Politics and the Conversion of French Sovereign Bonds

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Sovereign Bonds

• Large literature dedicated to periods when things go bad. More limited analysis of periods of improvement regarding the states’ credit. Usually viewed through the lenses of long term series and their yields

• One interesting element: historically many bonds had conversion features

• This project: understand the link between conversion and politics during the 19th century
Conversions in Modern Terms

- Conversion is just another term for a call option. The issuer has the right to initiate a conversion.
- The holder of the bond has then to chose between:
  - Getting reimbursed at par
  - Receiving a new bond with a lower coupon
- For the issuer it only makes sense to convert if the market rate is low enough and the new coupon close to the market rate
Callable Bonds

Where:  
\( a-a' \) = price/yield relationship for a noncallable bond  
\( a-b \) = price/yield relationship for a callable bond

Source: Sherwin (2010)
Theoretically, Schwartz (1977) and Ingersoll (1977): Call should be exercised as soon as the bond market value reaches the call price.

Empirically, calls are most of the time not happening as theory would suggest (when bond price = call price) in 86% of cases it happens later and on average after 27 months (King and Mauer, 2000).
France: Conversions Attempts and Successes

- Main attempts leading to a discussion in the Chambers in 1824, 1825, 1836, 1838, 1840, 1844, 1845, 1846, 1852 and 1862
- Plus proposals not reaching the chambers!
- Really successful only in 1852 and 1862
- Economically meaningful? If price above par and new coupon close to the market rate. Graphically… 1825-1851. In blue, yields below 4% => makes sense to convert the 5% into 4%
Conversions Attempts and Successes
Conversions Attempts

- Previous graph considers a move from a 5% coupon to a 4%
- But some attempts were not so bold! In 1838 and 1840 the proposal was to move to 4.5%, the level at which the conversion eventually occurred in 1852
- Long time before a success. Reasons?
What drives conversion success?

• Changes in political regimes?
  – Constitutional Monarchy (Louis XVIII, Charles X, Louis-Philippe)
  – 2\textsuperscript{nd} Republic (Louis Napoléon Bonaparte)
  – 2\textsuperscript{nd} Empire (Napoleon III)

• What is the role of Institutions?

• What about the willingness of the government to be viewed as acting in the state’s interest? What about its reputation?
Role of Institutions

• North & Weingast (1989): analysis of new institutions created in 1688 after the Glorious Revolution (UK).
• Change in institutions (parliament) paved the way for lower yields
• Before the revolution either incapacity to borrow, or need to impose forced loans, after the revolution: solvability and access to larger amounts
Institutions

- Sussman & Yafeh (2006), rewards from institutional reforms: long time to materialize
- Dincecco (2009) and Gelderblom and Jonker (2011) sound institutions: necessary but not sufficient conditions.
- Stasavage (2002 and 2007), multiple veto points increase credibility. But success of the Glorious Revolution also due to the important representation of government creditors in the Parliament
Reputation

- States do not default because they want to keep a good reputation. Probably the most often encountered explanation (Tomz, 2007 reputation is THE explanation)
- But who’s reputation are we talking about? Literature often vague on this point…
- Issuing country (government, private companies or population?), underwriters (Flandreau and Flores, 2010), third parties (Vizcarra, 2009)
From a financial point of view, the decision not to convert is sub-optimal.

Conversion would have reduced the debt burden (estimates vary but they are substantial) and the riskiness of the debt would have decreased...

Clear case of “badly managed” public finances! What or who is blocking? Why did it take so long to remove the blocking element?
Political System

• Chambre des députés: selective suffrage 1814-1830 (300FF), 1831-1848 (200FF) limit removed afterwards +/-100,000 voters in 1815, 245,000 in 1847, tax quota for voting rights measured by land owning.

• Chambre des pairs (later Senate), Hereditary (1815-1831) then the king’s choice, minimum annual revenue depending on the degree of nobility, only two main changes in 1819 and 1827; and following revolutions
### What or Who’s blocking?

<table>
<thead>
<tr>
<th>Date</th>
<th>Députés</th>
<th>Pair</th>
<th>End result</th>
</tr>
</thead>
<tbody>
<tr>
<td>1824</td>
<td>OK</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>1825</td>
<td>OK</td>
<td>OK</td>
<td>Facultative conversion In fact failure (16.10% converted) but very bad timing!</td>
</tr>
<tr>
<td>1836</td>
<td>OK</td>
<td>Gvt Change</td>
<td>Discussion post-poned</td>
</tr>
<tr>
<td>1838</td>
<td>OK</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>1840</td>
<td>OK</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>1844</td>
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<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>1845</td>
<td>OK</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>1846</td>
<td>OK</td>
<td>NO</td>
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<table>
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<tr>
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<th>Députés</th>
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<tbody>
<tr>
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<td>OK</td>
<td>OK</td>
<td>OK</td>
</tr>
<tr>
<td>1862</td>
<td>OK</td>
<td>OK</td>
<td>OK</td>
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</tbody>
</table>
Chambre des Pairs

• Blocks all conversion attempts but in 1825 (voluntary one)!

