

Presentation to the Joint Committee on Finance, Public Expenditure and Reform

May 16 – University of Limerick

Thank you for inviting us here today. I'd like to introduce my colleagues: Frances Shaw manages the trading floor at University of Limerick, and is doing her PhD on sovereign debt; John Garvey is a lecturer in Risk Management, with a focus on capital markets, and I am Sheila Killian. Together we put together the Audit of Irish Debt last year, and a more focused and up-to-date briefing paper prepared for today's meeting on bond markets, Irish debt and policy windows. We will refer to that latter paper today as it forms the basis for our talk, and should be useful in addressing your questions.

Initially, Frances will talk through the basics of bond trading and sovereign debt markets. I will talk through the scale and scope of Irish debt, with a focus on particular categories of debt, the opacity of bond markets and financial interconnectedness. John will wrap up with a discussion of agenda setting and policy windows. Then we're happy to take questions at the end.

Testimony of Frances Shaw

ref The Bond Markets, Irish Debt and Policy Windows, pages 2-13

Thanks Sheila. In this section I will talk to you about 3 main points –Firstly Irish sovereign bonds, secondly the mechanics of the bond market and thirdly about distressed sovereigns in the bond markets.

Firstly an Irish Sovereign Bond is a debt security issued by the Irish government with a promise of repayment of par value at maturity. The Irish government currently has around €83bn outstanding in sovereign debt. Figure one in the briefing paper shows the 10-benchmark bonds that Ireland currently has outstanding. Along with the coupon and maturity details, we can see from the bond prices that the majority of our bonds are trading at a discount or below par value. Page 2 of the briefing paper gives reasons as to why bonds would trade at a discount or a premium; the two main risk factors are credit risk, which includes the risk that an issuer would default on its obligations and the second reason being

interest rate risk, further risk factors that effect bonds are detailed on page 4. In Figure 5 on page 6 we can see the special inverse relationship between the bond price and the yield to maturity. These two graphs represent the price and yield of our current 5 year benchmark bond, we can see how the yield continued to rise from early 2010 through to July 2011 and simultaneously the price of the bond fell. One item to note is that changing yields and prices in the secondary market has no effect on the Sovereign entity that has issued the debt. Despite the rise in yield as described on page 7 the Irish government will continue to pay the coupon rate of 4.6% and a par value of €100 at maturity just the same as when yields were low.

The second section of my discussion in the briefing paper relates to the mechanics of the Irish bond market and how Irish sovereign bonds are traded. There have been a lot of questions recently surrounding the identity of Irish bondholders and who are the bond market participants. In the primary market bonds are issued to 16 primary dealers by the National Treasury Management Agency through scheduled electronic auctions. These 16 primary dealers bid on the bond, which in turn determines the bond price, and those successful in the auction can then sell the bonds on to their investors. All Irish bonds are then listed and traded in the secondary market on the Irish stock exchange. As described on page 8 of the briefing document the primary dealers are under no obligation to provide the NTMA with details on their clients undertaking the trades in the Irish bonds. Since December 2000 Ireland has used a clearinghouse called Euroclear for daily settlement of its bonds where the annual coupon payments and the principle value at maturity are also paid, although the central bank of Ireland keeps a bond register for each bond issue. Euroclear groups all security positions together into one account on the register, this one account makes up over 99% of the holders meaning it is not possible to identify the individual bond holders.

Thirdly I will talk about distressed sovereign entities; page 9 of the briefing document outlines the definition of default. Definitions vary across the literature defying the public perception of default as a binary event. The S&P definition defines default as the failure to meet a principle or interest payment on the due date contained in the original terms of a debt issue. Any type of restructuring or rescheduling is also classed as default.

Unlike corporate debt, sovereign debt markets are characterised by weak contractual enforcements, in that creditors are unable to seize assets directly in the borrower country in the case of default. Owing to this lack of secured assets the question often arises: Why do sovereigns repay their debt? Pages 10 and 11 in the briefing document discuss this question and an examination of the literature yields four main reasons.

