

Draft

Market Discipline for Financial Institutions and Sovereigns

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This paper explores how market discipline works for financial institutions, a highly regulated industry, and sovereigns. It is organized into two parts: (1) an assessment of what market discipline (MD) is and how it applies to banks and sovereigns and (2) mechanisms to induce greater MD discipline for banks and sovereigns.

A. How Market Discipline Works

1. Definition

Market discipline can be defined in different ways. One could equate market discipline with the classical conditions for perfect markets, including perfect information and competition, lack of agency problems and no externalities. But such “perfect” conditions are rarely found in most markets in the real world, even unregulated ones. Similarly, agency costs exist for all firms, regulated and unregulated alike. It is hard to attribute the failures in corporate governance reflected in the recent accounting and other corporate scandals to the fact that firms were *regulated*. This is not to say lack of corporate governance, as measured by independent boards and audit committees, is not a problem for financial institutions, but rather to say it is no more a problem for financial institutions than other firms.

2. Safety Net Distortion

MD for financial institutions (mainly banks) and sovereigns is undermined by the provision of safety nets, publicly supplied credit or guarantees, which relieve debtors from risk, thereby creating both debtor and creditor moral hazard. Debtors may borrow more or incur more risk, and creditors may supply more funds, and at better prices, than would be the case without such safety nets.

The safety nets take somewhat different forms for banks and sovereigns. In the former case, they consist of deposit insurance and bailouts (lending by central banks or governments to insolvent banks). In the latter case, they consist of loans to non-creditworthy or defaulting sovereigns by multilateral institutions, principally the IMF, or particular countries (official bilateral credits).

The rationales for the two safety nets also differ. In the case of banks, concerns of systemic risk are the principal justification for the safety nets. The idea is that the failure of one bank could trigger those of others, ultimately disrupting an entire economy.

In the case of sovereigns, the international safety net may be used to stem a country banking crisis. In many cases, financial crises are caused by the inability of banks to service their foreign debt. Korea and Turkey are recent prominent examples (Scott and Wellons, 2003). But there may also be a concern about country contagion, a financial meltdown in one country extending to others. In addition, there is a large political component of sovereign safety nets; countries and the multilaterals they control lend to countries whose support they seek to maintain.

There is, of course, an intense debate about whether these systemic risk concerns are real (Scott, 2004), either in the case of banks or sovereigns, and thus whether these public safety nets are justified. This debate is largely beyond the scope of this paper. The point here is that the existence of such safety nets can undermine market discipline.

3. Market Discipline Requisites

This paper formulates three general requirements for finding an acceptable level of market discipline: (1) a market in the financial instruments of the issuer; (2) enforceable credit contracts; and (3) a market for corporate control.

a. Capital Instruments

Market discipline requires a mechanism through which the market can penalize excessive risk-taking. Ordinarily, such discipline comes from losses or ultimately the failure of the firm. It is not obvious why one would demand that the issuer have instruments traded in the market. After all, many firms may be in perfectly competitive markets that penalize excessive risks taken, and not issue such instruments. But banks and sovereigns are different. Given our concern with the possible systemic consequences of bank failure and losses to public safety nets designed to minimize systemic risk, we must have confidence that the market provides sufficient

solvency signals to permit instrument holders to demand management changes, or that creditors or regulators be able to intervene before a bank's capital becomes negative.

Sovereigns are also different. As with banks, there is concern with systemic consequences—here both economic and political—and the need to avoid calls on public safety nets (new official or multilateral credits). In addition, sovereigns, unlike banks, are not private actors, and are thus generally less responsive to private incentives to avoid losses. This can be a problem for state-owned banks but it is always a problem for sovereigns. It may be essential in the case of sovereigns that capital instrument holders be at risk if sovereigns are to be subject to any MD. Also, unlike the case with banks, there is no fallback to regulation if MD fails. It is thus even more crucial that there be market discipline for sovereigns than it is for banks.

Market discipline from capital markets could, in principle, be provided from equity or debt investments. But debt instruments more directly provide signals of default risk through interest rates. While default risk in theory might be extracted from equity prices (Gropp, et. al., 2002), this may be difficult to do in practice.

MD with respect to debt instruments requires that key terms, including supply, price and maturity, in both the primary and secondary markets, be determined by risk. For this to occur, the instrument must be traded and priced, thus excluding, for example, a long-term credit facility arranged between a securities firm borrower and a bank creditor. Credit arrangements must also be capable of modulation in response to risk. Thus, senior and junior positions, and collateral and guarantee provisions, must be possible. These mechanisms assume credit suppliers have sufficient knowledge about risk to price it or design mechanisms to control or minimize it.

