Approaches to resolving sovereign debt crises in the euro area

During the course of the financial and sovereign debt crisis, a number of new mechanisms were created to foster coordination and overcome crises. The frequent increases in mutualised liability, with the exception of the banking union, have not, in practice, been accompanied by an intensification of joint control and decision mechanisms. Instead, the original governance framework of the European monetary union (EMU) has essentially been retained. Despite the implementation of additional coordination mechanisms, the member states are still largely accountable for their own fiscal and economic policy. At present, there do not appear to be majorities in favour of transferring sovereign rights, which would be necessary in order to make a major step towards deeper integration in a comprehensive fiscal and political union. In this case, reform efforts should aim to strengthen the basic principles agreed for the euro area and to safeguard the price stability-oriented monetary policy.

When combating sovereign debt crises in the euro area, it is, in principle, prohibited for either the other member states or the Eurosystem to shore up a member states' solvency. It is therefore crucial to ensure sound public finances at the national level and to strengthen financial stability by limiting the negative interplay between governments and systemically important financial institutions on a long-term basis. This ultimately implies that the monetary union must also be able to withstand the extreme scenario of a default of a member state. The European Stability Mechanism (ESM), which was set up in 2012, plays a decisive role in combating fiscal crises. In the event of liquidity problems, the ESM can provide financial assistance by implementing adjustment programmes. However, this presumes that the debt burden of the country in question is sustainable.

On the basis of past experience, this article presents a number of approaches aimed at improving the euro-area crisis resolution mechanism in the medium to long term and also to allow a necessary restructuring to be carried out in an orderly manner. This concerns, for one thing, the standardised conditions for future government bond issues (the bond terms). For instance, the inclusion of an automatic extension of maturities in the event of the implementation of an ESM programme could help to better distinguish between temporary liquidity problems and fundamental sustainability problems, as well as to strengthen the individual responsibility of investors, increase the clout of the ESM and contain the transfer of risk to the public sector and the other member states. Furthermore, in the event of overindebtedness, the necessary agreement between debtors and creditors could be simplified and accelerated by replacing the majority requirement in the collective action clauses with a one-limb procedure. Moreover, should a restructuring become necessary, it would also make sense to implement a more rule-bound procedure and to lay down the assignment of the necessary coordinating tasks in order to ensure an orderly and transparent procedure. This could mitigate the problems associated with a sovereign debt crisis. Ultimately, these additions could help to make a significant contribution towards strengthening the current no-bail-out principle and the member states' individual responsibility and thus, going forward, also towards reducing the likelihood of a government becoming overindebted.

Introduction

Proposals to ensure a more effective resolution of sovereign debt crises

In March 2015, the Bundesbank published an overview of the changes made to the governance framework of the EMU since the onset of the financial and sovereign debt crisis as well as a number of different approaches to make the framework more resilient.[1] This article focuses in greater depth on ways to combat sovereign debt crises in the euro area, including debt restructuring. It begins by addressing central measures and reforms in the euro area and the key elements required to create a consistent governance framework for the EMU. In a further step, it then looks at selected challenges in connection with the resolution of government financing crises and any necessary debt restructuring, before moving on to discuss possible reform approaches.

The financial and sovereign debt crisis has highlighted the need for reform in the governance framework of the EMU

The crisis saw assistance mechanisms created and reforms implemented

During the financial and debt crisis, a number of euro-area member states were cut off from the capital markets and financial stability in the euro area appeared to be in jeopardy. In view of these risks, financial assistance was granted by the other member states, and the ESM was set up to ultimately act as a permanent assistance fund. At the same time, a number of reforms were implemented which, among other things, were intended to mitigate the mutual reinforcement of problems in the financial sector and in public finances (sovereign-bank nexus).[2] In order to prevent or correct future undesirable macroeconomic developments, the macroeconomic imbalance procedure was introduced. It was also envisaged that the Stability and Growth Pact be toughened up and more firmly anchored across national regulations with the aim of ensuring sound public finances. With its first pillar, the Single Supervisory Mechanism (SSM), the banking union is intended to help forestall financial distress in the banking system. With its second pillar, the Single Resolution Mechanism (SRM), the aim is, among other things, to avoid having to use government funds in future to bail out the banking system.[3]

Problems with the current design

These reforms may contribute towards the prevention and resolution of future crises. However, with the exception of the banking union, the increases in mutualised liability have not, in practice, been accompanied by any substantial intensification of joint control and decision mechanisms. Furthermore, the design and implementation of the new regulations, such as in the area of fiscal rules, raise considerable doubts regarding their effectiveness.[4] Nor has adequate progress been made to date in containing the direction of impact of the fiscal distortions from the government to the banking

1 See Deutsche Bundesbank, Approaches to strengthening the regulatory framework of European monetary union, Monthly Report, March 2015, pp 15-37. For information on the causes and implications of the financial and sovereign debt crisis, see Deutsche Bundesbank, Adjustment processes in the member states of economic and monetary union, Monthly Report, January 2014, pp 13 ff. For an overview of the recommended measures and reforms, see p 44.
2 The role of monetary policy in the financial crisis and in preventing and combating crises is not the focus of this article. For more information, see, for example, Deutsche Bundesbank, The macroeconomic impact of quantitative easing in the euro area, Monthly Report, June 2016, pp 29 ff; Deutsche Bundesbank, The importance of macroprudential policy for monetary policy, Monthly Report, March 2015, pp 39 ff; as well as Deutsche Bundesbank, The implications of the financial crisis for monetary policy, Monthly Report, March 2011, pp 53 ff.
3 For more information, see Deutsche Bundesbank, Europe’s new recovery and resolution regime for credit institutions, Monthly Report, June 2014, pp 31 ff; as well as Deutsche Bundesbank, Launch of the banking union: the Single Supervisory Mechanism in Europe, Monthly Report, October 2014, pp 43 ff.
4 See, for example, Deutsche Bundesbank, Fiscal developments in the euro area, Monthly Report, May 2016, pp 61-65; Deutsche Bundesbank, The implementation of fiscal rules in the European monetary union, Monthly Report, December 2014, pp 8-10; or also European Court of Auditors, Further improvements needed to ensure effective implementation of the excessive deficit procedure, Special Report No 10/2016.

system.[5] On the whole, quite a number of loopholes have yet to be closed, and the imbalance between liability and control potentially creates substantial misguided incentives for policymakers and financial market participants alike.[6]

Need for a consistent governance framework for the EMU

Deeper economic and fiscal policy integration could prove to be a consistent reform option for the euro area. Even if the corresponding proposals are often primarily aimed at expanding joint liability even further,[7] a greater depth of integration would, however, require that relevant decision-making powers also be transferred to democratically legitimate European institutions, and ensuring a stability oriented policy as a whole.[8] However, national policymakers are not pursuing a change to the EU treaties at present and there are no apparent majorities in favour of surrendering sovereign powers. As long as this remains the case, the priority must be to strengthen the agreed governance framework for the euro area.[9] In this regard, the euro area is based on an independent monetary policy with a clear mandate to safeguard price stability, and it places an emphasis on the individual responsibility of the member states and the financial market participants. The formation of a fiscal bail-out community and the financing of governments through monetary policy are, however, prohibited.

No-bail-out principle credible only if further reforms are implemented

This means that government financing difficulties, and also the possibility of a euro-area member state defaulting, cannot be ruled out. The crisis has, however, shown that this framework is stretched to its limits when the economic and political costs resulting from sovereign solvency problems are considered to be much higher than the costs involved in granting public financial assistance. This can be expected, in particular, where financial stability as a whole appears to be threatened, and the costs of a default occur in the short term, while those arising from granting financial assistance are more of a medium to long-term nature. Against this backdrop, the ESM saw the creation of a support mechanism to provide assistance in the event of government liquidity problems. As a general rule, however, the ESM is not allowed to grant funds to overindebted governments, and the possibility of a default is not ruled out. Therefore, further reforms should aim to anchor a stability-oriented fiscal policy in the member states, to prevent systemic contagion effects as far as possible and to strengthen financial stability as a whole. Ultimately, macroeconomic imbalances, excessive government debt or even a (partial) default must also be manageable. Otherwise, the euro area is likely to remain vulnerable to crises. An overview of the reforms and measures proposed and discussed in further detail in the Bundesbank's March 2015 *Monthly Report* can be found in the table on page 44.

