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Orderly sovereign debt restructuring procedures for the euro area

Author:

Berthold Busch / Jürgen Matthes
busch@iwkoeln.de / matthes@iwkoeln.de

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Postfach 101942 - 50459 Köln
Konrad-Adenauer-Ufer 21 - 50668 Köln
www.iwkoeln.de
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Executive Summary

The case of Greece has reveiled an institutional gap remains in the institutional framework of EMU: an orderly insolvency mechanism for sovereign states. After weighing the pros and cons of such a mechanism, requirements are devised to maximise the advantages and minimise the potential drawbacks. Overall, an insolvency procedure for sovereign states needs to be effective, reliable and fair. It should limit the negative effects of a default for the debtor country, but must not provide incentives for the debtor country to default strategically. Bearing these requirements in mind and based on a combination and change of existing proposals, this study proposes an insolvency regime for sovereign states, but one only as an ultima ratio.

As a rule, the debtor country starts the procedure - and is then supported by ESM bridge financing and can benefit from a moratorium on debt service, litigation and enforcement in order to sustain basic government functions. These support measures are time-limited and go hand in hand with a robust reform programme of the ESM to avoid problematic incentives for fiscal policy. The ESM can also trigger the procedure under restrictive conditions as an ultima ratio, if the debtor country clearly delays this step. The ESM treaty (also) has to be changed to ensure that the insolvency mechanism is triggered, if a country applies for ESM loans but proves to be insolvent instead of illiquid. Finally, if an ESM programme for a formely illiquid country ends unsuccessfully, an insolvency procedure is triggered automatically.

An institutionalised framework (with time-limited stages) should be obligatory for debt restructuring negotiations between creditors and the debtor country. After a brief phase for market based negotiations, this framework kicks in and involves as a key feature a new judicial body (located at the Court of Justice of the European Union) that moderates the negotiations with increasing intensity over time. To raise the incentives for the negotiating parties to come to a constructive conclusion, the judicial body can eventually issue a binding proposal for the debt restructuring. To be effective the procedure particularly has to impede so-called holdout strategies. To achieve this aim, the collective action clauses in sovereign bonds of euro area countries must above all be changed to a so-called single limb voting procedure.

The credibility of the insolvency mechanism is essential, so as to set incentives for sound fiscal policy. To this end, in particular contagion effects on the financial system need to be sufficiently contained. Mainly banks need to be better capitalised and the sovereign bonds of euro area countries must no longer be considered risk-free in banking regulation. To reduce the excessive exposures of many banks to bonds, especially of their own state, the ECB as the single supervisor should induce overexposed banks to sell the respective bonds to the ECB as part of the current public sector purchase programme. Like this portfolio adjustment, other required changes and the reduction of government debts need time. The new insolvency procedure can be only be implemented in the medium term, but should be decided on in the short term.

1. Introduction[1]

Since the onset of the euro debt crisis, various reforms have been implemented to improve the institutional framework of the EMU. The euro rescue fund (Matthes, 2015) and a banking union were created, and several reforms are aimed at improving fiscal and macroeconomic stability (Matthes/Busch, 2012). However, the case of Greece has demonstrated in recent months that an important institutional gap remains: an orderly insolvency mechanism for sovereign states.

For countries in a currency union, the likelihood of a sovereign default tends to be higher compared to countries that can use an independent monetary policy to monetise public debts. Moreover, the need for an insolvency mechanism in the euro area has increased with the significant rise of public indebtedness in recent years. Therefore, this study proposes an orderly and reliable sovereign debt restructuring regime, but one which is only to be used as an ultima ratio.

2. Pros and cons of an insolvency procedure for sovereign states

This proposal is based on a systematic evaluation of the pros and cons of an insolvency mechanism. Diagram 1 provides a brief overview of the advantages: without a reliably triggered insolvency regime, the danger arises that the filing of insolvency proceedings by the goverment in question is unwarrantably delayed and that in the course of a disorderly default the affected country falls into a deep economic crisis.

