A defective default: keys to understanding the sovereign debt crisis – part 2[1]

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The sovereign debt crisis affecting several eurozone countries is a threat to Europe's financial stability and has had significant international repercussions. The fear of a default within the eurozone has spread from Greece to other states. The various summits that have taken place on the subject have provided only partial and insufficient responses to the problems confronted. For several months now, it has appeared that one of the main impediments to resolving the crisis has been the massive exposure of the financial sector to the debt of eurozone states. A fall in the value of this debt, owing to investor distrust, may lead to banks requiring financial injections to protect their capital positions. As a result, additional funds might well be required from eurozone states. Such support might come from the states directly or come from them indirectly via the European Financial Stability Facility: a double hit for eurozone members. The crisis has made clear the fundamental imbalances in the economies of European states that have, for many years, financed modest economic growth through a steady increase in public and private indebtedness.The eurozone's problems have also demonstrated that the risk of sovereign default is real and not merely theoretical. Because of a general failure, pre-crisis, to contemplate the possibility of a default in the eurozone, a satisfactory legal framework for sovereign debt on sovereign default has not been constructed, a consensus on accounting standards for assessing the value of risky debts has not emerged, and adequate rating methodologies which can be relied upon in unprecedented circumstances have not been devised. These three technical aspects of the sovereign debt matrix (the legal framework, assessment for accounting purposes and credit rating) have not been at the forefront of public attention. They are, however, critical to the effective management of the crisis. This article explores constraints on the policy options available for dealing with the eurozone crisis, explains the reasons behind certain policies which have already been adopted to tackle the crisis, and proposes a number of possible reforms which could help resolve the crisis.[2]

A. A criticised accounting framework

The International Accounting Standards Board (IASB) is the body responsible for the International Financial Reporting Standards (IFRS) which have been adopted by the EU. On 4 August 2011, two weeks after the adoption of the first Greek rescue plan, the president of the IASB wrote to the president of the European Securities and Markets Authority (ESMA).

The letter was sent following the decision by a number of financial institutions to assess the value of their Greek debt by comparing the original value of the debt with a model of future cash flows resulting from implementation of the July rescue plan. This type of assessment produced a discount of 21% while, in contrast, the small number of Greek debt transactions taking place at that time were at a discount of 50%. This difference of nearly 30% could, of course, have a considerable impact on a bank's balance sheet.

1. The basic rules

According to the IFRS (IAS 39.59), a financial asset has to be "impaired" (depreciated) where objective evidence of impairment exists. Such evidence might be, for example, that the issuer is in significant financial difficulties, that the creditor has granted the issuer a concession that it would not have granted under normal circumstances or that there is no longer an active market for the instrument concerned.

To take the example of Greek debt, evidence for its impairment includes the fact that: Greece now relies on external support to cover debt repayments; the International Monetary Fund (IMF) and certain EU Member States have indicated that a private sector haircut is needed; the number of investors who expect a default is increasing; the ability of Greece to fulfil its commitments in terms of austerity seems in doubt; the spreads on Greek debt and the prices of related credit default swaps (CDSs) have increased significantly; the volume of Greek debt exchanged has decreased by more than 95% (perhaps surprisingly, a drop in volume on this scale is not necessarily seen as signifying the disappearance of an active market); and the fact that Greek debt has been given the lowest rating of any sovereign debt in the world (under IAS 39.60, this does not constitute an automatic ground for impairment but does represent important evidence for it).

This evidence mixes the calculation of credit risk with measures of market value (eg sovereign debt spreads and CDS prices), signs of market breakdown (eg trading volume) and credit ratings. This mixed approach reflects a blurring of the distinction between credit risk (concerned with the probability of default, exposure at the moment of default and losses as a result of default) and market risk (fundamentally linked to possible changes in market value).[3]

The accounting treatment applied to the loss on an impaired debt will depend on the creditor's intention. The creditor may intend to hold the debt to maturity (HTM), to consider it as available for sale (AFS) or to include it in a portfolio of negotiated instruments (trading book). If the asset is AFS or trading book, the loss must be included in a profit-and-loss account. If the asset is HTM, the loss of value should be determined based on an appropriate reassessment of expected future cash flows using the original effective interest rate.

