Bailouts and longer term refinancing operations (LTROs): when temporary cures generate longer term economic concerns

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30 April 2012

ABSTRACT

It is increasingly becoming apparent to domestic and international investors that the European Central Bank's bond buying programme which commenced in May 2010, "a way of correcting market dislocations that were hampering the central bank's conduct of monetary policy", and its provision of much cheaper Longer Term Refinancing Operations (LTROs), constitute more of temporary, expected continuous measures aimed at addressing the Euro zone's sovereign debt problems (through fostering demand for sovereign debt and damping increases in yields).

This paper is aimed at evaluating means whereby a redress of the Euro zone's sovereign debt problems could be effectively achieved. In addition to present regulatory efforts and regulatory measures, it also considers other measures - one of which aims to combine "quantitative easing" schemes with other policies which would effectively address the need to reduce the debt burden of countries such as Greece, Portugal, Spain, Ireland and Italy, whilst incorporating corrective measures which lead to a growth in economic activities as well as increased competitiveness. The emphasis on tough fiscal measures - rather than the need for more stringent regulatory financial reforms is also considered to have played a contributory role – not only in the difficulty encountered by heavily indebted countries in reducing their levels of sovereign debts, but also creating further debts .

Key Words: bond swaps; Greek debt crisis, sovereign debt restructuring; bailouts; Securities Markets Programme; bond yields; domestic bondholders; fiscal, monetary policies; Basel III; Capital standards; Liquidity Standards; macro prudential policy tools; Over-the-Counter (OTC) derivatives; Credit-Default-Swaps (CDS); disclosure; bank; regulation; leverage ratios

Bailouts and Longer Term Refinancing Operations: When Temporary Cures Generate Longer Term Economic Concerns

Marianne Ojo

A. Introduction: The Real Cause of the Recent Financial Crises

The agreement resulting from the European Union Summit in Brussels in December 2011, is not only considered to have generated many headlines – particularly in relation to the disunity resulted from its conclusion, but also considered to have produced a "cure" which is regarded as an inappropriate response to the present challenges being encountered in the Euro zone.

According to Skidelsky, the agreement:

- Forecloses any possibility of Keynesian demand management to fight recession. Structural budget deficits are to be limited to 0.5% of GDP, with (as yet undisclosed) penalties for violators. This is the wrong cure for the euro zone crisis...... It was not deficit spending by governments that fuelled the economic collapse of 2007-2008, but excessive lending by banks. Government's mounting debts have been a response to the economic downturn, not its cause. What ought to have been hard wired into the EU's institutional structure was not permanent fiscal austerity, but tough financial regulation. Of this there is little sign."[1]

Whilst Skidelsky's argument (that tougher regulatory measures are required rather than penalising and permanent fiscal measures), cannot be denied, the contention that there is little

[1] See R Skidelsky, "The Euro In a Shrinking Zone" Business Day, 19 December 2011 <www.businessdayonline.com>

evidence of financial regulatory efforts is more contentious. However, his argument in relation to the need to incorporate the "Keynesian demand management to fight recession" is a valid one which will need to be implemented if a more permanent means of addressing the present Euro zone crisis is to be achieved. For this as well as other reasons, two factors which are considered crucial by the author in addressing the present sovereign debt crisis embrace financial regulatory measures as well as the implementation of fiscal measures which are such that whilst they generate corrective effects, they do not impede[2] the prospects of growth and development for the economy.

During the recent Financial Crisis, as well as the 2010 and ongoing European Sovereign Debt Crisis, several governments had/have had to raise their debt levels in order to stabilize their economies. The principal problem attributed to sovereign debts, which is linked to their characteristics, is the possibility of defaults occurring in relation to these – since they are usually accompanied without collaterals. The possibilities of such defaults occurring are further increased where bailouts are granted in relation to these debts. Increased doubts in relation to the likelihood of larger sovereigns "rolling over maturing debt on their own", as well as the consequential occurrence of "very high, economically penalizing, interest rates", is considered to be the present reality.

Even though it is argued that the most recent Financial Crisis was a capital crisis - not a liquidity crisis, events such as the failure of Northern Rock, as well as problems encountered by major banks which were considered to have been complying with Basel Capital

[2] "When an economy shrinks, government debt grows automatically, because its revenues decline and its expenses rise. When it cuts spending, it debt levels rise even further because cuts in spending lead to further shrinking of the economy. This makes the government more susceptible to defaults." See ibid

requirements, are plausible indicators of the fact that the recent Financial Crisis was triggered by pro cyclical, as well as liquidity related issues such as maturity transformations. The focus accorded by the Basel Committee on Banking Supervision to capital requirements - as opposed to liquidity standards, also provided further justification for evidence which corroborates a lack of sufficient focus on matters and factors which contribute in triggering a liquidity, and ultimately, banking crises.

Whilst it is widely agreed and not disputed that capital and liquidity requirements both contributed to the most recent Financial Crisis, the extent to which Basel III addresses major/fundamental questions arising from the Crisis, provides further grounds for further debates. This paper considers those fundamental issues which have arisen in light of the recent Crisis against the background of efforts which have been made by the Basel Committee to consolidate capital, liquidity standards – as well as macro prudential policy tools. As well as highlighting the increased focus accorded by the Basel Committee to the macro prudential level, the paper will consider macro prudential policies which have been introduced to address system wide risks.

