking to recover payment in full while the majority of creditors take a haircut. Understandably, techniques have been developed to attempt to deter holdout activity. We have already seen one such method: threaten not to pay them. However, this carries with it its own set of problems, particularly if the number of holdouts is small, as a refusal to pay will trigger litigation and may frustrate the ability of the borrower to access the capital markets in the future. Argentina has still been unable to restore market access since its 2001 default and defaulted again in August 2014 following its refusal to satisfy a judgment debt in favour of holdout creditors. Two established techniques are exit consents and collective action clauses.

Exit Consents

Basically, an exit consent is a method that seeks to take advantage of standard amendment language in bond issues to encourage bond-

31 *Ibid.* paras 1.23- 1.24.
32 *Ibid.* para 1.28.

holders to agree to an exchange offer by modifying the terms of the bonds by making them less advantageous to holdouts[33]. Sovereign bonds governed by English law will usually permit all provisions of the bonds to be modified by a specified majority (e.g. two thirds or three quarters). In the United States bonds will typically prohibit an amendment that reduces the amount of the principal or interest, but will permit other amendments. Once a sovereign has agreed a debt restructuring or forgiveness with a sufficient majority of its creditors it can propose to bondholders an amendment to the terms of the bonds that will reduce the value of the bonds to holders that refuse to participate in an exchange offer for new sovereign bonds reflecting the terms of the negotiated workout. The technique works owing to the inability of holdouts to organise themselves as well as the risk of being "frozen out" if they are left holding bonds that are worth less than the restructured bonds.

Case law in the United States has generally upheld the validity of exit consents provided that there is no fraud on the minority bondholders[34]. Holders that tender their bonds commit irrevocably to voting at the bondholders' meeting to support the amendments to the terms of the bonds. For example, in *Greylock Master Opportunity Master Fund Ltd. v. Province of Mendoza*[35] the amendment involved the abrogation of the Province of Mendoza's waiver of sovereign immunity which made it impossible in practice for holdouts to pursue the province under the original bonds.

The validity of exit consents under English law has recently been tested in a non-sovereign context in *Assénagon Asset Management S.A. v. Irish Bank Resolution Corporation Ltd.*[36]. The case arose out of the collapse of Anglo-Irish Bank. Anglo-Irish had issued subordinated floating rate notes which contained provisions enabling modifica-

33 LC Buchheit and GM Gulati, *Exit Consents in Sovereign Bond Exchanges* (2000) 48 UCLA Law Review 59.

34 *Katz v. Oak Industries Inc.* (1986) 508 A.2d 873; *Greylock Master Opportunity Master Fund Ltd. v. Province of Mendoza* (2005) No. 04 Civ. 7643 (S.D.N.Y. Feb. 8 2005); cf. *Strategic Income Fund v. Mechala Group Jamaica Ltd.* No. 99 Civ. 10517 HB, 1999 WL 993648, Fed. Sec. L. Rep. (CCH) 6 90,707 (S.D.N.Y. Nov. 2, 1999).

35 (2005) No. 04 Civ. 7643 (S.D.N.Y. Feb. 8 2005).

36 [2012] EWHC 2090 (Ch) [2013] All E.R. 495.

tion of the terms of the notes or the sanctioning of any compromise or arrangement between the issuer and noteholders if approved by a 75% majority. In January 2009 Anglo-Irish was nationalised and received substantial financial support from the Irish state as it was deemed to be systemically important. In 2010 the Irish government decided to proceed with a reorganization of Anglo-Irish that would involve losses to the subordinated creditors of the bank. This would be achieved through a voluntary restructuring of the debt completed, if necessary, by legislation that would be capable of enforcement in England under the Credit Institutions Winding-up Directive[37].

In October 2010 Anglo-Irish announced an exchange offer which would replace the subordinated notes with new senior notes at an exchange ratio of 0.2 (i.e. holders would receive new senior notes with a principal amount of 20% of the notes tendered). The terms of the existing notes would be amended to reduce their value to €0.01 per €1000. The issuer would then be entitled to redeem the existing old notes. The 20% exchange ratio broadly reflected the price at which the subordinated notes were trading in the secondary market. The amendment enabling Anglo-Irish to redeem notes held by holdouts at 0.001% of their face value was deliberately expropriatory. Over 92% of the holders accepted the exchange offer, following which the bank purported to exercise its right to redeem the outstanding notes.

Briggs J. held that the provision of the trust deed enabling "Reduction or cancellation of the principal payable on the Notes … or the minimum rate of interest payable thereon" was sufficiently broad to permit a majority to bind the minority to a cancellation of both the principal and interest payable under the notes[38]. However, he held that the notes offered and accepted for exchange were as a result held for the benefit of the bank. As the contract was liable to be specifically enforced on well settled principles, the bank held a beneficial interest in the notes[39]. The votes of all noteholders that had

37 Directive (EC) 2001/24 of the European Parliament and of the Council of 4 April 2001 on the Reorganisation and Winding-up of Credit Institutions [2001] O.J. L 125/15 5.5.2001 implemented in the United Kingdom through The Credit Institutions (Reorganisation and Winding up) Regulations 2004 SI 2004/1045.