In addition, the problem of so-called holdout investors needs to be tackled. Holdout creditors do not agree to a debt restructuring and often sue the government in order to obtain full repayment of their credits – at the expense of the government and of the consenting creditors that accept a debt restructuring. This strategy creates legal uncertainty and can significantly impede debt restructurings and also a fresh start for the indebted country. However, over the last decade, several relatively successful debt restructurings were negotiated in emerging and developing countries, with the notable exception of Argentina, where holdout investors played an important role (Bi et al., 2011). Also, the ad hoc debt restructuring in Greece in March 2012 with a relatively limited number of holdout investors could - at first glance – be seen as an example that an orderly insolvency procedure for sovereign states could be dispensed with. However, a second look shows these examples can hardly be generalised to apply to the euro area:

- The debt restructurings of emerging and developing countries were mostly based on specific features of sovereign bonds under U.S. law.

[1] This IW policy paper is a shortened version of a longer study in German, which contains a more nuanced and detailed argumentation for a sovereign insolvency mechanism (Busch/Matthes, 2015).

- The Greek solution relied on specific features of Greek sovereign debt securities, and it also proved a rather costly way for the euro rescue fund (and thus for Greece) to finance participation incentives for investors.

Thus, a reliable orderly debt restructuring regime is required. This is particularly true for the euro area where financial markets are intensively interconnected. Thus, high costs could arise, if legal uncertainty or a failed restructuring led to an upheaval and contagion effects in euro area financial markets.

Furthermore, it is necessary to strengthen the no bailout rule of the EU treaties in order to provide adequate incentives for sound fiscal pollicy in euro member states. This can be achieved by a reliable and credible insolvency mechanism for sovereign states because it raises the ability of financial markets to correctly price sovereign bonds. On top of this, there is a need to have an exit option from unsuccessful ESM programmes in order to prevent the provision of lasting financial support to effectively insolvent countries.

Diagram 1: Arguments for an insolvency procedure for sovereign states

Arguments
Danger of economic crisis: A disorderly sovereign default usually has severe negative economic repercussions for the indebted country, which can be mitigated by a reliable insolvency procedure.
Delayed filing of insolvency. Without a reliably triggered debt restructuring mechanism, the danger arises that the respective goverment unwarrantably delays filing for insolvency proceedings, because it hopes and waits for an improving situation („gambling for resurrection“). Such a delay would contribute to an increase in indebtedness and uncertainty. An orderly insolvency mechanism with a reliable trigger can avoid an unwarranted delay.
Problem of holdout creditors: Holdout strategies create legal uncertainty and can significantly complicate debt restructurings. An orderly debt restructuring mechanism impedes holdout strategies.
Problems of ad hoc debt restructurings: Ad-hoc debt restructurings, as effected relatively successfully in case of several developing and emerging countries (and also in Greece) in the last decade, have important drawbacks. In particularly, there is residual legal uncertainty that can impede a fresh start for the country concerned. A reliable orderly debt restructuring regime provides legal certainty and an effective debt restructuring.
Problematic incentives for fiscal policy: Financial markets tend to misjudge the risk of sovereign bonds, if they expect a bailout instead of the loss resulting from a debt restructuring. In this case, sovereign bonds could be priced incorrectly so that incentives arise for governments to excessively inrease fiscal deficits and debt levels. A credible sovereign debt restructuring mechanism improves the conditions for correct pricing of sovereign bonds.
Lack of an exit option from unsuccessful ESM programmes: If an ESM programme ends unsuccessfully without the country regaining market access on acceptable conditions, the danger arises that financial support is continued despite a country being effectively insolvent. A credible insolvence procedure provides the needed exit option.

