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The Euro Area Sovereign Debt Crisis: Secure the Debt and Modify Haircuts

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The Euro Area Sovereign Debt Crisis: Secure the Debt and Modify Haircuts*

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The euro area sovereign debt crisis and its corollary, the looming threat of a euro crisis, has been facilitated by a monetary design that has permitted the euro to be backed by unsecured sovereign debt at haircuts that appear to have been too low. For example, as of the time of writing, the ECB applies a haircut of 3% on 6 year Spanish and Italian government bonds, the same as on a corresponding German government bond.¹ The low haircuts have allowed cheap and excessive public borrowing, and the lack of security is now making it hard for creditors to collect on their loans. As a first step towards a sounder euro area monetary system, sovereign debt should be collateralized. The rules for setting haircuts should also be reviewed.

The current Greek debt restructuring and bailout process highlights the problems with ex-post renegotiation, whereby a defaulting debtor seeks to renegotiate her debt rather than repaying what she can. The costs associated with default are reduced if the debt is secured. Most lenders and creditors are aware of this, as illustrated for example by standard home mortgage contracts. Insolvency law recognizes this too, by providing mechanisms that allow creditors to take possession of the assets that secure the loans they have given as well as procedures for the orderly liquidation of a defaulting debtor's assets. Sovereign

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¹See [//www.ecb.int/mopo/assets/html/index.en.html](http://www.ecb.int/mopo/assets/html/index.en.html). Note that haircuts may change over time. See also Bindseil, Nyborg, and Strebulaev (2009) for evidence suggesting that the ECB uses collateral haircuts that do not equilibrate opportunity costs.

debt is a different matter because few mechanisms exist to enforce repayment. This makes it all the more important to secure sovereign debt, especially in a common currency area such as the euro zone, where the quality of the common currency is a function of what each individual member state brings to the table to back up the currency and to secure the banking and financial system.

An important, but underemphasized, element of monetary policy is the collateral that a central bank accepts in return for issuing central bank money to banks and the haircut that is applied to the collateral. Currently, counterparties (banks in the euro area) have outstanding repos with the European Central Bank of around euros 400 billion. A significant fraction of this rolls over as a matter of course every week. The underlying collateral in these repos is analogous to the metal that once backed currencies. The worse the collateral and the lower the haircuts, the more debased and weaker is the currency. The larger the scope and risk of debasement, the more fragile is the financial system built on and around the currency. Requiring the ECB to only accept secured sovereign debt will strengthen the euro area financial system.

In the case of Greece there are numerous assets that can be sold off to help service and repay her debt. Indeed, much has been made of this in the media. However, we are missing a mechanism to enforce such sales and, perhaps more importantly, a well considered plan as to what assets to sell. If the debt had been secured, this would already have been in place. Meanwhile, Greece, unlike most private non-bank borrowers, can continue to hold up Europe with the implicit threat of a full blown crisis, arising from contagion to other euro area member states. If Greece were not part of the euro zone, it is unlikely that her plight would draw the same headlines and have the same impact on world markets that it has. This underscores the importance of collateralizing euro area sovereign debt, for the benefit of all of its members states and their citizens.

It is hard to see a good reason for why one could not require euro area sovereign debt, that is eligible for use in repos with the ECB, to be secured. Member states may object because this may require a (contingent) weakening of their sovereignty, for example to ensure that real assets physically located in a member state could not be expropriated back by that state after a default. However, an example of a structure that does not compromise sovereignty is offered by the oil agreements that backed up US financial assistance to Mexico in the 1990s, whereby buyers of Mexican oil paid directly into an account with the Federal Reserve rather than to Mexico. This account then served as collateral for US

loans to Mexico (United States General Accounting Office, 1996). In the case of Europe, collateralizing sovereign debt may involve appointing a central agency to hold the collateral in escrow. If there is a risk that the value of the collateral could be reduced by the actions (or inactions) of the borrowing state, debt could be structured as de-facto lease-backs, thus giving the lender a certain amount of control over the asset as long as the debt is outstanding.

The rules for setting haircuts on sovereign debt in repos with the ECB should also be reviewed. Haircuts can be used to exercise a measure of fiscal control vis-à-vis euro area member states, without a fiscal union. For example, linking haircuts to the indebtedness level of the issuing country should help reduce member states' appetite for borrowing. As seen in the Appendix, this is currently not done.

Euro area member states could continue to issue non-secured debt, if there is a market for it. But the inability to use such paper in repos with the ECB would make it unattractive. Substantial increases in unsecured borrowing by a member state could become an indicator that there is a flaw somewhere in the system and thus something that could spark a review process.

Making euro area sovereign debt secured and setting appropriate haircuts is a matter of political will. It will not solve the current crisis, but would be an important measure towards securing a sounder currency and financial system and preventing future crises. In the case of default, secured debt provides for an orderly, pre-arranged settlement with minimal renegotiation or the possibility of hold-up by defaulting member states. That assets will be lost in default will incentivize nations to act more prudently in the first place, thus reducing the risk of default. Linking haircuts to the general indebtedness level of the issuing country will also help. A final advantage to making sovereign debt secured is that it would help preserve the sovereignty of member states relative to the alternative, that some have called for, of a stronger political and fiscal union.