This does not require perfect information since the market typically makes price or collateral adjustments to compensate for lack of information; it only requires that the market have a fairly good idea as to what it is missing, so that discounts or level of required collateral will not be excessive. It is wrong, in my view, to say that market discipline cannot exist for banks because of the opaqueness of their loan portfolios. Assets of other largely unregulated firms, like biotech or entertainment firms, may be much more difficult to value. It may be

enough for the market to know commonly disclosed aggregate data about loan portfolios such as number and type of borrowers.

There are obvious deficiencies in information available to creditors of banks and sovereigns. In the case of banks, there is the difficulty of accounting for loans. There is also the problem that banks may be discouraged by regulators from making disclosures, either because the regulators fear the market reaction could trigger a run on the bank or a run on the regulators themselves (insolvent banks reflect poorly on the regulators).

The problem in banking is that there is generally no capital instrument, immune from bailouts, through which judgments about the performance of the issuer can be reflected. The true risks of instruments will be distorted by the prospect of bailouts. Thus, the bank will not pay the same kind of price for inadequate performance or disclosure as will issuers without capital instruments protected by safety nets. The same is even more the case for sovereigns.

b. Legal Mechanisms to Foreclose on or Restructure Debt

Another key element of MD is that default on debt will result in losses to the issuer. This requires that there be legal mechanisms to foreclose on debt, and if necessary, to force debtors into bankruptcy or reorganization where value available for creditors may be maximized. In short, the potential discipline from capital market instruments requires that these instruments be enforceable.

Banks have some difficulty in issuing enforceable debt contracts. On the one hand, they can issue a range of debt, secured and unsecured, bank creditors can generally enforce debt contracts, and insolvent banks can go bankrupt and be restructured. However, the decision to invoke the bankruptcy process is left to regulators, e.g. the FDIC in the United States, rather than to private creditors, the usual case in other industries. Further, the actual bankruptcy process for banks is often within the control of the regulators themselves.

The problem is more severe for sovereigns. Political and constitutional dictates may preclude active use of secured credit or guarantee arrangements; debt contracts are less modulated. Secured credit may be difficult to enforce—the days of gunboat diplomacy to seize

country assets are long gone. The escrow arrangements for the zero coupon U.S. Treasuries securing payments on Brady Bonds appear to be a highly unusual exception.

And there is generally no process for dealing with default, as the extended crisis in Argentina clearly illustrates. Countries are not liquidated, and there is no regular process, as with companies, for dealing with insolvency (or inability to pay). As with banking, the process of dealing with sovereign default is largely managed by the public, e.g. the IMF, rather than the private sector.

c. Market for Corporate Control

Another essential element for MD is a market in corporate control. Poor performance by managers, reflected in the prices of capital instruments (higher debt yields, lower share prices), or potential defaults, should be capable of resulting in takeovers, friendly or unfriendly. A market for corporate control, at least for unfriendly takeovers, is itself dependent upon the existence of capital market instruments that can be used to gain control of a firm.

Takeovers of banks present significant obstacles as compared with takeovers of firms in most other industries. This was well-illustrated in the U.S. by the extremely rare hostile takeover of Irving Trust Company by the Bank of New York in 1988. Regulators have to approve the acquirer, a process which can take substantial time with attendant risk for both the acquirer and the target. Second, regulators may insist that the acquirer restore the acquired bank to health by injecting additional capital, adding expense. Third, extremely restrictive antitrust rules may be applied, e.g. review of the effect on competition in multiple local banking markets. These rules may reflect the unwillingness of regulators to put other banks at a competitive risk from the merged institution.

Of course, where sovereigns are involved, takeovers are a non-event, except in war, and even then are generally unrelated to poor economic performance. One might argue that countries with strong democratic arrangements do permit change in control and that poor economic performance may trigger such changes. However, it is unlikely that the changes will depend on

the degree to which sovereign debt—particularly that owed to foreign creditors—is honored. Indeed, as Argentina most recently illustrates, political advantage may result from default.

B. Mechanisms to Improve Market Discipline

1. Banks

The most important improvement that could be made to increase market discipline for banks would be to decrease or eliminate safety nets. This requires, however, that one accept the added systemic risk that may result, or independently attempt to decrease that risk. In banking, changes in payment arrangements—migration to real-time gross settlement systems like Fedwire, conversion of end-of-day net settlement systems to continuous settlement as in CHIPS, or the reduction of Herstatt risk (foreign exchange settlement risk) through the use of the CLS Bank, have reduced systemic risk. Limits also exist on interbank placements, and deposit insurance acts to prevent bank runs. Further, one can provide that safety nets like central bank lending to insolvent institutions will only occur after a determination that systemic risk is a real concern, the approach taken in 1991 in the Federal Depositors Insurance Corporation Improvement Act (FDICIA). And one can try to make risky banks pay more for deposit insurance than less risky banks, thus internalizing the cost of public support.

