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SOVEREIGN DEBT RESTRUCTURING IN THE EURO AREA

Summary

Euro area policymakers have recently agreed to enhance the framework for restructuring sovereign debt within the monetary union.

This paper reviews the existing process leading to sovereign debt restructuring, and identifies a number of aspects which limit its effectiveness and credibility.

Reducing debt restructuring that is "too little too late" requires more accurate technical tools. It also requires a more transparent governance framework for evaluating debt sustainability, one which separates technical from political decisions.

If a technically more sound and less bias-prone debt sustainability analysis framework can be achieved, and if spillover costs can be adequately embedded into this framework, it seems the task would have been accomplished and additional reforms would not be necessary.

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INTRODUCTION

The Greek crisis and the late restructuring of the country's sovereign debt have become a poster child of the negative consequences of the lack of a well-defined framework for resolving sovereign debt crises. The approach devised to restructure local law Greek sovereign bonds, by retrofitting through legislative act an aggregated collective action clause and using it to obtain sufficient creditor support for the restructuring, worked smoothly (Gelpern et al. 2016, Buchheit, 2018). It contrasts, however, with the approach taken on foreign-law Greek sovereign bonds, where holdout creditors managed to block the restructuring of six billion euros' worth of those bonds (Gulati et al. 2013).

Concerned by the large pool of holdout investors with which Greece was faced, and by the extent to which official bailouts were used to postpone debt restructuring, euro area policymakers have now agreed to enhance the framework for restructuring sovereign debt, and are negotiating a reform of the treaty governing the European Stability Mechanism (ESM).[1] On 4 December 2018, the Eurogroup stated: "*There is broad support for the need to improve the existing framework for promoting debt sustainability in the euro area. We intend to introduce single limb collective action clauses by 2022 and to include this commitment in the European Stability Mechanism Treaty*" (Eurogroup 2018).

Euro area sovereign bonds will include single-limb collective action clauses to simplify the voting procedure required to approve a debt restructuring. This will limit holdout incidence by reducing the likelihood that the strategy of holding out pays off. Since 2013, all euro area sovereign bonds have included two-limb cross-series aggregation clauses (euro CACs), which allow an agreement to restructure a range of bonds if certain majorities are achieved both in an aggregate (or cross-series) vote, and separately for each bond. It was probably the successful introduction of these clauses in 2013 that made the decision to incorporate single-limb CACs more palatable. When policymakers discussed introducing euro CACs, some feared these would segment bond markets, drain liquidity, and push up funding costs (Wiesmann 2013). However, studies analysing the effects of euro CACs on sovereigns' borrowing costs (Carletti et al. 2016, Picarelli et al. 2019, Grosse-Steffen et al. 2019, or IMF 2019a) have instead found no negative effects. It is only the Italian authorities that contest this proposal, on the grounds that introducing single-limb CACs would lead financial markets to consider that there is an increased likelihood of a restructuring (Galli 2019).[2] Yet according to Arnold et al. (2019), this concern is misguided. Given that euro area countries possess a 'local-law advantage', single-limb CACs only enlarge the menu of options.[3]

While single-limb CACs limit holdout risk by design, they are not without drawbacks. Fang et al. (2020) show that single-limb CACs are not bullet-proof, and would have failed to avoid holdouts during the restructuring of Greek foreign-law bonds. An additional complication is that, as described in Stumpf (2018) and Buchheit et al. (2019), sovereigns obtain financing using instruments different from bonds, which do not contain CACs.[4] Figure 1 shows this is true in the euro area.