38 *Assénagon Asset Management S.A. v Irish Bank Resolution Corpn Ltd (formerly Anglo Irish Bank Corpn Ltd)* [2013] Bus L.R. 266 paras. 54-55.

39 *Ibid.*, paras. 64-65.

tendered their notes therefore fell to be disregarded in accordance with a provision of the trust deed stipulating that "Neither the Issuer nor any Subsidiary shall be entitled to vote at any meeting in respect of Notes beneficially held by it or for its account". The purpose of the prohibition was aimed at avoiding the voting of notes in the bank's own interest rather than in the interests of the noteholders as a class. The bank's beneficial interest in the notes, in the judge's view, fell squarely within the contemplation of the prohibition[40] with the result that the modifications did not bind the holdouts.

This was sufficient to determine the case in favour of the holdouts. However, Briggs J. additionally held that the exit consent was unlawful constituting an abuse of power. The judge considered that the correct question was whether it was lawful for the majority to lend its aid to the coercion of a minority by voting for a resolution which expropriates the minority's rights under the notes, which he answered in the negative. Briggs J. accepted that the bank did not positively wish to obtain the securities by coercion, and would have preferred for the holdouts to have accepted the exchange offer. However "[t]he exit consent is, quite simply, a coercive threat which the issuer invites the majority to levy against the minority, nothing more or less. Its only function is the intimidation of a potential minority, based upon the fear of any individual member of the class that, by rejecting the exchange and voting against the resolution, he (or it) will be left out in the cold"[41]. It followed that the exit consent involved a form of coercion entirely at variance with the purposes for which majorities are given power to bind minorities[42].

Would the result have been different had the exit consent not expropriated the rights of the holders? United States case law suggests that there are many changes that can be made to sovereign bonds without triggering public policy concerns, such as removing a waiver of sovereign immunity. However, the approach of Briggs J. focusing on the exit consent as a means by which a majority may not impose more adverse terms on the minority, raises doubts as to whether this would be held to be the case in England.

40 *Ibid.*, para. 68
41 *Ibid.*, para. 84.
42 *Ibid.*, para. 85.

Collective Action Clauses

The second technique developed to minimize holdout activity is the CAC. In essence a CAC is a legal technique under which a super-majority of creditors can bind all creditors in respect of modifications to the terms of bonds. Collective action clauses can take many forms and were developed by the market as a response to the failure of the IMF-led SDRM initiative in the 2000s. The intention is to address the problem of holdouts provided that sufficient creditors can be persuaded to accept an exchange offer. CACs have been common in corporate debt since the late nineteenth century, but only became a feature of sovereign bonds from the 2000s (which resulted in a common understanding that foreign jurisdiction EU bonds would contain CACs). In 2002 the G10 countries formed a working group to elaborate a set of model CACs for use in bond documentation. Parallel work was undertaken by trade associations. Different approaches have been adopted between the US and Europe with the US requiring a specified majority of the aggregate principal of all bonds while European jurisdictions have tended to set the threshold by reference to the outstanding amount of bonds held by those present at a bondholders' meeting.

CACs generally distinguish between certain "reserved" matters where a higher threshold is required to approve changes and other matters. In 2011 the Eurozone agreed that uniform collective action clauses would be included in sovereign debt from January 1, 2013. These require, for reserved matters, either 75% of the principal amount of the outstanding bonds for resolutions passed at a bondholders' meeting or 66 2/3% for a written resolution of bondholders. For non-reserved matters a simple majority is required.

A problem with most CACs is that they operate only on an issue-specific basis. This means that the CACs will only be triggered if the requisite super-majority is realised on any series of bonds. For any series of bonds where the super-majority is not reached the CACs will not bite and the issuer will be left with the alternative of either defaulting on that series of bonds (which is not an attractive option) or continuing to pay in full the amount outstanding. This creates opportunities for investors to buy up blocking majorities in particular series of bonds in the expectation that if the restructuring is overall a success the issuer will continue to make payments in full on those issues where the CACs were not triggered.

One solution to this problem is aggregation. Where the CACs include an aggregation feature then it may be possible to trigger the CACs on particular series of bonds even though the requisite majority has not been reached. This is the case with the Eurozone CACs which provide for 75% at a meeting or 66 2/3% for a written resolution to trigger the CACs on an aggregate basis. However, in this case the trigger for individual series of bonds is lowered to 66 2/3 % (if a meeting is held) or 50% in the case of a written resolution. It should be noted that while this makes it easier to trigger CACs it does not prevent the purchase of a blocking majority, although it may make it more expensive.

