Legal perspectives on sovereign default

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1. Sovereign debt restructuring in the case of a state participating in the European Monetary Union: elements of differentiation vis-à-vis precedents in the history of sovereign debt restructuring

In the long history of sovereign bond workouts, the protagonists have almost always been single states rather than parties to a regional currency union.[2] Thus, new and unprecedented issues arose when Greece, a full member of the European Monetary Union (EMU), decided to proceed in February and March 2012 with a restructuring of its outstanding sovereign bonds. What are the elements that make this process different from more usual cases of restructuring, where the sovereign involved has full authority over its currency? I suggest five differentiating factors:

a) First, the sovereign's inability to devalue its currency. Very often,[3] indebted sovereigns have deliberately allowed their currency to depreciate with the aim of facilitating full repayment in nominal terms of bonds outstanding. Greece, for instance, formally devalued the drachma in 1882, 1928, 1953, 1985 and 1998, each time reducing the cost of drachma-denominated debt service and repayment.[4] But when, in 2012, Greece faced the need to obtain debt relief, it

[1] Director General Legal Services, European Central Bank. This text represents the personal views of its author, and not necessarily the views of the European Central Bank. It reflects the Law as it stands on January 2013.

[2] Three states of the East Caribbean Currency Union, namely Antigua and Barbuda (2010), Dominica (2004), and Grenada (2005), renegotiated their external debt. Twelve states participating in the two African regional monetary unions (the Central African Economic and Monetary Community and the Economic and Monetary West African Union) also renegotiated their external debts. In most of these cases such renegotiations took place in the context of the Paris Club, as their only creditors were public ones; still, in few of these cases, reschedulings of commercial loans took place in the context of the London Club. In no case was a rescheduling of bonds placed and traded in international markets.

[3] According to U Das, M Papaioannou, and C Trebesch, "Sovereign debt restructurings 1950–2010: literature survey, data, and stylized facts", IMF Working Paper, WP/12/203, 2012, between 1800 and 2007 there have been 150 cases of yearly inflation beyond 20% that allowed for de facto reduction of debt denominated in local currency.

[4] Greece has a long history of defaults on foreign loans, starting from its independence. These included loans from Great Britain of 1824 and 1825, further international loans in 1832, which had to be renegotiated following a principal default in 1843, and interest payments suspended. As from 1848, it suspended conversion of banknotes into gold or silver, allowing devaluation by banknote printing. Not until 1878 was outstanding debt finally settled, and Greece was for a short while able to tap foreign capital again, until 1893 saw another default on interest payments, leading in 1897 to the formation of an international committee with a mandate to guide Greek public finances and debt management. This led Greece to join the gold standard in 1910 and the Latin Monetary Union, and allowed the country to access foreign finance to fund the 1912–13 Balkan Wars. Following the

could not resort to a further devaluation, as its currency was the euro, the currency of 16 other EU Member States, the authority for which had been transferred to the EU. Greece had the major part of its public debt denominated in euro; had the country not been an EMU member, it could have unilaterally devalued the drachma, thus reducing the real cost of servicing and repaying its debt. Nor could Greece conduct an inflation policy that would have softened the debt burden, as the euro is governed by the ECB with a clear anti-inflationary mandate.

b) Second, the inability to impose capital transfer limitations. In the case of a sovereign crisis, there tends to be capital flight; often, sovereign states impose exchange controls to limit capital flight in financial crisis situations. But this is not possible in the EU, where since 1992[5] such tools have only been exceptionally permitted (i) vis-à-vis non-EU countries, temporarily and subject to a Community procedure (ie not by an individual Member State), or (ii) for specific reasons, such as taxation avoidance, supervision of mergers and acquisitions of financial institutions, the prosecution of fraud and crime, and statistical purposes. An internal market such as the EU, and a monetary union based on a currency-wide money market, are incompatible with capital barriers. A fiscal crisis situation, like that of Greece, which might lead to an outflow of bank deposits cannot therefore be addressed by way of exchange controls. As money consists not only of central bank money (M1) but also commercial bank money (M3), both need to be fully fungible within a monetary zone and to be treated as equivalent by the holders and users of such money. The introduction of exchange controls would have disrupted such fungibility and it would undermine the usual concept of money as encompassing both M1 and M3 money. Protective measures including capital restrictions were permissible under strict conditions before the start of Stage 3 of EMU (former Arts. 119(4) and 120(4) EC Treaty, Maastricht version). The Lisbon TFEU deleted such possibility.