Source: own compilation based on an evaluation of the relevant economic literature (for a full list of relevant articles see Busch/Matthes (2015)

However, a sovereign debt restructuring mechanism also involves certain risks (diagram 2). Apart from the financial damage to the creditors, problematic incentives can arise for fiscal policy, if a debt reduction can be achieved without sufficient political

costs or if the insolvency mechanism can be strategically misused to reduce debts in unwarranted cases. Moreover, the increased likelihood of a debt restructuring could induce investors to „rush to the exit“, which could cause a severe crisis in the sovereign bond market as soon as the first signs of overindebtedness become visible in a country. Moreover, possible contagion effects on other countries via sovereign bond markets or via the financial system have to be taken into account. Finally, a sovereign default and restructuring tends to have longer lasting effects for market access in terms of higher risk premiums for sovereign bonds.

Diagram 2: Arguments against an insolvency procedure for sovereign states

Breach of contract and creditor losses: Debt restructurings can imply a breach of contract and lead to financial losses for the affected creditors.
Problematic incentives for fiscal policy: If a government can achieve a debt reduction without sufficient political costs or if the insolvency mechanism can be easily and strategically misused to reduce debts in unwarranted cases, it could be tempted to excessively increase fiscal deficits and debts.
Danger of financial market instabilty: The increased likelihood of a debt restructuring in case of a new orderly insolvency procedure could induce investors to „rush to the exit“, which would cause a severe crisis in the sovereign bond market as soon as the first signs of overindebtedness become visible in a country**.**
Danger of contagion effects to other countries. Even an orderly sovereign debt restructuring might not be able to avoid contagion effects on other countries, if financial markets are nervous and see parallels to other vunerable countries or if banks are heavily exposed to the indebted country. This could lead, in a worst case scenario, to a sovereign default also of other euro area countries.
Problematic return to the financial market: A sovereign default and debt restructuring tends to have longer lasting effects for market access in terms of higher risk premiums for sovereign bonds, because a default negatively affects the trust of financial markets in the government concerned. A return to the financial market after the debt restructuring can thus be impeded.

Source: own compilation based on an evaluation of the relevant economic literature (for a full list of relevant articles see Busch/Matthes (2015)

Overall, the authors hold the opinion that these risks can be sufficiently mitigated by an adequate construction of an insolvency mechanism and that the remaining drawbacks are clearly outweighed by the advantages of an efficient insolvency procedure.

3. Requirements, existing proposals and elements within the ESM

As an intermediate step before our recommendations are put forward, we have drawn up a list of requirements for an orderly insolvency procedure, mentioning existing proposals and highlighting elements of the ESM that serve as a basis for our proposal.

Based on the above-mentioned pros and cons, several requirements for an orderly and reliable sovereign debt restructuring mechanism can be deduced in order to

maximise the advantages and minimise the risks of such a procedure. Diagram 3 (right hand side) provides an overview of these requirements.

Existing proposals for an insolvency mechanism for sovereign states (see annex) serve as an additional basis for the recommendations suggested by this paper. These proposals can be categorised according to various characteristics, for example the existence of a trigger or a mandatory dispute settlement mechanism, the way holdout strategies are impeded, the inclusion of financial support instruments, or a focus on the euro area.

The European Stability Mechanism (ESM) – while fallling significantly short of containing a fully-fledged insolvency procedure (SVR, 2013, Tz. 274) – still provides several rudimentary elements.

