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Discussion of  
The Role of Creditor Seniority in Europe's Sovereign Debt Crisis  
by Sven Steinkamp and Frank Westermann

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This paper investigates how the share of public debt held by multilateral lenders affected the evolution of government bond spreads in Europe during the sovereign debt crisis. Past experience, survey response and rating agency decisions are used to prove that these institutional lenders are *de facto* senior to market creditors (preferred creditor status), even if not formalized *de jure*. The large increase in the magnitude of the senior tranche of total public debt in the GIIPS (Greece, Ireland, Italy, Portugal and Spain) during the sovereign debt crisis and its observed co-movement with the interest rate spreads (Figure 4) make the question addressed in this paper extremely timely and policy relevant. The authors exploit three different empirical strategies to address the issue with a multifaceted approach. First, using a panel regression analysis, they quantify the correlation between the senior tranche share in total public debt and the interest rate spread of 10-year government bonds. A one percentage point increase in the share of debt held by multilateral lenders is associated on average with a larger interest rate spread of 0.047 percentage points. This result is robust to the inclusion of standard macroeconomic determinants of interest rate fluctuations. Second, with a probit regression model, they analyze survey data showing that indeed respondents that were considering multilateral loans to be senior expected relatively higher interest rate. Third, using two case studies, they illustrate that market strongly reacted to the news of a *pari-passu* clause in the OMT and that, in Cyprus, investors accepted a fluctuating risk premium for equivalent bonds with different legal terms of the contract.

The paper successfully convinces the reader that, while policy makers aim at stabilizing interest rates by involving multilateral investors, they should be well aware of a potential side effect: because international institutions are *de facto* senior lenders, private investors are pushed in a junior position that results in a higher demanded risk premium and an increased spread. Understanding this mechanism well is extremely relevant for policy makers. This paper has the merit to raise this point linking it to the euro sovereign debt crisis. A proof that the problem is now well embodied in the policy agenda while it was probably underrated in the past, is given by the specific introduction of the *pari-passu* clause in the OMT, which was a novelty with respect to the SMP. However, the paper is less persuasive when transforming the highlighted striking correlation in a convincing causal relationship. My discussion will focus on one general comment and few smaller remarks.