c) Third, individual states may get financial help from their central banks in a budgetary crisis. This is not possible in the EU. One of the pillars of EMU is that central banks are prohibited from financing the public sector.[6] Article 123 of the Treaty on Functioning of the European Union (TFEU) prohibits central banks from providing liquidity to the public sector. Some sovereign debt crises outside the EU have been managed by way of the central bank funding the

Great War and the Asia Minor War, financed by internal inflation, the League of Nations again intervened to assist in restoring orderly Greek public finances, establishing the Bank of Greece. This led to a subsequent pegging of the drachma to sterling, then to the US dollar, thereafter to sterling again, with regular devaluations and exchange controls. Exchange controls remained until 1995, and Greece joined the Exchange Rate Mechanism of the EU in 1999, leading to its adoption of the euro in 2001. See the full monetary history of Greece in S Lazaretou, *Greek monetary economics in retrospect: the adventures of the drachma*, Bank of Greece, 2003.

5 Exchange controls in the EU were prohibited by Council Directive of 24 June 1988, whose content was reflected in the Maastricht Treaty (current Articles 63 to 66 TFEU). Greece was exceptionally given three more years to eliminate capital controls, so only in 1995 was she bound by the general EU prohibition to use such instruments.

6 The only two exceptions to that rule being (i) credit institutions controlled by the public sector, which may obtain central bank liquidity on terms identical to private credit institutions; and (ii) the financing of state obligations vis-à-vis the IMF.

state, as the prohibition of so-called "monetary financing"[7] is by no means a universal rule and may, therefore, not apply to all countries outside the EU. In addition to the basic reasons for such bans,[8] which also apply to states that are not part of a regional monetary union, the prohibition is essential tool in the EMU's case to ensure that the neutrality of the central bank is preserved vis-à-vis the conflicting fiscal and economic policies of participating Member States.

Had Greece not been in the EMU, the Bank of Greece might have financed the country's fiscal needs, and in doing so it would have helped to drive down the external value of the drachma, thus helping the government service and repay its debt.

d) Fourth, advanced countries not infrequently allow emerging countries to be exempted from part of their debt obligations. EU Member States, for example, have agreed on several occasions to totally or partially forgive the outstanding debt of emerging countries, either in the context of the Paris Club or in multilateral programmes.[9]

Some have suggested that a partial forgiveness of Greece's debt would be a small price to pay for saving the euro, especially in view of the relatively small size of the Greek economy – around 2% – within the single currency area. However, debt forgiveness of this type is not permitted under the Treaty. Another pillar of the EMU is the *no-bailout rule*,[10] by which fiscal transfers among participating states are prohibited. This rule is intended to prevent the tax revenues of one state being used to systematically finance the public services of another; the prohibition is thus based on fundamental constitutional grounds.

However, it is noteworthy that the rule is not absolute; regional integration initiatives usually provide for some sort of fiscal transfer. Indeed, fiscal transfers have been an established fact in the EU since the 1950s in the form of structural funds that provide for regular fiscal transfers aimed at narrowing economic disparities within the Union[11] and at supporting common EU policies. Such fiscal transfers are based on EU law and have never been contested.[12] If Greece

7 The media tends to refer to such activity as "printing money", in spite of the fact that it does not necessarily entail an increase in banknote circulation.