Challenges for the crisis resolution mechanism in the event of sovereign debt crises

Effective crisis management fraught with challenges

The ESM plays a central role in combating sovereign debt crises in the euro area. It is permitted to grant financial assistance to member

5 In order to limit banks' risk arising from sovereign exposures, it is currently being debated whether the preferential regulatory treatment of sovereign debt securities should be reduced. It would also be important to back these claims with capital in a risk-appropriate manner and to implement large exposure limits in order to sever the sovereign-bank nexus. It would be essential to ensure that any losses which could occur elsewhere outside of banks' balance sheets remain manageable for the financial market as a whole. For more information, see Deutsche Bundesbank, Reducing the privileged regulatory treatment of sovereign exposures, Annual Report 2014, pp 23 ff.
6 See, for example, German Council of Economic Experts, Consequences of the Greek crisis for a more stable euro area, Special Report, July 2015.
7 See J C Junker, D Tusk, J Dijsselbloem, M Draghi and M Schulz, Completing Europe's economic and monetary union, The Five Presidents' Report, Brussels, June 2015.
8 Effective control of joint liability instruments is not possible without surrendering relevant decision-making powers. See Expert Group on Debt Redemption Fund and Eurobills, Final Report, March 2014.
9 See, for example, German Council of Economic Experts, European economic policy: stable architecture for Europe – need for action in Germany, Annual Report 2012/13, pp 102 ff; as well as German Council of Economic Experts, Against a backward-looking economic policy, Annual Report 2013/14, pp 156 ff.

Summary of selected recommendations and measures*

Financial stability

Strengthen banks' loss absorbency: capital requirements and/or leverage ratio

Consistently deploy and refine macroprudential toolkit

Improve integration of equity and debt markets
- Uniform legal framework
- Diversified lending

Segregate monetary policy and banking supervision

Single Resolution Mechanism (SRM)
- Adequate bail-in-able capital
- Apply bail-in rules strictly, and stringently wind down non-viable banks
- Common fiscal backstop with national loss retention

Properly regulate financial system outside the banking sector (eg shadow banks), too

Fiscal policy

Set up independent budgetary surveillance institution

Fiscal regime
- Simpler and clearer rules, strictly applied
- Uniform and transparent surveillance
- Reduce discretionary leeway
- Step up automatic corrective measures
- Strengthen role of debt ratio

ESM
- Conditional liquidity assistance
- Interest rate mark-ups for assistance
- **Stronger role in insolvency process[1]**
- Non-standard fiscal measures to avert or mitigate haircuts

Financial stability and fiscal policy

Deprivilege sovereign bonds
- Capital backing
- Large exposure limits
- Adapt liquidity rules

Revise sovereign bond contracts[1]
- **Collective action clauses with single-limb aggregation**
- **Automatic maturity extension if ESM assistance granted**

Create framework for more orderly sovereign insolvency[1]

Economic policy

Review imbalance procedure and adapt if necessary once sufficient experience has been gathered; implement strictly

Streamline and enhance transparency of European coordination mechanisms

Take account of cross-border effects, but no fine-tuning of economic policy by central authority

Monetary policy

Keep focus on core objective of price stability

Define mandate narrowly so as to legitimise independence

Do not undermine unity of liability and control in other areas or distort market processes

Assume no responsibility for financial stability risks caused by sovereigns' and banks' solvency problems

Avoid engineering joint liability for sovereign solvency risks via central banks' balance sheets

Institutional segregation of monetary policy and banking supervision

* See Deutsche Bundesbank, Summary of selected recommendations and measures, Monthly Report, March 2015, p 23. **1** These aspects are discussed in greater detail in this article.
Deutsche Bundesbank

states that have been cut off from the financial market, but not to overindebted governments, on the condition that the member state in question adopts an economic and fiscal adjustment programme.[10] If, despite a reasonable level of own efforts, major doubts still exist regarding debt sustainability, these are to be cleared up in advance by adopting suitable measures such as by involving private creditors (debt restructuring). In the interest of an effective crisis resolution, the objective is first and foremost to minimise the macroeconomic damage, to support stable macroeconomic developments and to safeguard the long-term sustainability of public finances.

Distinguishing between temporary financing difficulties and fundamental sustainability problems

Reliable assessment of acute government financing difficulties

When a government experiences acute financing difficulties in the capital market, it is often challenging to determine whether this is due to just a temporary liquidity shortage, which can be overcome by providing liquidity loans through an assistance programme, or due to a

10 See Deutsche Bundesbank, European Council decisions on the prevention and resolution of future sovereign debt crises, Monthly Report, April 2011, pp 53-58.

fundamental problem of the government's ability or willingness to pay. The assessment of the macroeconomic and fiscal perspectives and, in particular, the assertiveness of governments in implementing unpopular consolidation measures play a decisive role in this context. It is often the case that only during the course of an adjustment programme is it possible to see whether the causes of the acute financing difficulties can be rectified by implementing the agreed reforms (liquidity problem) or whether debt restructuring is required (fundamental sustainability problem). A crisis resolution mechanism should prevent debt restructuring from being carried out in the event of a liquidity problem and creditors from receiving a full payout in the case of a sustainability problem.

Make governments and investors accountable for their actions

Preserve responsibility of governments and investors

An effective crisis management strategy should preserve the responsibility of the member state concerned and the investors. Thus, within an adjustment programme, the citizens of the member states should remain primarily responsible for the solution to national financial problems. The member states are ultimately solely responsible for deciding on and implementing the domestic distribution of the adjustment burden (ownership). If it becomes apparent over time that the government's ability to pay cannot be restored by this alone, the creditors should be held accountable for their investment decisions and not released from their liability by granting public financial assistance.

Avoid delays in implementing necessary adjustment measures

Avoid tendency to delay crisis resolution

Where government financing problems occur, both the debtor country and its creditors could have an interest in delaying the implementation of crisis resolution measures (gambling for resurrection). Often, a government may want to avoid the political costs involved in implementing an adjustment programme or in debt restructuring. In addition, the predominately negative impact of a necessary consolidation on economic activity in the short term is likely to cause the parties concerned to hope that the economic situation improves by itself without resorting to any measures, and to put off a necessary restructuring until it becomes unavoidable. Creditors, by their very nature, have an interest in receiving a full payout of their claims. They will hope that a necessary debt restructuring will be delayed or will not materialise or that the adjustment burden will be carried by other private or public creditors. A delayed crisis resolution is, however, associated with prolonged spells of uncertainty and, as a rule, has a negative impact on further economic developments and increases the economic costs. In this respect, it is important that the necessary adjustment processes are initiated in a timely manner.[11] At the same time, a mechanism of this kind must not present governments with an easy way to be rid of their debt burden. The incentives for ensuring a sustainable fiscal and economic policy must be preserved.

Preserve the clout of the ESM in tackling crises

The higher the level of ESM funding required in a specific case, the lower its effectiveness

The ESM has limited resources at its disposal, which means that it is essential to keep the use of the ESM's funds to a minimum in each specific case. This, however, also applies with regard to the incentives for investors to make an appropriate risk assessment and to limiting the burden on the taxpayer in those countries providing assistance. In the case of the assistance programmes in place to date, however, large

11 The reduction in uncertainty is also of key importance when dealing with debt problems in the private sector. For more information, see Deutsche Bundesbank, Adjustment processes in the member states of economic and monetary union, op cit.

parts of public funds have been used to finance maturing bonds, resulting in the funds being rapidly depleted, and private investors have, at least in part, been released from their liability.

Should restructuring prove inevitable, make the procedure efficient

Effective crisis management by means of structured procedure in the event of overindebtedness, …

Acute government financing difficulties and the threat of overindebtedness harbour the risk of disorderly developments, not only limiting fiscal policy leeway but also placing a strain on the financial system and even, in extreme cases, on the functional viability of the national economy as a whole. Due to the close (financial and) economic interdependencies that exist in the euro area, contagion effects on other member states are foreseeable. The ESM is designed to prevent critical escalation and avoid the economic cost of the disorderly developments that would otherwise tend to follow. However, there is no procedure laid down in current regulations on how to carry out the inevitable process of debt restructuring in the event of a government running up excessive debt. That being said, an effective crisis management resolution should, in the interest of all parties concerned, bring with it planning certainty and help debt restructuring negotiations run smoothly. In this way, it is possible to limit the burden arising from consolidation measures, a haircut and macroeconomic side-effects. It is therefore necessary to reconcile the interests of all parties concerned, and to foster an environment in which all claims receive equal treatment, especially by minimising the associated coordination issues.[12]

… which, inter alia, limits holdout problem

From the creditors' viewpoint, it is only expedient to agree to a haircut if there would otherwise be a danger of even higher losses, and if the value of their remaining claims would subsequently seem safer. The latter presupposes confidence in the crisis resolution mechanism, the debtor country's willingness to reform and pay, and improved macroeconomic and financial prospects following restructuring. If there is any doubt in this regard, creditors are more likely to try to avoid losses and press for the regular payment of their claims.[13] Potential conflicts between creditor groups exacerbate the problem, especially when individual investors refuse to cooperate and are able to enforce their claims at the expense of the other creditors (holdout). The lower the haircut, the more likely creditors are to agree to debt restructuring. This entails the risk of restructuring proving insufficient, thus possibly rendering it necessary to restructure the debt again or placing a strain on the crisis resolution mechanism in future.