2. The IASB letter

The IASB letter acknowledges that the body itself does not have authority to police compliance with its standards. It argues, nevertheless, that it is in the interests of both the IASB and ESMA to ensure the best possible application of accounting rules. The letter claims that the application of the standards has, with respect to Greek debt, been inconsistent.

The letter criticises the assessment of AFS debt,[4] by some financial institutions, using internal valuation methods instead of market values. The letter argues that the former approach should only be used if there is no active market for a given financial instrument. It goes on to suggest that the existence of even a small number of Greek debt transactions represents evidence of the existence of an active market in Greek debt. The letter, moreover, argues that where a model is used to assess value, the model should itself reflect market conditions. The IASB, therefore, argues that where an active market exists, the accounting assessment value should be equivalent to the market value, and where no active market exists, the model on which an assessment is made should be based on an imagined market value.

To return to the facts of the Greek situation and the rescue plan of 21 July 2011, the Institute of International Finance (IIF), which was speaking for the banks, stated with regard to the plan that it would bring about a 21% discount on the original debt. The Greek authorities said that the plan would have to cover a very high proportion of the debt concerned (around 90% for example).

In the situation described above (in which around 90% of Greek debt was to be exchanged in an operation intended to reduce its value by 21%) adherence to the IASB's approach to accounting would prevent the value of 21% being taken into account for the purposes of impairing the Greek debt.

The letter's reasoning in this regard deserves to be quoted in full:

> "It would therefore not be in accordance with either the requirements in, or the intent of, IAS 39 to measure a loss on government bonds classified as AFS financial assets solely by assessing the present value of the future cash flows arising from a proposed restructure of those bonds. It is hard to imagine that there are buyers willing to buy those bonds at the prices indicated by the valuation models being used."

The IASB argues that creditors were unlikely to accept the terms of the July rescue plan. The plan's implementation did, however, appear a genuine possibility at the time; Greece's creditors seemed willing to exchange in the conditions set out.

One can imagine that if Greek debt had, in line with IASB's letter, been impaired by reference to a 50% discount (the existing market rate), and that the July rescue plan had subsequently been implemented, it would have been necessary then to reassess the debt by reference to a haircut of 21%. The practical impact of the temporary 50% valuation would have been to put a number of Greek banks into a net negative position and to weaken considerably the capital ratios of several other financial institutions. Those same banks might, following a reassessment, have found that their capital ratios were above the standard levels.

In view of these consequences, the IASB's argument seems inflexible and over-reliant on market values. The IASB approach also seems to call into question the ability of public authorities to design and implement processes for restructuring public debt in periods of crisis. The approach would, for example, have been a major obstacle to the emerging market debt restructurings of the 1970s and 1980s, such as the Brady Plan and the South Korean restructuring.

3. The situation after the 27 October 2011 rescue plan

The size of the debt reduction under the bailout of 21 July was quickly called into question and European states were, individually, very slow to adopt the bailout. The rescue plan was, of course, ultimately not implemented.

The new bailout agreement of 27 October seems to provide for a 50% discount, although, at the time of writing, the exact details remain unclear.[5] The 50% figure matches the level of market transactions which the IASB argues in its letter should form the basis for the impairment of debt. Does this vindicate the approach taken by the IASB? Perhaps not.[6] The argument in the IASB's letter is that the impairment of debt should be based on market values. The letter does not say that, because of Greece's financial position, the rescue plan needs to provide for a larger haircut. It remains plausible that, had further financial assistance been provided to Greece, the rescue plan of July could have been implemented successfully. This being the case, the value of Greek debt would have, as intended by the plan, been reduced by 21%.

4. Possible solutions

The sovereign debt crisis has resulted, in part, from macroeconomic imbalances that have been exacerbated by the ease with which states have been able to borrow. These macroeconomic imbalances have coincided with large fluctuations in the price and traded volume of sovereign debt, as well as variations in the ability of the market to absorb new issues.