8 Monetary philosophy since the 1980s, overturning decades of Keynesian economics, requires central banks to be independent from government and to serve the primary objective of ensuring the stability of the purchasing power of the currency they issue. Should central banks finance governments, such objectives would be put at risk, as they would become subordinate to political decisions, and in addition fiscal discipline would be weakened.

9 Eg the IMF and World Bank-sponsored *Highly Indebted Poor Countries* facility (HIPC facility).

10 In international meetings this is sometimes termed the "*OHIO Rule*": *Own House In Order*.

11 The European Regional Development Fund (FEDER), the European Social Fund, the European Agricultural Guarantee Fund, the European Agricultural Fund for Rural Development, the European Fisheries Fund, and the Cohesion Fund.

12 The odd exception being the United Kingdom which, since Margaret Thatcher headed the British Cabinet, has been demanding a sizeable rebate of British contributions to the EU. Mrs Thatcher became famous by stating at the EU Summit at Fontainebleau in 1985 "*I want my money back*!". Thus began the annual "*British cheque*" payment from the EU to the UK.

had not been subject to the no-bailout rule, foreign aid might have come to the rescue, as it did in on several previous occasions.

The *no-bailout* rule is established in Article 125 of the TFEU.[13] The EU Court of Justice has recently provided an interpretation of this provision in the so-called *Pringle Case*,[14] in which an Irish parliamentarian questioned the compatibility of the European Stability Mechanism (ESM) with TFEU Article 125. The ESM is a fund owned by the euro area Member States aimed at lending to EU Member States that are subject to a fiscal consolidation programme. The Court assessed the aim of the provision, and decided that (i) the ESM's lending is conducive to restoring the fiscal discipline of the borrowing state thanks to the conditionality attached to it, and thus it is consistent with one of the objectives of TFEU Article 125, namely, fiscal discipline for all EU Member States; and (ii) that the ESM in its lending does not replace Greece in its liabilities vis-à-vis its creditors, but rather "adds" to its liabilities. Lending is thus legally permissible, whereas "forgiving" or "paying for another" is not. The Court concluded that the ESM does not contradict TFEU Article 125.

Greece did benefit from financial assistance from fellow euro area Member States and from the IMF, not without hesitations and legal challenges.[15] Since May 2010, the budget of the entire EU, plus a syndicate of euro area Member States,[16] plus the "first rescue fund" of the euro area – the European Financial Stability Facility (EFSF)[17] – and the ESM, have, together with the IMF, provided funds to Greece to allow the country to restructure its public finances, all subject to strict conditionality and external monitoring.[18] The Court stated that, to the extent that no substitution of Greece´s liabilities vis-à-vis her creditors has taken place, the establishment of the ESM and its lending do not breach TFEU Article 125.

e) Contagion is another factor relevant to the renegotiation of the debts of a state within a monetary union. Such states are subject to an element outside their

[13] It reads: *"The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project."*

[14] Case 370/12, Judgment dated 27/11/2012.

[15] In addition to the *Pringle Case* mentioned in the text, a group of German professors and parliamentarians questioned the constitutionality of Germany's support to Greece, basically on two grounds: that such support escaped democratic control, and it had the potential of having inflationary effects hindering the fundamental right to property. On 7 September 2011, the German Constitutional Court rendered its judgment dismissing the three joined claims, but requiring a case-by-case approval by the German parliament of financial supports under the EFSF. A similar complaint was introduced in 2012 before the same Court asking for an interim injunction to stop the ratification process of the ESM by Germany; it was rejected on 12 September 2012; final judgment on the constitutionality of the ESM ratification by Germany is pending.

[16] It was a voluntary loan: one euro area Member State, Slovakia, decided not to participate in the syndicated lending.

[17] The EFSF was established in Luxembourg as a share-holding company in June 2010.

