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### Article The Seniority Conundrum – Further Evidence

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# The Seniority Conundrum – Further Evidence

One of the key differences in the current quantitative easing (QE) programme compared to the European Central Bank's previous securities markets programme (SMP) is seniority status. While under the SMP the ECB insisted on a preferred creditor status, it accepts a 'pari passu' treatment for its QE holdings. The response of interest rates was also markedly different. While interest rate spreads of government bonds increased during the SMP, they declined after the start of QE. In a recent article (Steinkamp and Westermann 2014), we argued that the seniority stance matters for the interest rate response and provided evidence from institutional arrangements, macro patterns, and survey data from the *ifo World Economic Survey*.

Not only did the ECB have seniority clauses, but, explicitly or implicitly, this was the case for all multilateral agencies, such as the IMF, ESM, EFSF, EFSM and bilateral loans. The seniority conundrum – the unexpected response of interest rates to senior loans or asset purchases – thus helps to explain why rescue efforts in the beginning of Europe's sovereign debt crisis were rather unsuccessful: Private lenders in the market were gradually pushed into a junior position and charged a higher marginal interest rate.

A challenging aspect when interpreting the evidence on the seniority conundrum was the direction of causality. While asset purchases with senior status may drive interest rates up, the rise in interest rates had also been the motivation for policymakers to take action and purchase government bonds. There is clearly endogeneity between the two variables that is difficult to disentangle. In a new paper (Steinkamp and Westermann 2016), we focus on this bidirectional causality and provide two approaches to addressing the issue.

#### **EVIDENCE FROM MACRO DATA**

The first approach is to look at macro data. There is a high correlation between multilateral loans (with senior stance) and the interest-rate spread. To identify the direction of causality, we take advantage of the details in the assessment of rating agencies to construct an instrumental variable. While some rating agencies assess the probability of default only, other agencies also consider the loss given default. Exploiting the differences between the two rating approaches enables us to construct a proxy of market expectations about the loss given default.

Figure 1 shows that these rating differentials are positively correlated with the share of multilateral loans in total government debt of the countries in crisis. Unlike the ECB's purchases of governments bonds, however, there is no political-economy motivation for rating agencies to target interest rates, rendering them endogenous to the interest-rate spread. Our proxy, thus, can help estimate the impact of senior loans on interest-rate spreads.

In a two-stage instrumental-variable regression analysis, where the rating differential is used as an instrument in the first stage, we find the effect of multilateral lending on interest rate spreads to be statistically significant and quantitatively important. This analysis explains a substantial part of the surge in interest rates observed in 2010–2012. We consider several different variants of the rating instrument. We also confirm this result using lagged values as well a recent heteroscedasticity-exploiting identification approach. Our regressions seem to be neither over- nor under-identified and pass all standard specification tests, such as a high *F*-statistic in the first stage of the regression.

#### **EVIDENCE FROM IFO SURVEY DATA**

In a second approach, we analyse new survey data from the Munich-based ifo Institute. As part of their regular World Economic Survey, the ifo institute asked about 1,000 experts worldwide about their expectations regarding the seniority stance of different multilateral institutions. In 2013, when this question was asked for the first time, around 70 percent of the respondents considered the IMF to have a preferred-creditor status. 88 percent considered at least one of the rescue funds senior to private-market participants. In the second wave of the survey, this had changed slightly. While even more experts consider the IMF to enforce a senior status, the ESM and the ECB were considered less senior in 2015 - a sign that markets noticed the recent changes with regard to seniority clauses of multilateral institutions.

The survey data can also be used to illustrate the impact of seniority expectations on interest rates. With two waves of the survey (2013 and 2015), we are now in a position to follow a differences-in-differences strategy to illustrate the seniority conundrum. Figure 2 illustrates the link between the two survey questions for different sub-groups of countries. For the countries in crisis - Greece, Italy, Ireland, Portugal and Spain - the figure shows that survey participants who considered the multilateral loans on equal footing (pari passu) with private markets had falling interest-rate expectations in 2013. Those experts who believed that multilateral institutions would enforce a senior stance expected interest rates to remain nearly unchanged. In 2015, after interest rates actually fell, the picture reversed. Those who still expected a senior stance have rising



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#### Seniority Lending and Rating Differentials





Notes: The red line shows the sum of multilateral lending in percent of government debt (senior tranche). The blue line is the difference between Moody's and Fitch's sovereign ratings, both transferred to a numerical scale.

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Source: Steinkamp und Westermann (2017).

interest-rate expectations, while this is much less pronounced in the other group.

Taking the rest of the euro area as a control group, we find that the pattern is the exact opposite. This is plausible, as many of these countries became net debtors *via* the official rescue packages. Survey participants who believe in a senior position for rescue institutions expect rising interest rates in the rest of Europe, but those who believe the rescue institutions will accept a *pari passu* treatment expect interest rates to increase more strongly.

In a probit regression analysis, we document that these differences are statistically significant, even when including other control variables, such as the countries' debt levels, trade deficit and exchange rate as well as GDP growth expectations. Exploiting the new panel dimension of the data set, we also run a twostage least squares regression with the survey data using the last round's responses as an instrument.

#### THE POLICY DEBATE

-20

2000

2002

2004

2006

2008

2010

2012

2014

Summing up, there is indeed evidence that the senior stance of rescue packages and bond purchases matters for the level of interest rates. Policymakers may disagree on whether or not this is a desirable feature of the recent trend towards *pari passu* arrangements. This trend is not only observable at the ECB. Also, the IMF seems to insist less strictly on its senior status (see also Reinhart and Trebesch 2016). At the same time, the presence of interest-rate spreads – provided they are not too large – is often considered a necessary market mechanism for an efficient allocation of capital. Also in the case of insolvency, the *pari passu* treatment may

Figure 2 Interest Rate Expectations (ifo World Economic Survey)



Notes: The graph shows the average interest expectation of different subsamples. Expectation is measured [-1, 0, +1] indicating falling, stalling or rising interest rate expectations, respectively. Only euro area respondents with repeated participation in the survey have been included (Obs. = 426). In the case of respondents from the GIPS countries (Greece, Ireland, Italy, Portugal, and Spain) with seniority expectations, the interest expectation is - on average - exactly zero.

Source: ifo World Economic Survey (April 2013 and July 2015). © ifo Institute

end up being costly for the multilateral institutions. In any case, it is important to be aware of this empirical regularity when designing future rescue packages and monetary policies targeting interest-rate stabilisation.

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