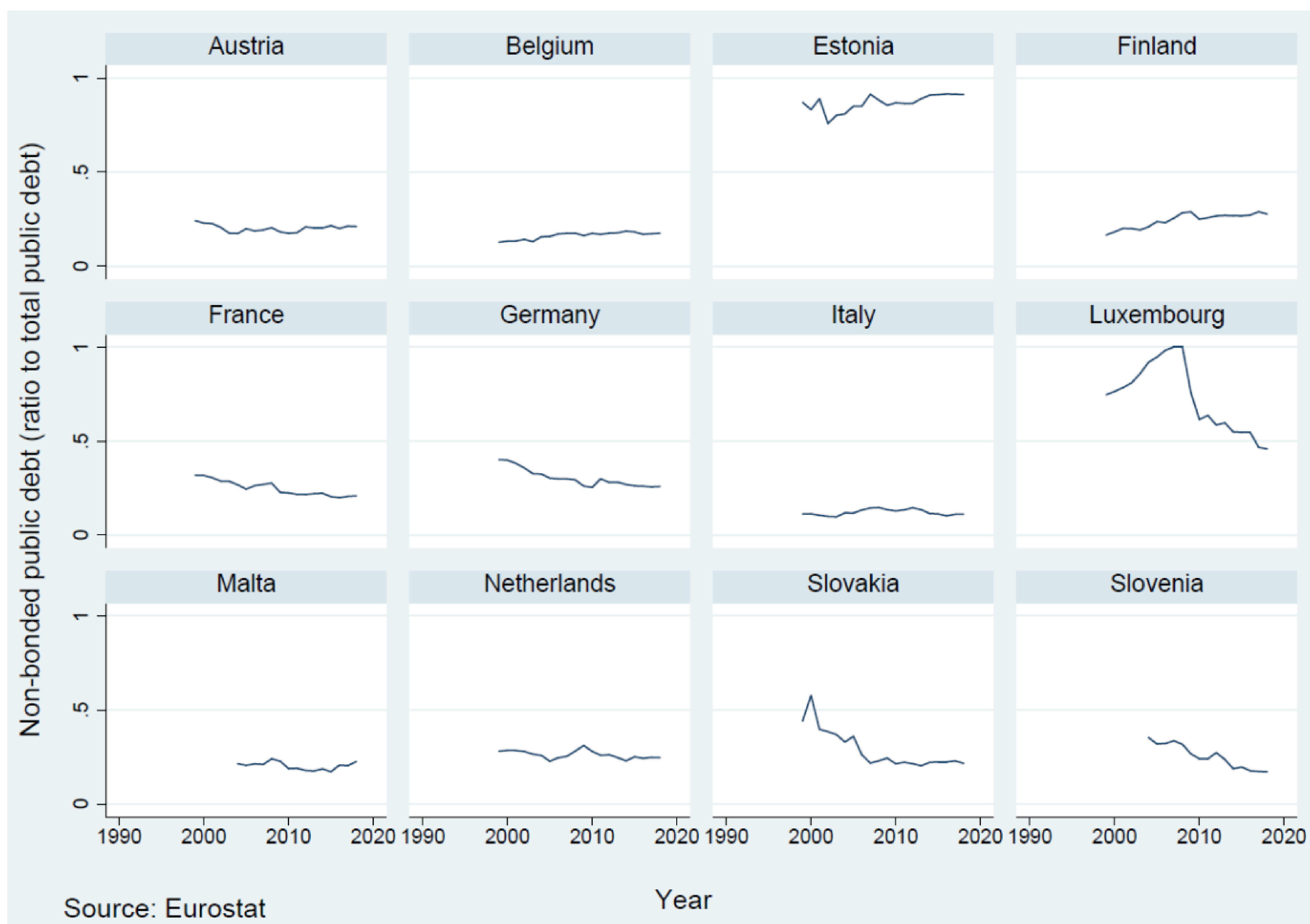
[1] The tendency of the actors involved in a debt restructuring to postpone it, together with the recurrence of situations in which the relief is not enough to resolve the crisis, led the IMF to argue that restructuring happens "too little too late" (IMF, 2014). According to the IMF (2019b) an effective restructuring framework should provide incentives for a proper pricing of sovereign risk and a prudent management of fiscal finances, and should tie the hands of policymakers.

[2] According to Galli (2019) single-limb CACs are procyclical, and lead markets to consider debt restructurings more likely.

[3] When local law governs sovereign debt, the government can restructure it through a parliamentary act (Buchheit 2018).

