

Preface

**John Raymond LaBrosse, James F. McCollum,
Rodrigo Olivares-Caminal and Dalvinder Singh**

*‘Collaboration between financial authorities has never been so testing and yet never has collaboration been so important. We face key coordination challenges in the area of financial regulation, particularly with respect to the consistency of the calculations of risk-weighted assets, the treatment of sovereign exposures, and liquidity standards. Yet, the institutional settings for collaboration are actually improving. Given sufficient commitment from the authorities, these new settings and processes will pave the way for enhanced cooperation’.*¹

I. THE GRAND SLUMP AND SETTING THE SCENE FOR RESTORING PUBLIC CONFIDENCE

At the time that the 2011 Banking Law Symposium² took place over 20 books and numerous professional journal articles had been written on the Global Financial Crisis (GFC). Interest in the crisis and its aftermath, including policy responses and corrective measures, continues unabated and the Symposium was one reflection of this. So too is this book and we are pleased to include several of the Symposium’s papers in it. The principal objective of this book is to examine the response to the crisis, with particular reference to the extensive use that has been made of government guarantees in private financial markets and the impact that those guarantees have had on sovereign debt.

During the editing process for the book we took the opportunity to look back at what analysts had to say about 2011 before the year began and the policies they felt were needed to restore confidence in governments,

¹ Speech by J. Caruana, General Manager, Bank for International Settlements, at the seminar on ‘Long-term growth: organizing the stability and attractiveness of European financial markets’, Berlin, 20 January 2012, available at <http://www.bis.org/speeches/sp120124.htm> (last accessed 1 October 2012).

² For a summary of the proceedings please see J.F. McCollum, *Financial Regulation International*, Issue 14.8, pp.4–7, October 2011.

banking systems and, of course, policy-makers and their advisors. At the end of 2010, publications such as *The Economist* were predicting 2011 to be ‘a tale of two economies: a rich world struggling with a weak and jobless recovery, and an emerging world growing four times as fast’.³ One year later, in its outlook for 2012, *The Economist* suggested that national leaders would be pre-occupied with domestic issues and that we should not expect very much out of global gatherings.⁴ Leaders will clearly need a new mantra for prospective global gatherings, as there appears to be diminishing interest in committing to necessary initiatives in a co-ordinated way.

It can be suggested that finance ‘will be more stable and thus more boring’. In the early days of 2012 and with a focus on the UK, the *Financial Times* released a survey of 83 economists that suggested that ‘[t]he coming year will rival 2009 for economic weakness as output is hit by the continuing debt crisis in the euro-zone . . .’.⁵ It is noteworthy that the survey included ‘11 former members of the Bank of England’s Monetary Policy Committee’ and that ‘three times more respondents thought the economic outlook would deteriorate rather than would improve in 2012’.⁶

While it is the mission of news organisations to sell their publications, they have no obligation to report on why things did not turn out the way they initially thought; the after-the-fact analysis task is often left to the academy. Accordingly, it is customary for books of this kind to analyse financial issues *ex post* and dissect decisions that were taken by policy-makers. This is a major challenge because so many uncontrollable factors can come into play and materially affect outcomes. Policy-makers concerned with the financial sector often focus on whether there was enough regulation or whether the regulation was of the right kind. In examining a financial crisis questions could be: have laws been adequately designed to smooth the exit of failing banks or to account for situations where sovereigns may not be able to repay bondholders and/or make good on programme entitlements. Answers can be inconsistent, confusing or even biased, as they may reflect less of reality and more of the views of the respondent.

Was the GFC and subsequent recession a result of too much regulation of financial institutions and markets, or not enough? It is still too early to know, but one area that is often overlooked is the impact of demographics on governments and financial markets. While this book focuses on

³ Franklin, D, (ed.), *The Economist*, ‘The World in 2011’, p. 13.

⁴ Franklin, D, (ed.), *The Economist*, ‘The World in 2012’, p. 15.

⁵ C. Giles and S. O’Connor, ‘Economists See Bleak Year Ahead’, *Financial Times*, (2 January 2012).