Firstly to avoid penalties, this is to avoid trade sanctions and embargos that may be enforced by creditor countries if the borrower were to cease payment. The second reason relates to reputational costs such as access to international bond markets and the increased cost of credit. Reputational costs have been found to be often short lived. While countries lose access during default, once all restructuring is complete markets do not discriminate against countries that have defaulted and those who have not. Trade and Trade credit are negatively affected by default however countries that defaulted in the 1980's were able to access the international debt markets in around 4 years after default. Markets do however discriminate in terms of the cost of credit for a short while as measured by spreads and by credit ratings.

The third reason for continued repayment of debt relates to the adverse impact that default could have on domestic financial systems and the fourth reason is that of political costs.

Finally this section concludes with two short examples of recent debt crises where countries chose not to repay debt; firstly the case of Iceland who chose not to repay its banking debt allowing its banking system to collapse. And second the case of Argentina who defaulted on all its debt in 2001 making it the largest debt default in history. My colleague Sheila Killian will now talk to you about the scale of Ireland's debt.

Testimony of Sheila Killian

ref The Bond Markets, Irish Debt and Policy Windows, pages 14-23

Thanks Frances. My focus is on the central part of the briefing paper, which contains a lot of detail, so I'll concentrate on just three points here: the scale of Irish debt, opacity in the bond markets, and interconnectedness.

First, on the scale of Irish debt, many reported figures such as that from the recent CNBC report include household debt and corporate debt as part of the total, bringing Ireland to the top of the list of most indebted countries worldwide. While personal debt is a very serious issue in Ireland, it is outside the scope of this discussion. The briefing paper focuses on six categories of debt for which the country has taken on responsibility, namely government bonds, bailout funds, guaranteed and unguaranteed bank bonds, promissory notes and the bond arising from the restructuring of the latest promissory note payment in March. We highlight the fact that these different types of debt are not equivalent in terms of cost, origin,

the way in which they are traded or the sensitivity of the market to any default or restructuring.

The discussion in the briefing paper ranks these in approximate order of market sensitivity, from government bonds which are highly sensitive, to unguaranteed bank bonds which are far less so. A table on page 19 sets out the key differences between them in terms of the scale, and notes the availability or otherwise of further funds under each heading. Two summary points are first, when discussing repayment of debt, it's important not to regard all of the debt as an amorphous mass of equal rank, or to regard a change in the terms of any of the debt as a binary, all-or-nothing event. The second point to take away is the sheer scale of the debt, especially in relation to the relatively narrow tax base which is expected to fund its repayment.

Secondly, the briefing paper discusses opacity in the bond markets, an issue which bedevilled our work on the Debt Audit last year. The lack of transparency around the identities of bondholders is by now well-known. This contrasts with the position of shareholders, whose identities are recorded on a register and made available to all the other shareholders in the company. There are obvious sound policy reasons why this is so, but there is no such provision for the holders of either government or corporate bonds. For reasons outlined in the document, the bond register is almost exclusively made up of nominee accounts, and the way in which bonds are traded through Euroclear precludes the identity of bondholders becoming publicly known. There is an argument that bonds should be treated like €100 notes – circulating freely with no open record of who holds them at a given time. This works well in the situation where the presence of the debt, or the identity of the debt-holders is not in itself a driver of economic or social policy. It is more problematic for public discourse in the current circumstances.

There are partial lists of bondholders available from such sources as Bloomberg, an example of which are included in the briefing paper. On page 21 there is a screenshot listing bondholders in AIB towards the end of April 2012. Such lists are less useful than they might appear, however for three reasons. Firstly, they have limited coverage – less than 3% in the example given. Second, the holdings are often listed in the names of hedge funds and nominee accounts – Julius Baer in the example discussed in the briefing paper is a private Swiss bank. Finally, the listings are not grouped by beneficial ownership, so it is possible for one group to hold a substantial portion of the bonds in a non-transparent way.

Some basic residence information is also available through the central bank, with the percentage of government debt held by Irish residents, for example, reasonably steady in recent years at about 18%. However, this is seriously clouded by the scale of treasury management operations in Ireland, with multinational firms moving funds in and out of the country, and many Irish-resident companies holding financial instruments on behalf of foreign investors. This means that the figures reported for corporate debt in Ireland, or for the ownership of debt in terms of nationality are less meaningful than they might be.