[4] Moreover, a framework that makes some liabilities easier to restructure (junior) incentivises the authorities

Figure 1- Non-bonded sovereign liabilities in selected euro area countries



Despite these concerns, there is wide agreement that a single-limb collective aggregation clause is the least disruptive alternative for limiting holdout risk (Zandstra 2018). However, the way to address "too little, too late" is not as clear. According to Grund and Stenstrom (2019), reflecting the potential political will for a better-defined mechanism for restructuring sovereign debt, Recital 12 of the European Stability Mechanism treaty, which deals with debt restructuring, was left deliberately loose.[5]

The most stringent proposals want to impose automatic maturity extensions when a sovereign requires official assistance (Grosse-Steffen and Schumacher 2014). According to Andritzky et al. (2016), in order to avoid biases against timely debt restructuring, the euro area needs a sovereign debt restructuring framework that prevents public funds from bailing out private creditors when debt is not sustainable. Destais et al. (2019) argue for a statutory mechanism that precisely defines the procedures and institutions for determining when to implement a debt restructuring. Buchheit et al. (2013) and Buchheit and Gulati (2018) meanwhile argue that a euro area sovereign debt restructuring framework should include amendments to the ESM Treaty in order to immunise ESM funds from litigation.

to borrow using harder-to-restructure (senior) instruments (Bolton and Jeanne 2009).

[5] An earlier version of the ESM Treaty detailed how to conduct debt restructuring, including considerations regarding cross-border spillovers (Dias and Zoppe 2019).

Additionally, Grund and Stenstrom (2019) propose the creation of a dispute resolution mechanism to be used when contractual remedies fail. For Baglioni and Bordignon (2019), the current case-by-case approach provides flexibility, and a legal framework for imposing a debt restructuring as a condition for obtaining ESM aid is already in place. In their view, it would be enough to clarify responsibilities and methodologies for restructuring debt under the existing framework. Rossi (2019), however, argues that a more explicit seniority structure of sovereign debt is needed (see also Zettelmeyer 2018).

To enhance the framework for sovereign debt restructuring in the euro area, policymakers need to answer two important questions. First, who should evaluate debt sustainability (and trigger the restructuring process) and the extent of debt relief, and how should this be done? Second, how should the framework account for spillover effects? In the rest of this paper, I provide an answer to these questions by reviewing the sequence of policy actions that lead the official sector to require a debt restructuring.

Debt sustainability analysis: the road to sovereign debt restructuring

The sequence of decisions and policies involved in a sovereign debt restructuring within the euro area is presented in Figure 2. Within the euro area framework, debt restructuring is requested by official lenders when the debt sustainability analysis (DSA) they use to evaluate whether a country's debt can be stabilised through adjustment and official lending says such a path is not feasible. Until 2016, the framework allowed for a country to receive official lending, even if the DSA was not passed with high probability, if it was deemed that a restructuring could have systemic effects.[6]

The approximate size of the country's financing gap, and how it can be filled combining fiscal adjustment, official lending and debt restructuring, are part of the output of the debt sustainability analysis conducted prior to any decision to provide official lending. With some differences in methods and data, the DSA developed by official institutions contains three elements: data inputs, a standardised technical assessment, and a final assessment informed by judgement. This approach has historically been preferred because it targets a homogeneous treatment across countries while, using judgement, it caters for country specificities (Corsetti 2018).

The DSA used during the euro area crisis was based on an evolution of the IMF blueprint to accommodate for the euro area setting. The IMF exceptional access policy did not allow the Fund to lend to Greece because the country's debt was not sustainable with high probability. In a controversial move, as part of Greece's request for a stand-by arrangement (SBA), the

[6] In 2016 the IMF eliminated the systemic exemption allowing this.

IMF passed a "systemic exemption" that allowed the IMF to lend to Greece, even if the country's debt was not sustainable, given that a restructuring could have systemic effects (Truman 2016).