- If an ESM member applies for financial support, a debt sustainability analysis will be carried out by the EU Commission, in liaison with the ECB und as a rule also with the IMF. While this is a reasonable arrangement, the ESM treaty remains too vague on the consequences of a country being found insolvent (Matthes, 2015). Thus it is not sufficiently clear that only solvent countries can obtain a normal ESM rescue programme.
- In the case of a defaulting member state, the ESM (and the ECB) can prevent or significantly limit contagion effects on other euro area countries' sovereign bonds. This is one precondition for a credible insolvency mechanism.
- ESM financial support could in principle also be used for a defaulting country which usually loses access to financial markets during debt restructuring negotiations when it does not service its debts. Moreover, additional ESM instruments (precautionary credit lines as well as purchase programmes on the primary and secondary sovereign debt market) could facilitate a return of the country in question to the financial market after the completion of the debt restructuring.
- As the only substantive element of an insolvency procedure, the ESM treaty stipulates that from 2013 onwards all newly issued sovereign debt securities of euro area countries shall contain collective action clauses (CACs) which contribute to impeding holdout strategies.[2] These CACs provide fore a so-called two-limb voting procedure, which means that two conditions must be fulfilled to successfully decide on a debt restructuring: a qualfied majority of 75 percent (of bond holders present at the vote) across all bonds and a majority of 66⅔ percent of each single bond issue. If the second condition is not met, the bond

[2] Collective action clauses are are part of the smallprint of sovereign bond issues and thus are a contractually based instrument against holdout strategies. CACs stipulate that a (negotiated) significant change of emission conditions (e.g. a reduction of interest rates, an extension of maturities or a reduction (haircut) of the nomimal debt amount owed) can be achieved by a qualified majority of bond holders. This majority decision would legally bind also minority bond holders and thus potential holdout investors.

issue concerned does not participate in the negotiated debt restructuring. Thus, holdout investors can still impede a debt restructuring if they obtain blocking minorities in single bond issues.[3] This threat significantly reduces the incentive of other investors to participate in a debt restructuring. Moreover, CACs also generally do not offer the indebted country legal protection from litigation and enforcements by holdout creditors (Benninghofen, 2014, 157).

4. IW recommendations

The institutional framework of the EMU is incomplete without an insolvency procedure for sovereign states. This creates economic problems for indebted euro area countries in case of a disorderly government default. Moreover, the lack of an insolvency procedure also tends to undermine incentives for sound fiscal policy, if countries rely on being bailed out even if they are effectively insolvent. For these and other reasons, the euro area needs an orderly, reliable and credible debt restructuring mechanism for sovereign states, to be used however only as an ultima ratio. Such a mechanism must, however, entail sufficient political costs to prevent governments from using it to strategically reduce their debts in unwarranted cases. In order to meet these and other requirements (while taking account of conflicting objectives), the authors submit a concrete proposal for an insolvency mechanism for sovereign states. [4] Diagram 3 displays the recommendations and shows how they contribute to meeting the stated requirements.

