19 June 2012

EUROPEAN PARLIAMENTARY FINANCIAL SERVICES FORUM

EPFSF Briefing
Sovereign Debt Crisis

1. Causes of the EU sovereign debt crisis

Fiscal shortcomings in some countries, institutional weaknesses, investor risk aversion and a lack of effective economic policy coordination have all contributed to the development of the sovereign debt crisis in Europe.

As a result, differences in sovereign bond yields have increased dramatically, with Greece, Ireland, Portugal, Spain and Italy watching funding conditions worsen, while yields on German bonds plummet. In parallel, banks in the weakest countries find it ever harder to access liquidity. Cross-border holdings of government bonds by euro-area banks as a ratio to total holdings have steadily declined, returning to pre-euro-area levels. There is fragmentation of eurozone sovereign bonds markets along national lines.

It is now clear that a deficit in economic and fiscal integration meant that the EU institutions supporting currency union did not have tools to enforce discipline in national budgetary policies, and there were insufficient incentives for Member States to maintain discipline.

Such weaknesses were exacerbated by the financial crisis in 2007-8, leading to intervention by the leading EU Member States in the financial sector. But this put more pressure on public finances. Measures taken to solve one crisis were the basis for another, as markets became concerned about sovereign debt restructuring and defaults.

Blame has also been attributed to the absence of instruments available to EU policymakers to address macroeconomic imbalances. The flow of cheap credit from the core to the periphery, made possible by the introduction of the Euro, and the convergence of interest rates, led to an asset bubble in vulnerable economies that the EU institutions could not prevent.

2. Evolution of the sovereign debt crisis

- **May 2 2010:** Greece, Eurozone nations (€80 billion) and IMF (€30 billion) agree Greek bailout.
- **May 9 2010:** Eurozone nations create the European Financial Stability Facility (EFSF) and fund it initially with €440 billion in capital. Additional firewall protection is put in place by the European Financial Stabilization Mechanism (EFSM) - pledging to make loans of up to €60 billion - and the IMF, pledging €250 billion. The total package is €750 billion.
- **July 23:** European banks face “stress tests”. Of 91 institutions tested, 17 barely pass and 7 fail.
- **September 2010:** ‘Six-pack’ proposals proposed by European Commission (EC).
- **November 28 2010:** Ireland agrees €85 billion bailout from Eurozone members and the IMF.
- **December 17 2010:** European Council agrees establishment of European Stability Mechanism ("ESM")
- **May 17 2011**: Portugal agrees €78 billion bailout with Eurozone members and IMF.
- **July 11 2011**: Euro-zone finance ministers sign ESM Treaty in Eurogroup.
- **September 28 2011:** ‘Six pack’ adopted, to enter into force in December 2011.
- **October 27 2011:** Eurozone members agree sovereign debt crisis plan, including: 50% ‘haircut’ on Greek debt holdings; increasing tier 1 capital of European banks to 9% (approx. €106 billion); leveraging the capacity of the EFSF up to €1 trillion.
- **November 2011:** ‘Technocrat’ Prime Ministers Papademos and Monti appointed pending elections in Greece (mid-2012) and Italy (2013) respectively. ,
- **November 23 2011:** EC publishes ‘Two-pack’ proposals on EU economic governance.
- **End-January 2012:** Eurozone members, Greek government and creditors agree new PSI terms.
- **February 2 2012:** Revised ESM Treaty signed, entering into force 1 July 2012.
- **March 2 2012:** Fiscal Compact Treaty signed by 25 EU members; rejected by UK, Czech Republic.
- **March 9 2012:** Greece closes a €200 billion ($266 billion) restructuring deal with creditors. ISDA adjudges the restructuring a ‘credit event’; total payments to CDS buyers amount to €2 billion.
- **March 14 2012:** Eurozone members (€130 billion) and IMF (€28 billion) agree new Greek bailout.

- **March 30 2012:** European leaders commit to a new €500 billion firewall to be added to the current firewall amount of €300 billion (EFSF+ESM). The amount is lower than many expected.
- **May 6 2012:** French Socialist François Hollande elected President on anti-austerity mandate. Greece votes for anti-austerity parties, forcing fresh June elections, in absence of a government.
- **May 31 2012**: Ireland votes in favour of ESM Treaty.
- **June 9 2012**: eurozone finance ministers agree to provide up to €100 billion of loans to rescue Spanish banks, from EFSF and ESM funds, with "appropriate conditionality for the financial sector".

3. The EU response

Short term responses

A key short-term concern for EU leaders has been preventing contagion from vulnerable countries e.g. Greece. This involved the Private Sector Involvement (PSI) deal and creation/reinforcement of 'firewalls'.

- ***European firewalls***

In order to provide emergency funding, limit potential intra-Eurozone contagion and reassure the markets on which countries depend for financing, financial firewalls were established. These took the form of:

i) European Financial Stability Fund (EFSF), a €440 billion temporary rescue fund which, together with the IMF, provided emergency loans to Greece, Ireland and Portugal, with strict conditions
ii) European Stability Mechanism (ESM) - total lending capacity increased to €700 billion, including €200 billion already allotted under its predecessor. Debate focuses on whether to allow the ESM to lend directly to troubled banks, or still go via Member State governments.