The first four sections of this paper (subsequent to the introductory section) will consider improvements which have been introduced through Basel III in respect of prudential supervisory tools. To facilitate this aim, these sections will consider capital, liquidity and macro prudential supervisory tools which currently exist or are about to be introduced. In emphasizing the need for greater focus on macro prudential policies – which ultimately facilitate a more system-wide market based approach to regulation, sections two to five illustrate how Basel III's more macro prudential focus should help facilitate the monitoring of vital and useful information such as market wide data on asset prices and liquidity. The need for such monitoring being of vital importance since derivative markets, (and the Over the-Counter (O-T-C) derivatives market in particular – being the largest[3] market for derivatives), are largely unregulated with respect to the disclosure of information between parties.

Hence the sixth section of the paper will consider the importance of information gaps – particularly within OTC markets, as well as steps taken by the Basel Committee to address these. The second half of this paper seeks to address some other important aspects, namely:

i) The need to introduce measures which are aimed at facilitating greater disclosure in respect of complex instruments which banks are exposed to during the course of their daily transactions. One of such complex instruments being the OTC derivatives markets – whereby many major banks are exposed to huge losses.

A second means whereby many major banks could be exposed to huge losses is attributed to sovereign debt exposures. "Many European banks are thought to have large holdings of sovereign debt from the "peripheral" countries that have not been marked-to-market, and thus represent sizeable potential losses for the banks when the sovereign debt is ultimately restructured." [4] In fact, the highest proportions of government debt within the Euro zone is

[3] The "OTC derivative market is the largest market for derivatives. According to the Bank for International Settlements, the total outstanding notional amount is US $684 trillion (as of June 2008). Of this notional amount, 67% comprise interest rate contracts; 8% credit default swaps (CDS); 9% foreign exchange contracts; 2% commodity contracts; 1% equity contracts; and 12% other.
Because OTC derivatives are not traded on an exchange, there is no central counter party and they are therefore subject to counter party risk – like an ordinary contract (since each counterparty relies on the other to perform)." See Financial Stability Board, "Implementing OTC Derivatives Market Reforms" 25th October 2010 <http://www.financialstabilityboard.org/publications/r_101025.pdf> and also <http://en.wikipedia.org/wiki/Derivative_(finance)#OTC_and_exchange_traded>

[4] "The ECB and the European central banks", it is further argued, "need to identify those banks that are impaired by excessive sovereign holdings and assist them in recapitalization – however, also pushing the larger, stronger banks to accept exchange offers in the interest of bank transparency and restructuring as well as in

held by private banks. As a result, the sovereign crisis will also transform to a banking crisis in the event of defaults – given the level of exposures.

At the present the European Central Bank is doing its best to sustain demand for sovereign debts. In the past two years, it has purchased bonds from euro zone governments in a bid to sustain demand for these debts, as well as lowering their yields. However the efficiency and effectiveness of the purchase of such bonds is being questioned – particularly owing to the fact that it is widely agreed that the recovery of competitiveness within the euro zone is required. Of greater concern, is the feedback effect generated by Longer Term Refinancing Operations (LTROs) in providing an avenue for banks to invest such cheaper loans (obtained at 1%) from the European Central Bank, in lucrative and financially rewarding investments.

Sovereign debt exposures, the effects of bail outs resulting from sovereign debts and Longer Term Refinancing Operations (LTROs), ways whereby the new Basel liquidity standards could help address sovereign debt problems (as well as other measures which have been proposed), the European Central Bank's recent efforts in its bond purchasing ventures, measures which could be adopted to address the sovereign debt crisis (whilst fostering economic development), as well as developments in what is considered to be "Western Europe's first sovereign debt restructuring in decades" will constitute the focus of discussion in relation to the remaining sections of this paper.

Of greater concern than the European Central Bank's bond buying programme, is the feedback effect generated by Longer Term Refinancing Operations in providing an avenue for

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resolving the sovereign debt problem." See N Economides and RC Smith, "Trichet Bonds To Resolve the European Sovereign Debt Problem" January 2011 at pages 2 and 3 <http://www.ssrn.com/abstract=1836743>

banks to invest such cheaper loans (obtained at 1%) from the European Central Bank, in lucrative and financially rewarding investments. Such investments sometimes assuming the form of the purchase of far higher yielding domestic government debt. It appears that several of these banks are already of the opinion that there will be sovereign defaults on the part of governments anytime and anyway in the near future and that they might as well recoup some profits at the earliest possible time – should sovereign defaults eventually occur.

ii) The sovereign debt problem leads us to another important aspect, the importance of timely implementation of additional leverage ratios which have recently been introduced by the Basel Committee. If the two new liquidity standards, the Liquidity Coverage Ratio (LCR), and the Net Stable Funding Ratio (NSFR), are introduced without coupling these to the additional new leverage ratios, this could lead to a concentration of banks' funds – which could subsequently be vulnerable to sovereign exposures.

Basel III is considered to be "fundamentally different" from Basel I and II as a result of its combination of "micro and macro prudential reforms to address both institution and system level risks."[5]

Basel III = Enhanced Basel II + Macro prudential Outlay[6]

[5] With respect to **micro prudential aspects**, Basel III reforms indicate i) "Significant increase in risk coverage – with focus on areas that were most problematic during the Crisis (for example, trading book exposures, counterparty credit risk, and securitization activities); ii) fundamental tightening of the definition of capital – as well as a strong focus on common equity (introduction of requirements that all capital instruments must absorb losses at the point of non-viability – which was not the case during the most recent Financial Crisis); iii) Introduction of a leverage ratio which should serve as a backstop to the risk based framework; iv) the introduction of global liquidity standards to address short-term and long term liquidity mismatches; and v) Enhancements to Pillar 2's supervisory review process and Pillar 3's market discipline – particularly for trading and securitization activities." S Walter, "Basel III: Stronger Banks and a More Resilient Financial System" http://www.bis.org/speeches/sp110406.pdf at page 3 of 12

Enhanced Basel II = Micro prudential Framework (aimed at "increasing quantity as well as improving quality of capital, adequate capital charges needed in the trading book, enhancing risk management and disclosure, introducing a leverage ratio to supplement risk weighted measures, addressing counter party risk posed by Over-the Counter (OTC) derivatives.")