⁶ *Financial Times*, 3 January 2012.

banking-law type issues, perhaps if we understood more about the impact that demographics can have on financial markets and institutions, we might better understand how to cope with or preferably avoid crises that seem to be recurring all too regularly.⁷

The sub-prime mortgage debacle that emerged in the US is often pointed to as the genesis of the GFC. Why were the accumulating risks to the financial system not recognised and preventive actions not taken? American families were (and still are) encouraged to borrow through tax-deductible mortgage interest. Bets on housing market price appreciation, due partly to demographics, for many years had turned out to be a sure thing. Many Americans acquired more properties than they needed, with a view to flipping houses for a profit. This all worked well until the proverbial music stopped and the chairs were taken away.⁸ The glut of houses caused severe price declines and, as underwriting standards had been diluted (or even ignored), builders, homeowners and investors were stuck with huge inventories.

In looking back we could ask: Where were the regulators? Clearly there were some regulatory failures. Another question that could be asked is: Where were the boards of directors since they are 'ultimately responsible for the oversight of management and overall risk governance of financial institutions'⁹ In response we could say that actions or inactions of boards have raised some important governance issues. Clearly, those two critical questions have not been fully addressed and this may explain part of the reason why *Time* magazine determined that the Person of the Year for 2011 was 'The Protestor'. This book does not focus on the Occupy Wall Street Movement and other scenes of protests surrounding the avarice and short-sightedness of certain financial market participants. We do, however, consider several issues surrounding the global financial crisis and many worthwhile suggestions are put forward.

⁷ For a comprehensive look at the history of financial crises, please see C.M. Reinhart and K.S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press, Princeton, NJ 2009).

⁸ In an interview with the *Financial Times* one month before the crisis began C. Prince, then Chief Executive Officer of Citigroup, was quoted as saying: 'So long as the music is playing, you've got to get up and dance. We're still dancing'. See *Financial Times* (10 July 2007).

⁹ Speech by J. Dickson, Superintendent of Financial Institutions (Canada) to the Toronto Board of Trade (4 April 2012).

II. WHAT'S IN THIS BOOK

The book is divided into four parts. We begin with a focus on ways to contain a financial crisis drawing on some lessons learned. Attention then turns to the special problems facing Europe and measures that are being devised and continuously revised to convince financial markets that a corner has been turned. Several scholars consider the role of government guarantees in Part III and in the final section we turn to the sovereign debt problem.

Part I: Containing a Financial Crisis

The primary objectives in containing a financial crisis are first, simply to stop it, and second, to minimize adverse impacts on the real economy.¹⁰ However, pulling out all the stops to contain a crisis can have serious long-term consequences for the ability of a central government to raise finance in the future at rates and levels approaching those prior to the crisis.¹¹ The GFC has led to considerable costs, which are well documented.¹² Panetta et al. note that:

The overall amount of resources committed to the various packages by the 11 countries examined totalled around EUR5 trillion or 18.8 per cent of GDP; the outlays have been EUR2 trillion or 7.6 per cent of GDP. The size of the interventions varies greatly across countries: it is higher in countries such as the UK and the Netherlands (where outlays have reached 44.1 per cent and 16.6 per cent of GDP, respectively) where the banking system is large relative to the real economy and is dominated by large institutions that have been severely hit by the crisis.¹³

¹⁰ Please see A. Gelpern 'Financial Crisis Containment', (2009) 41 Connecticut Law Review; D.G. Mayes 'Did Recent Experience of a Financial Crisis Help in Coping with the Current Financial Turmoil? The Case of the Nordic Countries', (2009) 47 Journal of Common Market Studies; D.G. Mayes, (2009) 'Resolution Methods For Cross-Border Banks in the Present Crisis' in J.R. LaBrosse, R. Olivares-Caminal and D. Singh (eds) *Financial Crisis Management and Bank Resolution* (Informa, London 2009).

¹¹ A. Sighvatsson and G. Gunnarsson, 'Iceland's Financial Disaster and its Fiscal Impact', in J.R. LaBrosse, R. Olivares-Caminal and D. Singh, *Managing Risk in the Financial System* (Edward Elgar, Cheltenham, UK and Northampton, MA, USA 2011).

¹² To illustrate, from 2007 to 2011, 430 FDIC-member (insured) institutions failed or received some form of assistance. The FDIC took a number of actions to deal with the losses and stabilize the Deposit Insurance Fund; the measures included increasing assessment rates, imposing a special assessment on member-banks and offering a facility for banks to prepay assessments. For more details on the measures please see www.fdic.gov.