A more radical approach was taken by Greece when it restructured its debt in 2012. As most of this debt had been issued under Greek law it was possible by legislation to amend the terms of the debt to retro-fit aggregative CACs to all Greek law governed debt. Basically, the terms of Greek law governed bonds (representing about 90% of the total debt eligible for exchange) were retrospectively amended to introduce CACs. Under the CACs, provided that holders of at least 50% of the principal tendered their bonds in the exchange, and two-thirds of those participating voted in favour, the debt exchange would become binding on all bondholders. No distinction was drawn in the operation of the CACs between individual series of bonds. To encourage acceptance of the offer, Greece made it clear in the tender offer memorandum that if the exchange failed there was a significant risk of default. In the event investors holding 85.8% of Greek law bonds eligible for exchange agreed to the tender offer. Greece then announced that it would activate the CACs, resulting in a 95.7% participation rate.

However, this was not a panacea as shown by the fate of the foreign law governed bonds. These already included CACs, but without an aggregation feature. Holdouts were scattered across 25 sovereign or sovereign guaranteed bonds, of which 24 were foreign law titles: seven bonds for which no amendment was attempted, one inquorate bond, and 16 bonds for which the amendment was rejected by the bondholders[43]. So far, Greece has continued to pay holdout creditors.

Holdouts and the *Pari Passu* Clause

The most fruitful approach for holdouts in respect years has been based not on purchasing blocking stakes in bonds subject to CACs, but in litigation in the United States based on the *pari passu* clause that is invariably included in all foreign law sovereign debt instruments. This obscure provision has recently come to life in a much awaited – and criticized – judgment of the US Court of Appeals for the Second Circuit concerning Argentine sovereign bonds. Argentina's refusal to satisfy United States judgments obtained by holdouts has resulted in the latest twist in the litigation in which they have sought injunctive and other relief against both Argentina and financial intermediaries involved in processing payments on the 2005 and 2010 excahnge bonds by seeking to prevent Argentina from paying on the restructured bonds unless it also paid in full the holdouts. This litigation has potentially significant consequences for eurozone member states that seek to restructure their debts in the future if a similar approach were taken.

It must be recognised that there are different formulations of the *pari passu* clause. Originally, the clause referred to the ranking of sovereign debt. However, starting in the 1980s and 1990s the clause was expanded to confer a promise to maintain the ranking of sovereign bonds[44]. The clause at issue in *NML Capital v. Republic of Argentina*[45] did both:

"The Securities will constitute (except as provided in Section 11

43 J Zettlemeyer, C Trebesch and M Gulati, *The Greek Debt Exchange: an Autopsy* p. 9.
44 M Weidemaier, *Sovereign Debt After NML v. Argentina*, 8 Capital Markets Law Journal 123; M Weidemaier, R Scott and GM Gulati, *Origin Myths, Contracts, and the Hunt for Pari Passu*, UNC Legal Studies Research Paper No. 1633439, March 2011, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633439.
45 (2012) 699 F.3d 246; 2012 U.S. App. LEXIS 22281.

below) direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank *pari passu* and without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness (as defined in this Agreement)".

Other versions of the *pari passu* clause include a promise that the bonds "will rank at least *pari passu* in priority of payment". Clearly, the interpretation of the clause will depend on its drafting and it cannot be assumed that all versions of the clause will have the same legal effect.

The question before the United States District Court and, on appeal, the Court of Appeals was what the second sentence meant. According to Argentina, the clause was intended to provide protection from legal subordination or other discriminatory legal ranking by preventing the creation of legal priorities by the sovereign in favour of creditors holding particular classes of debt[46]. On this view, Argentina had done nothing to affect the legal ranking of the defaulted bonds which was unaffected by its statutory moratorium on payment. The bondholders argued that Argentina had 'de facto' subordinated the bonds by reducing the ranking of the bonds to permanent non-performing status by passing legislation barring payments on them while continuing to pay on the restructured debt and repeatedly asserting that it had no intention of making payments on the bonds[47].

The Court of Appeals held that the second sentence of the clause manifested an intention to protect bondholders from more than just formal subordination. The latter "prohibits Argentina, as bond *payor,* from paying on other bonds without paying on the [defaulted] Bonds. Thus, the two sentences of the *pari passu* clause protect against different forms of discrimination: the issuance of other superior debt (first sentence) and the giving of priority to other payment obligations (second sentence)"[48]. Such a conclusion had previously

46 *Ibid.*, 258.
47 *Ibid.*
48 *Ibid.*, 259.

been reached by the Brussels Court of Appeals in the Elliot case. This decision had attracted significant academic criticism.
The court in *NML* justified this interpretation by reference to the differences between sovereign debt and corporate debt:

> "When sovereigns default they do not enter bankruptcy proceedings where the legal rank of debt determines the order in which creditors will be paid. Instead, sovereigns can choose for themselves the order in which creditors will be paid. In this context, the Equal Treatment Provision prevents Argentina as payor from discriminating against the [defaulted] Bonds in favour of other unsubordinated, foreign bonds"[49].