Macro Prudential Outlay:

This aspect addresses:

i) "stability over time" (pro cyclicality) through:

- Counter cyclical capital charges and forward looking provisioning
- Capital conservation rules for stronger capital buffers

ii) As well as "stability at each point in time" (system wide approach):

- Systemic capital surcharge for systemically important financial institutions
- Identify inter linkages and common exposures among all financial institutions
- Systemic oversight of OTC derivatives (CCP infrastructure)

Weaknesses in Basel rules will be considered from the perspective attributed by such rules to capital and liquidity requirements.

B. Capital Requirements

[6] See H Hannoun, „Towards a Global Financial Stability Framework" Bank for International Settlements Publications page 9 of 26 <http://www.bis.org/speeches/sp100303.pdf>

As highlighted in several papers,[7] Basel II's internal credit risk models[8] were not only considered to be:

- Unduly risk sensitive, but also tended to generate pro cyclical effects. This was illustrated during the Northern Rock Crisis.[9] It has also been stated[10] that Basel rules focused on one type of risk – the risk that a bank would make too many bad loans and lose so much money on those loans (such that its capital was wiped out). Whilst these observations reflect the magnitude of attention dedicated to capital requirements, it also highlights problems attributed to measurements in relation to such capital requirements.
- They also generated pro cyclical effects. Pro cyclicality is a fundamental issue arising from the implementation of Basel II capital requirements.

[7] For example, see M Ojo, "Basel III and Responding to the Recent Financial Crisis: Progress made by the Basel Committee in relation to the Need for Increased Bank Capital and Increased Quality of Loss Absorbing Capital" http://ssrn.com/abstract=1680886 at page 3 of 15. "The introduction of Basel II resulted in changes being made to the 1988 Basel Capital Accord to provide for a choice of three broad approaches to credit risk. This was introduced into Basel II in view of the realization that the optimal balance may differ significantly across banks. The increased focus on risk (and particularly credit risk), resulted from growing realization of the importance of risk within the financial sector. The range of approaches to credit risk – as introduced under Basel II, and which also exists for market risk, consists of the Standardised approach (which is the simplest of the three broad approaches), the internal ratings based (IRB) foundational and advanced approaches." See Basel Committee on Banking Supervision, "Consultative Document, Standard Approach to Credit Risk, Supporting Document to the New Basel Accord, January 2001 at page 1 http://www.bis.org/publ/bcbsca04.pdf and Basel Committee on Banking Supervision, "Consultative Document, The Internal Ratings Based Approach Supporting Document to the New Basel Capital Accord" January 2001 Bank for International Settlements publications <http://www.bis.org/publ/bcbsca05.pdf>

[8] Basel II's internal credit risk models generated pro cyclical effects – given the fact that such models were overly sensitive in their implementation for the calculation of regulatory capital (their implementation to facilitate "the derivation of fundamental inputs for formulas which will determine the level of capital which large banks must retain").

[9] "One of the underlying features of the recent Crisis was the build-up of excessive on and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while still showing strong risk based capital ratios. During the most severe part of the Crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses, declines in bank capital, and contraction in credit availability." See Basel Committee on Banking Supervision, "Basel III: A Global Regulatory Framework For More Resilient Banks and Banking Systems" December 2010 at page 68 – 69 of 77 <http://www.bis.org/publ/bcbs189.pdf>

[10] T Congdon, "Northern Rock Shows Up Mess of Basel Rules" January 2008 < http://www.telegraph.co.uk/finance/markets/2783500/Northern-Rock-shows-up-mess-of-Baselrules.html> (last visited 22 April 2012)

Another vital distinction between Basel II and Basel III is evident from the fact that under Basel III, systemically important banks will be required to have loss absorbing capacity beyond the standards approved and announced on the 12th September 2010.[11] Furthermore, the Basel Committee and the Financial Stability Board (FSB) are "developing a well integrated approach to systemically important financial institutions which could include a combination of capital surcharges, contingent capital and bail in debt."[12]

Total Regulatory Capital for systemically important banks is considered to be: [Tier One Capital Ratio] + [Capital Conservation Buffer] + [Counter Cyclical Capital Buffer] + [Capital for Systemically Important Banks][13]

C. Liquidity Requirements

In highlighting why the relatively low focus attached to liquidity requirements constituted another element of those weaknesses attributed to Basel rules, the importance of liquidity and the role of banks in maturity transformations (ultimately triggering banking crises), has been demonstrated in several respects.[14]

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[11] See Basel Committee for Banking Supervision, "Groups of Governors and Heads of Supervision Announce Higher Global Minimum Capital Standards" 12 September 2010 at page 2 of 7 <http://www.bis.org/press/p100912.pdf?noframes=1>

[12] ibid

[13] For further information on capital conservation buffer and counter cyclical capital buffer, see section D of this paper, "Basel III's Efforts to address Capital and Liquidity Requirements". See also Basel III Compliance Professionals Association (BiiiCPA), "The Basel III Accord: Capital for Systemically Important Banks Only" < http://www.basel-iii-accord.com>