¹³ F.T. Panetta, G. Grande, C. Ho, M. King, A. Levy, F.M. Signoretti,

The initial steps are to stabilise market confidence in individual banks and other major financial institutions, thereby reducing the risk of a bank run and to ensure that there is sufficient liquidity in the system. The attempts of depositors to place their money in what are perceived to be healthier banks during a crisis are not a material concern for the authorities if there is a well-publicized and effective deposit protection system. If such a system does not exist then there is a possibility of capital flight and contagion. The attempts to manage the recent crisis included a combination of private as well as public measures to restore confidence in institutions. Examples include moves to recapitalise banks by rights issues, and when this failed recapitalisation by governments. These strategies have been used in efforts to restore liquidity and stave off the insolvency of banks and enable them to continue lending and, in time, return to profitability.

To be sure, government guarantees delivered through the protection of deposits in banks have become an important feature of modern finance. Deposit insurance systems, however, have only a limited role in a systemic crisis, as they are generally designed to deal with small- or medium-sized bank closures, and thereby prevent contagion. What was evident from the GFC was that a poorly designed guarantee system with minimal public information can exacerbate a bank failure and result in a crisis with political implications. Northern Rock in the UK is a case in point.

Is it possible to manage a crisis without government guarantees? That issue is considered in depth by Christine Cumming in her examination of the crisis from the perspective of a senior US policy advisor. She places heavy emphasis on early intervention in resolving banks before technical insolvency. In that regard she underscores that early intervention is essential for resolution if recovery efforts fail. Additionally, the private sector should be readied to play a role. One measure that has been used to accomplish and facilitate action is stress testing of bank balance sheets and, if adjustments are called for but action is not forthcoming, further intervention may be called for.

Is there a handy guidebook to help policy-makers manage a crisis? That question is addressed by John Raymond LaBrosse and Dalvinder Singh as they consider some recent experience and effective practices with a particular focus on Europe. They do so by setting out the main structure of a financial safety net (FSN) and how the mandates, roles and responsibilities of the agencies within it tend to change during the course of a

M. Taboga and A. Zaghini, 'An assessment of financial sector rescue programmes', BIS Paper No 48 (2009).

crisis. Recent practices offer many examples of the need for more clarity and coordination in the management of a crisis. As an aid a decision tree is offered and explained as an alternative to a series of *ad hoc* pronouncements that can confuse market participants and undermine the public's confidence in the authorities' effectiveness.

Which member of an FSN should take the lead in tackling a financial crisis or should it be a new agency? Charles A.E. Goodhart notes in Chapter 3 that macro-prudential institutions are springing up, like field mushrooms after a September rain, in a wide range of countries: the Financial Policy Committee in the UK, the Financial Stability Oversight Committee in the US, and the European Systemic Risk Board are but a few examples. Indeed, Professor Goodhart and J-C. Rochet have been separately involved in proposing the adoption of a similar macro-prudential authority in Sweden.¹⁴ If the new macro-prudential authority is to have some bite and ability to provide systemic financial stability, it needs to be given the requisite powers to do so and Goodhart discusses what these powers might be.

Is there a policy framework for resolving systemically important financial institutions? The G20 Leaders asked the Financial Stability Board (FSB) to develop recommendations designed to reduce: moral hazard risks, the potential for contagion and disruptions associated with troubled systemically important financial institutions (SIFIs). Eva Hüpkes notes in Chapter 4 that SIFIs are financial institutions whose distress or disorderly failure, because of their size, complexity and interconnectedness, could cause significant disruptions to the wider financial system and economic activity. Dr Hüpkes explains that to assist policy-makers the FSB has developed a framework that consists of:

- a requirement that SIFIs and initially in particular global SIFIs (G-SIFIs) have additional loss absorption capacity beyond the Basel III standards to reflect the greater risks that these institutions pose to the global financial system;
- improvements to resolution regimes to enable national authorities to resolve financial institutions, whatever their size, without disruptions to the financial system and without taxpayer support;
- more intensive and effective supervision through strengthened supervisory capacity and resources, and raised supervisory expectations

¹⁴ C.A.E. Goodhart and J-C. Rochet, 'Evaluation of the Riksbank's monetary policy and work with financial stability 2005–2010', Reports from the Riksdag 2010/11:RFR5, The Committee on Finance, Sveriges Riksdag (2011).

for risk management functions, risk data aggregation capabilities, risk governance and internal controls;

- stronger robustness standards for core financial market infrastructures, including central counterparties, central securities depositories and trade repositories; and
- rigorous implementation, monitoring and reviews by an FSB Peer Review Council to evaluate consistency in the implementation of G-SIFI specific requirements.