Reform options for a crisis resolution mechanism to tackle sovereign debt crises in the euro area

Improve future crisis management

This section outlines ways in which the existing crisis resolution mechanism could be improved. These include changes to the current standard terms of sovereign bonds issued by euro-area

12 The lessons learned from the restructuring of Greek debt in 2012 illustrate the problems with the current procedure. A liquidity problem was assumed when the first economic adjustment programme was negotiated. Over the course of this programme, private creditors were released of liability when their debt instruments matured and risks were transferred to the public creditors. The excessive level of Greek debt became apparent during the second economic adjustment programme. The participation of the remaining private creditors in the debt restructuring was achieved by retroactively amending the bond contracts under Greek law and using additional funds provided by the fiscal assistance mechanisms. At the same time, creditors who primarily held Greek government bonds that had been issued under another legislation received full repayment. See Committee on International Economic Policy and Reform, Revisiting sovereign bankruptcy, Report, Brookings Institution, October 2013; and J Zettelmeyer, C Trebesch and M Gulati (2013), The Greek debt restructuring: an autopsy, Economic Policy 28(75), pp 513-563. The vast majority of debt restructuring carried out in recent decades took place in developing countries and emerging market economies. See D Udaibir, M Papaioannou and C Trebesch, Sovereign debt restructurings 1950-2010: literature survey, data and stylized facts, IMF Working Paper 12/203. The challenges surrounding crisis resolution and crisis management in the euro area differ from those.

13 Other countries or multilateral institutions could also, as creditors, have an incentive to hold out for an improved scenario that does not involve restructuring as, in addition to suffering financial losses, they could also be faced with significant political costs.

countries as well as core elements of a structured procedure in the event of debt restructuring.

Change standardised terms of euro-area sovereign bonds

Automatic maturity extension in the case of ESM programmes

Automatic maturity extension in the case of ESM programmes offers advantages

Euro-area member states finance themselves predominantly through bonds, for which they have agreed on standardised terms. In the case of newly issued bonds, these terms could be supplemented by a passage stipulating that their maturity will be automatically extended by three years, for instance, under identical terms as soon as a member state receives ESM assistance.[14] It is of particular importance in this context that the extension constitutes neither a restructuring nor a credit event, as this would form part of the bond's terms and be known when buying the bond.

Problems in reliably assessing the causes of acute financing difficulties …

It is necessary to perform a debt sustainability analysis before any assistance is provided under the ESM. In the event of overindebtedness, the first step would be to restructure the debt. If a liquidity shortfall were mistaken for overindebtedness, this could potentially lead to an ultimately unnecessary process of restructuring with all its unwanted side-effects. But what is likely to be of greater relevance in practice would be to initially fail to recognise a need for debt restructuring and instead first identify it as merely a liquidity problem.[15] Under the current set-up, financial aid is used to repay holders of maturing securities. Taxpayers in countries providing assistance assume considerable risks under the programme as, in addition to the deficits (including interest payments on sovereign debt), redemptions – which are generally far more substantial – are also financed.

… would be eased substantially

Automatically extending maturities would significantly mitigate the diagnostic problem. If no need for debt restructuring is identified, a country could receive financial aid under an ESM programme to cover its financing requirements,[16] adjustment measures would be decided on and implemented in a controlled manner, and bondholders would not be released of their liability. A decision pertaining to the possible need for restructuring could be made in further course when, once progress has been made in implementing the programme, a clearer picture emerges of the member state's macroeconomic and fiscal outlook. Should it nevertheless become necessary to restructure debt in further course, extending the maturities of government bonds could allow this to take place under less time pressure, based on a more certain outlook and therefore in a more targeted and orderly manner.

Reduced risk assumption of public creditors increases ESM clout

Compared with the *status quo*, the level of ESM funds deployed for each assistance programme would be considerably lowered. Consequently, its clout and credibility as a stabilisation mechanism would be enhanced, while the risks for taxpayers in the other member states would be significantly reduced.

Automatic maturity extensions in the event of government financing problems could provide a possible incentive for governments to use this

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14 See Deutsche Bundesbank, Proposal for an effective private sector involvement for bond issues from mid-2013 onwards, Monthly Report, August 2011, pp 68-71; and Bank of England, Sovereign default and state-contingent debt, Financial Stability Paper 27, November 2013. To date, the programmes have run for three years, during which period uncertainty about further developments is likely to diminish substantially.

15 This diagnostic problem presents a particular difficulty with regard to the current design of the ESM assistance programmes.

16 A temporary maturity extension could even be triggered upon submitting an application if it were initially limited to the decision-making period envisaged under the procedure for an assistance programme (probably around one to two months). This would reduce the risk of unwanted default and ensure that liability remains with the investors during the negotiation period. The maturity would not be automatically extended by three years until the ESM programme was adopted. Any temporary assistance to cover acute financing needs above and beyond that would have to be made subject to special collateralisation requirements and, like regular financial aid, would be excluded from any debt restructuring.

Strengthened incentives for sustainable fiscal policy by linking it to adjustment programme …

time gained to postpone necessary – and politically uncomfortable – reforms. However, this could be counteracted by linking automatic maturity extensions to a commitment to adhere to a targeted reform programme. On the one hand, this results in the maturity of bonds purchased by creditors being extended; on the other hand, the probability of repayment should be higher compared with a procedure that does not involve a programme, as the financial aid provided and adjustment measures implemented under a programme would probably improve the outlook for sustainability significantly. In addition, restructuring would, on the whole, be less likely than in a scenario without a programme. It would therefore also remain in the creditors' interest for the implementation of the adjustment programme to succeed.

… and investors' heightened sensitivity to risk

Upon introduction of the maturity extension, government financing costs could most likely increase for those member states in which investors see the possibility of an ESM programme being implemented within the regular time span of their bonds. These investors would then assume that the maturity of their bonds would, with a certain probability, be extended. All other things being equal, however, it would be quite unlikely for a maturity extension to lead to an increase in financing costs such that they would, in total, exceed the costs associated with a bond running three years more, in which case the implementation of an ESM programme would already be firmly expected. Provided the yield curve were rather flat for medium to longer-term debt, interest effects would probably remain within limits overall.[17] Should this exacerbate the financing problems of a country in a doubtful financial situation, causing an application for ESM financial assistance to be submitted at an earlier date, this would also counteract the tendency to postpone necessary adjustment measures and, to this extent, should not be regarded as harmful.

Reform of standardised collective action clauses

Collective action clauses introduced in 2013 for euro-area government bonds improving coordination between creditors

Since 2013, all bonds issued by euro-area member states with maturities exceeding one year have been subject to a standardised euro collective action clause (Euro-CAC).[18] This allows a qualified majority of holders of an individual bond series to agree on a modification to the bond's terms that is binding for all holders of the series.[19] If a qualified majority in presence of a quorum of all outstanding bond series subject to the CAC votes in favour of modifying the bond terms, the majority needed to modify the term at the single series level is lowered (two-limb majority requirement). This reduces the incentive to hold out. However, such a two-limb decision cannot prevent a blocking minority from being achieved by purchasing a sufficiently high share of an individual bond series. It therefore cannot be ruled out that investors could act contrary to the vote taken by the creditor community by moving to block the restructuring of their bond and press for their claims to be met in full.[20]

17 The scenario of a programme-driven three-year postponement of maturities and redemption dates would need to be assigned a present value loss of the debt securities, the amount of which would depend on the yield curve. The higher this present value loss and the more investors consider it likely that an ESM programme will be triggered, the higher the spread they are likely to demand.

18 CACs are currently not mandatory for bonds with a maturity of less than one year, for regional and local government bonds or in loan agreements. See EFC Sub-Committee on EU Sovereign Debt Markets, Collective action clause explanatory note, July 2011; and Model collective action clause supplemental explanatory note, March 2012. The effectiveness of reform proposals would suffer if these forms of financing were not incorporated and utilised to a greater extent.

19 The majority requirement differs depending on the intended adjustment (reserved matter or non-reserved matter of the bond term) and the voting procedure (bondholder meeting or written resolution), and on whether a modification is to apply to an individual bond series (single series) or to multiple bond series at the same time (cross series). If a qualified majority agrees to debt restructuring, this will also affect bonds held by other countries, the Eurosystem or multilateral institutions.

20 See, for example, International Monetary Fund, Strengthening the contractual framework to address collective action problems in sovereign debt restructuring, IMF Policy Paper, September 2014.