[14] For example, see Basel Committee on Banking Supervision, "Principles for Sound Liquidity Risk Management and Supervision" September 2008 at page 1 <http://www.bis.org/publ/bcbs144.htm>; As well as (banks) being regarded as highly leveraged institutions which are considered to be "at the centre of the credit intermediation process", functions related to credit and maturity transformation are considered to be "vulnerable to liquidity runs and loss of confidence." See also S Walter, "Basel III: Stronger Banks and a More Resilient Financial System" http://www.bis.org/speeches/sp110406.pdf at page 1 of 12

The Liquid Coverage Ratio (LCR) which imposes a requirement that banks maintain an adequate level of "unencumbered, high-quality liquid assets that can be converted to cash to meet its liquidity needs for a 30 calendar day time horizon under severe liquidity stress conditions specified by supervisors"[15] and the Net Stable Funding Ratio (NSFR) Standard which is designed to "promote longer-term funding of the assets and activities of banking organizations by establishing a minimum acceptable amount of stable funding based on the liquidity of an institution's assets and activities over a one-year horizon",[16] it is argued, should facilitate a diversification of liquid assets – hence discouraging a situation where they could be accumulated and susceptible to exposures such as those relating to sovereign debts.

It will however, be highlighted in subsequent sections of the paper, that the two new Basel liquidity standards, will probably not achieve their desired objectives where such standards are not coupled with leverage ratios.

D. Basel III's Efforts to address Capital and Liquidity Requirements

The incorporation of macro prudential elements into Basel III – in the form of capital buffers, the new liquidity standards, and leverage ratios, can be regarded as efforts aimed at addressing capital and liquidity requirements.

Capital Buffers: Such buffers are intended solely (as well as not exclusively) to address problems attributed to pro cyclicality. They consist of:

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[15] See Basel Committee for Banking Supervision, "Consultative Document, International Framework for Liquidity Risk Measurement, Standards and Monitoring" December 2009 at page 3 (11 of 44) <http://www.bis.org/publ/bcbs165.pdf>

[16] ibid

- Counter cyclical capital buffers[17]
- Capital conservation buffers

Counter cyclical capital buffers and capital conservation buffers constitute macro prudential tools in the "time dimension"[18] – such tools focusing on the need to mitigate pro-cyclical effects.

Whilst counter cyclical capital buffers and capital conservation buffers are synonymous with capital requirements, equivalent "buffers" which serve to address liquidity imbalances comprise the two new liquidity standards, the Liquid Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). Further, these new liquidity standards and the additional minimum leverage ratio, it is argued, "could limit the build-up of financial imbalances during the expansion phase of the financial cycle.

In particular, the additional leverage ratio provides an important back stop in cases where excessive optimistic point-in-time risk measures tend to shrink risk weighted assets and required cushions."[19]

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[17] With counter cyclical capital buffers, "the build-up of the buffer is encouraged through restrictions on capital distributions. Authorities would then release the buffer based on signs of strains, such as aggregate losses or tighter credit terms. In both cases, the exercise of discretion still applies." See Bank for International Settlements, "Macro prudential Policy Tools and Frameworks: Update to G20 Finance Ministers and Central Bank Governors." at page 5
<http://www.bis.org/publ/othp13.pdf>

[18] The first of two dimensions on which macro prudential policies aim to address system wide risk. The second dimension is referred to as "the cross sectional dimension". The "time-dimension" is defined as "the evolution of system-wide risk over time" whilst the "cross sectional dimension" is defined as "the distribution of risk in the financial system – at a given point in time". See ibid at page 2

[19] Ibid at page 6

Leverage Ratios: The minimum leverage ratio and the new liquidity standards are considered[20] to have the potential to limit the build-up of financial imbalances during the expansion phase of the financial cycle. Leverage ratios such as debt ratios (ratio of debt to assets); debt-equity ratios, usually provide good indication of an entity's means of financing. Such ratios reflect whether such an entity is able to meet its obligations as it falls due. Hence they also reflect how "liquid" a firm is. If the quality of debts issued by an entity is poor, then the possibility of redeeming such may result in a situation where the company is left in a vulnerable position (owing to level of losses incurred) – since it finds it difficult to meet its obligations as they fall due. The impact of short term borrowing on maturity and liquidity has been considered in various literature on the topic.[21]

Deleveraging is a process whereby an undertaking or financial intermediary attempts to reduce its balance sheet, for example, by disposing of its assets.

Recent Basel III reforms will play a huge role in the level of deleveraging (by banks) - which is presently occurring (and which is expected to take place in the subsequent months).

E. Macro prudential policies

A macro prudential policy is one which "uses primarily prudential tools to limit systemic or system wide financial risk – thereby limiting the incidence of disruptions in the provision of key financial services that can have serious consequences for the real economy by:

[20] See S Walter, "Basel III: Stronger Banks and a More Resilient Financial System" http://www.bis.org/speeches/sp110406.pdf at page 6 of 12

[21] "Deleveraging also puts **additional** downward pressure on financial markets." Furthermore, consequences of short term borrowing include "serious liquidity problems especially in the case of financial distress: the funding of long term investments through short term debt widens maturity and liquidity gaps, making banks more vulnerable to runs." See N Papanikolaou and C Wolff, "Leverage and Risk in US Commercial Banking in the Light of the Recent Financial Crisis." March 2011 Draft

- Dampening the build-up of financial imbalances and building defences which contain the speed and sharpness of subsequent downswings and their effects on the economy;
- Identifying and addressing common exposures, risk concentrations, linkages and interdependencies that are sources of contagion and spill over risks that may jeopardize the functioning of the system as a whole."[22]

Pro cyclicality (as well as its impact), is usually attributed to the aggregational build-up of system wide risks over time. Policies which exacerbate cyclical tendencies (for example Basel II's capital requirements)/cyclical effects which are exacerbated during peaks and booms and which usually demonstrate the impact of aggregational effects of cyclical phases, are referred to as being pro cyclical.[23]

F. **Information gaps in Over-the Counter (OTC) derivative markets –** ongoing efforts by the Basel Committee to address these.