Part II: The Special Problems of Europe

The second Part of the book focuses on, as its name indicates, the special problems of Europe. The topic, in its entirety, goes beyond the scope of our work, but to make it tractable attention is centred on the banking sector. However, the importance and magnitude of the evolving sovereign debt crisis, which undoubtedly has had an impact on the banking sector and is, for the time being, currently confined to Europe, also receives attention.

We begin with a concise overview of crisis management and the use of government guarantees in Europe with an analysis prepared by Charles Enoch. He starts by outlining the general features of guarantees, why they are attractive, and how they can have both positive and negative effects. He goes on to look at the role of guarantees in the banking sector, in particular for deposits, both in crisis and in more normal times. Enoch then turns to the emerging European deposit guarantee framework in the context of the single European market. To highlight the role of deposit insurance and its use in response to the crisis, a few examples are examined in terms of what can be learnt about deposit guarantees. It is argued that guarantees were extended beyond depositor protection and that they underwent changes during and after the crisis. It is important to emphasise that deposit insurance is only one of several pillars of a financial sector safety net (FSN).

Enoch notes that much progress has been achieved in Europe during recent years in enhancing the FSN. He acknowledges that the idea of permanent deposit guarantee arrangements is on balance on the right track, and that important lessons learned from the crisis are being taken into account. However, gaps remain in the overall safety net. Amongst these he draws attention to the modifications to Basel III in the proposed Capital Regulation Directive noting that: supervisory enhancement has not yet been demonstrated; recapitalization of the European banks is not yet comprehensive (indeed, is far from complete); and that, despite some progress, the bank resolution framework is not yet in place. He concludes by noting

that without a resolution framework it is not clear that European authorities would be able to close a large cross-border bank smoothly, and thus bring the deposit guarantee mechanism properly into play.

Rosa Lastra begins her chapter with a quote by Rahm Emmanuel, the former chief of staff to President Barak Obama, in response to the 2007–9 crisis: '[n]ever let a good crisis go to waste'. She provides an account of the most salient regulatory responses to the financial crisis. In particular she analyses the EU, UK and US regulatory frameworks after the 2007–9 crisis. It was noted that while there is consensus regarding the magnitude and the severity of the crisis, there are a range of views when it comes to understanding the causes of the crisis and the regulatory responses that can best tackle the imbalances and fragilities that underlay it. In order not to let a good crisis go to waste, five aspects are considered: (1) what to regulate; (2) who regulates, how to regulate and the intensity of supervision; (3) bankers' behaviour, corporate governance and risk management; (4) fiscal and compensation considerations; and (5) structural reforms.

Her focus is not limited to the EU, which helps build a bridge between the 'global' nature of Part I and the European focus of the chapters in this section of the book. Lastra makes a number of important points. First, that regulators are often fighting a war that already took place, that is, responses to a crisis are by definition *ex post*. Second, that there is a need for international rules due to the global nature of markets and that they need to be supported by much more effective cooperation amongst domestic authorities. Third, she argues that an underlying requirement for optimal results is that both gains and losses need to be internalised.

The chapter by Christopher Pleister outlines the German perspective with an analysis of the role performed by the *Bundesanstalt für Finanzmarktstabilisierung* (Financial Market Stabilisation Agency or FMSA). The collapse of Lehman Brothers had a particularly devastating effect on Germany and as he notes, '[t]he order of the day was to act as fast as possible because the survival of the German banking sector was at stake'. A key element of the response was to establish a new institution to supplement the range of tasks already performed by the Deutsche Bundesbank and the *Bundesanstalt für Finanzdienstleistungsaufsicht* (Germany's Federal Financial Supervisory Authority or BaFin). In the aftermath of the Lehman collapse, neither prudential instruments nor German insolvency laws were adequate to the task of rescuing troubled German banks. The FMSA was established as a temporarily governmental 'lifeline' to help distressed banks.