The crisis is challenging not only European states but also financial institutions. The stabilisation of these financial institutions may be hindered by the application of accounting standards in a way that, as described above, relies on market values. The effect of standards being applied in this way could be to force financial institutions to reflect erratic market movements in their capital ratios. There is, moreover, a risk that public sector deficits could be aggravated because of the need to provide financial institutions – struggling to meet rising capital requirements – with funding to compensate them for the impairment of the sovereign debt that they hold.

In light of the above discussion, it is clear that greater consideration needs to be given to the way in which accounting standards are applied in this period of crisis. It is necessary to allow for a distinction to be drawn between debt subject to a restructuring plan and debt that is not. At the European level, amendments to the IFRS that would allow restructuring plans to be taken into account when valuing sovereign debt held AFS could help to achieve this distinction. Before a plan could be taken into account in this way, it would need to appear sufficiently probable that the plan would, with only a short delay (eg within 12 months), be implemented and that it would concern a significant proportion of the debt (eg over 50%). The debt would be valued on the basis of the future cash flows of the instruments issued during the restructuring with an appropriate discount applied. The key parameters of an assessment model of this type should be published and these models should, to the extent possible, be harmonised. Net and gross exposure to debt would be updated at each financial statement publishing date.

It might also be sensible to simplify the reclassification of debt from AFS to HTM and vice versa. This would need to be done in a way that would satisfy the need for market information. Reclassification would have to be taken into account for the purposes of calculating prudential ratios, in the same way in all European countries. The advantage of such a loosening would be to introduce a certain degree of "viscosity" into prices, to reduce the procyclical impact of market volatility, and to provide space for the stabilisation and gradual reduction of eurozone debt levels.

AFS eurozone sovereign debt, not subject to a restructuring plan and not impaired, could be valued on the basis of the probability of default, exposure on default and probable losses on default. This method already prevails for debts categorised as HTM.

Guidelines published by, for example, the IIF[7] could facilitate these changes. Any departure from the guidelines would have to be accounted for and the financial impact of the departure set out.

The changes described would help reduce exposure to market valuations which can be volatile and can deviate for long periods from theoretical equilibrium values. Market volatility can, in particular, have a procyclical effect. Where the market loses confidence in a state – as it did in Italy in autumn 2011 – that state may find it difficult to finance its debt. Even where there has been an increase of several hundred basis points in a country's spreads, this does not necessarily mean that the state's actual ability to repay has changed. Relying on market valuations can leave public authorities running to catch up with events and deprive them of instruments to counter a crisis. Europe may not be able to overcome the sovereign debt crisis if financial support for struggling states has to match erratic movements in the market.

It should be noted that it seems feasible to provide investors with information on the impact of different sovereign debt valuations without turning automatically to market values. This can be done by publishing banks' net and gross exposure to sovereign debt. The EBA has previously, though perhaps not in the most timely or comprehensive manner, published such information. The documents annexed to the EBA's second stress tests set out the country-by-country exposure to sovereign debt of each of the 90 banks studied.

B. Criticised credit rating methods

The way in which rating agencies rate sovereign debt has been shaped by the debt crises of the emerging markets. Their methods do not appear properly adapted to the crisis in the eurozone.

1. Multi-criteria methods for looking at the ability to honour debts

The methodologies used by rating agencies are in the public domain. Although differences exist, the agencies all rely on multi-criteria indicators. Each indicator provides a qualification or quantification. These qualifications and quantifications are the basis for "points" and, ultimately, a rating level (eg AA or BBB). A sovereign rating represents an assessment of the institutional, political and macroeconomic ability of a state to repay its debts when they fall due.

