Why an ESM programme could be a kiss of death:
Recovery Values and Subordination

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A crude way some investors look at the risk in investing in government bonds in the euro area periphery is to simply calculate a hypothetical 'recovery value' for the country by comparing the size of its foreign debt (excluding equity, which is loss absorbing) to its total foreign assets. The difference between these two figures gives the amount the country would not be able to repay if it had to liquidate all its assets to pay off its foreign creditors (but not foreign equity holders). The ratio gives one the 'recovery ratio', i.e. how many cents on the euro foreign creditors could expect in this kind of situation (column 3 in Table 1)). The table below thus provides the ratio of (gross) foreign debt to total (gross) foreign assets where (gross) foreign debt is defined as total (gross) foreign liabilities minus inward FDI and minus portfolio equity in the country.

Table 1. Basic data for recovery ratios (€ billion)

	Total foreign assets (1)	Foreign debt (2)	Recovery rate (in %) (3)=(1)/(2)	Official financing (= non-loss absorbing debt)
Greece	212	361	0.59	228.5
Ireland	2,314	1,426	1.62	49.1
Portugal	279	350	0.79	51.1
Spain	1,211	1,597	0.76	-
Italy	1,599	1,669	0.96	-

Source: Own calculations based on data from Eurostat, IMF, ECB and the European Commission.

Table 1 shows the recovery ratios in two ways: i) as a percentage of the overall recovery rate in which no distinction is made between private and official creditors and ii) as a percentage of the recovery value for *private investors*, which must be adjusted for that part of the debt that is senior and will thus be repaid before private investors are repaid.

i) The overall recovery values vary widely among the GIIPS countries (Greece, Italy, Ireland, Portugal and Spain), with a low of close to 60% for Greece. But for Ireland the hypothetical recovery value would even be above 100% because the net debt of the country is more than covered by loss-absorbing equity. Even on a liquidation basis, Ireland thus looks like a safe bet. Italy is not quite in the same situation as Ireland, but given its modest net debt, its hypothetical recovery rate would be very close to 100%. Portugal has a slightly higher overall recovery rate than Spain because a higher proportion of its external liabilities is in the form of loss-absorbing equity. This variability in recovery rates points to the importance of foreign direct investment and other 'non-debt creating' capital inflows, which can mitigate the vulnerability of a capital-importing country.

ii) Given that most official lending – i.e. funding from the IMF, the ECB and probably even the EFSF (certainly the ESM) – is senior, the recovery value for private investors must be lower. (A comparison of the prices of local law bonds to foreign law bonds provides some indication of the relevance of the phenomenon.[1]) The second column of Table 2) thus shows the estimated private recovery rate given the known amounts of official funding. For Greece the private recovery rate thus falls to 35 % if one takes into account only EFSF and the bilateral loan facility. If one takes into account the funding that Greek banks have received from the ECB as well, the recovery rate the private sector can expect actually goes to essentially zero.

Table 2. Recovery rates in the GIIPS

	Overall recovery rate (in %)	**Private sector recovery rate (in %)**
Greece	59	35 (1.0)
Ireland	163	
Portugal	79	76
Spain	76	74 (69)
Italy	96	95

Source: Own calculations based on Eurostat data for the international investment positions.

Since the amounts of official lending are increasing continuously, it may make more sense to look at what would (will) happen if the official funding of the GIIPS continues.

The series of charts below thus shows the evolution of the hypothetical recovery value for the GIIPS[2] countries as a function of the amount of official financing they receive (all sources combined). It is apparent that the relationship is not linear: initially official, senior financing has only a small impact on recovery values as the total amount is small relative to the total debt of the country. However, once the total amount is large, even small additional amounts can have a large impact on recovery values.

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[1] This note concentrates on recovery values, not present values of long dated official credits at favourable rates. The argument made recently in VoxEU by Piero Ghezzi – "Debt Seniority and the Spanish Bailout", 23 June 2012 (http://www.voxeu.org/index.php?q=node/8150) – that official lending could enhance recovery values if it is at or below market rates does thus not apply when insolvency actually occurs because at that point the official credits become due immediately.

[2] As an interesting aside, one should note that in the case of Ireland the subordination effect does not work because the recovery rate would in any event be above 100%.

This implies that the argument that the €100 billion provided to Spain will not have a strong subordination effect is misplaced. Even if this sum has only a small impact, it will still increase the need for further support, which in turn will lead to larger subordination effects. There is thus a danger that the combined impact of the EFSF programme for bank recapitalization, higher ECB lending to Spanish banks and the Securities Markets Programme (SMP)[3] will lead to a spiral of ever-increasing risk premia and ever-larger injections of official financing – which then leads to higher risk premia.

This seems to be a danger for Spain and also but to a smaller degree for Portugal. It is less likely in the case of Italy, whose recovery value remains rather high even for large values of official financing.

Secondary market purchases by the EFSF (or even by the ESM) should not have this negative effect since they should be *pari passu* with private investors. Secondary market purchases should thus be preferred to a full EFSF/ESM programme or the SMP (after the ECB asserted absolute seniority in Greece) or even regular ECB lending to banks for which the ECB is also likely to assert seniority.

