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Orderly Sovereign Default in the EU: A Strong Case for European Regulation*

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1. A BRIEF INTRODUCTION

This paper endeavours to offer a view on the need for an orderly sovereign default process in the EU. Section 1 provides an introduction. Section 2 illustrates why a Greek or other peripheral Economic and Monetary Union (EMU) country default would not trigger a systematically relevant banking crisis that could entail the need of additional (substantial) state aids. Section 3 briefly comments on the indirect but relevant costs associated with a sovereign default in the EMU area. Section 4 considers the May 2010 sovereigns' rescue package and whether it is compatible with an orderly default procedure. Section 5 calls for the swift introduction of a European statutory sovereign default procedure also to reconcile properly the May 2010 initiatives with their legal basis. Section 6 lists a series of statutory provisions that should be incorporated into the European sovereign default procedure. Section 7 concludes, briefly commenting on the idea of a European Monetary Fund and its legal basis under the current Treaty on the Functioning of the European Union (TFEU).

History shows that big financial crises are often followed by sovereign defaults. Thus, there is very little new in the feared (and threatened) Greek default in this respect; what is new is however that (1) this would have been the first sovereign default of a western European country since the interwar period and, obviously, the very first of a EMU member (entailing yet unknown implications for the common currency); (2) the Greek default could potentially inoculate contagion to other EMU members (notably Portugal, Ireland and Spain, and, to a lesser extent, Italy), leveraging the risk of a currency crisis; (3) the magnitude of the economic resources devoted by the EMU members and the IMF to avert (or at least tame) the risk of default through official sector intervention is unprecedented. Suffice to say that the rescue package adopted in May 2010 totals more than one trillion US dollars in loans available for countries with funding problems – an amount significantly above that committed by the United States under the TARP in 2009.[1]

2. ON THE EXPECTED DIRECT EFFECTS OF A GREEK DEFAULT ON THE EUROPEAN BANKS' CAPITAL

Sovereign defaults are historically related to banking crises; often in the sense that sovereign defaults weaken the banks' balance sheets and, in the extreme, could even create the threat of a bank run. In the current financial crisis, the circle has been perhaps even more vicious.[2] Indeed, the financial crisis and, to some extent, even banks' rescue packages adopted in 2008–2009 (the case of Ireland seems to be quite illustrative in this respect), contributed significantly to the worsening of the debt to GDP ratio of many sovereigns bringing about the risk of a sovereign crisis.[3] However, in the current scenario, a risk of contagion from EMU peripheral sovereigns back to the European private banking sector should not be overestimated either. The Greek example seems quite exemplary. Greek outstanding national debt is reported to be around EUR 300 billion, roughly equivalent to about 125% of the country GDP. The country's budget deficit is estimated at about 12.7% of the GDP. The Italian, German, and French banking system exposures to Greek sovereign debt calculated at the end of the third quarter of 2007 and at the end of 2009 were as follows:

Lenders' Country	Exposure in 2007	Exposure in 2009
Italy	6.3	4.8
France	41.3	52.2
Germany	25.6	31.2

Note: Data expressed in EUR billion.
Source: Bank of Italy (briefing note of the hearing of Dr Fabio Panetta at the Italian Parliament, Rome, 8 June 2010).

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1 D. Gros & T. Mayer, *How to Deal with Sovereign Default in Europe: Create the European Monetary Fund Now!*, CEPS Policy Brief, 17 May 2010, at 1.
2 Compare recently B. Candelon & F.C. Palm, 'Banking and Debt Crises in Europe: The Dangerous Liaisons?', *De Economist* 158, no. 1 (2010): 81–99, where they quote at 81 the warning of Kenneth Rogoff in the *Korean Times*, 30 Nov. 2009, that 'essentially there is still a risk that the financial crisis is simply hibernating as it slowly morphs into a government debt crisis'.
3 See IMF, *Global Financial Stability Report*, April 2010, 3–10.