In the face of intense criticism, the IMF's Independent Evaluation Office (IEO) prepared an evaluation of the IMF programmes with Greece, Ireland, and Portugal (IEO 2016). According to the IEO (2016), the IMF had lost its agility to manage crises. In addition, because the European Commission negotiated on behalf of the Eurogroup, the troika (the European Commission, IMF and ECB) potentially subjected the technical judgments of the IMF staff to political pressure from an early stage (see IEO 2016). The IEO (2016) recommended the IMF to develop procedures to minimise the room for political intervention in the IMF's technical analysis. Following this recommendation, the IMF conducted a preliminary assessment of its DSA framework for countries with regular market access (MAC DSA), concluding that the framework required a rigorous reform. The 2018 Review of Conditionality (RoC) (IMF 2019b) carried out another thorough review of the framework, and reported that the mechanical part of the MAC DSA methodology had little capacity to identify stress periods. It also noted that the use of judgement within the DSA did not improve the identification of risks, and that its use proved controversial.

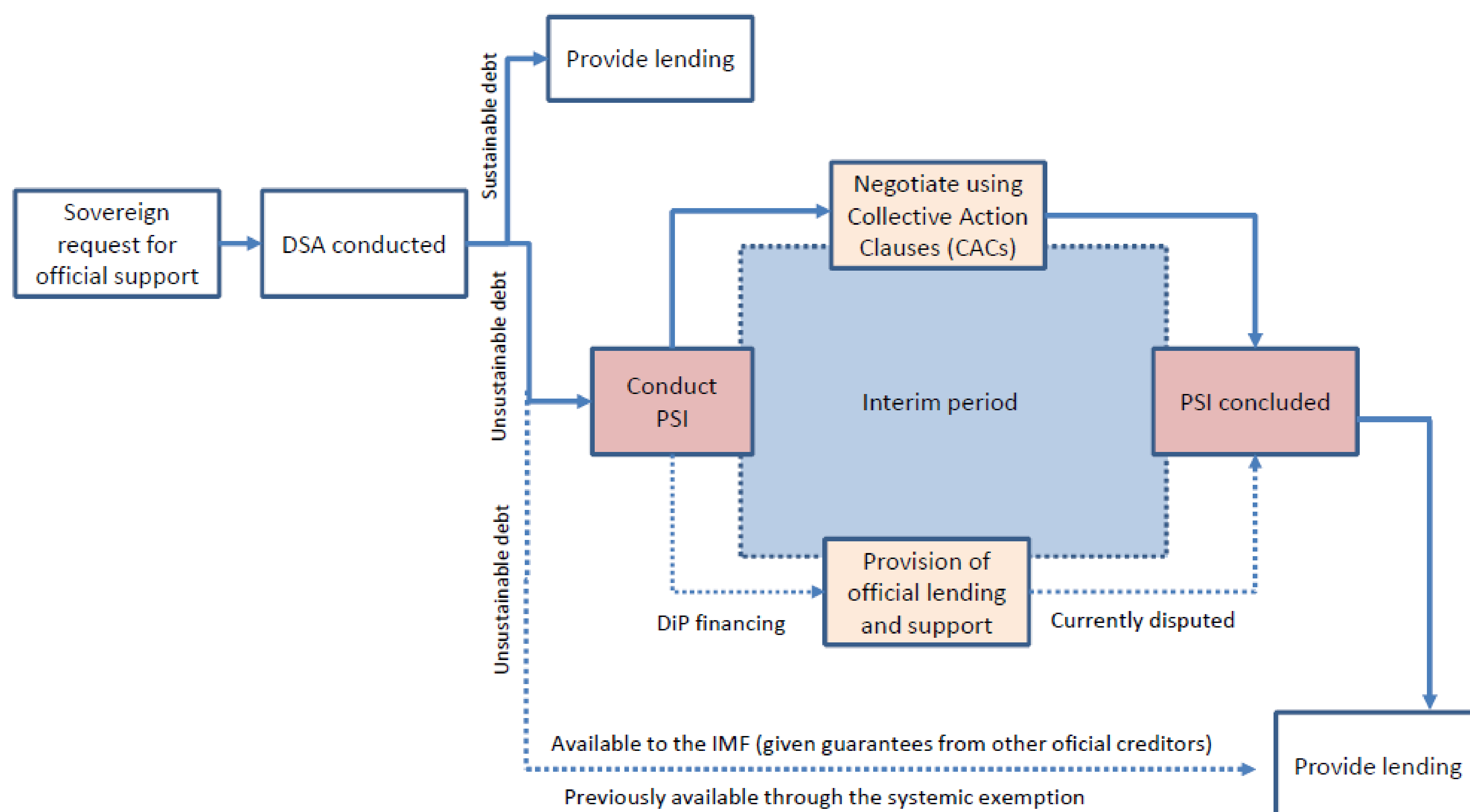
Surprisingly, there is little debate regarding whether the euro area framework has been affected by the issues identified in IMF (2019b). From a euro area perspective, as part of the proposed reform of the ESM treaty, the European Commission, European Central Bank, and European Stability Mechanism will cooperate in performing a DSA in the future. According to Dias and Zoppe (2019), the DSA will be carried out on a transparent and predictable basis, while allowing a sufficient margin of judgement. In the event of disagreement, the Commission will make the overall assessment of public debt sustainability, while the ESM will assess the country´s capacity to repay the ESM.