Effectively, the second part of the clause was interpreted as conveying a guarantee of rateable payment with other creditors even though the clause did not, in terms, state this. The court did not make explicit whether this conclusion followed from the fact of non-payment, passage of the Argentine law prohibiting payment, or both. This is significant as even if a *pari passu* clause of the type included in the Argentine bonds did not confer a right to rateable payment, an argument can be made that passage of the law prohibiting payment resulted in a change in the ranking of the bonds through subordinating the holdouts' rights to the rights of the exchange bondholders. Such an interpretation would have far less practical significance as states do not commonly pass legislation of the type enacted by Argentina. On this interpretation, all Argentina would need to do was to repeal the law.

Uncertainty as to the precise payment formula resulted in the case being remanded to the District Court which held that Argentina must pay the same percentage of the amount due on the defaulted bonds as it intended to pay on the exchange bonds i.e. if Argentina wished to pay 100% of the amount due on the exchange bonds at the next payment date it must pay all amounts already due under the defaulted bonds[50]. The District Court saw no injustice in requiring payment in full in circumstances where the holders of the exchange

49 (2012) 699 F.3d 246; 2012 U.S. App. LEXIS 22281, 259
50 *NML Capital Ltd. v. Republic of Argentina* United States District Court Southern District of New York, Opinion dated November 21 2012, pp. 3-6.

bonds had accepted losses of 70 cents on the dollar as part of the exchange offer. In accepting, the holders bargained for certainty and the avoidance of the burden and risk of litigating their rights. However, they knew full well that the holdouts were seeking to obtain full payment of the amounts due through litigation[51]. In the court's view it is hardly an injustice to have legal rulings which mean that Argentina must pay the debts which it owes.[52]

Argentina appealed the District Court's orders and sought a rehearing before the Court of Appeals *en banc* which was refused. The Court of Appeals affirmed the District Court's amended injunctions[53]. The court held that there was nothing inequitable in requiring Argentina to pay holdouts in full: "We believe that it is equitable for one creditor to receive what it bargained for, and is therefore entitled to, even if other creditors, when receiving what they bargained for, do not receive the same thing. The reason is obvious: the first creditor is differently situated from other creditors in terms of what is currently due to it under its contract"[54]. The court discounted Argentina's threat not to pay the exchange bondholders if it were forced to pay holdouts and stated that it was unwilling to permit Argentina's threats to punish third parties to dictate the availability or terms of injunctive relief[55]. The court similarly dismissed claims by third parties involved in the payment process. The injunctions were aimed at Argentina alone and federal law automatically forbids others – who are not directly enjoined but who act 'in active concert or participation' with a party – from assisting in a violation of the injunction[56].

This interpretation of the *pari passu* clause has proved highly controversial. The conclusion of the Court of Appeals was contrary to the *amicus* brief filed by the United States and risks seriously interfering with the prospects for consensual debt restructurings in the future. If holdouts are able, through the *pari passu* clause, to require rateable payment then a sovereign that defaults on its debts may be unable

51 *Ibid.*, p. 8.
52 *Ibid.,* pp. 8-9.
53 727 F.3d230; U.S.App.LEXIS 17645
54 *Ibid.*, p. 6.
55 *Ibid.*, p. 7.
56 *Ibid.*, p. 8.

to prioritise limited funds for payments considered to be significant for economic, political or military reasons. Effectively, the sovereign's ability to dispose of its resources in the manner considered to be expedient is abrogated. Moreover, the decision will make sovereign workouts significantly more difficult to negotiate. Most sovereign debt restructurings involve the exchange of 'old' bonds for 'new' bonds that are issued on terms significantly less advantageous to the holder than the original bonds. If holdouts can insist on rateable payment with bondholders who agree to exchange their bonds what incentive is there for bondholders to agree? Given the existing volume of bonds in issue without CACs this is not an academic argument. According to briefs filed by Argentina, there is at least $68.5 billion of sovereign debt outstanding that is not subject to CACs[57]. Indeed, the form of *pari passu* clause at issue was widely used in the 1990s and 2000s.