Single-limb majority requirement neutralises incentives to hold out and purchase blocking minorities

The introduction of more comprehensive aggregation clauses would simplify and speed up the debt restructuring process. This would enable a qualified majority of creditors to be determined across all government bonds subject to the same CAC to trigger a debt restructuring (single-limb majority requirement).[21] Approval from the holders of each individual bond would then no longer be required. What is more, creditors would no longer need to worry about restructuring burdens being shifted to the rest of the creditor community as a result of individual investors successfully holding out. This should substantially reduce the holdout options and the incentive to purchase blocking minorities. In principle, the majority requirement for the first step of cross-series restructuring currently set out in Euro-CACs could be maintained for single-limb CACs.[22] Moreover, consideration could be given to lowering the majority requirement further in specific cases where restructuring is to take place as part of an ESM programme.[23] This could reinforce the crisis resolution mechanism. Nevertheless, it must be ensured that the bondholders' position is not unduly weakened. It would also be necessary in this context to prevent a fragmentation of bonds issued by member states into issues with different CACs.

Orderly procedure for any debt restructuring under an ESM programme

Rule-bound procedure could boost effectiveness of crisis management

The prerequisite for the provision of financial aid under the ESM's assistance and crisis resolution mechanism is the programme country's capacity to repay. Should a country be unable to repay, debt restructuring would require the involvement of private investors either prior to launching the programme or, if this does not become apparent until a later point in time, in further course. Under these circumstances, it makes sense to establish a reliable and transparent procedure beforehand.[24] This should create greater planning certainty and help keep friction losses, macroeconomic costs and ultimately also the haircut to a minimum.[25] Moreover, a rule-bound procedure is better suited to incorporating claims arising from bonds and loans into restructuring negotiations.

ESM could monitor procedure and take on coordination tasks

The ESM – which already plays a key crisis management role if euro-area member states face financing difficulties – would be a suitable choice for taking on a coordinating role should there be a need for a debt restructuring. In terms of an orderly procedure, the first step would be to define the rights and obligations in the relationship between the member states, the creditors and the ESM as restructuring coordinator, and to draw up a concrete timetable detailing when the individual steps in the procedure should be taken (for more information,

21 The introduction of single-limb aggregation clauses necessitates an adjustment to the uniform CACs of euro-area countries (Article 12(3) of the ESM Treaty) and of corresponding national regulations such as, for example, sections 4a et seq of the Federal Government Debt Management Act (Bundesschuldenwesengesetz).
22 Under Euro-CACs, the first limb with regard to a bondholder meeting calls for a qualified majority of 75% by principal amount of outstanding bonds represented at a quorate meeting of 66⅔% of the outstanding principal amount of the affected bond series; in the case of a written resolution, modifications require the approval of 66⅔%. If these majorities are achieved, the majority requirements are reduced in the second limb for the respective bond issues.
23 Majority requirements also play a significant role in the Eurosystem's purchase of government bonds on the secondary market, for example as part of a broad-based purchase programme (public sector purchase programme: PSPP).
24 With a view to assessing a country's financial situation and debt sustainability as objectively as possible, the procedure could still benefit from the currently envisaged – if possible – involvement of the IMF, with its expertise in accompanying reform and adjustment programmes and, where required, debt restructuring processes.
25 For further proposals on an orderly procedure, see F Gianviti et al (2010), A European mechanism for sovereign debt crisis resolution: a proposal, Bruegel Blueprint Series, Vol 10; Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie (Scientific Advisory Board at the Federal Ministry of Economics and Technology), Überschuldung und Staatsinsolvenz in der Europäischen Union, Gutachten Nr. 01/11; G Corsetti et al, A new start for the eurozone: dealing with debt, Monitoring the Eurozone 1, CEPR Press, March 2015; and G Corsetti et al, Reinforcing the Eurozone and protecting an open society, Monitoring the Eurozone 2, CEPR Press, May 2016. See also C Fuest, F Heinemann and C Schröder (2016), A viable insolvency procedure for sovereigns in the euro area, Journal of Common Market Studies 54(2), pp 301-317; and J Andritzky et al, A mechanism to regulate sovereign debt restructuring in the Euro Area, German Council of Economic Experts, Working Paper 04/2016, July 2016.

Further proposals for reforming bond contractual terms

With the automatic maturity extension in the case of ESM programmes and adjustments to the majority requirements in collective action clauses, this *Monthly Report* article introduces important approaches to fundamentally change the terms of sovereign bonds issued by euro-area countries. If embedded in reforms of the governance framework of the EMU, these approaches could play a part in dealing with crises more effectively. Moreover, other changes to the contractual terms of future bond issues are currently being debated as well; two of these elements will be briefly outlined and discussed below. However, further analysis would be needed in order to better evaluate the desired advantages of each against the potential drawbacks.

Splitting bonds into tranches with lower and higher loss risk

In order to both mitigate the negative consequences of government financing difficulties for the financial markets and strengthen the credibility of the no-bail-out clause of the governance framework, it is crucial to break the strong sovereign-bank nexus that persists in the euro area. In particular, the purpose of the banking union is to help avert financial distress in the banking system and to prevent use of government funds for bail-out purposes. However, fundamental changes would also have to be made to banking and financial market regulation such that sovereign bonds are no longer considered as risk-free.[1]

With the aim of preventing undesired distortions as a result of government sustainability problems, reforms have been proposed which would increase the volume of safe assets for the financial markets and strengthen incentives to diversify, but without implying any further joint liability. Various concepts are currently under discussion.[2] One specific proposal[3] envisages bundling sovereign bonds of all euro-area countries into one bond according to a predefined key. With this instrument, each country would continue to be liable only for the bonds that it issues. The new securitised bonds would be divided into a junior (first-loss) tranche and a senior (second-loss) tranche, the latter constituting European safe bonds, or ESBies for short. Under the proposal, senior tranches would be excluded from the tightening of banking and financial market regulation with regard to holding sovereign bonds, even though more stringent regulation is generally considered necessary. The combination of diversification and tranching means that ESBies could indeed increase the volume of safe assets for the financial markets, although the individual member countries would continue to issue their bonds autonomously.[4] However, the proposed regulatory exemption for ESBies would, besides other practical problems, constitute a privileging of ESBies, for example, over highly

1 See Deutsche Bundesbank, Reducing the privileged regulatory treatment of sovereign exposures, Annual Report 2014, pp 23-40.
2 See, for example, M Brunnermeier et al, European safe bonds (ESBies), mimeo, September 2011; and G Corsetti et al, A new start for the Eurozone: dealing with debt, monitoring the Eurozone 1, CEPR Press, March 2015.
3 See M Brunnermeier et al, ESBies: safety in tranches, mimeo, May 2016.
4 Under the concrete proposal, the volume of potentially available ESBies is likely to depend on the actual division into junior and senior tranches as well as, primarily, on the pre-defined key by which sovereign bonds would have to be bundled. With a design such as this, the comparatively low level of government debt in individual euro-area member states would probably limit the ESBies issued.

rated national sovereign bonds.[5] In addition, the proposed mandatory composition of the bonds, which would then continue to benefit from preferential regulatory treatment, would be determined according to a specific key covering all euro-area countries. This would be tantamount to distorting risk premiums in favour of countries whose debt securities would otherwise be in less demand. At the end of the day, the pros and cons of tranched securities would depend on the specific design. A market-based solution[6] which does not provide for additional joint liability or preferential regulatory treatment would be compatible with the existing governance framework of the EMU, however.

As an alternative, tranching of the respective national bonds is currently also under discussion. This proposal, too, would require tighter banking and financial market regulation with a view to enabling systemically important financial institutions to cope with unsound developments in public finances or to be resolved in an orderly fashion in that risks stemming, in particular, from sovereign bonds are subjected to adequate regulatory requirements. In this context, dividing the individual national bonds into a junior and a senior tranche (national safe bonds, or NaSBies for short) could help to increase the volume of safe assets, thereby making it easier to implement the regulatory reform.[7] Here, each member state would have to continue issuing its bonds on its own responsibility. However, every bond would comprise two tranches, each with a pre-defined distribution of loss in the event of a debt restructuring (ie the two tranches would only be issued in tandem). Thus, this proposal is not about the separate sale or purchase of individual tranches of a bond issue, but about distributing government loss risks within a financial system with risk-appropriate regulation of government debt securities.