The removal of safety nets would, of course, permit more accurate risk-based pricing of capital instruments. A more modest step is to insure that banks issue some instruments that are immune from bailouts. The proposal of the Shadow Financial Regulatory Committee to require banks to issue bailout-proof subordinated debt is intended to accomplish this result (Shadow Financial Regulatory Committee, 2001).

Other measures have been adopted to decrease risk, such as activities restrictions and capital requirements, but these approaches, as most command and control regulation, can have perverse effects. Activity restrictions may actually prevent risk-reducing diversification and capital requirements may not achieve their objective, e.g. most analysts believe that present Basel rules require too much capital for good risks and too little for bad risks (a result that may also occur under the approach of Basel II) (Crouhy, et. al., 2004).

Other improvements could be made. A more private creditor-friendly bankruptcy process could be designed, regulators could abandon efforts to block banks from making damaging disclosures (and could even disclose more of their own information about banks) (Hoenig, 2003) and rules more favorable to acquisitions could be adopted.

2. Sovereigns

a. Safety Nets

As with banks, a principal problem is with safety nets. Limitations on multilateral lending to sovereigns have been proposed, such as in the Bank of England-Bank of Canada proposals (Haldane and Kruger, 2001), but so far no restrictions have been adopted or even seriously considered. Further, there has been almost no discussion of limiting bilateral official credit. The lack of movement on this front largely reflects the present reality that the international system has no acceptable alternative way to deal with financial crises.

Reform in the sovereign debt area has focused on improving the process of dealing with insolvency. This could in theory improve market discipline by providing better legal mechanisms which, in turn, might mean less need for public support. If sovereigns and their creditors had effective means for decreasing and restructuring debt, less public support might be needed. However, these processes may take a long time to use when a crisis does arise, and there may well be the same pressure, in the short-term, for public support.

Two approaches to dealing with insolvency have been actively considered, providing for collective action clauses (CACs) (Taylor, 2002) in bond covenants and the creation of a legal process for debt restructuring, the so-called sovereign debt restructuring mechanism (SDRM) (Krueger, 2001 and Krueger, 2002).

b. CACs

There are several different types of bond covenants that could be subject to CACs. The primary attention has been on CACs that permit a majority of creditors to change the payment terms in outstanding bonds. Traditionally, sovereign debt issued under U.K. law has included such CACs, permitting 75% of creditors (by value) to take action, whereas debt issued under

U.S. law (over 60% of present debt) has required creditor unanimity (unanimity action clauses or UACs). U.S. law actually only requires this result for corporate bonds, not sovereign ones—so parties have freely chosen UACs over CACs.

The G-7 countries, led by the United States (with Undersecretary of the Treasury John Taylor as the champion) have urged emerging market countries to use British-style CACs. This effort has borne some fruit. For example, Mexico, Brazil and Uruguay switched in 2003 from using UACs to CACs in substantial new 2003 bond issues. However, it unclear to what extent speculative grade issuers (who are most likely to use such clauses) will or will have to pay a premium for use of CACs (Eichengreen, et. al., 2003, believe they have). If the cost is significant, the use of CACs may be limited. In addition, some of the recent CAC issues have effectively required a higher than 75% majority requirement. For example, in the Uruguay \$5.1 billion issue in May 2003, all debt holders “controlled” by the sovereign, such as state banks, are to be excluded in obtaining the required 75%. It is unclear, just how much easier this stringent collective action rule makes restructuring than a complete unanimity requirement.

There are other problems about the effectiveness of CACs. First, it is questionable whether they will really ever be used. As Argentina has most recently demonstrated, creditors and debtors would rather obtain public support. While this may be bad for sovereigns in the long run, since it increases debt costs, in the short run it permits them to avoid painful adjustments. And creditors also benefit by avoiding losses. Second, there is a severe “aggregation” problem. Some bonds may have CACs, and others may not, and those issues with CACs may have different majority requirements. It is unclear what rules would apply across different bonds. Uruguay’s recent issue attempts to deal with this problem by using a super CAC, providing that all future bonds issued in the same series would require the same 75% CAC, and that collective action across all bondholders in the series could be taken by a 85% majority of creditors, and 66.6% of the holders of each separate bond issue. But this aggregation solution could be easily undone if Uruguay were to decide in the future to issue a new “series” of bonds without CACs or with different CACs, or not subject to aggregation.