Pleister highlights that the collaborative efforts between the Bundesbank, BaFin, the Federal Ministry of Finance and the European Commission and FMSA were successful in stabilizing the German banking sector: no

German bank had to be wound up and a second Lehman-type incident may have been averted. He observes that a one-off rescue of a distressed bank may strengthen that particular institution, but at the cost of weakening the overall banking system in the long run. It is noted that since late 2010 Germany has a Restructuring Act and hence an institutionalised legal framework for resolving systemically important banks. Importantly, this means that the tasks of the FMSA have become permanent. The mandate of the FMSA is to rescue only the systemically important parts of a bank while liquidating the others. Emphasis is also put on banks bearing the costs of restructuring themselves by paying a bank levy into a 'restructuring fund', thus relieving taxpayers of bailout costs. This particular aspect of the German system is in line with the policy considerations raised by Lastra in the previous chapter.

The final chapter in this Part analyses the adoption of 'extraordinary measures for extraordinary times' and the need for effective bank resolution laws in Europe. Gillian G. Garcia and Maria J. Nieto argue that a number of EU member states have been struggling to overcome problems with their sovereign debt, whose increase has been attributed to measures adopted during the financial crisis. Those governments committed financial resources equal to 39 per cent and expended 9.3 per cent of 2009 GDP levels in attempts to rescue their banking systems. They also stress that the crisis revealed inadequacies within financial safety nets, including those of Germany and the UK. In that respect they highlight the absence of legal frameworks for resolving failed banks along with limited arrangements for funding failed bank resolutions. Germany and the UK, however, did lead reform efforts by adopting measures designed to better maintain financial stability and protect the public interest, including minimizing costs to taxpayers when banks fail. Consistent with Enoch's remarks, the authors conclude that the financial crisis tested not only the perimeter of safety net policy action but also the inadequacies of traditional safety net mechanisms themselves. In company with Lastra and others, Garcia and Nieto conclude by emphasizing the need for better tools and powers to enable regulators to resolve failed banks. While they acknowledge that a significant improvement has been achieved, the task remains unfinished.

Part III: Using Government Guarantees

The opening chapter by Már Guðmundsson provides an insight into the management of the Icelandic crisis. It highlights how the authorities tried to grapple with the crisis in a way to limit the burden on the state, having recognised that backstopping all the liabilities of the banks would have been catastrophic and would have had little credibility in the inter-

national marketplace in any event. The Icelandic authorities introduced the Emergency Act of October 2008 in an effort to protect the domestic payments system and to ring-fence the state, and by extension taxpayers, from the bank failures. The lessons learnt focus on the inadequacy of EU supervision of banks with passport rights; the need for better coordination for crisis containment and management designed to protect both national and regional interests; and, the limited ability of the domestic authorities to cover banks' foreign currency liabilities.

David G. Mayes explores the pressures that can arise for the authorities in a country when a neighbouring state decides to put in place a guarantee to protect the financial system that they simply cannot match. Rather than taking such a step, Mayes argues for better pricing arrangements of guarantees to mitigate spillover effects of such decisions, and thereby limit moral hazard. His chapter explores the range of guarantees employed in a broad sample of countries during the financial crisis, as well as during earlier crises in the Nordic countries. Norway, for example, did not resort to blanket guarantees when Sweden and Finland did. In many cases the alternative to guarantees is that the private sector absorbs the losses, whereas in others it is that the government invests in the troubled institution, thereby taking a stake in the upside gains and not just taking the residual losses.

Guisèppe Grande, Aviram Levy, Fabio Panetta and Andrea Zaghini examine the use of public guarantees of bank bonds to stabilise the ability of banks to access medium-term funding. Their chapter highlights the success of such guarantees and the impact on the creditworthiness and cost of borrowing of the country providing them. It is argued that guarantees need to be more accurately priced to avoid introducing financial market distortions. When the sovereign debt crisis surfaced the markets quickly lost confidence in the guarantees on offer. They suggest that there is a need for a supranational guarantor of last resort so the creditworthiness of national governments would not be impaired by issuing guarantees.