The Court of Appeals argued that the inclusion of CACs "effectively eliminate the possibility of 'holdout' litigation" making it highly unlikely that future sovereigns will find themselves in Argentina's predicament[58]. However, this also seems unlikely. CACs are not a panacea. As has been seen, most CACs operate on a series-by-series basis with the result that to trigger CACs on a particular series of bonds it is necessary to reach the required supermajority. Investors intending to hold-out and seek payment in full can therefore seek to acquire a sufficiently large holding in one or more series of bonds to prevent the CACs from being triggered. In this case the sovereign will have to decide whether or not to pay holdout bonds. CACs may therefore make the process of holding out more predictable by enabling investors to target certain series of bonds.

What would an English court make of the reasoning of the US Court of Appeals? It is considered that the approach is contrary to established principles of contractual interpretation under English law[59].

57 *Petition for Panel Rehearing and Rehearing en Banc of Defendant-Appellant the Republic of Argentina*, November 13 2012, 12-105-cv(L), p. 14, available at http://www.ambito.com/diario/aw_documentos/archivospdf/2005/id_doc_5849.pdf.
58 (2012) 699 F.3d 246; 2012 U.S. App. LEXIS 22281, 264-265.
59 T Petch, *NML v. Argentina in an English Legal Setting*, capital Markets Law Journal 266

The first objection to the rateable interpretation is that sovereign bonds may expressly stipulate for rateable payment. For example, Italy's 3.125% Notes due 2015 provide that:

> "The debt securities will be the direct, unconditional, unsecured and general obligations of Italy. They will rank equally with all of our present and future unsecured and unsubordinated general borrowing. … We will pay amounts due on the debt securities equally and rateably with all general loan obligations of Italy".

The last sentence is a clear promise of rateable payment. Its absence from the Argentine bonds, or most other series of sovereign bonds, suggests that ensuring rateable payment is not inherent in standard *pari passu* clauses.

What of the Court of Appeals' reliance on discrimination against the holdouts? If the intention of the parties is to confer a promise of rateable payment then the clause protects against discrimination of this kind. Otherwise, the 'discrimination' referred to is simply not legally relevant[60]. Equally, the comparison drawn by the Court of Appeals with corporate bankruptcy is not persuasive. Legal ranking is addressed (on any view) by the *pari passu* clause. The inability to liquidate a sovereign and apply its assets in accordance with a statutorily defined scheme emphasises the importance of contractual protections, but cannot a *priori* dictate what those protections should be. This is for the parties to determine under the terms and conditions of the bonds.

In 2005 the Financial Markets Law Committee ('FMLC')[61] argued that the 'rateable' interpretation[62] is incorrect and that the 'ranking' interpretation is the proper construction[63]. The principal reason given by the FMLC was that an interpretation that requires all creditors to be paid rateably would not be acceptable to debtors or creditors

60 WN Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning*, Greenwood Press, 1978.

61 FMLC, Issue 79 – *Pari Passu Clauses*, March 2005, available at http://ftalphaville.ft.com/files/2012/11/fmlc79mar_2005.pdf.

62 Adopted by the Brussels Court of Appeal in *Elliot v. Peru* September 26th, 2000 Case No. 2000/QR/92.

63 *Supra* n. 15. p. 2

and would be unworkable. It would therefore offend the 'business commonsense' principle used by English courts to construe contracts. In the view of the FMLC, requiring rateable payment is also contrary to the ordinary meaning of the clause. The FMLC focused in its report on the practical difficulties[64]:

> "if the borrower is a sovereign state unable to service its foreign currency debt as it falls due, it will not be allowed to pay any of its senior creditors in full. These include the IMF, the World Bank and any of the other multilateral organisations that may have lent it money. The restriction potentially bites even wider than this and would prevent the borrower from paying in full creditors who have sold it commodities or licensed it intellectual property rights or from paying in full its government ministers, civil servants, police force, armed forces, judges and state teachers".

The FMLC also referred to the difficulties the interpretation would present for the restructuring of sovereign debt, noting that the orderly and expeditious resolution of sovereign debt crises in a manner beneficial to both debtors and creditors is a policy objective to be pursued. The use of the *pari passu* clause to disrupt the process does not make business sense[65]. The rateable interpretation requires imputing to the parties an understanding of the standard clause that no sovereign borrower would agree to[66]. Sovereign debt crises and sovereign defaults have been with us since the dawn of time. Absent a statutory framework, such as the SDRM, contractual solutions remain the only means for addressing such crises. Where a sovereign does not tie its hands by promising rateable payment, both investors and sovereigns know that negotiations will be needed to restructure sovereign debt if an issuer becomes unable to service its debt burden. This requires the ability to privilege certain functions, such as the police power or armed forces, as well as maintaining current payments to international financial institutions such as the IMF.

64 *Ibid.*, p. 14
65 *Ibid.*, p. 17.
66 L Burn, *Pari Passu Clauses: English Law after NML v. Argentina* (2014) 9 C.M.L.J. 1, 5-7.