Nothing would change as a result for creditors of bonds already outstanding. All issued bonds, ie previously issued (untranched) bonds and the new (tranched) bonds, would have to be treated equally in debt restructuring negotiations. But for the new bond format, any loss on the bond – which would be identical to the loss on a non-tranched bond – would first have to be borne solely by the junior tranche. The second-loss (senior) tranche would only be affected once the junior tranche was completely used up.[8] If the prescribed division envisaged a 60% senior and a 40% junior tranche, say, the senior tranche would not

5 The concept currently on the table suggests possibly passing on the practical implementation, ie producing the ESBies, to private issuers. Beforehand, however, it would have to be clarified how to reliably ensure that earnings and, in particular, potential losses stemming from the financial intermediary's regular business activities do not affect the cash flows from the junior tranches and the ESBies, and vice versa. This could make it necessary to coordinate the issues of the underlying sovereign bonds to be able to prevent potential liquidity risks stemming from different cash flows at the intermediary. In addition, the specific procedure in the event of the resolution of an intermediary would have to take such potential interaction into account, and appropriate regulations would have to be laid down beforehand. An implicit or explicit government guarantee would create misguided incentives and increase the mutualisation of liability.
6 Tighter regulation with regard to holding sovereign bonds could give market participants an incentive to diversify as well as to create safer assets through securitisation and tranching. The weighting of the individual government bonds of such securitisations would then be the result of a market process.
7 See Deutsche Bundesbank, Approaches to strengthening the regulatory framework of European monetary union, Monthly Report, March 2015, pp 15-37; and K Wendorff and A Mahle, Staatsanleihen neu ausgestalten – für eine stabilitätsorientierte Währungsunion, Wirtschaftsdienst, September 2015, pp 604-608.
8 The new bond would initially have to be bought containing both tranches together. Investors could subsequently hold both tranches, sell individual tranches or sell both tranches together. If the bond were held with both tranches, this would be equivalent to purchasing a bond in the present form; in the event of a debt restructuring, a bond of this format would then be affected by a haircut to the same extent in financial terms as the "old" (present) bond format.

be affected by a haircut unless the haircut exceeded 40% of the total volume of all the outstanding sovereign bonds.[9]

One would expect both the junior and the senior tranche of a bond issued by a highly-rated country to be deemed safe. But generally speaking, countries with a poorer rating, too, could see their senior tranches rated as safer bonds and receive a better ranking for them than for their present, untranched bonds. Accordingly, a larger volume of highly rated government bonds could be made available by more countries[10] – bonds which banks would need to back with less capital if the necessary banking and financial market regulation were executed. The government default risk would generally be concentrated in the junior tranches. One effect of regulation could then be that the risky junior tranches are distributed to those areas of the financial system which are better able to absorb any losses or are less interconnected with other financial market participants. The pressure on monetary policymakers to also accept sovereign bonds of poor credit quality as collateral for refinancing operations or as part of an asset purchase programme could subside as a result.

The specific pros and cons would have to be examined in greater detail, as they would with regard to the ESBies proposal, too. The effects on sovereign borrowing costs would also need to be looked at more closely. Generally speaking, the tranching of national government bonds should not, in itself, have any major impact on the probability of default or on risk premiums. As the bonds would first be issued as a single entity (as is the case with bonds at present), a change in the individual countries' financing conditions would be unlikely – all other things being equal – solely as a result of the proposed tranching. But the yield spread between the junior and the senior tranche would probably be greater, the higher the assessment of a sovereign's default risk. A country's risk premium could rise as a whole, however, if the tranching were accompanied by further adjustments to the bond terms and the governance framework of the EMU, and if investors consequently considered the overall possibility of a bailout by other member countries or by means of monetary policy to be less likely. A higher risk premium would ultimately not pose a problem, though, if the sovereign solvency risk were adequately priced in by the market.[11]

GDP-linked bonds

To be able to better avert sovereign debt crises in future and to deal with them more effectively if they do occur, discussions are currently under way on issuing sovereign bonds with a coupon and/or a redemption amount that would be linked to growth of gross domestic product (GDP).[12] If the econ-

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9 Accompanying reforms of, among other things, collective action clauses would be needed to ensure that a debt restructuring remains possible and, at the same time, that a haircut does not constitute an easy way for governments to be rid of their debt burden. From a legal perspective, it would need to be defined how, if debt restructuring negotiations became necessary, claims of a junior tranche would be represented when a junior tranche was no longer held along with the senior tranche.
10 See also M Brunnermeier et al (2016), The sovereign-bank diabolic loop and ESBies, American Economic Review: Papers & Proceedings, 106(5), pp 508-512.
11 The proposed tranching would lead to a lower volume of individual tranches than in the case of an untranched bond, which is why the new bond structure could result in a certain increase in liquidity premiums. Yet given the similarity of the bond yields of member countries with very different issue volumes in the run-up to the crisis, such an increase could prove to be rather insignificant.
12 For further details see, for example, O Blanchard, P Mauro and J Acalin, The case for growth-indexed bonds in advanced economies today, Policy Brief 16-2, Peterson Institute for International Economics, February 2016; and D Barr, O Bush and A Pienkowski, GDP-linked bonds and sovereign default, Bank of England, Working Paper No 484, January 2014.

omy as a whole were to perform better than had been forecast when the bond was issued, this would benefit the holders of GDP-linked bonds. On the other hand, if there were an unexpected, less favourable development, lower payment obligations would take pressure off the country's finances. In this way, the risks and opportunities presented by uncertain economic developments would, to an extent, be shifted away from public finances to the private sector. For advocates of GDP-linked bonds, this holds the promise of strengthening the resilience of public finances against negative shocks. This could serve to reduce the risk of a sovereign debt crisis involving high macroeconomic costs, and leave greater fiscal policy leeway to deal with a negative shock. In particular, this would be the case if the sovereign bonds were widely distributed internationally, meaning that the burdens caused by a negative shock would be spread globally, too.

Moreover, GDP-linked bonds could be used in the event of a debt restructuring.[13] Given that growth prospects are particularly uncertain in such a situation, these bonds could help to facilitate an agreement between the debtor country and its creditors and in limiting the danger of having to repeat a restructuring procedure. Ultimately, the deleveraging would be greater if developments proved to be less favourable than anticipated in the baseline scenario underlying a sovereign debt restructuring. Conversely, it would be lower if developments were more favourable.

In this context, the impacts of GDP-indexed bonds would largely hinge on the specific bond design, and no standardised instrument has been developed thus far.[14] Before they could be widely introduced as a regular financing instrument, the drawbacks they would entail would likewise have to be examined more closely and weighed up against the advantages. For instance, GDP-linked bonds could help reduce the danger of a sovereign losing access to capital markets, and blunt any need for short-term procyclical consolidation measures. On the other hand, risks would be shifted to the private sector that could also affect financial stability and macroeconomic developments. One point that is likely to be crucial is whether GDP-linked bonds are primarily held domestically or abroad, and how negative global shocks in the financial system would be dealt with. If GDP-linked bonds were mainly held by domestic players, less of a smoothing effect on the economy as well as on the robustness of public finances would be expected overall. However, a fundamentally stable financial system would be a prerequisite for introducing GDP-linked bonds to ensure that the unexpected fluctuations in the instrument's value and payments can be absorbed by the creditors in such a way that they do not exacerbate or even trigger a systemic financial crisis. Otherwise, there is a danger that the risks ultimately have to be shouldered by the state (or community of states) again after all. Another danger could be that the desired relief would only come after a time lag pending more reliable data on economic developments. Nor can the basic uncertainties involved in objectively calculating GDP be dismissed out of hand; moreover, it would have to be ensured that the data are transparent and largely protected against manipulation. On the whole, the ef-

13 For example, GDP-indexed bonds were issued when Greece's debt was restructured in 2012. See, for example, J Zettelmeyer, C Trebesch and M Gulati, The Greek debt restructuring: an autopsy, Economic Policy 28(75), pp 513-563.
14 At the initiative of the Bank of England, work is currently under way, with the collaboration of market participants, to design a standardised instrument known as the London term sheet. See Allen & Overy LLP, Indicative term sheet – GDP bonds, 30 November 2015.

fect of GDP-indexed bonds would probably also depend on the maturity structure: the shorter the maturity of the outstanding bonds, the less relief likely to be experienced by the government budget in the event of adverse developments, as its impact would only last until the maturity of the respective bond. Investors' yield demands with regard to new issues would likely be adjusted to the revised growth forecasts.

Essentially, sovereign borrowing costs would probably rise if such bonds were introduced, because risks would be passed through to the private sector. Investors would demand compensation if the risks under a GDP-linked bond were not negatively correlated with the risk profile of their remaining portfolio. If the resilience of public finances to negative shocks were strengthened, however, at least the default-related part of the risk premiums could decrease as a result.

see, for example, the chart on p 60). To enhance credibility, the individual steps could be incorporated into the ESM Treaty. The aim of entrusting the tasks to the ESM would be to ensure that the otherwise loose elements of a debt restructuring are effectively coordinated.