Arturo Estrella and Sebastian Schich offer a framework for pricing sovereign debt guarantees from a contingent claims perspective. The framework would apply to both implicit and explicit government guarantees and their empirical work involves evidence drawn from a sample of 100 large European banks. Their results have implications for pricing sovereign bank debt guarantees, be they provided individually by each sovereign for its domestic banks or by several sovereigns jointly. In the former case, stronger sovereigns should charge higher premiums for their bank debt guarantees for a given level of bank risk to avoid creating distortions to competition. In the latter, the stronger sovereigns should receive greater

allotments of premium incomes even where the share of the guarantees provided is identical among countries.

Michael Faure and Klaus Heine offer a different approach to reduce the social costs of future financial crises. They suggest the introduction of insurance along the lines of catastrophe insurance for natural disasters and other risks, such as the costs from the fallout of a terrorist attack. Their multi-layered approach consists of the following features: in the first layer the 'excess' should be borne by the banks, the next layer could be covered by the insurance industry and the third layer absorbed by the state. In order to mitigate the moral hazard created by the insurance instruments the need to accurately price risk has to be built into their model.

Jeffrey Manns provides another view on managing financial crises and bailouts. While bailouts can be a necessary component of dealing with a financial crisis, they have occurred in an *ad hoc* manner and public and political support for them is problematic. He argues that the US government should create an investor-of-last-resort agency to handle bailouts, which he calls the Federal Government Investment Agency (FGIC). Rather than providing short-term financial assistance, the agency could take a medium-term investment position, with the prospect of sharing in upside gains. Such a structure could help depoliticise the bailout process and reduce public criticism of it.

The FGIC would complement the Federal Deposit Insurance Corporation whose functions include not only insuring deposits but also winding up insolvent banks and systemically important financial institutions. As no single government institution is in a position to address bailouts, the FGIC would establish *ex ante* conditions for receiving aid and thereby temper corporate risk taking, protect taxpayers, and establish clear contours for bailouts. Aid would, of course, be contingent on managers, shareholders, and creditors facing upfront reductions in their respective stakes (based on the scale of the FGIC's investment) to deter over-reliance on the new agency and excessive risk taking. Second, the FGIC would assume a proportional stake in beneficiaries and seek longer term returns. Third, beneficiaries would be required to implement corporate governance reforms, including the appointment of independent directors in proportion to the government's stake, and to adopt substantive reforms to target the roots of systemic risk.

Part IV: Sovereign Debt Issues

The global financial crisis and ensuing economic downturn has resulted in the deterioration of budget deficits and caused an overall increase of sovereign debt levels. According to the IMF's data for 2010, advanced

countries averaged budget deficits of 8.3 per cent of GDP while emerging economies averaged just 3.3 per cent.¹⁵ In that same year the public debt relative to gross domestic product in advanced economies reached a level of 97 per cent (rising from below 75 per cent in 2006) while in emerging economies that ratio reached 37 per cent (about equal to the 2006 level).

In advanced economies the fiscal deterioration has been associated with revaluations of risk and less willingness to take it on. Turmoil within the banking sector was linked to large infusions of government financial aid, which in turn resulted in a considerable increase in the amount of sovereign debt. That development has undermined the fundamentals of sovereign sustainability and produced a severe deterioration in their borrowing prospects as sovereign debt markets have become more fragile. The euro-area member states (EAMS) are of particular interest since they are at the epicentre of the sovereign debt crisis. Greece, Ireland and Portugal have had to procure financial assistance from the EU, other EAMS, the IMF, the ECB and other non-EAMS sovereigns in an attempt to reduce their sovereign debt burden in an orderly manner. As an added complication this all followed the earlier crisis in Iceland.

Due to the seriousness and magnitude of the sovereign debt crisis, which is ongoing and could involve other countries, they highlight some key aspects of the interrelationships of sovereign debt and government guarantees. The three main areas identified are: (1) the treatment of contingent liabilities in the context of sovereign debt, particularly due to the possibility of grossing up the total amount which potentially could be owed under a guarantee; (2) what has been the EU response to the crisis and the development of a new regional architecture; and, (3) what has happened within the credit default swaps arena, including the (in)experience with these hedging instruments in the sovereign context.