Conclusion

Absent any legal framework, the market has developed mechanisms for the effective restructuring of sovereign debt. Where a state requires debt relief it has been able to obtain it on reasonably effective terms. However, the current institutional framework is not ideal. In a report published on April 26 2013 the IMF reported that debt restructurings have often been too little too late, thus failing to re-establish debt sustainability and market access in a sustainable way. Secondly, while creditor participation has been adequate in recent restructurings, the current contractual, market-based approach to debt restructuring is becoming less potent in overcoming collective action problems. Thirdly, the growing role and changing composition of official lending call for a clearer framework for official sector involvement, especially with regard to non-Paris Club creditors.

These criticisms all make cogent sense and raise the question of whether a statutory scheme should be given another look, purged of the conflicts of interests that were seen in locating the SDRM within the IMF. There is no reason why a sovereign bankruptcy court could not be established that would rely to a degree on the IMF for expert evidence but would not be bound by its analysis. If this is deemed too ambitious then further work on aggregative CACs would improve the ability of creditors to bind holdouts while it may be helpful to clarify that the *pari passu* clause does not confer a promise of rateable payment (unless it expressly does). This would be controversial given the amount of sovereign debt already issued with existing forms of the clause. However, it could be helpful in avoiding upsets such as *Elliot* or *NML*. Interestingly, in December 2013 the International Capital Markets Association ('ICMA') published a consultation paper on sovereign debt in which it proposed industry standard wording for aggregated CACs and the *pari passu* provision clause. The proposal on aggregated CACs is designed to allow a sovereign issuer to modify several series of notes, including series of notes governed by local law as well as foreign law. The proposal on the *pari passu* provision extends to ranking but specifically does not extend to an obligation to make rateable payments. Finally, given that sovereign debt crises are for the most part the result of states accumulating unsustainable levels of sovereign debt, a perhaps forlorn plea may be entered for greater fiscal responsibility by states when accumulating new debt.

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14
Speech to the European University Institute

Tony Barber

The demand for certainty is one which is natural to man, but is nevertheless an intellectual vice… To endure uncertainty is difficult, but so are most of the other virtues.
Bertrand Russell, Unpopular Essays (1950)

My subject tonight is the virtue of uncertainty – or, to put in another way, the importance for European policymakers, as they strive to repair the damage inflicted for seven years on Europe's economy, financial system and political institutions, of keeping an open mind, closing off no avenue of intellectual inquiry and, above all, rejecting the temptations of dogma masked as wisdom and guesswork masked as truth.

Uncertainty governs Europe's condition. But if I can be certain of anything, it is that most of us around these tables regard ourselves as virtuous, in the sense that we do not claim to possess unassailable insights into how to rectify the ills of Europe, and do not claim the power to forecast with pinpoint accuracy the patterns of political and economic change in the European Union over, say, the next 10 years.

Of course, it is the intellectual's privilege to stress the limits of human knowledge; and to point out, from the sidelines, that the consequences of political decisions or financial market behaviour may, more often than not, diverge from the intentions behind them. But is this awareness of fallibility a luxury that for some reason is not permitted to those who hold the reins of government, or who trade tens of millions of euros every day on the stock, bond and currency markets? Or should it, in fact, be imperative for those wielding most power and influence in our societies to appreciate the unpredictability of outcomes, to alter course when results fall short of expectations, to adjust flawed models – in brief, to be humble in the face of uncertainty?

The dangers inherent in proceeding as if certainty governs the motions of free market democracies were illustrated in the first 10 years of European monetary union. From the start the union was upheld as a construct so unbreakable that investors, regulators and the European Central Bank itself treated all government bonds as equally risk-free, with the result that interest rate differentials all but vanished between Germany at one extreme and Greece at the other. In a process that was initiated by the euro's creation, but was then driven on by private sector investment decisions – thousands upon thousands of them, week by week, month by month, year by year – vast amounts of credit were poured from Germany and other affluent countries into less prosperous nations on the entirely false assumption that risk had disappeared.

The collapse of this assumption has not, I fear, removed the impulse, now that the first acute phase of the crisis is behind us, to seek certainty where none exists. First, there is the prevailing view among financial market actors that the ECB's announcement in 2012 that it would defend the euro, whatever it took to do so, has shrunk risk to the point at which it is safe to reinvest in the sovereign debt of the eurozone's most fiscally and economically challenged nations. Bond yields in Greece, Italy, Portugal and Spain are all suddenly back at pre-crisis levels. This creates an illusion of stability that rests not least on the notion that, if the financial markets have pronounced the return of safety, then safety must indeed have returned, because markets are efficient and markets know best. How quickly the lessons of the recent past are unlearnt!