In view of the inter dependencies between systemic, liquidity risks, moral hazard, transparency, information asymmetries and disclosure, ongoing efforts by the Committee to address information gaps in OTC derivative markets cannot be regarded as surprising. Efforts being undertaken by the Basel Committee, as well as other bodies such as the Financial Stability Board, in focusing on a more system-wide based regulatory process involve the implementation of "time dimension" and "cross sectional dimension" macro prudential policies, as well as plans aimed at facilitating these policies. Such a macro prudential

[22] See Bank for International Settlements, „Macro prudential Policy Tools and Frameworks: Update to G20 Finance Ministers and Central Bank Governors" February 2011 at page 2 < http://www.bis.org/publ/othp13.pdf>

[23] „Leverage ratios serve a macro prudential response – in respect of the cyclical movement of leverage at the system wide level. Leverage which tends to build up prior to crisis periods, is subsequently unwound when a crisis occurs. This cyclical aspect exacerbates both the upswing phase and the downturn. In addition, what could appear to be very low risk assets at the institutional level, can ultimately create incentives for the build-up of risks at the broader system level."

approach will consequently result in greater extension of regulation to the securities markets. Further, it will help facilitate the monitoring of vital and useful information such as market wide asset prices and liquidity. Substantial work is currently taking place to address important data gaps:[24]

Within the overall programme, priorities involve the provision of information on aspects where the absence of good information has proved costly, and in particular:

i) The inter linkages between large, globally systemically important institutions
ii) Emerging concentrations of risk in terms of both exposures and funding dependencies to certain institutions, countries and financial sectors;
iii) The transfer and ultimate holding of risk
iv) System wide leverage and maturity mismatches

G Sovereign Debts and Moral Hazard Attributed to Sovereign Debt Bailouts

During the recent Financial Crisis (as well as the 2010 and ongoing European Sovereign Debt Crisis), several governments have had to raise their debt levels in order to stabilize their economies. The principal problem attributed to sovereign debts, which is linked to their characteristics,[25] is the possibility of defaults occurring. Increased doubts in relation to the

[24] See Bank for International Settlements, „Macro prudential Policy Tools and Frameworks: Update to G20 Finance Ministers and Central Bank Governors" February 2011 at page 3 <http://www.bis.org/publ/othp13.pdf>
[25] Sovereign debts differ from private debts in view of the fact that:
- Collateral is rarely ever provided;
- No direct means exist to ensure the enforcement of the repayment of sovereign debts
- No specified procedures exist in respect of a sovereign debtor who is unwilling to pay. See S Brandauer, "Sovereign Debt and Economic Policies in Global Markets: A Political Economy Approach" (2006) – particularly chapter on "Domestic Debt as a Commitment Device – A Probabilistic Voting Model of Sovereign Debt" at page 20 http://edoc.ub.unimuenchen.de/5082/1/Brandauer_Stefan.pdf (last visited 23 April 2012)

likelihood of larger sovereigns "rolling over maturing debt on their own", as well as the consequential occurrence of "very high, economically penalizing, interest rates", is considered to be the present reality.[26]

Another problem involves bailouts related to sovereign debts: Whilst bailouts are deemed essential in facilitating financial stability, moral hazard, increased costs (particularly with regards to high interest rates), attributed to such bailouts need to be addressed. Where bailouts are eventually granted, distressed countries in need of such bailouts should be assisted in completing the repayments relating to such bailouts (through the extension of repayment periods or reduced interest rates) – rather than aggravating their position (hence facilitating the risk of defaults).

Whilst bailouts, in certain instances, are necessary in order to facilitate financial stability, such bailouts should occur as a means of last resort – after other initiatives and remedies have been applied and sought. On March 12 2011, EU officials announced the following remedies as a means of sustaining European sovereign debt markets: [27]

- Doubling the lending capacity of the European Financial Stability Facility (EFSF)[28] from 220 billion Euros to 440 billion Euros;

[26]See N Economides and RC Smith, „Trichet Bonds To Resolve the European Sovereign Debt Problem" January 2011 NET Institute at page 7 http://ssrn.com/abstract=1836743

[27] See N Isaac, „EU Bailouts Fail to Keep European Sovereign Debt Markets Afloat" April 2011 <http://www.elliottwave.com>

[28] On the 9th May 2010, Europe's Finance Ministers approved the creation of the European Financial Stability Facility – which is aimed at preserving financial stability in Europe (through the provision of financial assistance to Euro zone states during periods of economic difficulty). The objective of the EFSF being the collection of funds and the provision of loans in conjunction with the IMF to address the financing needs of Euro area member states in difficulty. Euro area member states are to provide guarantees for EFSF issuance of up to a total of 440 billion euro on a pro rata basis. See G Calice, J Chen and J Williams, "Liquidity Interactions in Credit Markets: An Analysis of the Euro zone Sovereign Debt Crisis> at page 1 of 41

- Purchasing the sovereign debt of primary markets, as needed;

- Extending the repayment period for and lower than the interest rate charged on Greece's rescue loans.

It is not surprising that yields on the ten year Spanish, Greek and Portuguese bonds soared to new records, following the announcement. Such reaction serves only to justify the assertion that bailouts should not always be granted liberally without having consulted other measures. Sovereign debts, as highlighted previously in the paper, given their nature, are more susceptible to defaults than other forms of private debts. The possibilities of such defaults occurring are further increased where bailouts are granted in relation to these debts.