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This finding is plainly confirmed by the recently published (23 July 2010) banks' stress test performed by the ECB, which contemplates haircuts on sovereign debt but does not consider sovereign default in the exercise.[4] The same holds true, according to a different (albeit less sophisticated) stress test performed by a leading investment bank, also in a worst-case scenario, where the severity of the test contemplates several sovereign defaults of peripheral EMU countries occurring at the same time and an haircut of 30% of the face value of the sovereign bonds. Indeed, a Bank of America/ Merrill Lynch Report of 10 May 2010 ('*Sovereign fears: direct impact manageable*') shows, albeit with several cautionary warnings (in very few cases, there were available the exposure to peripheral European sovereign debt, and not all banks had disclosed their total holdings of government debt) an attempt to quantify the impact on European banks if Portugal, Ireland, Italy, Greece, and Spain all restructure their debt applying an 'haircut' of 30%. The report estimates that the 'first order impact would be a fall in the Core Tier 1 ratio of the banks covered in the exercise (thirty-three leading European banks) from 9.3% to 8.4%', and it concludes therefore that 'the European bank sector would still have twice the minimum level of regulatory capital in a scenario whereby every peripheral sovereign restructured its debt. Admittedly, most of the Greek banks and a number of Italian banks would need additional capital in such a scenario'. More in general, in such a scenario – which is described by the reporters themselves as 'flawed in that it treats the risk of an Italian restructuring the same as a Greek restructuring and it also assumes that no other actions (i.e., disposal) are taken by banks (two assumptions which are overly simplistic)' – it is estimated that 'the European bank sector could need to raise an additional Euro 22 billion'. This number should be confronted with the over EUR 200 billion raised by the sector since the start of 2007[5] and can be considered, hence, quite manageable. In turn, according to a staff note of an Institute of International Finance, Greek government debt represents (only) 2.4% of international bank equity capital (2.2% of Italian bank regulated capital according to the Bank of Italy); Ireland debt, 0.7%; Portugal, 1.9%; and Spain, 4.0%. As to the question whether European bank balance sheets could withstand a sovereign default without recourse to further state aid, to my mind, the answer should therefore be affirmative. Data suggest that a Greek default, albeit negatively affecting the balance sheets of European banks, could not be credibly considered, per se, as a trigger of a European systemically relevant banking crisis.

3. SOVEREIGN DEFAULTS AND LIKELY INDIRECT EFFECTS ON THE EUROPEAN BANKING SYSTEM

This is not to say a sovereign default of an EMU member would be without significant impacts on the global financial system of the area. Although direct effects of a sovereign default on banks' balance sheets could prove manageable, its indirect effects could have a negative longer term impact both on funding and economic growth. The impact on funding could, on one hand, derail the bank funding recovery still underway and, on the other hand, make funding costs higher and more differentiated within the Euro area on country-specific fundamentals. On the other hand, as it has been recently observed by Hui and Chung,[6] 'the onset of the European sovereign debt crisis in late 2009 called into question the grand experiment of pooling 16 countries into a monetary union'. It results indeed that 'sovereign credit risk is an important determinant of the prices of deep out-of-the money dollar-euro put options' and that, therefore, 'the creditworthiness of the euro-area countries could affect market expectations on the stability of the euro'. In other terms, 'the atmosphere of collective safety provided by a common currency in the first ten years of its existence is gone (probably for good)'.[7] This is due to the fear of a chain reaction, and such a chain reaction was considered as a real possibility by the market, since currency traders and hedge funds reportedly betted nearly USD 8 billion against the euro, amassing the biggest ever short position since the monetary union was formed.[8] The weakness of the euro signals also the deep deterioration of the debt to GDP ratio of all EU members: rating agencies expect that by the end of 2010, sovereign debts in the EU area will have an increase of 760 billion in respect to end 2009; of these, 490 billion concern EMU countries – an amount six times bigger than the increase experienced in 2007.[9] As Willem Buiter, Citi's chief economist, wrote in a recent note:[10]