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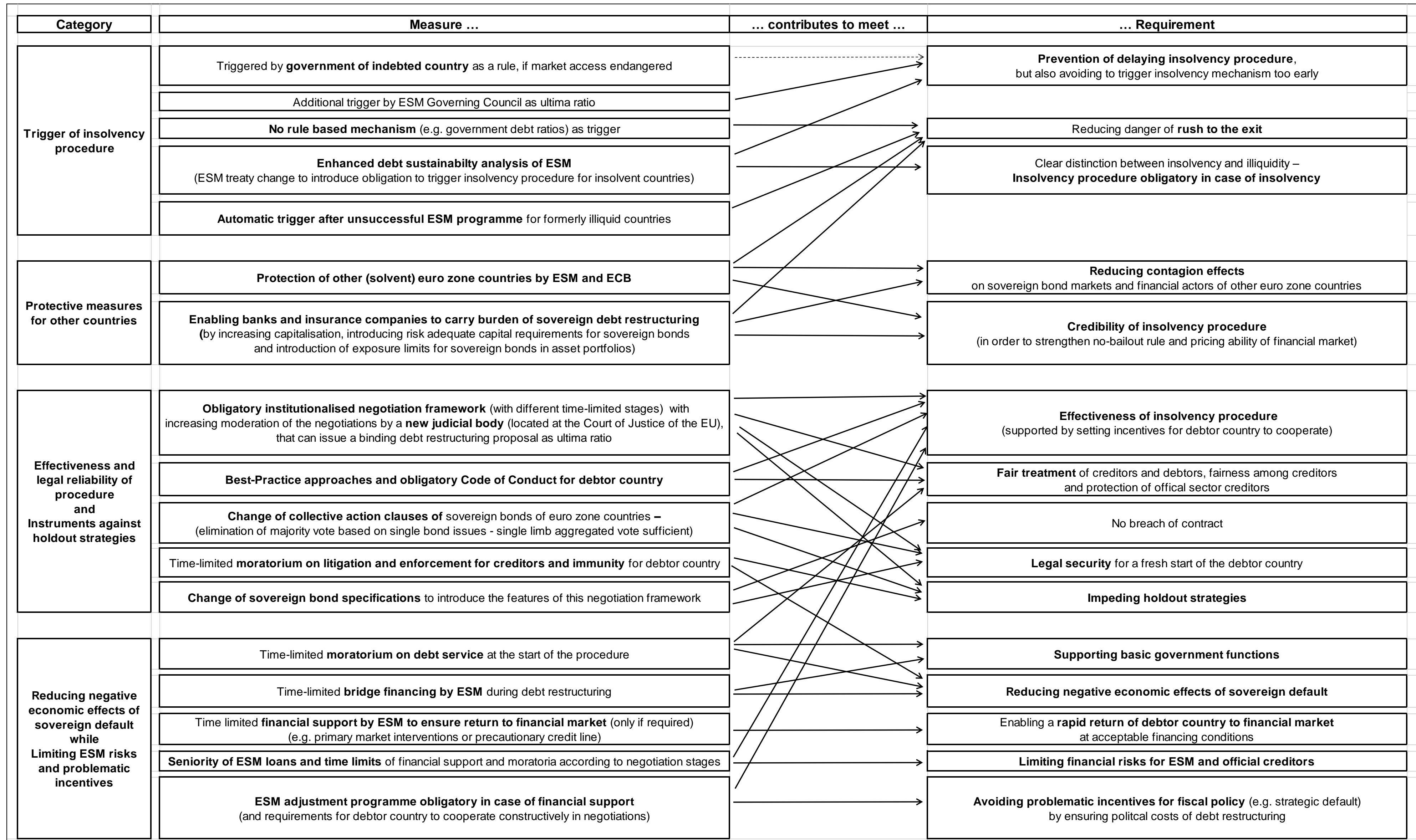
[3] This was the case in Greece’s debt restructuring in March 2012, when about half of the Greek bond issues under foreign law did not participate due to successful holdout strategies (IMF, 2014).

[4] The authors generally build on existing proposals, but combine, change and enlarge elements of these proposals.

Diagram 3: IW recommendations for an orderly, reliable and credible insolvency procedure for sovereign states in the euro area



Dotted arrow: limited impact
Source: own compilation

The most important recommendations read as follows:[5]

- As a rule, the government of an overindebted country triggers the insolvency mechanism if financial market access is endangered or considered too expensive. However, if a significant delay occurs in opening the procedure, the ESM should also be able to trigger it with a very large majority. Moreover, implementing the insolvency procedure has to become obligatory if and when an ESM programme ends unsuccessfully after three years. Contrary to some other proposals, our proposal does not rely on a rule-based trigger such as the threshold of a certain ratio of government debt to GDP, because we fear that such a construction could increase the danger of a "rush to the exit“ and of a resulting crisis in the sovereign debt market. Instead, the practice of the ESM should be maintained, that the institutions EU-Commission, ECB and IMF carry out a debt sustainability analysis to determine whether the country in question is still solvent. However, the ESM treaty should be revised and made more explicit, to ensure that in case of insolvency an insolvency procedure becomes obligatory.
- When an insolvency procedure is triggered, the country is usually excluded from the financial market, with severe repercussions for the economy and possibly also for the ability of the government to fulfil elementary functions like payment of pensions and public servants. In order to reduce these risks, a moratorium for debt service and ESM bridge financing are needed temporarily, until the debt restructuring has been completed and the country returns to the financial market. In case of problems in the course of this return, the ESM could support this step with primary or secondary market interventions and a precautionary credit line.
- The negotiations about the debt restructuring should be structured in several stages. First, market-based negotiations should be possible for a maximum of two months. If unsuccessful, a more institutionalised transparent negotiation framework becomes obligatory – with strong incentives for the debtor country to cooperate constructively. The economic know-how of the institutions (EU Commission, ECB and IMF) should be part of the procedure, particularly in order to determine the impact of debt restructuring scenarios on debt sustainability. Even more important, a new judicial body, which should be located at the European Court of justice as a new chamber (Gianvity et al, 2010), would oversee the negotiations with increasing stringency. If this approach also remains unsuccessful after a sufficiently narrow time limit, the judicial body could set binding restructuring conditions, but only as an ultima ratio. This construc-