Lee Buchheit and Mitu Gulati played a critical role in the Greek debt exchange offer and were instrumental on the political and legal sides of the deal. Their remarks are contained in ‘The treatment of contingent liabilities in a sovereign debt restructuring’, the first chapter in this Part. At the outset, they pose the question of how to best treat contingent liabilities. They identify the central problem with contingent guarantees as being that neither the beneficiary of the guarantee (the creditor) nor the sovereign guarantor can know at the outset whether the primary obligor (the borrower) will be able to repay the debt on its own. Thus, it is difficult to place a value on them. If the beneficiary is forced to call on the sovereign guarantee as a means of bringing the liability into a restructuring in order

¹⁵ IMF, *World Economic Outlook* (2010).

to treat it in a manner identical to other debts, the sovereign may have to explicitly recognize the guarantee as a liability on its balance sheet and as a component of public debt. However, if on the contrary, contingent liabilities are not included in a sovereign debt restructuring, this may result in a 'land mine on the road to debt sustainability once the restructuring closes'.¹⁶

Buchheit and Gulati identified different options and highlight their respective problems. They draw on some historical examples from the 1980s and 1990s plus the more recent experience with Grenada in 2006. From those experiences they put forward the following view: the preservation of the economics of 'two-name paper'. By this they mean that when a beneficiary joins a sovereign's debt restructuring, if the exercise of any subrogation rights against the primary obligor produces a recovery after the restructuring closes, the proceeds of that recovery will be paid first to the beneficiary up to the amount of the financial loss it realized by joining the restructuring. After that point funds are paid to the sovereign.

In Chapter 16, Rodrigo Olivares-Caminal analyses the EU institutional reaction to the sovereign debt crisis and, in particular, focuses on the new architecture designed to avert similar events. This chapter considers the impact that global conditions have had on Greece and the need for financial assistance. It is noted that this modern 'Greek tragedy' provided the basis for the development of new arrangements mainly based on: (1) the European Financial Stabilisation Mechanism (EFSM), a financial assistance scheme available to all 27 member states; (2) the European Financial Stability Facility (EFSF), a temporary credit-enhanced special purpose vehicle with minimal capitalization created to raise funds from the capital markets (via an investment grade rating) and provide financial assistance to distressed EAMS at comparatively lower interest rates; and, (3) the European Stability Mechanism (ESM), an intergovernmental organization created under public international law.

Considerable attention is given by Rodrigo Olivares-Caminal to the ESM since by the time of publication of this book the role of the EFSF is likely to have been overshadowed by the ESM, which was scheduled to be put in place by mid-2012. He notes that the ESM should be welcomed as the latest pillar of the international architecture to prevent and/or minimise the effects of a European financial crisis. However, the work of the architects remains far from complete.

¹⁶ Please see L.C. Buchheit and M. Gulati, 'The Treatment of Contingent Liabilities in a Sovereign Debt Restructuring', Chapter 15 in this volume.

The final chapter addresses the problems related to liquidity spillovers in credit markets in the EAMS. Giovanni Calice, Jing Chen and Julian Williams note that the theory of complete markets suggests that sovereign debt and credit default swap (CDS) spreads should track each other very closely. In addition, liquidity risk should be priced into both instruments in such a way that buying exposure to the same default risk is identically priced, given appropriate collateral requirements for the hedging instruments and the payout structure in the CDS providing the desired recovery on the defaulting cash flow instrument. In this regard, the authors developed an empirical model of the co-evolution of credit and liquidity spreads in sovereign bond and CDS markets to study the liquidity and credit interactions for euro-zone countries over a period of time. They observed that a sudden loss of confidence in sovereign debt markets revealed itself in the form of a widening of credit spreads between several EAMSs and Germany.

In addition, Calice and his colleagues investigate the potential spillover effects between the credit and liquidity spreads among EAMS sovereign bonds and sovereign credit default swaps (CDS) during 2010. They found that: (1) explosive trends appeared during the 2010 sovereign debt crisis and the CDS market appears to have been a driver in most cases; (2) a positive and significant lagged transmission from the liquidity spread of the CDS market (using the bid-ask spread as a proxy) to the credit spread in the bond market; and (3) there have been several variance breaks in the time varying models indicating that the noise structure inundating the VAR models has changed markedly over the 2007–10 period. To conclude, they suggest that future research focus on an analysis of potential spillover effects between countries, rather than simply the CDS versus the bond market for individual countries.