According to Economides and Smith, the European authorities' solution relating to the ECB's purchase of outstanding sovereign debt in the market (as of January 2011) had only succeeded in buying a small amount of the distressed debt whilst pushing bond prices upwards as a result of such intervention. They propose the creation of so called "Trichet Bonds" which are intended to be "new long duration bonds issued by countries in the EU area that are to be collateralized by zero coupon bonds of the same duration issued by the ECB".[29] Advantages attributed to such "Trichet Bonds" are as follows:[30]

- Trichet Bonds Eliminate Uncertainties in respect of the Refinancing of Distressed Countries' Maturing Debt;

<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1776425>

[29] See N Economides and R C Smith, „Trichet Bonds to Resolve the European Sovereign Debt Problem" at page 2 <http://ssrn.com/abstract=1836743>

[30] Ibid at pages 5 and 6

- Trichet Bonds will be of much higher quality than present sovereign debt of distressed countries;

- Trichet bonds will be liquid;

- Trichet bonds will require no bailouts and imply no moral hazard;

- Trichet Bonds provide debt relief for distressed economies;

- The exchange is voluntary and beneficial to both countries and debt holders.

Such Trichet bonds, indeed, would have provided a better alternative to the remedies announced by EU officials on March 12, 2011. Had such Trichet bonds been considered as an initial resort, and given the existence of appropriate and adequate incentives for countries issuing such bonds, as well as debt holders to participate in the exchange process, they could have served as better initial options than the subsequent European bailouts.

Any possibilities or likelihood of successfully implementing such Trichet bonds at present, should be considered doubtful since no incentives would appear to exist – with respect to distressed EU countries such as Greece, Spain, Ireland and Portugal, in issuing such bonds. This is attributed to the fact that such countries having had a "better offer" in agreeing to the March 12 2011 remedies, are likely to be more reluctant to purchase "zero coupon collateral bonds" directly from the (European Central Bank) ECB. Apart from addressing whether such countries are able to "apply some of (or any of) their reserves held by the ECB for this purpose, or otherwise enter into an appropriate financing package with the ECB,"[31] there would appear to be less incentives for such countries to issue these Trichet bonds since they

[31] Ibid at page 5

have relatively long term obligations (ten year bonds) at present. For these reasons, such possibilities of having provided a collateral with exchanged sovereign bonds (via the issue of Trichet bonds by distressed European countries), have been significantly reduced. There is now increased likelihood (with increased national deficits of certain distressed countries) that defaults will occur.

II. Should sovereign debts be encouraged?

Since the ECB's bond purchasing programme commences in May 2010, "all of the bonds have been purchased on secondary markets rather than directly from governments. Further the ECB holds 214 billion worth of Euros in euro zone government bonds."

Increased costs[32] of sovereign debts will not only discourage investors in purchasing such debts (hence promoting a situation where higher yields occur) but would also increase possibilities where some bond holders (investors) may have to share costs attributed to future bailouts – with possibilities that taxpayers could even become involved in the cost sharing process.

Sovereign debts should be encouraged: i) where such debts are required for the stabilization of economies and; ii) where some form of collateral accompanies such debts.

[32] - Booming deficits and the need to finance banking bailouts worth billions have turned sovereign bonds into the new "junk debt market". Investors are now paying $88,000 to insure $I million worth of debt issued by a group of sovereign countries – or 88 basis points – more than the $83,000 paid to insure $1 million worth of corporate debt. The growing problems of the Greek economy during 2010 resulted in the cost of its protection against default rising to more than 400 basis points." See E Moya, "Greece and the Rising Costs of Sovereign Bonds" 29 January 2010
<http://www.guardian.co.uk/business/2010/jan/29/greece-debt-eu-sovereign-bonds>

III. Longer Term Refinancing Operations (LTROs)

The potential effects of the announcement of Longer Term Refinancing Operations in December 2011, were initially undermined – however their generative effects, with particular respect to the relationship between banks and governments, is becoming all the more apparent.[33] "The LTRO effect" is considered to be so powerful because it provided banks with "a simple domestic trade that looked potentially lucrative."

- The market is now re-evaluating the European Central Bank's cheap three-year loans of LTROs to banks. The ECB would lend banks money at 1 per cent which they could then invest – particularly if they were Spanish or Italian – in far higher-yielding domestic government debt. The banks not only obtained these in record amounts, there was also clear evidence of international investors selling out to domestic institutions. This has aroused great worry for many – particularly since (ultimately) the market is only sustained by domestic banks which are running out of money – which could even generate wider and wider spreads."

Hence, Longer Term Refinancing Operations have also contributed towards triggering high yields – domestic far higher yielding government debt. Hence they are considered by many to have had little impact in easing the euro zone's sovereign debt problems. Although they are considered to provide a temporary solution, they do not address the sovereign debt problem. The provision of LTROs by the ECB – rather than a resort to its bond buying programme, has also raised suspicions about the effectiveness of, and belief in the bailout measures. However,

[33] See R Milne, Financial Times, Friday 13 – 15 April 2012, page 21 Business Day, www.businessdayonline.com

whilst the liquidity assistance by both measures offers ease to the governments involved, it also appears that the European Central Bank as well as domestic banks, will continue to accumulate higher proportions of sovereign debt. The European Central Bank, with its contentious bond buying programme has attempted to facilitate a situation whereby governments are able to buy time – having the knowledge that both the bond buying programme as well as the Longer Term Refinancing Operations might only serve as temporary measures.