An effective framework for evaluating debt sustainability needs to be based on a technically sound assessment. This requires having well-established procedures that provide ex-ante clarity on what data, assumptions and methodological tools are to be used (IMF 2013b, 2019b).[7] From a methodological perspective, although recent DSA frameworks (e.g. Bouabdallah et al. 2017) cover a larger number of indicators and use statistical methods to study tail risks, a number of important issues remain open. The seriousness of this gap is underlined by the findings of the 2018 RoC and the ongoing revision of the MAC DSA discussed above. According to Corsetti (2018), until liquidity risks and debt management are properly accounted for, the framework's ability to evaluate debt sustainability will remain limited. Corsetti (2018) argues that as official lending has moved from supporting developing issuers with irregular presence in international bond markets to heavily financial economies, in which governments operate large and liquid domestic bond markets, the traditional approach to debt sustainability has become insufficient. In contrast with the practice of advanced economies' debt management offices, existing DSA frameworks use simple and unrealistic rules for the rollover of maturing debt.[8]

[7] A robust DSA should specify which institution is to yield the relevant data and assumptions. For example, long-term growth assumptions could come from the OECD, which has an outstanding reputation and provides credible standards.

[8] The frameworks also fail to recognise that the terms of official loans strongly affect market access (Corsetti 2018).

Figure 2 - The euro area road to sovereign debt restructuring



Note: PSI stands for private sector involvement (debt restructuring of debt held by the private sector, whilst DiP stands for debtor in possession finance.

An adequate use of judgement is also critical for an effective DSA framework. Unfortunately, as noted in the IMF's RoC (2018) and in Lang and Presbitero (2018), the track record shows that the IMF's use of judgement can be controversial. Lang and Presbitero (ibid) study the role of judgement in altering the mechanical decision process embedded in the World Bank-IMF Debt Sustainability Framework. They show that both political interests and bureaucratic incentives influence the decision to intervene in the mechanical decision-making process, suggesting that the room for discretion in official lenders' DSA can be a source of biased decision-making.

A related complicating factor is the variety of roles played by the official DSA. While it is a risk-management instrument for the lender, it is also the platform where the policy response is put together, and a source of information to all parties involved in a debt restructuring. These multiple uses can expose the DSA to conflicting roles. Simpson's (2006) evaluation of the IMF's role in Argentina noted that the IMF came to be perceived as more concerned about its own financial resources than about providing an accurate representation of the underlying problems. The impartiality in evaluating sustainability may be viewed with scepticism, especially if the lender is already heavily exposed to the sovereign (Diaz-Cassou and Erce 2011). Baglioni and Bordignon (2019) and Destais et al. (2019) note that similar concerns exist in the euro area where various institutions, with multiple and potentially conflicting mandates, are involved. Key arguments in favour of involving the European Commission and ESM in the DSA are that the lending institutions should be involved in all

analytical steps (Destais et al., 2019) and that the analysis could benefit from their country and capital markets expertise (Corsetti, 2018).

Key arguments against delegating the DSA to the ESM and the Commission are that they suffer from political biases, and that the potential for conflict coming from their roles as accountable lenders and impartial debt sustainability judges could challenge their governance.[9] Schadler (2013) argues that a credible evaluation process requires safeguards to guarantee that, through the use of judgement, sustainability assessments do not become biased. According to Gelpern (2016) and Truman (2016), in order to guarantee that technical sustainability assessments do not become politically biased, an effective and reliable technical analysis needs to be in place.