In short, it may be extremely difficult, if not impossible, to use private contracts—bond covenants—to achieve real coordinated majority action requirements across different debt instruments, where different creditors extend credit to the same debtor over time. Indeed, this explains why we have bankruptcy laws for corporate debt, and why some think we need a SDRM for sovereign debt. The marginal price increases, if any, associated with the recent conversions to CACs by some countries may indicate that these clauses will have a marginal effect on the sovereign debt risk process.

c. SDRM

The SDRM proposal put forward by the IMF in 2002 failed to get support from the G-7, particularly the United States. It is officially on hold, but could always be reactivated if CACs were found wanting. The key elements of the SDRM are: (1) at a debtor's request, a majority of creditors could impose a standstill on payments and a stay of creditor litigation for a fixed duration, e.g. 90 days; (2) facilitation of new financing by providing that, upon consent of a super-majority of existing creditors, old claims would be subordinate to new money (so-called debtor in possession or DIP financing); (3) during the SDRM process, priority creditors (multilaterals like IMF and World Bank, and possibly countries) would still be paid—outside of restructuring, but some parallel restructuring of their debt would occur; (4) a restructuring plan could be approved by a super-majority of creditors, informed by the IMF's view of the sustainability of the resulting debt burden; and (5) an independent tribunal (maybe a judicial organ) would adjudicate issues like lack of equitable treatment or valuation of claims.

It is highly unlikely that such a procedure will be adopted in the near future due to opposition from the United States and most creditor groups (who see this as making restructuring too easy). Even if SDRM were to be adopted, it would not by itself necessarily increase market discipline. Like CACs, it is unclear it would ever be used. It can only be triggered by debtors who may prefer not to use it, and instead obtain additional multilateral or official bilateral funding.

d. Another Suggestion: Reform of Sovereign Immunity Laws

Some more limited measures may be possible. The IMF has made major efforts to improve the disclosure of country finances. Better information may lead to more realistic debt terms. The IMF has also used its conditionality requirements and financial sector assessment program, FSAP, to promote macroeconomic measures and structural reforms that might reduce crises in the future. However, it is unclear whether such measures actually do reduce risk.

One additional possibility would be to expose sovereigns to more threat from creditor foreclosure actions. This can be analyzed with reference to the United States. Under U.S. law, creditors of defaulting sovereigns can get judgments in U.S. courts against defaulting sovereigns, but cannot easily attach assets in satisfaction of such judgments. Absent a waiver of sovereign immunity, the only attachable assets are those used in connection with the issue of such debt—and it is hard to imagine what those assets might be. This has not, in fact, proved to be a problem since sovereigns commonly waive sovereign immunity. While this opens up U.S. assets to seizure (except those specifically excluded by statute, such as central bank assets), U.S. courts will not enforce the attachment of assets outside the U.S.

What assets would a sovereign have in the U.S.—or other countries—that are now available for seizure? As the *Elliott Associates* case demonstrates, payment of interest on existing debt is an important asset available for seizure outside the sovereign issuer's country. Payments in foreign currency to foreign creditors require a transfer of funds through the payment system of the country of the currency to foreign accounts of the creditors. In addition, payments from other countries to defaulting sovereigns, e.g., in connection with imports from the defaulting sovereign, may also be exposed to seizures. Any doubt that such assets are available for seizure could be removed by clarifying statutory enactments.

Countries own substantial commercial ventures, state-owned enterprises (SOEs). While the SOEs are separate corporate entities, sovereigns do own them, and the stock in such enterprises could be available for attachment. If such stock is held in the defaulting sovereign's own country, foreign courts, like those in the U.S., cannot attach them. This outcome could be changed by a law giving the U.S. courts the power to order the delivery of such stock to

creditors. If such an order were not complied with, U.S. courts could allow the creditors to levy on the assets of the SOE. This would result in a possible conflict of claims between the creditors of the sovereign and those of the SOE, but this conflict could be resolved by giving the sovereign's creditors a claim subordinated to all of the SOEs creditors—a pure equity interest.

Interestingly, Jeremy Bulow (2002) has proposed a reform of sovereign immunity laws going in the exact opposite direction. He has recommended increasing sovereign immunity protection on the theory that creditors who are more at risk from sovereign default will be more careful in lending to those sovereigns in the first place. It seems odd, however, to address potential sovereign default problems by decreasing creditor remedies. Bulow is obviously focused on the creditor moral hazard problem—the fact that creditors are not sufficiently at risk because of public bailouts. But, as long as such bailouts exist, creditors will be relatively indifferent to their remedies—like CACs they will not have to use them. Indeed, as long as such bailouts exist, creditors will be relatively indifferent to an *increase* or *decrease* in their rights.

Absent bailouts, however, or given that bailouts are not always assured or complete, one would want the market to discipline debtors as well as creditors. Creditors should be disciplined by uncompensated losses and debtors should be disciplined by creditors exercising their rights. The latter could be promoted, in my judgment, by decreasing sovereign immunity protection. At the margin of the safety net, this should lead to fewer defaults and cheaper credit.

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