In reality, the return of apparent calm to bond markets disguises the fact that the ECB's Outright Monetary Transactions initiative re- mains an untested, albeit firmly stated commitment. It has en-coun- tered a severe rebuke from Germany's constitutional court, which takes the view that it undermines the German Basic Law by em- bracing debt monetisation, or the printing of money by the central bank to finance sovereign debt. Despite having referred its ruling to the European Court of Justice, the German court may not have spoken its last word on this subject. Furthermore, the willingness of private sector financial institutions to reinvest in southern European government bonds has merely reinforced the so-called "doom loop" between shaky banks and shaky sovereigns that was exposed at the height of the crisis.

Now, I can think of various ways for banks to allocate money that might produce more durable, beneficial outcomes for the eurozone, and one of them is to restore the flow of credit to cash-starved companies which, much more so than in the United States, depend on banks, not the capital markets, for funding. The busy accumulation of sovereign debt holdings crowds out private lending, and it is surely encouraged by the zero-risk weight that banks attach to such holdings in measurements of their capital adequacy. It might be wise for banks and their regulators to phase out zero-risk weighting and, if banks must own government debt, to diversify their holdings, so that no bank is over-exposed to a single sovereign. Otherwise, as the Or- ganisation for Economic Co-operation and Development observed in its latest report on the euro area, "financial disruptions are still likely"[1].

To sum up my thoughts on recent financial market behaviour, then, I detect a complacency about the way the crisis has died down which is rooted, at bottom, in the same certainties that contributed to the crisis at the start: that is to say, that the search for maximum return is the proper function of a market; that, where risk is concerned, hope must triumph over experience because the alternative is a lower return; and that the wider political, social and economic context of

1 OECD Economic Surveys: Euro area April 2014, Overview, p12 (Organisation for Economic Co-operation and Development: Paris, 2014)

financial market activity is someone else's problem, because a Tablet of Stone inscribed in the Scottish Enlightenment supposedly stated – though I think Adam Smith would take issue with this narrow read- ing of his work – that markets are all-knowing and therefore must be unfettered in their freedom.

What of the certainties that drive governments, politicians and European Union institutions? There is, quite clearly, no single certainty, no unanimous agreement about the correctness of the steps taken so far, and to be taken in the future. The animated debates about austerity, structural economic reform, pro-growth measures, deficit and debt reduction and how to organise rescue programmes testify to that. Yet what we do see are prejudices and special interests that take on the mantle of certainty.

For example, a neutral observer would, I suspect, make the point that the banking union which is such a fundamental element of Europe's crisis-fighting response does not yet seem comprehensive enough to address the frailties of the financial sector to which I have just alluded. It is not only that the authority empowered to handle bank emergencies will have one hand tied behind its back. It is that a European deposit insurance scheme remains a far-off prospect. For these shortcomings there is a general explanation – that no collective European will exists to go so far; and a specific explanation – that no collective German will exists to do so.

Yet Germany tends to express its reluctance to deepen the content of European monetary union not as a straightforward political preference, but as a set of legal, moral and economic certainties. German interpretations of the EU treaty law underpinning the euro encapsulate imperishable legal truths; German insistence that everyone should repent of their fiscal sins reflects a timeless ethical precept; and the path of internal devaluation imposed on southern Europe embodies an iron law of economic recovery in a single currency area.

All this was colourfully expressed in a speech in Amsterdam on April 7 by Jens Weidmann, the Bundesbank president[2]. In his view,

2 Jens Weidmann, "Monetary Union as a Stability Union", 7 April, 2014 Speech, available at http://www.bundesbank.de/Redaktion/EN/Reden/2014/2014_04_07_weidmann.html

Europe's rescue mechanisms – the European Financial Stability Facility and the European Stability Mechanism – have weakened the principle of individual responsibility, because fiscal responsibility has remained essentially national whilst liabilities have been partly mutualised. I quote: "The balance between liability and control has become lopsided... To put it rather bluntly: you would certainly not want to share your bank account with your neighbour if you were unable to control his or her spending."

The difficulties with this argument start with the observation that the establishment of the EFSF and ESM was rendered necessary in part by the determination of Germany and other creditor nations to protect their banks from the consequences of reckless lending to southern Europe. In Ireland's case, the insistence that the government should assume responsibility for its own banks placed unbearable pressure on the sovereign and led to the 2011 emergency rescue of Ireland.