Indeed it has provided such measures in the hope that governments will be able to act with the time purchased (through provision of emergency liquidity) in rectifying fiscal problems. However, such expected returns (on the part of the government) do not appear to be forthcoming and indeed, it is not very difficult to appreciate why governments faced with austere fiscal measures, are able (in the face of such measures) to reduce present debt levels – given a situation which only exacerbates and increases such debt levels.

The ensuing sections of the paper are aimed at highlighting measures which could be adopted to address the sovereign debt crisis (whilst fostering economic development).

H. Role of New Basel Liquidity Standards in Mitigating Sovereign Debt Crises

It is argued that the new liquidity standards should help facilitate greater diversification of the pool of liquid assets held by banks – contrary to the argument presented by those who are of the opinion that the new liquidity standards will facilitate a situation where a concentration of government debts are encouraged.[34]

[34]See S Walter, „Basel III: Stronger Banks and a More Resilient Financial System“

According to the Basel Committee's most recent impact study, "bank holdings of liquid assets – which continue to be dominated by exposures to sovereigns, central banks and zero percent risk weighted public sector entities, comprise 85% of banks' liquid assets."[35]

Having considered both new liquidity standards,[36] it could be said that the second standard, that is the Net Stable Funding Ratio (NSFR) Standard, is more likely to facilitate a situation where assets are concentrated and susceptible to sovereign exposures. In any case, the crucial issue relates to the need to address the liquidity needs of such banking entities – and consideration of the fact that such standards did not exist previously – hence contributing to the fuelling of systemic and liquidity risks which triggered the recent Financial Crisis.

Furthermore, the additional leverage ratios which are to be introduced[37] by the Basel Committee, should help in facilitating the diversification of liquid assets. The two new standards, on their own, would probably not be able to effectively achieve the objective of diversification of liquid assets.

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http://www.bis.org/speeches/sp110406.pdf at page 4 of 12

[35] ibid

[36] "The first objective of the two standards is to promote the short-term resiliency of the liquidity risk profile of institutions by ensuring that they have sufficient high quality liquid resources to survive an acute stress scenario lasting for one month. The Committee developed the Liquidity Coverage Ratio to achieve this objective. The second objective is to promote resiliency over longer term time horizons by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing structural basis."

[37] "The Basel Committee agreed to introduce a simple, transparent, non-risk based leverage ratio that is calibrated to act as a credible supplementary measure to the risk based capital requirements. The leverage ratio is intended to achieve the objectives of constraining the build-up of leverage in the banking sector, helping avoid destabilizing deleveraging processes which can damage the broader financial system and the economy; and reinforcing the risk based requirements with a simple non-risk based "back stop" measure." See Basel Committee on Banking Supervision, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" at pages 68-69 of 77

Leverage ratios will therefore play vital roles at the present time (and in the future) by:

- Helping to facilitate the diversification of assets – liquid assets in particular (and with respect to the new liquidity standards); and
- Helping to avoid the present consequential effects of Basel III – where banks, in an aim to achieve regulatory capital and leverage ratio requirements, are compelled into a situation where aggressive de leverage occurs.

I How Can the New Basel Liquidity Standards be Implemented More Optimally to Mitigate Sovereign Debt Crises?: Importance of Information Channels

Market Liquidity and Sovereign Debts: Monitoring of Information Channels\

- Manipulation of market liquidity is often the primary mechanism through which speculative attacks are channelled and in this case, the object of interest is the bilateral liquidity structure of the sovereign debt market and the sovereign CDS (Credit Default Swap) market."[38] The role and impact of the manipulation of the CDS market by speculative investors in exacerbating the liquidity dry up in the market for Greek, Irish, Portuguese and Spanish sovereign debts, during the 2010 Euro Crisis, raised concerns amongst several commentators.[39]

In this respect, greater focus on Pillar 3 of Basel II and the ever increasing need for greater measures aimed at extending capital rules (as well as other regulatory measures) to the securities markets, comes into play. If securities markets were not so lightly regulated as is the case with banks, less opportunities would be presented to investors who are able to

[38] See G Calice, J Chen and J Williams, "Liquidity Interactions in Credit Markets: An Analysis of the Euro zone Sovereign Debt Crisis> at page 5 of 41 <http://papers.ssrn.com/sol3/papers.cfm? abstract_id=1776425>
[39] See ibid at page 2 of 41

manipulate[40] CDS markets. Measures aimed at facilitating greater enhanced disclosures continue to play a vital role in facilitating market discipline. However, in order to reduce incidences of "manipulation" by speculative investors, greater discretion in respect of the timing and release of information to investors, will be required. Just as information plays a crucial role in fuelling bank runs, it also plays a vital role in manipulation within the CDS markets. Regulations which are able to address "short-term speculative short selling practices" in respect of sovereign debts will be required within the CDS markets.

It has also been demonstrated that "whilst liquidity of the sovereign debt market dried up over the Crisis period of 2010, the liquidity of the CDS market increase dramatically with spread bids and spreads asked (offered) – approaching a one to one ratio."

J. Greek Debt Re structuring Process and "Quantitative Easing" Measures

With a partial sovereign default having already taken place in Greece, it is considered highly likely that further debt restructuring in other heavily indebted countries will occur – with Ireland or Portugal being tipped to follow suit. This not only highlights the eventualities of bailouts but also underlines why in the event of sovereign debt restructuring, further deeper and more effective measures than merely the purchase of sovereign debts will be needed to address ever accumulating levels of government debt.