National sovereignty and need to fulfil sovereign tasks must be taken into account

The restructuring of sovereign debt differs in a number of ways from a private corporate insolvency. For instance, the primary objective cannot be to liquidate the available assets.[26] Rather, the goal is to restore a sustainable financial situation as quickly and on as durable a basis as possible – including a sound macroeconomic perspective – not least in order to be able to service the remaining debts. This should be ensured, in particular, through the adjustment programme that is to be agreed in such a situation and which should include both the ESM assistance and a debt restructuring. In this context, the member state's national responsibility must be observed and it cannot be forced to implement debt restructuring. This would be in conflict with the principles of constitutional sovereignty and democratic self-determination. A restructuring coordinator is therefore not able to make an autonomous decision about a debt restructuring, but merely supports an orderly process and the search for compromise. The debtor country must ultimately play its part in the agreed procedure. Finally, a debt restructuring requires the agreement of the creditors – in line with the pre-defined majorities. However, this is only likely to come about if the member state credibly indicates that it will rigorously implement the necessary reform measures. It thus remains the case that any measures would hinge on cooperation between the

26 Moreover, the value of sovereign assets is uncertain, not least in a crisis situation, and assets can only be liquidated to a limited extent.

member states and the creditors.[27] In this context, the ESM's goal should be to reconcile the interests of all the parties and support a rapid restoration of the sovereign's ability to pay without pushing for a premature or excessive haircut.[28]

ESM could produce sustainability analysis and record claims

In this context, thought could be given to fundamentally strengthening the role of the ESM. When a member state requests financial assistance from the ESM, the assessment of further economic developments, debt sustainability and financial requirements are currently drawn up by the European Commission in liaison with the ECB, and this is also envisaged for the monitoring of economic policy conditions. These tasks could in future be transferred to the ESM, or the latter could take the leading role in the process. To this end, the comprehensive information on the country's current situation would have to be submitted to the ESM along with the request for financial assistance and subsequently checked. At the same time, when drawing up an assistance programme, the sovereign exposures would also need to be recorded by a central body. This task could likewise be assigned to the ESM. However, this new strand of work, which would need to be specified in advance, would only become relevant if a member state is found to be overindebted. To this end, creditors of bonds and credit obligations could be asked to register their claims as a precautionary measure when the request is submitted.[29] The ESM could subsequently check the claims and, where appropriate, rank them according to different servicing categories to ensure that verified claims in the same group can be given equal treatment during the debt restructuring negotiations.[30]

Agreement on adjustment and debt restructuring plan requires appropriate reconciliation of interests

If the ESM decides as part of the debt sustainability analyses that a debt restructuring is a necessary prerequisite for an adjustment programme or the continuation thereof, this assessment should serve as a starting point for the negotiations on how to distribute the adjustment burdens. During the exploratory talks and negotiations, the interests of the debtor state and claimants should be reconciled; this will then facilitate an agreement on a reform programme and a debt restructuring plan. In this context, there must be a sharing of burdens between fiscal and structural measures, for which the member state is responsible at a national level, on the one hand and reducing the debt burden on the other hand. To ensure that claimants are treated equally, in addition to the verified claims arising from sovereign bonds, claims from creditors arising from credit obligations should also be included in the negotiations. This should minimise the risk of coordination problems and the opportunistic be-

27 To ensure that negotiations on debt restructuring do not start too late, an automatic debt restructuring was also discussed (sovereign CoCos). This should be triggered automatically if the thresholds for fiscal stress indicators – such as a certain debt ratio – are breached, and could, for instance, be set solely for any debt in excess of the reference values for the Stability and Growth Pact (accountability bonds). See, for example, A Mody, Sovereign debt and its restructuring framework in the Eurozone, Oxford Review of Economic Policy, Volume 29(4), pp 715-744; and C Fuest, F Heinemann and C Schröder, Reformen für mehr fiskalische Eigenverantwortung der Euro-Staaten: Das Potenzial von Accountability Bonds, study for the Bavarian Business Association (Vereinigung der bayerischen Wirtschaft, vbw), forthcoming. However, such automatic triggers over and above a maturity extension present considerable problems in terms of selecting suitable indicators for debt sustainability (eg with regard to country-specific characteristics, economic content, misguided incentives, transparency, audit compliance and manipulation resistance) and, moreover, particularly as a result of there being no obligation to implement reforms. Here, too, the onus is ultimately on the member state concerned to comply with the agreements that were previously reached.

28 Owing to an automatic maturity extension in bond contracts, the ESM would in future play only a relatively minor role as creditor of the member states concerned and would therefore have less of an interest in the member state being relieved too easily at the expense of the creditors. This could potentially increase the risk premiums of the other member states.

29 This also includes claims arising from purchases of bonds by other member states, the Eurosystem or claims of other multilateral institutions. Otherwise, the equal treatment would be in jeopardy, private creditors might be less inclined to consent and the fragmentation of debt restructuring negotiations would probably unnecessarily hamper the process. In the case of IMF claims arising from balance of payments assistance to a country, the IMF would, as it has up to now, have preferred creditor status.

30 If claims are not contested by the debtor country or other creditors, these could be deemed to have been verified. The clarification of any disputed issues could initially be supported by the ESM before the parties take legal action.

haviour of individual creditors preventing an orderly debt restructuring.

National responsibility necessitates possibility of ruling out financial assistance

The member state's individual responsibility plays a particularly important role when drawing up an adjustment programme and debt restructuring plan that permit compromise. In addition to the typical consolidation measures and potentially improving debt sustainability through privatisations, a one-off capital levy could also be considered when assessing debt sustainability and deciding how to reconcile the interests of the parties.[31] This would be in line with the principle of the member states' individual responsibility that is anchored in the governance framework of the EMU, because responsibility for and the making of fiscal policy decisions lies at the national level. Thus, unsound developments must also primarily be corrected through own funds. However, as stated above, the decisions on the national distribution of adjustment burdens and thus the specific measures should finally be made and implemented by the member state concerned. But, ultimately, the ESM must then have the option of recommending that the Board of Governors rejects a request for financial assistance, particularly if the member state concerned does not make sufficient efforts and can thus rather be judged to be unwilling to repay its debts.[32] This would result in a less orderly procedure in which the ESM does not play a role.

ESM financial assistance can facilitate agreement by private creditors to necessary debt restructuring

The agreed adjustment programme should support sustainable economic developments and make it highly likely that the member state's ability to repay its debts will be restored. If combined with the supplementary deployment of financial assistance, private creditors might also be more inclined to agree to a necessary haircut. The implementation of the programme could likewise be monitored by the ESM in future.

With no access to capital markets, threat of (further) debt restructuring at end of programme

However, an adjustment programme's success – with or without debt restructuring – ultimately cannot be guaranteed even if all the measures are implemented in full. It therefore cannot be ruled out that the member state concerned is not able to return to the capital markets when the programme ends without restoring debt sustainability. In this case, (renewed) debt restructuring negotiations might be required. These would then also include those claims that have already been automatically extended or were reduced during a previous debt restructuring.[33] Furthermore, it cannot be ruled out that no agreement is reached on an adjustment programme or that a member state ceases to service its debt without requesting financial assistance. This would presumably be the least favourable option for all parties. For the euro area, it is nevertheless important that financial stability is strengthened in future so that it is also safeguarded if such a scenario with potentially somewhat unorderly debt restructuring negotiations occurs.[34]

Impact on financing costs unclear

Agreement on a credible restructuring procedure could result in market participants considering there to be a generally higher likelihood of debt restructuring occurring in future. However, it is not clear what impact this will have

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31 The prospect of a one-off capital levy in the event of a crisis could potentially also counter incentives for unsound fiscal policy, which might otherwise arise from the member state's expectation that it will later be able to rid itself of its sovereign debt burden in a supposedly easy way at the expense of the creditors (or the other member states). For more information, see Deutsche Bundesbank, A one-off capital levy: a suitable instrument for solving national solvency crises within the current EMU framework?, Monthly Report, January 2014, pp 49-51; and G Kempkes and N Stähler, A one-off wealth levy? Assessing the pros and cons and the importance of credibility, Fiscal Studies, forthcoming.

32 The Board of Governors is the ESM's political decision-making body. It is composed of the member states' government representatives responsible for finance, each of whom nominates a member of the Board of Directors as well as the ESM Managing Director. If the ESM proposes granting financial assistance, the Board of Governors must agree to this in order to ensure the necessary democratic legitimacy of the associated assumption of default risks by other member states.

33 Before providing any financial assistance under a follow-up programme, it would have to be ensured that the maturity of the restructured debt securities runs for the planned duration of the programme so that the ESM continues to finance outstanding deficits but not any redemption payments to private creditors.