III. A DEBATE ON THE USE OF GOVERNMENT GUARANTEES AND FINANCIAL CRISIS MANAGEMENT

The chapters included in this book were discussed at the Third Banking Law Symposium held on 3 and 4 October 2011 at the OECD in Paris. The participants reviewed recent and prospective measures (both national and international) as well as further changes needed to contain and prevent financial crises. *Inter alia*, they focused on:

- the role of sovereign guarantees, particularly in relation to the newly established European Financial Stability Fund;

- an assessment of public guarantees on bank assets in the light of the recent experience in several countries;
- the valuation and hedging of contingent fiscal liabilities associated with government guarantees and the linkage between guarantees and European sovereign debt issues;
- the pricing of government guarantees and the implications for financial sector competition; and
- the containment of moral hazard and taxpayer exposure.

The Symposium was organized by John Raymond LaBrosse, Rodrigo Olivares-Caminal, and Dalvinder Singh with the assistance of Sebastian Schich from the Secretariat for the Committee on Financial Markets (CMF). The event was part of the OECD's 50th anniversary special events and took place just prior to a regular meeting of the CMF of the OECD, serving as an input to it. This very timely symposium, in light of concurrent European financial developments, was part of the OECD's ongoing work on the fallout of the global financial crisis and major financial sector issues, of which the role of government guarantees is a significant component.

Keynote speakers included: Christine Cumming, First Vice President, Federal Reserve Bank of New York; Charles A.E. Goodhart, Professor Emeritus, London School of Economics, Már Guðmundsson, Governor, Central Bank of Iceland; Lee Buchheit, Partner, Cleary Gottlieb Steen & Hamilton, Mitu Gulati, Professor, Duke University, and Charles Enoch, Deputy Director, Monetary and Capital Markets Department of the IMF. Additionally, some 20 presentations were made by academics, as well as private and public financial sector specialists.

When problems began to appear in the US sub-prime mortgage-backed securities market in 2007, it was largely felt that, despite some strains, the banking system, or the financial system more generally, could absorb them within a relatively short time frame and that the world would go on as before. Underlying this was the experience of other financial shocks during the past 25 years or so, when financial safety nets, despite some country specific exceptions, proved equal to the task.

As it has turned out, problems quickly revealed other fragilities and that systemic risk in the financial system more broadly had been building up for some time. As the situation evolved the various problems began to feed on each other, resulting in a virulent global financial crisis. It can be argued that one type of financial crisis can quickly morph into another, with 2008–09 clearly being a case in point. It seems fair to say, with the benefit of hindsight, to be sure, that there was a lack of awareness and understanding of accumulating systemic risks, both by the private sector

as well as by the authorities, and that safety nets in most cases were inadequate and/or incomplete and risked being overwhelmed. Financial innovation, globalisation and the introduction of the Euro all had implications for risk containment that were not fully recognized at the time.

The Symposium, however, was a clear example of the international community's commitment to forging enhanced, well thought-out, mechanisms for containing systemic risks in the context of a highly interconnected global financial framework with ongoing financial innovation.

While the use of government guarantees was a central theme, the Symposium also analysed the roles played by prudential regulators, central banks, deposit insurers and treasuries in dealing with the crisis. These included traditional measures such as the central banks' lender of last resort role (including its lack of availability, particularly in some European countries), some extraordinary measures, such as recapitalisation, asset purchase and guarantee schemes, as well as more inclusive guarantees on the liability and asset sides of bank balance sheets. Even by traditional standards a number of countries had a less than complete financial safety net and deposit insurance had to be quickly introduced and/or substantially enhanced. Under the circumstances, and the need to act quickly, mistakes – often very expensive ones – were made at public, that is, taxpayers', expense, and they will shoulder a burden for many years. A central message is that the midst of a global financial crisis is not the best time to start thinking about creating a safety net and those guarantors should have some idea of potential exposure beforehand. Insufficient financial institution supervision coupled with blanket guarantees can jeopardise the financial viability of the state.