References

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Appendix: Sovereign bond haircuts and financial indicators

The haircuts are on sovereign bonds that can be pledged to the Eurosystem as collateral in its central bank operations. The haircuts are based on the eligible collateral file as of June 24, 2011 (see: www.ecb.int). They are for coupon bearing bonds, whose maturity are listed in the table below the haircuts.

	Long Term (LT) Rating		Debt/GDP (%) (2010)	Gross debt-to-income ratio of households (%) (2009)	Government deficit/surplus (% of GDP) (2010)	Net Current account (% of GDP) (2010)	Haircut					
	Local Currency	Foreign Currency					Haircut (2012)	Haircut (2014)	Haircut (2016)	Haircut (2017)	Haircut (2018)	Haircut (2020)
	LT Rating/Outlook	LT Rating/Outlook										
Luxembourg	AAA/Stable	AAA/Stable	18.42	n.a.	-1.7	7.82	-	-	-	-	-	4.0
							-	-	-	-	-	18/05/2020
Finland	AAA/Stable	AAA/Stable	48.37	100.6	-2.5	3.13	1.5	2.5	2.5	3.0	-	4.0
							15/09/2012	15/09/2014	15/04/2016	15/09/2017	-	15/04/2020
Netherlands	AAA/Stable	AAA/Stable	62.73	241.3	-5.4	7.66	0.5	2.5	3.0	0.5	4.0	4.0
							25/10/2012	15/07/2014	15/07/2016	16/10/2017	15/07/2018	15/07/2020
Austria	AAA/Stable	AAA/Stable	72.26	87.3	-4.6	2.73	1.5	2.5	3.0	3.0	3.0	4.0
							15/07/2012	20/10/2014	15/09/2016	15/09/2017	15/01/2018	15/07/2020
France	AAA/Stable	AAA/Stable	81.70	77.2	-7.0	-2.13	1.5	2.5	3.0	3.0	4.0	4.0
							26/12/2012	25/10/2014	25/10/2016	25/10/2017	25/10/2018	25/10/2020
Germany	AAA/Stable	AAA/Stable	83.23	89.2	-3.3	5.66	1.5	2.5	3.0	3.0	4.0	4.0
							14/12/2012	10/10/2014	20/09/2016	04/07/2017	04/07/2018	04/09/2020
Belgium	AA+/Negative	AA+/Negative	96.79	83.6	-4.1	1.36	1.5	2.5	3.0	3.0	4.0	4.0
							24/12/2012	04/12/2014	04/12/2016	04/12/2017	04/12/2018	28/09/2020
Slovenia	AA/Negative	AA/Negative	38.00	44.2	-5.6	-1.13	1.5	2.5	2.5	3.0	3.0	4.0
							02/12/2012	15/10/2014	17/02/2016	19/04/2017	08/04/2018	26/01/2020
Spain	AA/Negative	AA/Negative	60.11	124.6	-9.2	-4.51	1.5	2.5	2.5	3.0	4.0	4.0
							41213	31/10/2014	30/04/2016	30/07/2017	30/07/2018	31/10/2020
Slovakia	A+/Stable	A+/Stable	40.96	50.9	-7.9	-3.44	0.5	1.5	2.5	3.0	-	4.0
							12/06/2012	20/05/2014	24/02/2016	15/05/2017	-	27/04/2020
Italy	A+/Negative	A+/Negative	119.00	60.5	-4.6	-3.29	1.5	0.5	3.0	0.5	4.0	4.0
							15/12/2012	01/12/2014	15/09/2016	15/10/2017	11/11/2018	01/09/2020
Estonia	A/Positive	A/Positive	6.56	97.2	0.1	3.57	-	-	-	-	-	-
							-	-	-	-	-	-
Malta	A/Stable	A/Stable	68.02	n.a.	-3.6	-4.11	1.5	2.5	3.0	3.0	4.0	4.0
							31/12/2012	31/12/2014	31/12/2016	31/12/2017	31/12/2018	31/12/2020
Cyprus	A-/Negative	A-/Negative	60.80	n.a.	-5.3	-7.74	0.5	2.5	3.0	3.0	4.0	4.0
							08/06/2012	09/12/2014	26/10/2016	28/09/2017	23/10/2018	09/06/2020
Ireland	BBB+/Stable	BBB+/Stable	96.19	199.1	-32.4	-0.72	1.5	1.5	2.5	-	4.0	4.0
							30/09/2012	15/01/2014	18/04/2016	-	18/10/2018	18/10/2020
Portugal	BBB-/Negative	BBB-/Negative	93.00	130.7	-9.1	-9.89	5.5	7.5	8.0	8.0	8.0	9.0
							15/06/2012	15/10/2014	15/10/2016	16/10/2017	15/06/2018	15/06/2020
Greece	CCC/Negative	CCC/Negative	142.76	n.a.	-10.5	-10.45	5.5	7.5	8.0	8.0	9.0	5.5
							31/12/2012	30/09/2014	13/09/2016	09/10/2017	20/07/2018	13/07/2020

Sources: European Central Bank, Eurostat, Standard&Poor's

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