There are fundamental differences between the rating of sovereign bonds and the rating of company bonds (the original task of rating agencies). There are a large number of companies to be rated and there are regular examples of corporate defaults. Agencies can, therefore, check the accuracy of their ratings by monitoring, for example, whether defaulting companies have the lowest ratings. Moody's, for instance, publishes statistics each month to help demonstrate that its ratings are consistent. There are, in contrast, few examples of defaults by sovereign states. It is, as a result, more difficult to monitor the consistency and effectiveness of the ratings of sovereign states. In May 2011, Moody's published its seventh study into defaults by sovereign states, which covers the years 1983–2010.[8] Of more than 100 sovereign states rated in that period, just 14 defaulted. Contrary, perhaps, to public perceptions, there were twice as many sovereign upgrades as downgrades in 2010.

In contrast to states, which issue bonds regularly, companies issue bonds relatively infrequently. Investors in corporate bonds are generally interested in the probability of default and the implicit assumption is that companies should be in a position to honour all of their debts at any time. The implicit assumption with regard to sovereign states is, in contrast, that they should be in a position to borrow on a continual basis. In other words, the focus is not on whether states can repay their debt definitively (this, in fact, being something that very few states would be able to do).

The debt crisis has shown the drastic impact that the closure of debt markets, to a state in financial difficulty, can have. A eurozone state in particular, because it does not have the option of devaluation, can move very quickly from a situation where it has a poor credit rating to a situation where it risks defaulting on its debt. This is what happened to Greece and, to some extent, to Ireland and Portugal. It is what is feared may also happen to Spain and Italy. In effect, the closure of the debt market leads the state to default because it cannot survive without issuing new debt. States are like banks in this sense: both, even if in a fair capital position, can become insolvent if they do not have access to liquidity.

States have, effectively, lost some of their sovereignty by becoming reliant on markets. France, for example, has had a primary deficit for the last 30 years. There is, in France, a quasi-consensus that the deficit should be reduced in order to meet EU rules and stabilise the debt-to-GDP ratio. No such consensus exists around the need to eliminate the state's debt. The policy is one of moderation rather than abstention.

One of the results of this situation is that credit rating agencies, rather than focusing on capacity to repay debt definitively, need to take more account of the ability of sovereigns to continue borrowing. Agencies have to pay more attention to the risk that the market might prevent a state from borrowing, an issue which has often affected emerging economies but has, in the past, rarely affected developed states.

Credit rating agencies also find themselves caught between criticism that they are at once guilty of being "asleep at the wheel" (consider their perceived errors in the context of the subprime crisis) and at the same time responsible for influencing the events that they claim to predict (eg bringing about increased borrowing costs for a country such as Italy).

Certain actors, such as the Cercle des Economistes in France, have suggested that credit rating agencies should suspend their ratings on sovereign debt which is subject to exceptional circumstances. It is, however, not clear that such an approach would be effective or that it could be justified in terms of principle. In autumn 2011, the European Commission considered taking measures in this direction but, ultimately, chose not to do so.

2. Restructuring and default

When rating agencies analyse situations where debt is subject to restructuring, they make an assessment, according to the specific circumstances, as to whether the debt holders have a genuine choice with regard to accepting the restructuring. Where they find that such choice does not exist, the agencies classify the restructuring as an event of default. This appears logical given that a restructuring may force a creditor to suffer an unexpected loss.

One of the results of this approach is, paradoxically, that restructurings, which are intended specifically to avoid a default *in the legal sense*, may nonetheless be classified by rating agencies as events of default. The rescue plan of 21 July, for example, was intended to avoid a legal default. The rating agencies, however, found that its implementation would constitute a distressed (ie forced) restructuring and, therefore, an event of default.

3. Default or selective default?

Just as there is no clear legal meaning for the term "selective default", the rating agencies do not all share the same understanding of the concept. Moody's does not formally recognise the term. Standard & Poor's and Fitch, for their part, classify a situation where a default concerns only part of a state's debt (eg debt of a certain maturity) as a selective default.

As regards their use of the word "default", rating agencies only recognise an event of default, linked to a distressed restructuring, once a plan is being implemented and the exchange of securities has started. Rating agencies can therefore be described as reactive in terms of recognising defaults (in terms of solvency they can be described as anticipatory).