⇒ Why would they do so? And why would the Chambre des députés agree to the conversion? Since both were wealthy groups

⇒ Pairs only the aristocrats who had established a so-called “Majorat” were eligible
Majorat

- Majorat, system established by Napoleon but kept afterwards: the aim was to link nobility with wealth.
- Duménil (1842): revenues needed Duke: 30,000FF, Count: 20,000FF etc…
- Majorat: Eligible wealth limited (real estate or inscribed public debt). Once established wealth is blocked => impossibility to sell or to mortgage the goods
Rent(e) protectors?

- Chambre des Pairs: important rente holders! Larousse (1869):
  - *Presque toutes les familles tenant à la pairie étaient engagées dans la rente, et parmi elles se trouvaient les grosses inscriptions. La réduction de l’intérêt eût dérangé là bien des combinaisons domestiques. Telle fut la vraie raison pour laquelle la conversion qui obtenait les deux-tiers des voix à la Chambre électorale, fut toujours repoussée aux cinq-sixièmes des voix par la pairie*. 
Rent(e) protectors?

• Villèle (1890) mentions some examples in his memoirs

• Comte Roy, pair de France was a firm opponent to the conversion as he was an important rente owner: “possesseur de 500.000 francs de rente comptait que ce serait 100.000 francs de rente que la loi [sur la conversion] lui enlèverait”

• White (1995): church other main rente holder close to the Pairs also benefits
Majorat

- Legislation granting the majorat => analysing this on average revenue of 7,800FF from the rentes but with big outliers (Comte Stacpoole, 50,000FF; Duke de Richelieu, 30,000FF; Duke (Prince) de Talleyrand, 30,000FF, Duke de Montmorency, 30,000FF)

- Votes not recorded but interventions well

- Large overlap between wealth in rente and opposition!
Rent(e) protectors?

- Parliaments: usually reduction of default likelihood (Kohlscheen, 2003 and Van Rijckeghem & Weder 2004).
- Here the reverse! Institutions protect a rent!
- Bad management punished? No. Chambre des Pairs with limited variation in composition => stickiness of decisions and no eviction!
- Argumentation?
<table>
<thead>
<tr>
<th></th>
<th>For</th>
<th>Against</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legality</td>
<td>Legal, as shown by the texts (1793)</td>
<td>Illegal. Text never mention the capital because there was no willingness to convert 1825 precedent!</td>
</tr>
<tr>
<td>Abroad</td>
<td>Usual</td>
<td>Their debt structure is different</td>
</tr>
<tr>
<td>Economy</td>
<td>Too high rate limits investment in other sectors</td>
<td>No guarantee other sectors would benefit</td>
</tr>
<tr>
<td>State credit</td>
<td>State is rf no need to pay more than the required market rate: no negative impact good management!!</td>
<td>⇔ repudiation! Terrible</td>
</tr>
<tr>
<td>Opportunity</td>
<td>Good timing</td>
<td>No cash at hand</td>
</tr>
</tbody>
</table>
Market perception

• Changes in the credibility of the state depends on the perceived legality of the operation

• If legal (it was) then the state is just exercising an option. If not (as suggested by opponents) the state would abuse its sovereign power and despoil bondholders

• What was the market’s perception?
Impact on state credit

• Conversion announcement, what could we expect?
• Flight to “non-convertibility” or general deterioration of credit?
• Event study methodology using prices of the 3% rente (unlikely to be converted)
• Events: announcement of conversion, vote in the two chambers
Impact on state credit

- No impact using traditional event studies
- Why? Limited credibility when announced?
- Or Bayesian process $\Rightarrow$ successive failures lead investors to downplay the likelihood of success
- Possibility to consider the political environment and the power of the Pairs as sufficient to block any attempt to convert
Impact on state credit

- But there is an effect on risk perception however
- Volatility of the 3% rente seems to be much higher during the conversion discussion
- Perceived risk and uncertainty seem to prevail
- And also increased trading activity on the 5% just before the discussions related to the conversions
- Was conversion risk priced?
Price compression

- Observed price of the 5% rente
- Theoretical price of the 5% rente
After 1852

- Dramatic regime change Napoleon III becomes emperor
- Senate members as well as president designated by Napoleon III
- Increase in the number of bankers, high-ranked military and industrialists in the Chambers
- Conversion in line with the willingness to industrialize the country
Conclusion

• Political economy of conversions => role of institutions and of the Chambre des Pairs
• Parliament may protect creditors’ rights “too much”
• Impact of conversion proposal and votes on conversion on state credit: No clear impact on prices, but well on volatility
• Reputational concerns seem limited here…