The debt swap in Greece which took place during the first half 2012, the Private Sector Involvement (PSI), the "largest debt restructuring in history", was considered a success. The

[40] "In particular, "naked" CDS positions were blamed for driving bond yields on Greek, Irish, Spanish and Portuguese debt higher during the first half of 2010. Further, the manipulation of the CDS market by speculative investors was considered to have played a vital role in facilitating the dry up in the market for such countries' sovereign debts. See ibid

completion of the bulk of the swap (which had been accepted by at least 97% of investors around the 6th April 2012 – with May 15th being the latest deadline for the Greek government to decide what to do with those bondholders who did not wish to participate in the PSI), enabled Greece "to obtain a new EU/IMF bailout in March 2012 – which has helped to ease market concerns over the euro zone crisis" – if even this was a temporary measure.[41] "The government is left with three options to confront those bondholders still resisting, namely:[42]

- Continue to service the bonds
- Default and trigger litigation
- Come up with a new offer while ensuring fair treatment for those who have already accepted the swap.

Having obtained another bailout, with more bailouts or probably another LTRO on the way – for those countries who have been granted bailouts and who are likely to undergo debt restructuring soon, it appears likely that these countries will eventually default.[43] Even more likely if urgent measures and effective measures are not implemented to address their sovereign debt problems.

Two measures, which in Skidelsky's opinion might address these problems include:

i) Quantitative easing (printing of money on a heroic scale). He adds further that the ECB should be empowered to buy any amount of Greek, Italian, Spanish, and Portuguese government bonds required to drive their yield to near German levels. This might stimulate real growth through several channels of which include: the

[41] See The Punch, "Greece Extends Bond Swap Deadline Again" April 6 2012 at page 21.

[42] ibid "Greece completed the bulk of its bond exchange on March 12 2012, swapping a nominal amount of 177 billion worth of Euros of domestic law government paper for new securities, inflicting real losses of about 74% on private sector bondholders."

[43] "To make the PSI palatable, euro zone officials are offering incentives, including a 30 billion Euros worth pool of cash. In addition to a cash payment worth 15 percent of the face value of their bond, each participant will get a new Greek bond worth 31.5%. Those new bonds are far more secure since they will be issued under English law, making it impossible for the Greek Parliament to force a default in future. They will also be treated identically to bailout loans, meaning any future losses would have to be shared by euro zone governments."

reduction of lending rates, through raising the nominal value of public and private assets, and through weakening the euro against the dollar and other currencies."[44]

He however adds that the effects of quantitative easing on economic activity are uncertain and that such an inflationary policy might trigger retaliation from Europe's trading partners. For this reason, he proposes:

ii) A combination of quantitative easing with public investment – which should impart the growth impetus that the euro zone is urgently in need of – in order to bring about a gradual reduction in its aggregate debt burden."[45]

K. **Conclusion**

As highlighted in a previous paper, "the monitoring of useful data - such as market wide data on asset prices and liquidity, institution related information such as credit default swap (CDS) spreads and equity prices, additional institution-specific information related to the ability of the institution to fund itself in various wholesale funding markets, and the price at which it can do so, will be vital in obtaining a source of instantaneous data on potential liquidity problems."[46]

In relation to the "cross sectional dimensional aspect" of the Basel Committee's macro prudential policies, several provisions in Basel III should help to "address system risk and

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[44] R Skidelsky, "The Euro In a Shrinking Zone" Business Day, 19 December 2011 <www.businessdayonline.com>

[45]ibid

[46] See M Ojo, „Preparing for Basel IV (Whilst Commending Basel III) – Why Liquidity Risks Still Present a Challenge to Regulators in Prudential Supervision (II); and also Basel Committee on Banking Supervision, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" at page 18 of 17 <http://www.bis.org/publ/bcbs189.pdf>

interconnectedness among (global) systemic institutions, by mitigating the risks arising from firm-level "cross dimensional" approach exposures.

These include: higher capital requirements for trading and derivative activities, complex securitizations and off balance sheet exposures, capital incentives for banks to use central counter parties for OTC derivatives; liquidity requirements that better address funding risks related to excessive reliance on wholesale short term funding."[47]

Until intended leverage ratios are introduced and coupled with the new liquidity standards [namely: the (Liquid Coverage Ratio) LCR and the Net stable Funding Ratio (NSFR)]; these standards will probably not achieve half their desired effects – since liquid assets could be accumulated under these standards, such as to an extent where they are susceptible to sovereign exposures. This is one reason (amongst many),[48] for concluding that whilst the Basel Committee has gone a long way in addressing liquidity risks, its efforts still remain a modest milestone in combating liquidity risks in prudential supervision.

In relation to the ECB's efforts to provide temporary liquidity assistance – through measures such as the Securities Markets Programme and LTROs, more effective measures aimed at bringing about a reduction in overall debt levels, whilst stimulating economic growth, would be required if defaults are to be avoided by countries with sovereign debt problems. At the moment it appears more likely that bailouts will continue to be provided and that sovereign debt levels will continue to rise – given tough and austere fiscal measures operating in

[47] Bank for International Settlements, „Macro prudential Policy Tools and Frameworks: Update to G20 Finance Ministers and Central Bank Governors" February 2011 at page 7 <
http://www.bis.org/publ/othp13.pdf>

[48] Further challenges presented to Basel III include the restrictions imposed on it by the Dodd Frank Act – even though the Act is similar to Basel III in several respects (for example, in respect of its requirements of more stringent capital and liquidity standards, and a non risk leverage ratio).

countries who have received bailouts. Given these circumstances, it becomes much easier to appreciate why these countries are likely to default on their sovereign debt obligations.

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