[5] A more detailed explanation and justification for these recommendations can be found in Busch/Matthes (2015).

tion is intended to increase the pressure on the negotiating parties to come to a constructive conclusion themselves.[6]

- Further instruments are required in order to curb holdout strategies. First and foremost, the CACs of the euro area should be changed to a single-limb voting procedure, i.e. the requirement for a second qualified majority based on a single bond issue (on top of a qualified majority in an aggregated vote) should be eliminated. [7] Second, the indebted government should be granted immunity temporarily, until the country has returned to the financial market. Third, as a reaction to the US Supreme Court ruling on Argentina, the so-called pari passu clause should be sufficiently nuanced as recommended by the IMF (IMF, 2014).
- The moratoria on debt service, litigation and enforcement as well as the financial support measures of the ESM need to be based on robust conditionality in order not to undermine incentives for sound fiscal policy. The obligatory macroeconomic reform programme of the ESM - which primarily aims at helping the country to regain growth and competitiveness - should also induce the government to cooperate constructively in the debt restructuring negotiations. To this end, the moratoria and the financial bridge support of the ESM should have strict time limits, which are aligned to the negotiation stages, and these supporting measures should only be continued if the country cooperates sufficiently. Morever, the amount of financial bridge support needs to be limited to truly essential government functions and the ESM loans should be given seniority status.
- The credibility of the insolvency mechanism is essential for setting the intended incentives for sound fiscal policy. Therefore, contagion effects on the domestic banking system and on other euro area countries need to be sufficiently contained. With regard to sovereign bond markets, the ESM and the ECB can use their existing instrument to this end. As regards possible contagion effects on the domestic banking system or on foreign banks (or insurance companies), these financial operators must be sufficiently capitalised and must not be overexposed to sovereign bonds of the indebted country. In particular, domestic banks are often heavily exposed to their own governments, largely because sovereign bonds of euro area countries are considered riskfree by the banking regulators. This has to change, and also banking liquidity regulations must no longer excessively favour sovereign bonds. Moreover, the public sector purchase programme (PSPP) of the ECB should be used to reduce the

[6] If this approach is considered too far-reaching, a "comply or explain“ procedure is possible as a less binding alternative. The judicial body would make a restructuring proposal and both parties would have to comply with it or explicitly explain why they refuse to do so. If the debtor country refuses to comply, financial support would be withdrawn by the ESM.

[7] The new judicial body has to make sure that creditors are treated sufficiently equally and that the consenting majority does not disadvantage the minority creditors.

amount of sovereign bonds in banks' portfolios. As a single supervisor of euro area banks, the ECB should induce overexposed banks to sell the respective government bonds to the ECB.