The fact of a rating agency announcing a default has little practical effect in legal or accounting terms. For investors, the effect is also generally minor because investment rules rarely distinguish between the lowest rating grades. This can be contrasted with the fact that investors are often constrained by the upper rating grades. Investors may, for example, be authorised to buy only "investment grade" debt.

It is important to note, however, that the ECB cannot accept as collateral debt from a country classified as in default by two rating agencies. The liquidity of the Greek banking system, of course, depends on intervention by the ECB. That is why it was necessary, in the context of the bailout of 27 October, to find an *ad hoc* guarantee mechanism through which to avoid the restriction.

C. Conclusion

The sovereign debt crisis is the outcome of fundamental macroeconomic imbalances which have, for many years, remained unchallenged. The risk of default is now forcing states to address their deficits and to move towards a position in which they can repay their debts.

There is also a eurozone governance imbalance. The ECB is not matched by a political institution that, by enforcing the Stability and Growth Pact, is able to maintain deficits at lower levels and provide for a co-ordinated response to the current crisis.

Finding solutions to these problems requires political will from the leaders of the eurozone and the EU as a whole. The success of such solutions will, of course, also depend on the unpredictable financial and economic environment.

Technical problems affecting the sovereign debt matrix – legal framework, assessment for accounting purposes and credit rating – will also have to be overcome. This paper has highlighted some of these legal, accounting and credit rating difficulties.

The crisis has been encouraged by the linkages between various factors. It has become clear that the ability to issue debt is linked to prices in the CDS market. The prudential treatment by regulators of sovereign debt has encouraged its purchase by banks. Accounting standards have, conversely, helped to render these large holdings of sovereign debt untenable. The legal framework for sovereign debt has not provided the tools necessary to gather creditors around the negotiating table at times of crisis.

In order to find a way out of the debt crisis, it will be necessary to make a number of technical changes. Issuance contracts need to be standardised, with the inclusion of collective action clauses and the alignment of default terms with those in derivative contracts. In order for CDSs to work predictably, the International Swaps and Derivatives Association's Determination Committees need to make clear determinations. Accounting standards must ensure the provision of accurate information to the market and, at the same time, must not hinder the implementation of restructuring plans or add to procyclical effects. Rating methodologies must be clearer as to how bailout plans are taken into account for the purposes of ratings. These methodologies must also better understand and take into account erratic market behaviour.

Such changes will be the work of experts. Politicians must, however, show vision in order to ensure that reforms do not fail. In the case of accounting standards, in particular, the EU can and must ensure that it speaks with a strong voice in response to views from bodies such as the IASB. ■

The views expressed are those of the authors and do not necessarily reflect those of their institutions.

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1 This is the second part of a translation of the French article "Les défauts du défaut – Quelques clefs pour comprendre la crise de la dette souveraine", published by the French think-tank, En Temps Réel. The first part of the translation was published in the previous issue of this journal. The complete article is available in French at http://entempsreel.com/2011/11/18/les-d%C3%A9fauts-du-d%C3%A9faut-quelques-clefs-pour-comprendre-la-crise-de-la-dette-souveraine-cahi. The article was translated by Manuel Fernandez and Roland Susman.

2 The circumstances and the issues considered by this article are continuing to evolve and develop. The drafting of this article was completed on 16 November 2011.

3 *Cf* Basel Committee on Banking Supervision, working paper no 16, "Findings on the Interaction of Market and Credit Risk".

4 The letter expressly excludes debt classified as HTM from its scope.

5 *Cf* statements by Josef Ackermann and Charles Dallara on the IIF website on 27 October. The statements gave considerably less detail than that given for the 21 July plan.

6 In considering the validity of the IASB's comments, a further relevant issue (not considered in this paper) is whether the body, charged only with creating accounting standards, should intervene in their implementation.

7 It seems, at first blush, more appropriate to entrust this role to the IIF than to a public body, such as the European Commission or a European Supervisory Authority, since public bodies are linked to the sovereigns which issue the debt.

8 Moody's, sovereign default rates and recovery rates, 1983–2010, 10 May 2011.