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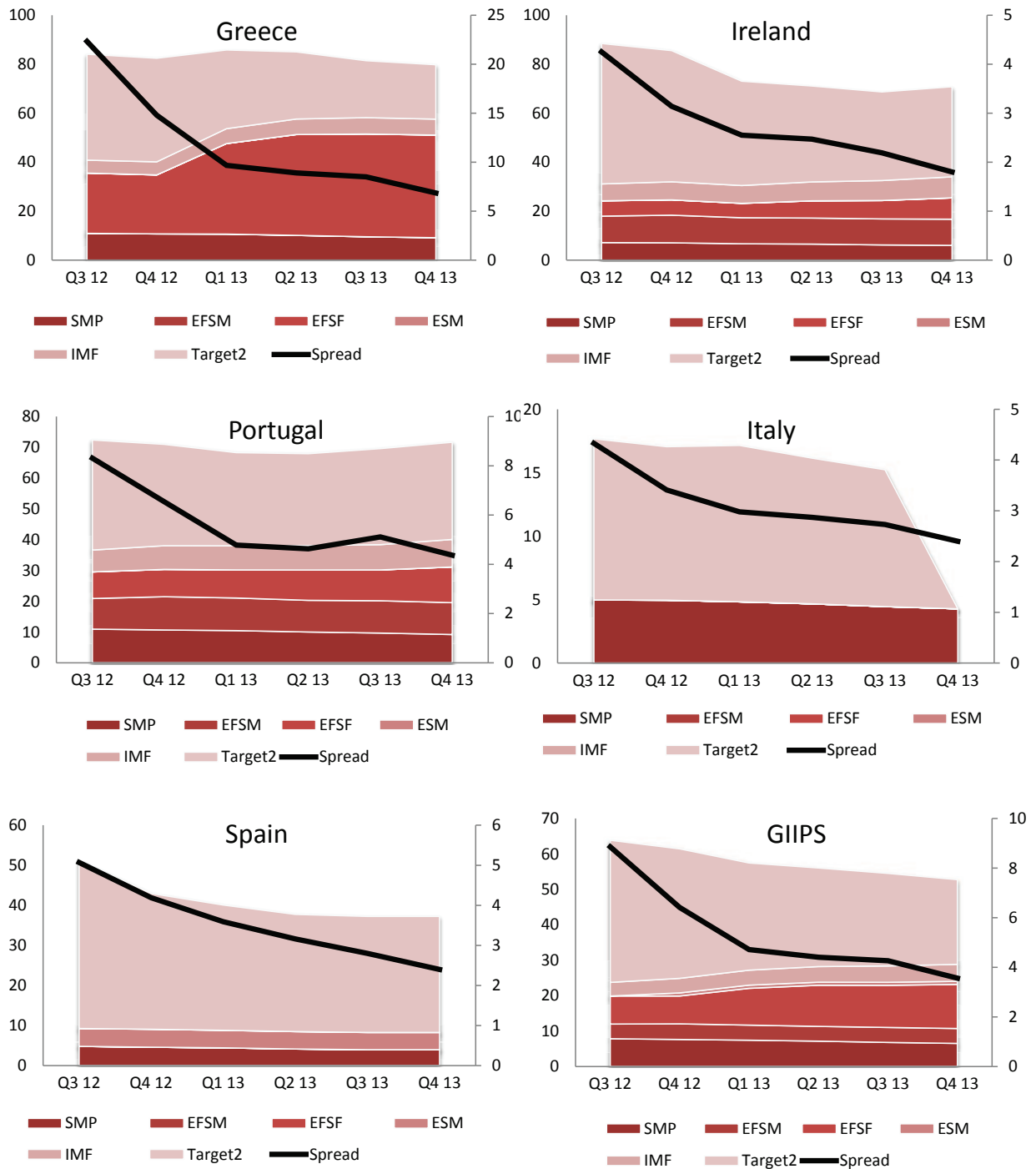
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The question is as much policy relevant as it is complicated to answer. Positive and persistent correlation between government bond spreads and multilateral lending can be explained with really different and not necessarily mutually exclusive models. Saravia (2010), for example, presents a theoretical framework which satisfies the assumption of higher seniority of multilateral lenders and can match the evidence of a positive co-movement between interest rate and senior share of debt. However, in this framework the causality goes in the exact opposite direction from the one proposed here by the authors: a liquidity shock is pushing up the spread that leads to an efficient intervention of the senior lender, which is able to reduce the interest rate relatively to the counterfactual rate (the interest rate that would have prevailed in the economy without the official intervention). This result is based on reasonable assumptions which can be applied to the GIIPS experience: sufficiently large liquidity shock and ex ante private sector involvement in case of default (before the multilateral intervention). This is a reasonable alternative explanation of the correlation between the spread and the seniority share and it is used to make the point that it is really difficult to understand the dynamic behind the correlation found in the panel regression. Perfectly aware of this, the authors include as many reasonable controls as possible to show that the correlation, between senior tranche lending and government bond spread, is high and robust. To assess causality, they then turn to survey data analysis. Nevertheless, both analyses leave some open questions which I focus on below.