> (i) the public finances of advanced industrial countries are in a worse state today than at any time since the industrial revolution, except for wartime episodes and their immediate aftermath; (ii) 'most of the industrialized nations are on unsustainable fiscal trajectories'; (iii) 'fiscal unsustainability problems have been driven by (1) pro cyclical fiscal behavior in the boom years; (2) direct fiscal costs of the financial crisis; (3) the impact of the recession on taxes and spending; and (4) lower post bubble revenues from real estate and the financial sector'; (iv) 'unsustainable public finances are not just an issue for Greece and disproportionate attention has been placed on Euro periphery countries. The deterioration in the

4 Compare ECB, EU *Stress Test Exercise – Key Messages on Methodological Issues* (23 Jul. 2010), 7, fn. 8.
5 According to the ECB stress test published on 23 Jul. 2010, from October 2008 to the end of May 2010, EU governments injected EUR 236 billion in the capital of EU banks (ECB, *EU Stress Exercise – Key Messages on Methodological Issues*, 3).
6 C.H. Hui & T.K. Chung, *Crash Risk of the Euro in the Sovereign Debt Crisis of 2009–2010*, working paper, 28 Jun. 2010.
7 M. Dabrowski, 'The Global Financial Crisis: Lessons for European Integration', *Economic Systems* 34 (2010): 38–54, at 45.
8 C.H. Hui & T.K.Chung, *Crash Risk of the Euro*, 4.
9 F. Panetta, *Briefing Note, Hearing at the Italian Parliament*, 8 Jun. 2010, 5.
10 *Global Economic Views – Sovereign Debt Problems in Advanced Industrialised Countries*, 26 Apr. 2010.

structural (or cyclically adjusted) fiscal balance of the US and the UK is larger than in Greece, Portugal or Spain'; (v) 'Markets, commentators and analysts will in due course realize that fiscal sustainability is not just a problem of a handful of Euro Area members. Unless the US, the UK, France, Japan and even Germany change course quite radically, there may not be a single AAA rated sovereign left five years from now'.

4. THE MAY 2010 SOVEREIGNS' RESCUE PACKAGE

All the foregoing – probably coupled also with a strong, albeit undemonstrated, official belief (transmitted also to the market) that the Eurozone cannot endure a single sovereign default among its members[11] – should help in understanding the reasons beneath the adoption:

(a) On 3 May 2010, of the 2010–2012 program of financial support for Greece, up to 110 billion, eighty of which extended as bilateral loans by other EMU members. Note that in some cases, the financial effort required by a single EMU member is quite disproportionate in respect to the threat posed by the Greek sovereign debt held by its national banking system (Italy, for example, made available through Decree No. 67 of 10 May 2010 up to EUR 14.8 billion, an amount three times higher than the exposure of its banking system to the Greek sovereign risk). The same day, the ECB – in order to prevent disruptions on the side of liquidity, especially for the Greek banks – derogated to the rating requirements for the Greek sovereign bonds used as collateral in liquidity transactions.

(b) On 10 May 2010 of the European Financial Stability Facility, through which EMU Members, in a final attempt to prevent sovereign defaults in the EMU and the correlated risk of contagion, decided to put at stake (although indirectly, enabling the Facility to extend conditional loans to EMU members facing exceptional circumstances up to EUR 500 billion and undertaking, at the same time, to guarantee the euro bonds to be issued by the Facility to fund such loans) an unprecedented amount of their taxpayers' money. The same day, the ECB adopted the Securities Market Program to support failing euro-denominated government bonds in order to prevent new disruptions in such markets.

(c) On 12 May 2010 of the joint Communication on 'Reinforcing Economic Policy Coordination' (COM (2010) 250 final).

In turn, the foregoing should also help in making clear that, despite all these efforts and programs, one or more EMU members could eventually end up confronted not simply with a liquidity crisis – which can be overcome through the extension of the loans made possible by the newly adopted European programs – but with a true solvency crisis. This means, to my mind, that an orderly default procedure could eventually follow the European Financial Stabilization Mechanism and Facility and should be considered compatible with it. For Greece, an insolvency scenario has been recently predicted, for example, by Nouriel Roubini,[12] who believes that it is now time to admit that Greece is not just undergoing a liquidity crisis but is going to face a solvency crisis and calls therefore for a prompt debt restructuring and an orderly default procedure. Not surprisingly, a recent J.P. Morgan Report[13] puts it this way:

> one way or another Greece, Spain, Portugal and Ireland will all reach a position of debt sustainability. In practical terms, this means being able to access capital markets at a borrowing cost that is not too far from the country's nominal growth rate. The only uncertainty is how this destination will be reached and to what extent the burden of adjustment is shared between domestic residents (via fiscal tightening), creditors (via debt restructuring or inflation), other residents (via fiscal transfers) or trading partners in the rest of the world (via a weaker euro).