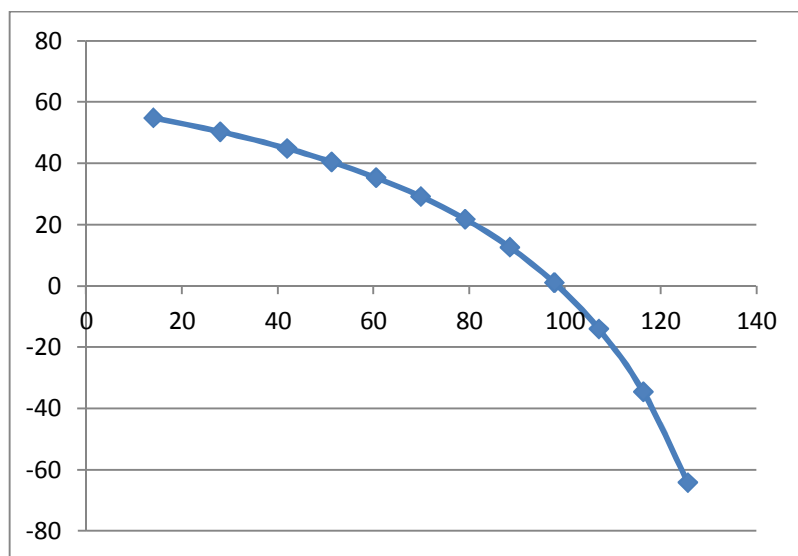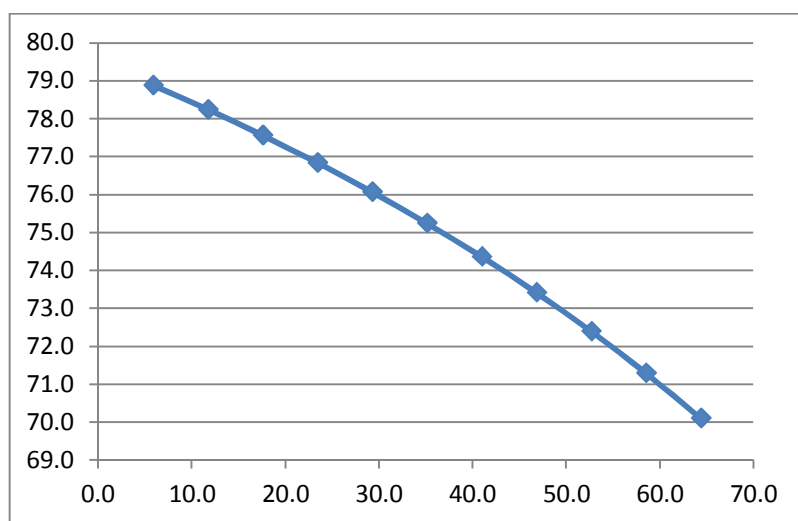*Figure 1. Greece: Recovery rate for private sector (%) as a function of the rescue package (% GDP)*

Figure 2. Portugal: Recovery rate for private sector (%) as a function of the rescue package (% GDP)

[3] Interventions by the Eurosystem in public and private debt securities markets in the euro area to ensure depth and liquidity in those market segments that are dysfunctional.

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Figure 3. Spain: Recovery rate for private sector (%) as a function of the rescue package (% GDP)
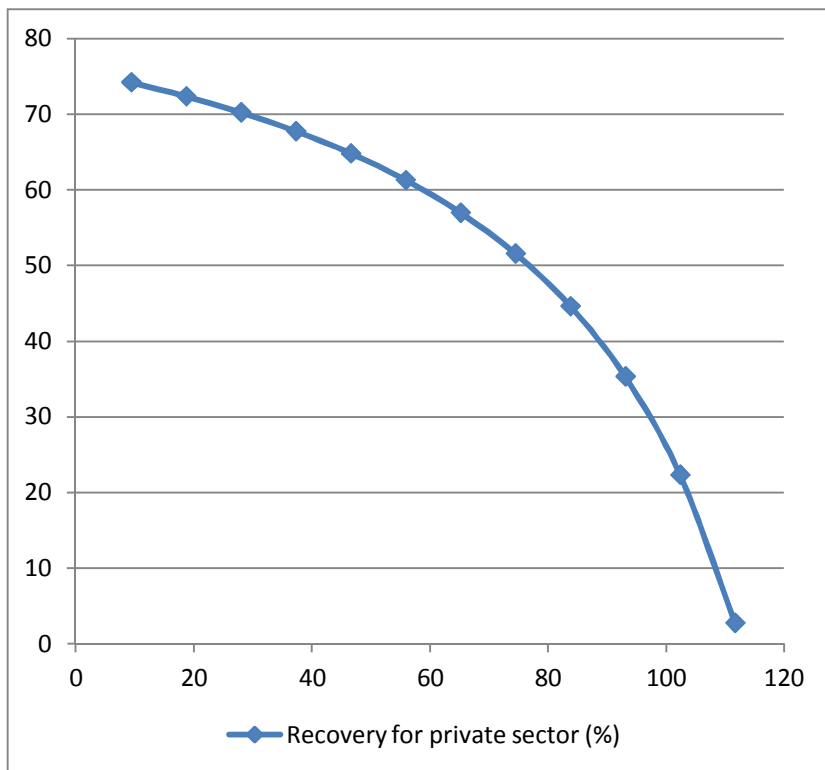

Figure 4. Italy: Recovery rate for private sector (%) as a function of the rescue package (% GDP)