Assuming that movements in the spread were partially caused by the increasing share of senior lenders, we would expect the correlation to be not necessarily symmetric, but positive in both upward and downward movements. In support of this idea comes the fact that the causal relationship in the probit regression analysis was found, in April 2013, within respondents that were expecting already decreasing interest rates. Reconstructing and updating the disaggregated data series for the senior tranche, following the detailed appendix, I show in Figure 1 that the seniority of the lending, in the period following the peak of the crisis, did not decrease, or decreased only marginally, while the spread dropped significantly. In fact, up to the last quarter of 2013, the only reduction in multilateral lending came from the slow re-absorption of the SMP by the ECB and almost entirely from the reduction in TARGET 2 transactions (Figure 1). As clearly pointed out by the nested panel regression and by survey responses, TARGET 2 and SMP are the least senior among all multilateral lending. In addition, contemporaneously, IMF share increased in all countries up to the last quarter of 2013. If someone believes that seniority played an important role in pushing up the spreads, the paper leaves an interesting question for future research: what triggered a decrease in the spread with an almost constant share of seniority in total lending?

Moving to the ordered probit regression section, the idea of including a survey question on seniority in the World Economic Survey and exploiting it to address the causality problem is extremely interesting and promising for future research. The authors show that interviewed economic experts, who are resident in one of the country receiving official loans and who assign a “preferred treatment” to this loan, are 21.2 percent more likely to expect rising interest rate and 9.3 percent less likely to have falling expectations. I present here four quick comments on this analysis. First, summary statistics on the seniority question could be useful, for example, to get an idea on what

Figure 1: Senior tranche components and yield spread after the OMT



Notes: Figures show the spread between the interest rate of countries government bonds and the German Bund (10 years - left scale) and the senior tranche share of total government debt decomposed in its components (right scale). The dataset is constructed following Appendix A5. The differences of the two multilateral lending series are imputable to two elements: 1. only amounts effectively distributed of the rescue packages are considered here 2. Repayments of part of the debt are considered as reduction in the total senior share. Data are available upon request.

share of experts ranked rescue packages as *pari-passu*. Second, if the question on seniority was iterated in later surveys, it would be interesting to check the evolution of the results in periods of

“more stabilized” recovery. Third, a different seniority dummy should be considered to make results cleaner. Given that each survey participant was asked about interest rate expectation in his/her own country of residence and the seniority question is explicitly referring to the official lending in the European Monetary Union, it is better, for the GIIPS sub-sample, to construct a dummy which takes value 1 only if respondents expected at least one of the multilateral lending received by their country to be senior (ex: target 2 and SMP and not IMF for Italy). Fourth, even though this is interesting but not surprising that economic experts recognize that seniority matters for the expected returns on lending, it is hard to generalize and use this result to explain the macroeconomic co-movement between spread and the official lending.

The last two comments refer to the SMP vs. OMT case study. Although it would be extremely interesting and appropriate to isolate market reactions to the OMT *pari-passu* clause announcement on September 6, 2013, it is really far stretched to assume that this news was more “unexpected” than the surprise that, for the first time, a program was ex ante unlimited in size. It is true that in August 2, 2012, ECB governor Draghi declared that the package would be “of a size adequate to reach its objective” but he also clearly stated that “the concerns of private investors about seniority will be addressed”. Market on that day didn’t react as strongly (Figure 6). Therefore it is really impossible to claim that agents anticipated the unlimited amount novelty but not the *pari-passu*. In conclusion, both innovations had an impact on markets reaction, but it cannot be said which component played a major role. On top of this, while the paper assigns a lot of credit to the success of the OMT to the *pari-passu* clause, the experts in the WES survey declared, in April 2013, that they consider the OMT to be at least as senior as the SMP (indeed slightly more senior). This jeopardizes the credibility either of the survey or of the case study.

In summary, the paper addresses a really interesting and complicated question which has been proved to be extremely relevant by the last ECB decision to include a *pari-passu* clause in the OMT. The strong correlation between government spread and seniority tranche of the lending is robust to different macroeconomic control but it is difficult to assign a direction to the causality. The results of the paper cannot be the last word on the topic and more research is needed to rule out other plausible explanations. Survey data are neatly used by the authors to try to address the causality direction but it is difficult to extend micro-evidence on the expected effect of seniority on the cost of lending to macro co-movements, especially given the fact that even economic experts do not assign, in the survey, a *de facto* junior status to lending which is explicitly constructed to have a *de jure* juniority.