5. A CALL FOR THE SWIFT INTRODUCTION OF A EUROPEAN STATUTORY SOVEREIGN DEFAULT PROCEDURE

In this context, it is worth questioning (1) whether it makes sense that the EMU does not provide any orderly European sovereign default procedure and what form this procedure could take and (2) whether there is sufficient legal basis in the Treaty for the measures adopted on 9 May 2010 setting up the European Financial Stabilization Mechanism and Facility and for the adoption of an orderly European sovereign default procedure. On this latter point, it is well known that all the measures adopted in the last months to face the feared sovereign default must be assessed against the so-called no bail out provision of Article 125 TFEU, taking into account, though, also the enabling provision of Article 122 TFEU, which entitles the Council, on a proposal from the Commission, to 'grant under certain conditions Union financial assistance' to a Member State where it is 'in difficulties or is seriously threatened with severe difficulties caused by . . . exceptional circumstances beyond its control'. It is apparent that European institutions stretched quite a bit the enabling provision of Article 122 and at the same time construed in a very restrictive way the 'no bail out' provision of Article 125 to find a sufficient legal basis in the Treaty for the measures recently adopted. The underlying idea was that the extension of conditional loans does not amount to the 'assumption of the commitments of central governments' (as prohibited by Article 125 of the Treaty) and that the current sovereign

11 Calling for a change of such official doctrine, J. Mélitz, *Eurozone Reform: A Proposal*, CEPR Policy Insight No. 48, May 2010, 2, where the conclusion that 'there is little reason why Eurozone should view government defaults with any greater alarm than any other central bank management in the world would view government defaults within its territory. To the contrary, the Eurozone is particularly well armed to deal with such defaults since its own central bank has no large central government to contend with, the Maastricht Treaty guarantees the central bank's independence and member governments are explicitly forbidden to bail out one another'. Note that, consistently with the official doctrine, also the ECB stress test recently conducted did not consider in the exercise, under the adverse scenario, sovereign default.

12 N. Roubini, *Niente Pasticci in Salsa Greca*, Il Sole 24 Ore, 30 Jun. 2010, 14.

13 J.P. Morgan, *Euro Area Sovereigns: The Long Journey Back to Solvency*, Economic Research Global Data Watch, 9 Jul. 2010.

difficulties, albeit deriving from lax fiscal and budgetary policies of the Member States concerned, could nonetheless be characterized – in consideration of the extraordinary effects derived from the on going global financial crisis and, to be true, using also a discreet amount of hypocrisy – as 'exceptional circumstances beyond the control' of the Member State concerned. The impression is very strong, however, that EMU countries, having failed to prepare in advance a mechanism capable of managing an orderly default and debt restructuring within the EMU, acted to prevent any sovereign failure in the strong belief that such a failure could be too dangerous for the EMU. Watering down the 'no bail out' provision (as well as Article 123 TFEU) could prove very dangerous also. It does not come as a surprise, thus, that markets reacted negatively on the currency, 'fearing that impaired government bonds would end up on the balance sheet of the ECB undermining the long term stability of the euro'[14] and that the ECB, at the extreme, could become the 'bad bank' of the area. I agree therefore with those who advocate as a key policy aim for the future to restore market discipline by making sovereign default possible. To this aim, it is necessary to pre-emptively put in place a European orderly default procedure. To my mind, such a procedure should come along with the enforcement of the measures adopted with the 3–10 May 2010 rescue package, so as to ensure adequate priority to the claims related to all loans extended under the plan and in this way reconcile the program with its legal basis (diminishing, if not averting, the risk that bridge loans operate in practice as assumption of the commitments of the sovereign in default). In other words, the legal basis that supported the adoption of the rescue plan not only authorizes but, to my mind, also requires that an orderly default procedure is adopted, so as (1) to set a rule-based deterrent threat to national fiscal profligacy,[15] (2) to make the application of the rescue package more stringently directed at tackling a liquidity crisis and not an insolvency, and (3) to ensure a higher level of safety (through the higher priority) to the claims related to the loans extended under the new facility, in this way making the intervention more compliant with the no bail out provision.