34 See Deutsche Bundesbank, Approaches to strengthening the regulatory framework of European monetary union, op cit.

Outline of a reformed procedure for resolving sovereign debt crises in the euro area

The article weighs up a range of reform measures aimed at resolving the financing problems of euro-area member states. To this end, this box presents a possible plan for such a procedure, based on some of the reform approaches described.[1] The respective timeframes, in particular, can be set differently. As explained in the main text, the prerequisite for any such procedure would be a prior reform of the bond terms and of the Treaty establishing the European Stability Mechanism (ESM).

Triggering the procedure and next steps

As in the past, if a member state encounters major financing difficulties, the crisis resolution procedure would be triggered by the member state submitting a request for financial assistance to the ESM. Government bonds receive an automatic maturity extension once an ESM programme is in place, based on the assumption of an upfront reform of the bond terms; thus, the maturities of the outstanding bonds would be extended under the agreed conditions. The request would initially facilitate an extension of, for example, ten weeks, prior to a final decision being taken regarding the programme. During this period, the ESM would conduct an initial stock-taking, on the basis of which an adjustment programme would be negotiated (within the set time) and an agreement reached regarding any restructuring that may be necessary, the latter to be negotiated with creditors. In addition, the ESM's Board of Governors would need to approve any potential financial assistance. Therefore, until a final decision has been made regarding the programme, no funding requirements arise due to redemptions.[2] Nevertheless, the financing of deficits might be necessary. Any temporary assistance to cover acute financing needs above and beyond that would need to be made subject to special collateralisation requirements and, like regular financial aid, would be excluded from any debt restructuring.

Initial stock-taking

In concrete terms, upon a request being submitted by the member state, all the relevant information would need to be presented at that juncture in order to work out an aid programme. An initial stock-taking would be conducted within a fixed period of, say, four weeks from the date of submitting the request. To this end, an analysis would be compiled of the macroeconomic and fiscal situation and of the perspectives, in particular with respect to the sustainability of the public finances and thus to any debt restructuring deemed necessary. The possible courses of action would also be drawn up.

The tasks performed by the ESM, which would also be responsible for overall coordination, would take the form of two simultaneous strands of work. The first of these would consist in the ESM preparing a projection of the macroeconomic and fiscal development for the member state and a forecast of that country's expected financing needs amid a no-policy-change scenario.[3] At the same time, the ESM would draw up a "programme scenario" under which the member state would be obliged

1 The procedure outlined here would gain in importance with every new issue of a bond with the reformed bond terms. However, it does not offer a direct solution to problems posed by the, in some instances, very extensive ongoing liabilities of member states not subject to an automatic maturity extension or (aggregate) collective action clauses. As such, nor does it provide a direct solution to the difficulties involved in a possible restructuring during the transition period.
2 Ideally, the member state should not submit a request a very short time before a due date that it is unable to comply with.
3 In principle, the ESM could be supported in this task by the European Commission in liaison with the European Central Bank and, where appropriate and possible, the International Monetary Fund (IMF).

(in keeping with the subsidiarity principle) to specify reforms and measures that it would implement under its own national responsibility to consolidate its budgets and improve the conditions for macroeconomic development. These scenarios provide the basis for the ESM's assessment of the sustainability of public finances and thus also its quantification of any restructuring needs upon completion of the initial stock-taking.

The ESM's second strand of work would involve taking precautionary steps to quantify claims on the member state arising from outstanding bonds and credit obligations, should it become necessary to conduct debt restructuring. As an integral part of the stock-taking, the member state would be required to supply the ESM with an overview of all eligible claims. In this context, the ESM could function as a central point of contact for creditor claims.[4] Upon activation of the procedure, these creditors would be asked to present their claims on the state within a specified time period (eg two weeks), backed with eligible documentation.

Decision on assistance programme and possible restructuring

The initial stock-taking would be followed by negotiations to specify reforms and measures. To accommodate these, a second fixed timeframe of, for example, four weeks could be set.[5]

Scenario involving a temporary liquidity problem

As a general rule, it is virtually impossible to reliably distinguish between a temporary liquidity problem and sustainability difficulties from the outset. Where the problem is probably of a temporary nature and thus rectifiable by means of an adjustment programme, the approach would not change much under an ESM programme, in which case the adjustment programme would be substantiated following completion of the stock-taking. Where alterations to the drafted programme scenario seem necessary, any concrete reforms and measures should, in turn, be proposed by the member state concerned, while the ESM would determine the scope of whatever financial aid was deemed necessary, as in the past. The final adjustment programme would be determined in accordance with the ESM's decision-making process. Upon the programme's inception, the maturity extension stipulated in the bond contracts would result in maturities automatically being extended by three years. Thus, without triggering a credit event (and the attendant potential distortions in the financial markets), investors would remain liable for their investment decisions over a longer timeframe, and recourse to ESM funds would be limited. Implementation of the programme would be subject to ongoing monitoring by the ESM, and financial assistance would be paid out contingent on the implementation of the agreed measures.

Scenario involving a sustainability problem

In the course of the initial stock-taking, however, it could also turn out that the member state is unlikely to regain access to the capital market by the end of the programme's duration, even if the measures contained in the programme scenario are fully implemented, indicating that the problem is not a liquidity shortage but an issue of sustainability. In this case, a debt restructuring would have to be negotiated with the creditors within the stipulated second timeframe of four weeks (in parallel to the finalisation of the adjustment programme) as a prerequisite for ESM financial assistance. This would entail convening an initial

4 As an alternative, this task could be handled by a separate body that would present the information to the ESM for further processing.
5 If the ESM concludes that the member state's request for financial assistance is basically unwarranted because the country concerned could overcome its difficulties through its own efforts, the Board of Governors should be advised to reject the request.

meeting of all claimants at the beginning of the second four-week period. At this meeting, the ESM would present the provisionally advised adjustment programme and specify the ensuing need for a debt restructuring. On this basis, the specifics of distributing the adjustment burdens by way of reforms and potential losses for creditors as part of a debt restructuring would be negotiated. Here, too, the national distribution of the burden would have to be proposed autonomously by the member state in question.[6]

During the restructuring negotiations, the ESM would classify the claims according to any ranking that may exist for servicing purposes, explore the different views, manage the negotiations and seek to ensure that the interests of the parties concerned are reconciled.[7] At the end of the second four-week period, another bondholder meeting would be convened and the specific restructuring plan that had been negotiated would be presented for voting.[8]

If the debtor country cannot reach an agreement with its creditors at the deciding meeting, a further period of two weeks, for example, could be set in which to come up with a last compromise proposal.[9] In the final vote, the (aggregated) majority requirement could have been reduced by a corresponding clause in the bond contracts.[10] If no agreement is reached, the ESM would have to recommend that the Board of Governors reject the request for financial assistance. Accompanying reforms to the governance framework of monetary union, implemented prior to this, would have to be designed in a way to ensure that a sovereign default outside an ESM programme is manageable in future for financial stability in the euro area.[11] Regardless of this, neither the country in question nor its creditors are likely to have an interest in such a development.

If, however, the parties concerned manage to agree on a debt restructuring and an adjustment programme at the final vote at the latest, the agreed conditionalities would be set with the country in question and, together with a proposal for the granting of financial assistance, be presented to the Board of Governors for the final decision. The restructuring would be conducted in parallel to this. The programme’s progress would then be monitored by the ESM on an ongoing basis and, as before, the financial assistance would be paid out contingent on the implementation of the agreed measures.