To move the framework away from governance issues, Baglioni and Bordignon (2019) propose leaving the technical analysis to an independent body that is less exposed to governance tensions and conflicting roles, such as the European Fiscal Board (EFB). The role of this independent body would be to perform the technical analysis, using input from European Commission, European Stability Mechanism, and European Central Bank. This would allow the institutions involved in the bailouts to provide their own technical analysis and judgement, enabling them to argue in favour of or against a restructuring (due to contagion, financial stability, or other considerations).[10]

One advantage of the technical analysis being carried out by the EFB would be that it provided more clarity on whether the drivers of a decision to restructure are technical, judgemental or political. This additional transparency would increase the value of the DSA as public information (a public good). By reassuring investors that they are to contribute only when justified, a more transparent DSA might well reinforce the ability of CACs to smooth the restructuring and the process of market re-access.

[9] Pisani-Ferry et al. (2011) favour including the IMF because its neutrality reduces the risk of political biases.
[10] Currently, the EFB secretariat is still in the Commission and its available resources are limited. Taking on DSA would require an increase in the resources of the EFB. This could be achieved by shifting resources from the ESM and Commission to the EFB, and by leveraging the large (and increasingly capable) network of national fiscal councils.

Debt relief, spillovers and credibility

Once it is accepted that a country´s public debt is not sustainable without some form of debt relief, the official sector uses the results from the DSA to set an envelope for the amount of debt relief that is necessary.

As highlighted in the IMF's 2018 RoC (2019b), an important limitation of how the current framework determines the extent of relief is that there is no sound or generally accepted method to evaluate the costs that a restructuring can have, either domestically or on third parties.[11] Understanding the size of potential spillovers is critical. In fact, the relevance of systemic effects was a critical lesson from the Greek debt crisis (IMF 2019b). When Greece asked the IMF for support, its debt did not pass the sustainability test with high probability and, according to the policies existing at the time, the IMF could not lend (Hagan et al., 2017). Given the fears that a disordered default in Greece could trigger a systemic meltdown, the IMF modified its exceptional access policy, to allow lending to sovereigns whose sustainability is not guaranteed if a default can have large systemic effects (for a detailed description of this episode see Schadler 2013).[12]

Euro area countries are heavily interconnected, making systemic effects and large spillover costs from a debt restructuring by a euro area sovereign almost certain. Figure 3 exemplifies the prevalence of spillover risk. It presents the exposure of selected euro area banks to the Italian economy.[13] While the exposure to the public sector is already very significant, once the private non-financial sector is accounted for, the exposures become a multiple of various banks' capital.[14]

What role should spillovers play in the euro area framework for sovereign debt restructuring? Along the lines suggested by Schadler (2013), the framework could accommodate systemic considerations as follows: before a decision to ask for a debt restructuring is triggered by the failure of a country to pass the DSA, a rigorous analysis of spillover effects should be carried out. This would allow policymakers to evaluate the potential benefits and costs of a restructuring beforehand.[15]

[11] Sovereign defaults spill across borders through multiple channels: trade, asset valuation, and private-sector exposures (Asonuma et al. 2016). Harsher restructuring terms are more likely to dampen activity (Trebesch and Zabel 2017), generate sudden stops (Panizza et al 2009), financial instability (Asonuma et al. 2019) and contagion.