6. A FEW EXAMPLES OF STATUTORY PROVISIONS THAT SHOULD BE INCORPORATED INTO THE EUROPEAN SOVEREIGN DEFAULT PROCEDURE

How then to devise a proper European or EMU default procedure? Reliance can be made both on international experience and on some recent proposal calling for the setting up of a European Monetary Fund. As to the former point, in my view, there is here a very strong case for a European *statutory* procedure based on a EU regulation (under the existing TFEU), which should set out in detail *mandatory rules* aimed at making the restructuring process more orderly, more predictable, and more rapid. The reasons that supported the attempt to introduce such a process in the international setting[16] – an exercise that failed so far, despite the IMF 2002 proposals and the authoritative support that this project received by leading scholars[17] – are even more compelling within the EMU.[18] In my opinion, pure contractual solutions do not adequately respond to European needs. As to the form that an orderly default procedure should take, the economic literature indicates that statutory provisions should comprise at least the following (the list is purely indicative and in no way comprehensive):

(1) A timely suspension on re-payment to prevent a rush to exit from the sovereign debt, applicable once the default is declared. Default should be made possible both on a voluntary basis (i.e., the sovereign declares the default starting the procedure) and on a involuntary basis (i.e., the creditors call the default, starting the procedure), since the economic literature convincingly demonstrated that involuntary bankruptcy would alleviate the sovereign's reputational concerns in calling for a more timely voluntary procedure and would also provide a mechanism for creditors to block new debt issues that could dilute their outstanding claims.[19]

(2) A 'fair' priority rule, according to which creditors should be divided into different classes with different rights depending on a set of criteria pre-emptively defined. To my mind, 'first-in-time absolute priority' – that is, the principle whereby bonds issued first would have priority over those issued later and higher priority creditors would be paid up in full before lower priority creditors receive anything – might prove too harsh and may even lack fairness.[20] A differentiation in the amount of the haircut depending on the time of the issue, the type of collateral, and other relevant circumstances (if any) could prove a more viable and 'fair' solution. In any event, what is important is that the priority structure for the sovereign own debt is clearly set in advance so as to settle questions of equity and facilitate the enforcement of the default procedure.[21]

(3) A reasonable differentiation, in the structuring of the creditors' classes, between domestic and external debt. Economic literature

14 D. Gros & T. Mayer, *How to Deal with Sovereign Default in Europe*, 2.

15 R. Goldbach & C. Fahrholt, *Burying the Stability Pact: The Reanimation of Default Risk in the Euro Area*, GFinM working paper, No. 10, April 2010, 25.

16 For an accurate account, compare M.C. Malaguti, 'Sovereign Insolvency and International Legal Order', *International Community Law Review* 11 (2009): 307–326; Banco de Espana, *Recent Episodes of Sovereign Debt Restructuring: A Case Study Approach*, No. 804/2008, passim.

17 See for a thorough and convincing discussion of the matter, N. Roubini & B. Setser, *Improving the Soverign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions and a Roadmap for Reform*, paper presented at a conference on 'Improving the Sovereign Debt Restructuring Process', Paris, 9 Mar. 2003.

18 This is even more so if we consider that there is no safe legal basis in the Treaty on the Functioning of the European Union for the expulsion of a EU or EMU member: compare P. Athanassiou, *Withdrawal and Expulsion from the EU and EMU*, ECB working paper series, No. 10, December 2009, passim. On the intricacies of the re-establishment of one or national currency after the adoption of the Euro, H. Scott, *International Finance* (New York: Foundation Press, 2005), 200–204.