More profoundly, the dominance over intergovernmental decision- making that Germany has acquired as a result of the crisis has in- flamed national feeling and led to a sense of disempowerment among citizens in debtor countries. Even if Jens Weidmann is right and li- abilities have been partly mutualised, that appears as small comfort to southern Europeans who, one imagines, would define the lop- sidedness of the eurozone's refurbished architecture in a quite dif- ferent way to that of the Bundesbank president. As René Cuperus, the Dutch thinker, puts it: "Does the European Union threaten to transform itself from an anti-nationalistic into an anti-democratic project...? Can a German-style fiscal union strengthen European solidarity, or will it, as a sorcerer's apprentice, unleash the very nationalism Europe was designed to overcome?"[3]

René Cuperus is right to frame this point as a question rather than a prediction, because, to remind you of tonight's theme, we just don't know what the future holds in store. In some respects the spread of

3 René Cuperus, "Against a 'One-Size-Fits-All Europe': Euro-Realists Squeezed Between Federal Radicals and Anti-EU Extremists", p32, in *Shaping A Different Europe: Contributions to a Critical Debate*, ed. Ernst Hildebrand & Anna Maria Kellner (Verlag J.H.W. Dietz: Bonn, 2014)

anti-German sentiment and the incidence of social unrest during the crisis have been reassuringly limited. On the other hand, populist, anti-establishment and anti-EU parties are now well-entrenched on the European political landscape and may cause more than a few upsets in next month's European Parliament elections.

What we also know is that public trust in the EU, as measured by opinion polls, has dropped sharply since the pre-crisis year of 2007 – not just in rescued countries such as Greece, Ireland or Spain but even in better-off countries such as Austria, Finland or the Netherlands. Here is to be found one more reason for being cautious about whether a buoyant bond market tells us anything useful about social reality.

Naturally, if, as seems to be the case, declining public trust moves in close correlation to declining living standards, rising unemployment and a shrinking welfare state, then one might expect public trust in the EU to go up when an economic rebound takes effect. I suppose this depends on how you define a rebound. In its final quarterly report on the eurozone economy in 2013, the European Commission made the startling forecast that, in the absence of vigorous economic reforms, the euro area would end up in 2023 with average living standards at only 60 per cent of US levels – which is to say, their low- est, relative to America, since the mid-1960s[4].

Shortly after the Commission released this report, I was in Milan and ran into one of its authors, who confided that a great deal of agonised internal debate had preceded the decision to go public with this forecast. One can see why, though if the forecast had been buried and then leaked, the impact might have been worse.

But in any case it's only a forecast, based on economic models which, like politicians, central bankers, academics and most emphatically journalists, do not have some scientific or divine power of perfect prediction.

4 Quarterly Report on the Euro Area: Volume 12 No. 4 (2013), p14 (European Commission: Brussels, 2013)

I know what I would like to forecast: a Europe that restores growth, controls markets, unlocks its human potential and rebuilds a spirit of endeavour and confidence in its future. But I do not have any certainty we will get there.

ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES

Bearing the Losses from Bank and Sovereign Default in the Eurozone

Workshop

Organized by: **Franklin Allen**, **Elena Carletti** and **Joanna Gray**

Co-organized by: **Pierre Werner Chair Programme/Robert Schuman Centre for Advanced Studies** and **Wharton Financial Institutions Center**

Sala Europa, Villa Schifanoia
Via Boccaccio 121 – Firenze

24 April 2014

Programme

09.30-10.00	Registration and coffee
10.00-10.15	Welcome **Brigid Laffan** | RSCAS Director
10.15-12.15	**Panel 1 – *Asset Quality Review in the Eurozone***
Chair:	**Elena Carletti** | EUI and Bocconi University
	Claudia Buch | Halle Institute **Bart Joosen** | University of Amsterdam **Thomas Mayer** | Deutsche Bank **Andrea Resti** | Bocconi University **Till Schuermann** | Oliver Wyman
12.15-13.15	**Keynote Lecture**
Chair:	**Franklin Allen** | Wharton School, University of Pennsylvania
	Miguel Ángel Fernández Ordóñez | former Governor of the Bank of Spain
13.15-14.30	Lunch at Villa Schifanoia
14.30-16.30	**Panel 2 – *Bail-in, State Aid and Resolution in the Banking System***
Chair:	**Joanna Gray** | Newcastle University
	Barbara Attinger | European Central Bank **Emilios Avgouleas** | University of Edinburgh **Clemens Kerle** | European Commission, DG Competition **Stefano Micossi** | Assonime **Huw Pill** | Goldman Sachs
16.30-17.00	Coffee break
17.00-18.30	**Panel 3 – *Sovereign Defaults and Banking Crises***
Chair:	**Richard Portes** | London Business School
	Mitu Gulati | Duke University **Kris Mitchener** | Warwick University **Tolek Petch** | Slaughter and May **Jeromin Zettelmeyer** | Federal Ministy of the Economy
18.30	Reception and Dinner at Villa Schifanoia
	Dinner speaker **Tony Barber** | Financial Times

Wharton
University of Pennsylvania
Financial Institutions Center

This book contains the proceedings of the conference "Bearing the Losses from Bank and Sovereign Default in the Eurozone", which was held at the EUI in Florence, Italy, on 24 April 2014.

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