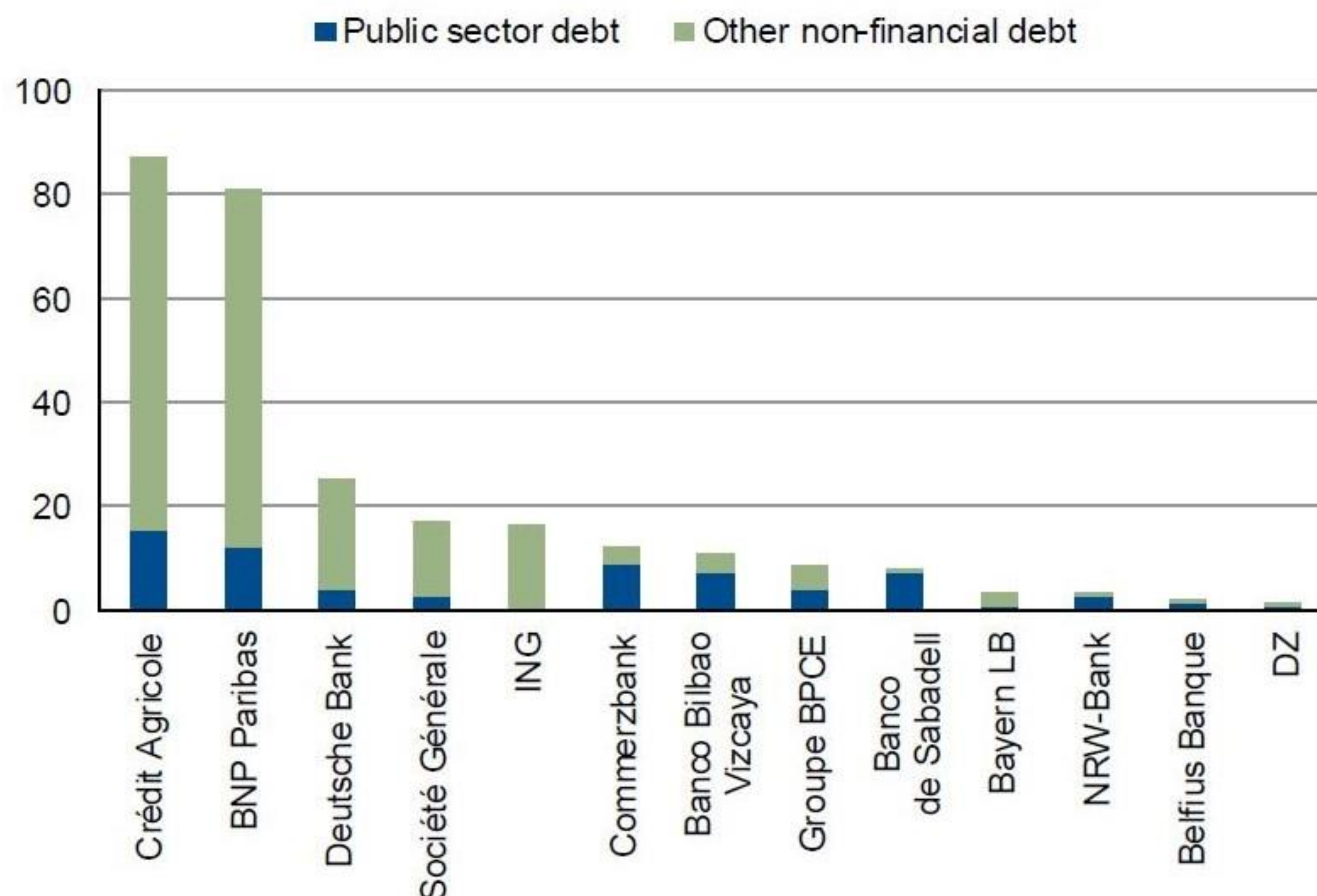
[12] The main argument used to convince the IMF to modify its exceptional access policy and lend to Greece (Corsetti et al. 2017) was the fear that, through the exposure of euro area banks to Greece, a default could trigger a systemic meltdown.

[13] To mitigate financial instability risks, Zettelmeyer (2018) proposes regulatory actions to reduce the balance sheet connection between domestic banks and governments, a European deposit insurance system, and a euro area safe asset. It is unclear the extent to which any of those measures will be effective to contain spillover effects.

[14] As discussed in Tirole (2015), it might be cheaper to lend into doubtful solvency and engineer debt relief through the official sector rather than imposing a debt restructuring and facing significant spillover costs.