19 P. Bolton & D.A. Skeel, 'Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?', *Emory Law Journal* 53: 763.

20 A solution advocated by P. Bolton & D.A. Skeel, *Inside the Black Box.*

21 N. Roubini & B. Setser, *Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions and a Roadmap for Reform, mimeo*, IIE, 6.

indicates that 'domestic debt and external debt are likely to be restructured at different times, using different restructuring processes and on different terms'.[22] In my view, since, unlike corporate defaults, sovereign default does not bring about, per se, a change in the management of the country and only domestic creditors vote to that end, a reasonable discrimination against domestic creditors could make sense to better correlate risk and governance, to prevent moral hazard, and, by this way, also to indirectly prompt the removal of the incumbent political élite if it were to be blamed for the default.[23]

(4) Majority *mandatory* restructuring *clauses*, whereby the restructuring proposed by the sovereign is made binding also for minority creditors if the majority accepts the contractual change. Such a rule has obviously to be carefully crafted so as to take into account the differentiation of claims deriving from a multi-class structure of the restructuring and is needed to overcome 'hold out' problems, that is, the risk that creditors willing to exacerbate conflict and resist the restructuring also where the majority of creditors approve it might take advantage of the unanimity principle applicable to the amendment procedure of many existing bond covenants (e.g., those governed by the US law) to 'green mail' sovereigns and get by this way a preferential treatment.

(5) Super-seniority rank for all loans extended to the sovereign after the default is declared or in the months preceding the default in so far as these loans are needed to prevent a liquidity crisis and/or the contagion of the default to the banking sector. Absolute priority should be given to those loans made available by the public sector under a conditionality policy. As it has been correctly noted, 'the strongest negotiating asset of a debtor is always that default cannot be contemplated because it would bring down the entire financial systems';[24] measures capable to minimize such risk and the unavoidable disruptions that come along with a sovereign default deserve, therefore, a preferential treatment.

(6) Express derogation to the sovereign immunity defence,[25] although in the context of a better regulated framework for creditors' litigation, including also provisions on clawback on payment made in the months preceding the default.

(7) New disclosure principles, whereby the sovereign should be expected to provide full and accurate information on its debt profile and restructuring plans. As noted by Roubini and Setser, this should include 'publishing a full accounting (detailed and disaggregated) of its outstanding debts soon after defaulting and informing creditors of any significant changes to its debt stock'.[26]

7. A PROVISIONAL CONCLUSION

Is there merit, in the current circumstances, for a further advance of the regulatory framework, so as to set up, as advocated by some commentators, a European Monetary Fund?[27] To my mind, probably there is, but only through the enhanced cooperation procedure: a procedure that, so far, has never been followed – and not surprisingly so.

22 N. Roubini & B. Setser, *Improving the Soverign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions and a Roadmap for Reform*, mimeo, IIE, 15.

23 Economic research indicates that this is actually an outcome often determined by sovereign default: E. Borensztein & U. Panizza, *The Costs of Sovereign Default*, IMF working paper, WP/08/238, at 22.

24 D. Gros & T. Mayer, *How to Deal with Sovereign Default in Europe: Towards a Euro(pean) Monetary Fund*, CEPS Policy Brief, No. 202, February 2010, 4.

25 A defence whose applicability is debated and unevenly admitted in different jurisdictions: for the applicability in Italy of such defence, in respect of the Argentinean debt restructuring, see the judgment of the Supreme Court of 27 May 2005, no. 6532.

26 N. Roubini & B. Setser, *Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions and a Roadmap for Reform*, mimeo, IIE, 14.

27 T. Meyer, *The Case for a European Monetary Fund, Intereconomics*, May/June 2009, 138; D. Gros & T. Mayer, *How to Deal with Sovereign Default in Europe*, rightly claiming that 'recently events have vividly demonstrated that in the absence of a mechanism to manage an orderly sovereign default, adjustment programmes lack credibility and the balance sheet of the ECB is put at risk. Indeed, without a fiscal agent like the EMF in times of crises, the ECB becomes the fiscal agent of euro area governments by default. This role, if maintained, will destroy the institution in the intermediate future'.