- The proposed insolvency procedure for sovereign states cannot be implemented in the short term as this could lead to financial upheaval. First, it takes time to reduce banks' overexposure sovereign bonds, increase capital and eliminate the risk-free status of government bonds. Second, vulnerable countries need some years to demonstrate that they can gradually reduce and thus live with high government debt ratios. Third, several elements of our proposal require changes in the small print of sovereign bonds (for example the change in CACs, the introduction of the moratoria and of the staged procedure with the possibility of a binding ruling of the judicial body). Fourth, the ESM treaty also has to be changed. This need for time notwithstanding, a binding political decision to introduce a concrete insolvency procedure for sovereign states (which would be introduced at a later stage) should be taken as soon as possible.

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Annex:
Existing proposals for insolvency procedures for sovereign states

Diagram: Existing proposals for insolvency procedures for sovereign states
Selection

Proposal	Trigger	Type	Adjustment programme	Financial support	Protection of government functions
… with arbitration court or statutory mechanism					
Sovereign Debt Restruc-turing Mecha-nism (SDRM) Krueger, 2002 (IWF)	Indebted country	IMF to estab-lish a single body)	Adjustment programme of IMF		Moratorium for payment and stay on litigation and enforcement
Fair and Transparent Arbitration Process (FTAP) Raffer, 2010	Indebted country	Arbitration panel			Moratorium for debt ser-vice
Resolvency machanism Paulus, 2013b	Indebted country	Sovereign Debt Tribunal (Resolvenz-gericht)	Plan of indeb-ted county		

to be continued

Diagram contiued

Proposal	Trigger	Type	Adjustment programme	Financial support	Protection of government functions
… with automatic trigger					
Insolvency procedure for sovereign states from EEAG EEAG, 2011		Rule based mechanism with negotiations		Financial support in case of illiquidity	Short-term ESM support to keep up basic government functions
Insolvency procedure for sovereign states from German Council of Economic Experts SVR, 2011	ESM loans for country with government debt ratio over 90% of GDP only with debt restructuring	Rule-based mechanism	Macroeconomic adjustment programme	ESM loans	
European Sovereign Debt Restructuring Mechanism (ESDRM) Weder di Mauro / Zettelmeyer, 2010	Financial support for country with government debt exceeding a to be defined ratio, only with debt restructuring	Rule-based mechanism	Adjustment programme	Loans from a financing mechanism	
European Sovereign Debt Restructuring Regime (ESDRR) Buchheit et al., 2013a (CIEPR)	Like SVR und Weder di Mauro / Zettelmeyer	Rule-based mechanism	Adjustment programme beside financial support, if government debt ratio btw. 60% and 90%	ESM loans	
Sovereign Contingent Convertible Bonds Mody, 2013	Debt restructuring, if government debt ratio exceeds certain values (to be defined)	Rule-based mechanism			Extension of maturities possible

to be continued

Diagram continued

Proposal	Trigger	Type	Adjustment programme	Financial support	Protection of government functions
… without automatic trigger					
European Monetary Fund (EMF) Gros/Mayer 2010; 2011 (CEPS)		Sovereign bonds exchanged by EMF at face value	Reduction of face value only with adjustment programme	Limited financial support	
Insolvency procedure of Wissenschaftlichen Beirats beim BMWI, 2010	Indebted country	Negotiation body	Fiscal adjustment measures		General requirement to guarantee government functions sufficiently
European Crisis Resolution Mechanism (ECRM) Gianvity et al., 2010 (Bruegel)	Indebted country	Judicial body (Court of Justice of the EU)	Economic body to provide the necessary economic expertise	If agreement with creditors	Moratorium for debt service
Viable Insolvency Procedure for Sovereigns (VIPS) Fuest et al., 2014 (ZEW)	If ESM programme ends without success and no return to finacial market possible	Rule based mechanism		ESM loan	Moratorium on debt service, stay on litigation; immunity for debtor country
International Lender of Last Resort (ILOLR) Panizza, 2013	Indebted country, Financial support of ILOLR ends automatically, if debtor country exceeds set limits	ILOLR analyses debt sustainability		Only for countries where situation is sustainable	Moratorium for debt service

Source: own compilation