- ***Greek debt and PSI***

Greece's unsustainable debt levels required one of the largest debt restructurings ever. The January 2012 PSI deal (following an October 2011 deal that proved inadequate) involved a huge bailout of the Greek state, through a combination of 'voluntary' debt write-offs by private sector creditors and provision of public sector funds (by the EFSF (€109 billion) and IMF (€28 billion)), conditional on major structural reforms. The negotiations which led up to this deal were politically, economically and technically complex. May's Greek parliamentary election results complicate matters further, with a substantial portion of seats going to parties who wish to reject the deal. Failure to form a government forced another (17 June) election, creating fresh uncertainty about Greece's Eurozone future.

Medium term responses

In the medium term, commitments have been extracted from EU Member States to implement structural and budgetary reforms. Several (Ireland, Greece and Portugal) face macro-adjustment programmes, while for Spain a programme targeted to some parts of its banking sector will be drawn up.
Also, steps have been taken to reinforce the economic governance framework for the euro-area. The three main components are the 'six-pack', the 'two-pack' and the Fiscal Treaty.

- ***"Six-Pack'***

This "economic governance package" was adopted in September 2011. New measures include:

- Strengthening the Stability and Growth Pact (SGP) rules – stronger and earlier surveillance of fiscal policies, and more importance attached to debt reduction (and not only deficit).
- New control introduced: the Excessive Imbalances Procedure (EIP) – for detecting and preventing the build-up of macroeconomic imbalances (bubbles, competitiveness divergences).
- New standards for independent, accurate compilation of statistics, improving budget monitoring.
- Increased transparency and accountability in procedures.

- ***"Two-Pack'***

The second economic governance package complements the first package by introducing two new regulations: the first enhancing the surveillance of Members States' budgetary policies, the second introducing better monitoring of Members States experiencing difficulties concerning financial stability or receiving financial assistance. The package is now being negotiated in 'Trilogue'.

- ***Fiscal Treaty***

The key element of the Treaty is tougher budget rules, with a limit of 0.5% of GDP for any Member State's annual structural deficit. It also introduces a new, reverse qualified majority voting system (ie, a QMV is required to *stop* sanctions being imposed) and an automatic correction mechanism. It finally empowers the ECJ to impose fines on countries who do not implement the rules correctly.

The Treaty has provoked controversy, causing the collapse of the Dutch government and the political isolation of the UK and Czech Republic (who rejected it). The new French President, François Hollande, ran his campaign on a promise to renegotiate the Treaty with growth policies in mind.

- ***Political backlash against 'speculators' accused of driving market sentiment***

EU Member States raise money by issuing bonds and selling them to capital market investors. Naturally, investors demand a higher return for bonds issued by governments more at risk of default. Over 2010-2012, the yield on the bonds of many governments, notably Greece, rose significantly, reflecting deteriorating fiscal conditions. Some commentators blamed speculators, including short sellers – either through so-called 'naked' CDS or by short selling sovereign bonds – rather than fundamentals such as rising debt levels and current account imbalances. In the case of sovereign CDS, they argued that speculation therein was sending negative signals to sovereign bond investors.

Industry groups – and indeed some international organisations and regulators[1] - question such assertions, believing there is little evidence that speculative activity is driving CDS price changes, or that changes in CDS markets are driving sovereign spreads. They suggest that increasing CDS prices are driven among other things by market participants responding to accounting changes and new Basel III capital rules. These require banks to hold capital against changes in Credit Valuation Adjustment (CVA, ie, counterparty creditworthiness – exacerbated in the case of sovereigns by the fact that they do not post collateral). They also point out that the size of the sovereign CDS market is relatively small - on average the net notional size (or maximum total claim under all CDS on the sovereign in question) is less then 2 per cent of the value of underlying bond markets. [2]

Nevertheless, the political desire to punish speculation led ultimately to adoption of the CDS and Short Selling Regulation in late 2011. Technical standards and delegated acts (which, inter alia define what is a (permitted) 'covered' or 'hedging' transaction) are near finalisation.

Proponents of banning 'uncovered' sovereign CDS say that such a ban will prevent harmful speculative behaviour serving no social purpose and damaging the interests of ordinary taxpayers. Opponents of the ban point to the lack of evidence to support the ban and assert that the presence of 'uncovered' participants in the CDS business ultimately makes it easier for hedgers to access hedges, thus aiding liquidity in sovereign CDS and debt markets, with benefits for debt pricing and, ultimately, taxpayers.