[15] An earlier version of the ESM Treaty gave spillovers an explicit role in deciding when to conduct a debt operation: *"An adequate and proportionate form of private-sector involvement shall be sought on a case-by-case basis where financial assistance is received by an ESM Member, in line with IMF practice. The nature and the extent of this involvement shall depend on the outcome of a debt sustainability analysis and shall take due account of the risk of contagion and potential spill-over effects on other Member States of the European Union and third countries. […]"* (Grund and Stenstrom, 2019).

Figure 3 - Credit exposures (in billion euros) to Italy of selected euro area banks



Who should provide such analysis? Both the European Central Bank (Fahr and Żochowski 2015, Dieppe et al. 2018) and the International Monetary Fund (IMF 2014, IMF 2015) already provide analysis of spillover effects. As part of its efforts to strengthen its surveillance, the IMF adopted an Integrated Surveillance Decision (ISD) in 2012, moving towards more systematic coverage of spillovers. While the ISD allows the IMF to discuss with its members the full range of spillovers from their policies, on domestic and also global stability, the IMF's RoC (2019b acknowledged that more work was needed to understand the drivers of cross-border costs from a sovereign debt restructuring.[16] In turn, in the context of the European Systemic Risk Board's (ESRB) expert group on cross-border spillovers and reciprocity, the ECB has been working on a framework for analysing spillovers from macroprudential policies.[17]

As with the other components of a debt sustainability analysis, the choice of the institution in charge is not without implications. One the one hand, delegating a DSA to the IMF risks recreating, in future systemic crises, the same controversies and stand-offs between the IMF and European institutions that were witnessed during the Greek crisis. On the other hand, assigning a DSA to the ECB risks exposing the DSA to additional political pressure, which is likely to be highest when international spillovers are potentially large. Moreover, the ECB's role as a supervisor of euro area banks and as a lender of last resort

[16] From a technical perspective, the IMF (2014) presented a methodology to quantify spillover risks by evaluating sovereign contagion through the use of a vulnerability index (VI). The VI allows contagion to be assessed in two ways: first, by evaluating how vulnerable crisis countries are to distress in other countries; second, by quantifying how relevant crisis countries are as a source of contagion to related countries.

[17] Dieppe et al. (2018) introduce the European Central Bank's global macroeconomic model. This is a semi-structural, global multi-country model, featuring multiple channels of international shock propagation, including through trade and financial markets.

for sovereigns could also end up in conflict with its role as an evaluator of systemic effects.

Arguably, regardless the institution in charge of the analysis, such an escape clause may reduce the ex-ante incentives to markets and fiscal actors that the framework is expected to provide. While taking into consideration spillovers can weaken the case for debt restructuring, the goal is not to have less restructuring, but to have a framework that embeds systemic effects into the DSA. Moreover, the lack of a contingency plan, for situations where spillovers make it ex-post efficient to avoid a disordered default of an insolvent country, could render the framework time-inconsistent and non-credible.[18]

CONCLUSIONS

The complicated resolution of the Greek debt overhang triggered an ongoing reform effort to facilitate future sovereign debt restructurings. On the road to euro area sovereign debt restructuring, governments not only enjoy the advantage provided by the domestic nature of the law governing most of their liabilities, but by 2022 should also have at their disposal the means to conduct restructuring through the use of single-limb CACs. Including single-limb CACs will greatly reduce holdout risk during debt restructuring. Reducing debt restructuring that is too little too late requires more accurate technical tools, and a more transparent framework for evaluating debt sustainability, one which separates technical from political decisions. It also requires a decision on the role to be played by systemic considerations in determining when a debt restructuring is the right policy. This question is crucial in the design of an effective debt restructuring framework. Embedding into a DSA framework a formal way to evaluate the potential spillover costs of a debt restructuring would help reduce political and institutional biases.

If the euro area framework is to reduce too little too late debt restructuring, in addition to single-limb CACs, it needs more accurate technical tools and a sharper use of judgement. It also requires a more transparent framework for evaluating debt sustainability, one that caters for different degrees of sustainability and separates technical from political decisions. The framework should also clarify the role to be played by systemic considerations. If these considerations would be addressed, no additional reforms would be necessary.

[18] Not acknowledging that in some cases spillover concerns would override the DSA result makes the framework time inconsistent (as we know that systemic countries will eventually be rescued).

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