[18] The so-called *Troika missions* (EU, IMF and ECB).

control: the market perception of the effect of one country's fiscal behaviour on another. A fiscal crisis within a state with its own currency would normally have only a limited effect on other states but, in a monetary union, contagion effects can lead to herding behaviour in financial markets.[19] The sovereign crisis in the euro area has shown two kinds of market contagion:

a. Contagion between sovereign and banks beyond the sovereign's borders: the rating downgrade of the sovereign implies a downgrade of its banking system, even if the banking system is healthy and sound; eg the Greek banking system, which until the 2011 private sector involvement (PSI) was well capitalised. The effect of sharing a currency area is that any downgrade of the local banks affects the currency-wide money market (via counterparty and collateral risk), with the consequence of increased differentials in interbank rates or even the dysfunction of segments of the interbank market (eg beyond the overnight market, or the unsecured money market).

b. Contagion between one sovereign and another. Indeed, the 2011–12 episode shows that (eg) a given shock in Italy can impact (eg) Spanish bonds, and vice versa; the procyclical behaviour of the market – fed by the procyclical behaviour of credit rating agencies and by the financial media – tends to amplify such effects beyond any rational dimension, leading to a domino effect. Furthermore, the nightmare prospect of Greece leaving the euro suggested to some market players and financial media that the euro as a currency might be doomed. The resulting market hysteria led to an extraordinary volatility in CDS prices, driven very much by the prevailing newsflow. This explains how sovereigns with lower indebtedness and a smaller deficit than others could sometimes receive what seemed to be an unjustifiably harsh treatment by the market. This is what is referred to as contagion.

2. Two selected legal issues arising from the 2012 Greek PSI

a) The negative pledge clauses and the continued eligibility of Greek government bonds as central bank collateral throughout the exchange process

Greek government bonds (GGBs) have been eligible collateral in Eurosystem operations since Greece entered the euro area in January 2002. Following the debt exchange proposed by Greece in 2012, such GGBs (i) have suffered a rating downgrade to "selective default" status, and (ii) were subjected to a "haircut" in the exchange process. This made the GGBs ineligible as Eurosystem collateral, as the

[19] When in 1994 Mexico suffered a balance of payment crisis, triggering a devaluation of the peso and an international rescue package, the effects extended to the whole of Latin America, in what was then termed the "Tequila effect", whereby market players simplified facts and considered all Latin American countries as similar to Mexico. The same dynamics, albeit more intensely, played out in the euro area.

Treaty requires collateral to be “adequate”. But declaring the bonds ineligible would have put the whole Greek banking system into jeopardy by depriving it of a functioning interbank market. With a view to mitigating that risk, Greece proposed to the Eurosystem several ways of temporarily enhancing the quality of the GGBs as collateral: many of these methods had to be rejected, because of the existence of negative pledge clauses (NPCs) in GGBs issued outside Greece. Such NPCs prohibit the issuer from encumbering assets to the benefit of some but not all equal-ranking creditors. Thus, allowing a pledge of Greek assets to further enhance the GGBs given as collateral to the Eurosystem would have created the risk of breaching the NPCs, leading to an acceleration of maturities, default and cross-default, with catastrophic consequences.

An agreement was reached on 21 March 2012, when (i) the Eurogroup accepted in Brussels[20] that the EFSF would be used to provide Greece with EFSF bonds on loan that would be made available to the Eurosystem for exchange against GGBs obtained by it in the case of a counterparty default during the GGB exchange period; (ii) the ECB in Frankfurt accepted the adequacy of this credit enhancement, which had the legal nature of a buyback offer that was purely contractual in character and hence did not create any security in the legal sense and was thus consistent with the usual NPCs. In practice, no counterparty defaulted on its borrowings from the Eurosystem during the exchange period, and so the collateral enhancement was never put to the test.

b) The question of a voluntary participation of the Eurosystem in a collective action clause process leading to GGB haircuts or in further voluntary debt reduction exchange offers