Finally, this question of money flows raises the idea of financial interconnectedness. Ireland was identified in a 2010 IMF paper as one of 11 principal nodes of banking interconnectedness, worldwide. A diagram from the study on page 23 of the briefing paper shows Ireland's connections to among others Sweden, the UAE, the Czech Republic, Saudi Arabia and China. Such interconnections mean not only that we are open to the impact of actions taken elsewhere. They also mean that any action taken by Ireland will have repercussions overseas. My colleague John Garvey will now discuss the implications of this interconnectedness for policy

Testimony of John Garvey

ref The Bond Markets, Irish Debt and Policy Windows, pages 24-28

Thanks Sheila. There has been extensive discussion on the existing European austerity policy, its social and economic impact in member states as well as its expected long-term effects. In this section I set out why the austerity agenda will evolve and what an alternative European agenda might look like.

It is clear that the choices available to European institutions as well as distressed member states are limited. The complexity and interconnectedness of the market and the significant private debt that has become public debt has reduced the number of pathways available to European institutions.

The current policy can be viewed as a conservative approach that is attempting to provide a coherent strategy. It relies on implementing austerity measures and complementing this activity through the ongoing provision of funding to member states and activity in the interbank market. At this point in time (15th May 2012) there appears to be an increasing gap between the objectives set out in the existing policy and its desired goal ('problem steam').

Senior European politicians are now more willing to accept that the existing approach is insufficient to cope with the gravity of the problem and are willing to implement the policies required to address it ('politics stream'). For the current policy to change there needs to be greater clarity around alternative policy instruments that can be used to solve the problem. It is this third, so-called 'policy stream' that is likely to emerge as a consequence of a 'focusing event'. This may be a Greek re-election and subsequent exit from the Eurozone, it may be an emergence of a significant issue within Spanish banking.

This type of 'focusing event' may influence a greater momentum behind a new European-wide agenda. Within the media and sparked by the French presidential election there is a stronger rhetoric around an agenda founded on *growth-oriented policies*. Without a more precise analysis of how these policies will be funded and how they will address the crisis this agenda may fade.

The scale of aggregated Eurozone debt may require proposals other than those loosely categorised under growth-oriented policies. Potential solutions may reside within new financial regulation. Regulation can be either ex-ante or ex-post.

The limitations of ex-ante financial regulation are well documented. Regulators rely on motivating a degree of self-monitoring by a diverse group of financial institutions operating in a complex and opaque financial system. When financial failure does occur, its systemic consequences are usually controlled through financial safety nets. These safety nets exist in the first place for financial institutions (e.g. US Fed & LTCM) as well as for sovereigns (e.g. IMF). The Eurozone crisis demonstrates the insufficiency of the IMF safety net when sovereign default has disproportional regional effects. The combined intervention of the IMF, European Commission and ECB is an extension of this, where a regional safety net is put in place to stabilise a group of distressed sovereigns.

Regulation is required to deal with the systemic risk presented by sovereign default. This systemic risk is due in part to the greater use of sovereign debt as a financing tool and in the case of the Eurozone crisis the sovereign guarantee that overlays privately created debt.

Because of the characteristics of the sovereign debt market, an orderly debt restructuring is generally prevented for two reasons. Traditionally these are the holdout problem¹ and the

¹ Creditors are motivated to resist agreeing to a debt-restructuring plan in the hope that others will settle and they will be allocated more than their fair share of the settlement.

funding problem² (Bolton & Jeanne, 2007; Schwarcz, 2011). In the case of the Eurozone crisis an additional issue is maintaining sufficient funding for the European banking system so that an extensive bank-run is avoided.

In 2002, the IMF proposed a so-called, sovereign debt restructuring mechanism (SDRM) which attempted to adopt a legislative solution to sovereign debt not dissimilar to US corporate bankruptcy law. Some version of the SDRM designed by European institutions may be one of the few ways forward for European institutions as they look for an effective long-term solution to the crisis. The objective of this mechanism should be a controlled, well-signalled restructuring of debt that is consistent for Eurozone member states.

² A country will require new money to fund critical expenses during the debt restructuring phase, but no lender will provide such funds.