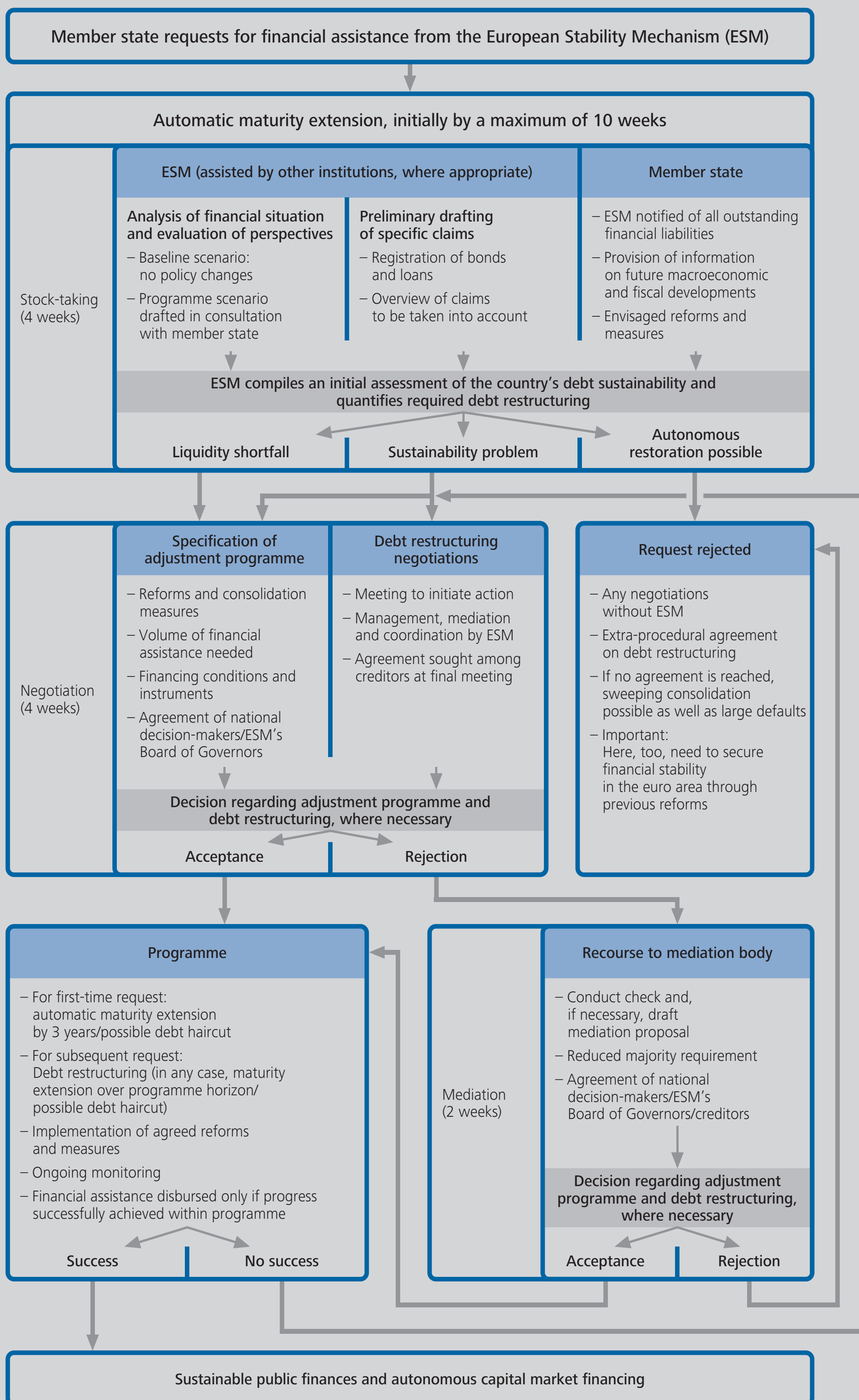
Course and end of the programme

If the programme runs as expected, the country could regain access to the capital market by the end of the programme – if not before – and, going forward, be able to service the liquidity assistance granted as well as private creditors’ debt securities falling due.

Even if all the agreed fiscal and structural reforms are implemented in full, however, it is uncertain whether an adjustment programme will succeed – regardless of

6 In the case of overindebtedness, drawing on the private net wealth of citizens for a one-off extraordinary capital levy would be an option in principle, in addition to permanent consolidation measures and privatisations.
7 Any credit claims held by the IMF or ESM enjoy preferred creditor status.
8 For bonds with (reformed) collective action clauses, restructuring requires a qualified majority of creditors.
9 Under certain circumstances, the establishment of a “mediation committee”, which should be independent to the greatest degree possible, could also be considered. The European Court of Justice, for instance, could assume this role.
10 For example, in the case of a bondholder meeting, the required majority could be reduced from 75% to 50% of the principal amount present, given the same quorum of 66⅔% of the outstanding principal amount of the affected debt securities or, in the case of a written resolution, from 66⅔% to 50% of the affected debt securities. Such a rule would be planned into the fundamental reform of collective action clauses which, like the proposed reform of the bond terms, is a prerequisite for the procedure described here.
11 See Deutsche Bundesbank, Approaches to strengthening the regulatory framework of European monetary union, Monthly Report, March 2015, pp 15-37.

Potential steps of a reformed procedure for resolving sovereign debt crises in the euro area



Deutsche Bundesbank

whether or not it involves a debt restructuring. There is thus no way to rule out that the need for a (further) restructuring only becomes apparent during or at the end of an adjustment programme. If the debt sustainability and capital market access of the country in question were not restored by the end of the programme's duration, despite the agreed measures being implemented in full, (renewed) restructuring negotiations would be the only way forward. These should likewise be conducted according to a standardised process in order to establish sustainable public finances in line with the agreed procedure and within the set time period given as an example. This process would also include those claims that were already extended under the adjustment programme or that had already suffered losses during a previous restructuring. If, during this process, the ESM negotiates a new adjustment programme for which it proposes financial assistance, it would have to be ensured that, in the restructuring, the outstanding debt securities are substituted such that their maturities exceed the estimated programme duration, and the creditors thus remain liable. If a liquidity problem is identified once more, a maturity extension could be deemed sufficient. Only then, at the latest, would the action no longer constitute an extension agreed in the bond terms, but a restructuring. If no agreement were reached, the ESM would have to recommend that the Board of Governors reject the granting of additional financial assistance. Restructuring negotiations would then have to be conducted without the participation of the ESM.

on the risk premiums of the member states. An orderly procedure reduces the uncertainties for investors in terms of the necessary steps and the intervening period until fundamental sustainability has been restored, and curbs the costs of the coordination problems. This should make a more reliable calculation of the risk of loss possible, and the proposed reforms should expedite the process as a whole, thereby reducing the economic costs of an overindebted government and thus, as a general tendency, any necessary haircut. If such a procedure were to result in an increase in risk premiums, for instance if a bail-out by the other member states were deemed less likely after such a reform had been introduced, this would have to be viewed as a correction of previously distorted market pricing, as such a bail-out is not envisaged under the existing framework of the EMU. This would, in turn, counteract excessive debt accumulation and prevent costs potentially being passed on to other member states. If this were to lead to sounder public finances overall, lower risk premiums could even be expected in future.

Conclusion

Reforms must enhance governance framework and financial stability

No fundamental changes have been made to the governance framework of the EMU since the outbreak of the financial and sovereign debt crisis, but the current framework remains in need of reform. In this context, there seems to be a lack of consensus for further developing the EMU into a real fiscal or political union. Therefore, the EMU should be further developed within its originally agreed framework. Safeguarding financial stability plays a key role in this context, particularly with regard to the negative interplay between sovereigns and financial institutions.

Adjustments to bond terms facilitate future crisis resolution

Changes in the terms of the member states' sovereign bonds could make an important contribution, particularly with regard to tackling

future sovereign debt crises. An automatic maturity extension if financial assistance is granted by the ESM and a single-limb majority requirement for debt restructuring could be included in the bond terms. This could alleviate the problem of diagnosing acute government financing problems, strengthen investors' individual responsibility, boost the clout of the ESM and curb the transfer of risk to the other member states, which, in turn, could facilitate an agreement on any debt restructuring.

Rule-bound procedure could strengthen crisis mechanism

If it is agreed in advance how to proceed in the event of a debt restructuring – and particularly if this is linked to the proposed changes to the bond terms – this could expedite the process and make it more predictable. In this context, the coordination and associated tasks, such as recording the existing claims, could be given to the ESM and, if there is a vote in favour of debt restructuring, the latter could also be tasked with an adjustment programme and ESM financial assistance. If the crisis resolution mechanism is strengthened, it could furthermore also be considered whether, over and above this, the ESM should be assigned the function of an independent fiscal authority. The tasks of assessing budgetary developments and compliance with the fiscal rules, which have up to now been the remit of the European Commission, could be transferred to this fiscal authority. Overall, the cost and level of any future haircut could thus be reduced. However, since under the existing governance framework of the EMU the decision-making powers for financial and economic policy continue to lie with the member states, even once a debt restructuring procedure has been set up, its success would crucially hinge on the member states' willingness to pay and cooperate.

Gradual entry into force of individual elements avoids abrupt market reaction and enhances the procedure

The proposed reforms could consequently help to strengthen the no-bail-out principle in the euro area and the member states' individual responsibility, and thus also render future sovereign debt crises less likely. The key elements would be implemented gradually, rather than on an *ad hoc* basis, by adjusting the bond contracts of new issues. This would strengthen the crisis resolution mechanism outlined above. However, this mechanism does not present a direct or simple solution for the member states' – in some cases – still very high sovereign debt, and the problems of a possible need for debt restructuring during the transitional period would also only be alleviated gradually. Overall, the member states should therefore use the time available to implement the consolidation course that has already been agreed and make their public finances more crisis-resilient. At the same time, it is crucial to introduce reforms aimed at increasing financial market stability, which not least break the nexus between national government finances and the banking system while making the restructuring of sovereign bonds a viable option.