- ***Publication of the Crisis Management Directive, and consideration of a "Banking Union"***

There is a close link at national level between the perceived credit risk of sovereigns and that of banks (viz, the Spanish government in June calling on the EU to support its banks while saying it was losing access to credit markets). On 6 June 2012, the European Commission published a draft Crisis Management Directive (CMD), to avoid future bank bailouts and enhance coordination between Member States in a crisis (bearing in mind that bank failures can have a global impact). Measures envisaged focus on:

(i) Prevention tools: recovery plans to be drawn up by banks and investment firms, and resolution plans to be prepared by supervisory authorities

(ii) Early intervention powers to be given to supervisors,

[1] IMF Global Financial Stability Report; (April 2010), p. 45 – 49; (April 2012)
http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf (p. 59 - 63 in pdf)
http://www.imf.org/External/Pubs/FT/GFSR/2012/01/pdf/text.pdf (Chapter 3)
Autorité des Marchés Financiers, Price Formation on the CDS Market: Lessons of the Sovereign Debt Crisis (2010-), January 2012
http://www.amf-france.org/documents/general/10330_1.pdf

[2] DTCC Trade Information Warehouse Reports www.dtcc.com/products/derivserv/data/index.php

(iii) Resolution tools: In case of failure, national authorities in all Member States will have the same tools: (i) sale of part of the business; (ii) separation of "good assets" or essential functions in a new, bridge bank; (iii) segregation of bad assets in an asset management vehicle; (iv) bail-in, whereby the bank would be recapitalized, with shareholders wiped out or diluted and creditors' claims reduced or converted to shares. Funding would be provided through resolution funds established at national level, which would raise contributions from banks proportionate to their liabilities and risk profiles (as a single European resolution fund has not materialized yet).

The same day the Commission published this proposal, it published a memo on a future European Banking Union – an idea recently pushed by Mario Draghi at the European Central Bank. Such a union would rest on four pillars: a deposit guarantee scheme at the EU level; a common resolution authority and resolution fund; a single EU supervisor; and a single rule book for prudential supervision of all banks.

4. Orderly management of the Greek CDS 'credit event'

In the course of 2011, there was much misinformed commentary in the media and among policymakers as to the likely systemic impact of the payments and losses that would result from declaration of a 'credit event' in relation to Greek sovereign debt, thus triggering CDS payments.

In fact, the payments that eventually had to be made were small when compared with the losses that materialised in Greek sovereign bond markets. While total losses materialising for Greek (private sector) bondholders amounted to close to €160 billion, the total payments made following triggering of Greek sovereign CDS (once a 'restructuring credit event' had actually occurred, under CDS contractual terms) was approximately €2.5 billion.

Informed market participants and regulators had long been aware of the *non*-systemic impact of triggering Greek CDS, by examination of data available on Greek CDS at the DTCC Trade Information Warehouse (in aggregated form to the public, with more granular and sensitive information available to regulators). The so-called 'CDS auction mechanism' had already been tested successfully many times (including in the Lehman Brothers default, where no more than $6 billion in aggregate payments had to be made between counterparties). (In fact, the auction mechanism, and other facets of CDS such as the Determinations Committee rules, had been developed in cooperation with US and EU regulators in the course of 2007-08. In Europe, ISDA worked with the European Commission on the project, as part of the drive towards 'standardization' and legal certainty.)

Nevertheless, there is a consciousness in industry of the need to continue to enhance the safety and efficiency of the detail of the CDS product – including sovereign CDS – and a process of review of CDS documentation was initiated in May 2012. This process should ensure even higher standards of safety and efficiency in resolution of sovereign credit events in the future, should such an event materialize.

5. Next steps and key dates

In light of electoral developments in France and Greece, no clear roadmap is apparent. Some countries (e.g France and Italy) argue for combining the 'austerity' zeitgeist with European measures for growth and jobs. The 23 May informal European Council tasked Council President Van Rompuy with a report to the June 28-29 European Council on 'main building blocks and a working method' for full economic union. This summit will be key in setting the Eurozone agenda. Whatever the Greek election outcome on June 17, there is no consensus on how to manage its debt situation, with solutions mooted ranging from 'Grexit' to 'public sector involvement' (EFSF/ESM and IMF debt forgiveness).

Other ideas being discussed – including for the June Council meeting - include:

- **European Investment Bank fund increase:** a proposal to double funds to €20 billion.
- **Roadmap toward a "banking union":** including an EU wide deposit guarantee scheme, resolution fund, and bank recapitalisation facility.
- **Plan to strengthen job-creation:** reforms creating jobs in key sectors, National Job Plans etc.
- **Eurobonds:** Bonds issued in common by eurozone MS. Germany, the Netherlands oppose (absent progress on fiscal and financial integration and economic governance); France and Italy support.
- **ECB mandate:** a suggestion to extend the mandate of the ECB to include lender of last resort.

Key upcoming milestones at time of writing include:

17 June 2012	Greek national elections;
18-19 June 2012	G-20 leaders summit
28-29 June 2012	Quarterly EU Council meeting (Heads of State)
Mid-June 2012	EU-mandated external audit of Spanish banks to be released; Several decisions in relation to rating of EU banks expected from Moodys.
July 2012	(possibly) further Greek elections (depending on June elections outcome); (possibly) further Greek debt negotiations (depending on above); Effective date for ESM rescue fund commencement
25 July 2012	ECB publishes next EU bank lending survey
July-August 2012	Scheduled disbursement of 2nd and last tranche of approx €23 bn in EFSF recapitalization notes for Greek banks, conditional on Troika approval.

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