GGBs have been acceptable as Eurosystem collateral since 2001, in most cases by way of repos (ie acquiring the temporary legal ownership as security for liquidity operations). As a result, the Eurosystem would have been affected by the activation of the collective action clause (CAC) in the Greek PSI. But in addition, since May 2010, the Eurosystem had carried out secondary market purchases of GGBs in order to mitigate the malfunctioning of the secondary GGB market, with the basic aim of preserving the monetary transmission mechanism. This market intervention programme is known as the Securities Markets Programme (SMP), and the ECB has emphasised its character as a pure monetary policy instrument, to counter media allegations that the SMP represented some kind of quantitative easing along the lines of programmes conducted by the Fed, the Bank of England and the Bank of Japan.[21] Further, the ECB is prohibited by TFEU Article 123 from financing the public

20 Eurogroup Statement of 21/2/2012: “The Eurogroup considers that the necessary elements are now in place for Member States to carry out the relevant national procedures to allow for the provision by EFSF of a buy back scheme for Greek marketable debt instruments for Eurosystem monetary policy operations.”

21 A full explanation of the SMP is given in a speech by ECB President Jean-Claude Trichet in Vienna on 31 May 2010, available on ECB’s website. See also a speech by ECB President Trichet, on 20 May 2010: “Our present monetary policy stance is appropriate. Our decisions taken on 9 May have confirmed it. We are not engaging in any form of ‘quantitative easing’. The ‘Securities Markets Programme’ is designed to ensure an effective functioning of the monetary policy transmission mechanism by helping to resolve a malfunctioning of some segments of the euro area debt

sector, ie to provide quantitative easing. By contrast, the SMP was a secondary market programme aimed at keeping the repo market alive by offering a potential buyer-of-last-resort to counterparties with a portfolio of GGBs.

Because of the SMP, the Eurosystem was an important holder of GGBs by the time that the negotiations over the PSI between Greece and the private bondholders represented by the IIF were well advanced. Whether the GGBs held by the Eurosystem would participate in the projected debt exchange very much influenced the projected level of the haircut.

The following considerations were important for the final decisions adopted:

a. Against participation in the proposed debt exchange:

   a) The Eurosystem's portfolios of GGBs had resulted from its basic mandate: monetary policy and price stability. GGBs were held by Eurosystem members either because the securities were admissible as eligible collateral or because of the SMP market interventions. By contrast, private investors had made investment decisions based on the pricing and perceived risk.

   b) The proposal for a debt exchange was termed PSI with reference to the private sector. That is, until the PSI was agreed, only the public sector had supported Greece, by way of the several European funding mechanisms, and through the large-scale support for the Greek banking system from the Eurosystem. The overall idea was that the private sector now had to share part of the financial burden, so that European taxpayers would not have to finance private investors. If the Eurosystem had been drawn into the Greek PSI, the aim of the PSI would have been subverted, since the losses in the Eurosystem would have impacted the budget of euro area treasuries, ie taxpayers.

   c) The monetary financing prohibition was an important consideration: the Eurosystem would have breached TFEU Article 123 if it had in any manner cooperated in a mechanism that pumped central bank money into the Greek Treasury. As Eurosystem GGBs had been acquired with central bank money, a "haircut" in favour of the issuer would have had the economic effect of a monetary financing in breach of the Treaty.

   d) The ECB had been consistently and publicly opposed to the idea of a sovereign debt exchange in the European Union; fundamental considerations of bolstering confidence in financial markets required that every sovereign should stand behind its commitments. If a European sovereign did not honour its obligations, the whole trust-based edifice might collapse. The financial system is based on the existence of risk-free financial assets,[22] such as those hitherto represented by the sovereign bonds of developed economies. Based on these considerations, (i) the Eurogroup included in all its public statements a proviso that the Greek PSI was an exceptional and unique case, and that European states would stand

securities markets. The liquidity provided through this programme is withdrawn in its entirety through tenders of term deposits."

22 Since the demise of gold and silver as kind of risk-free asset. The successive Basel "Concordats" on capital adequacy have retained until this day the zero-weight of sovereign bond holdings for regulatory capital purposes.

behind their commitments; and (ii) the basic condition was observed that any sovereign debt exchange would be on a "voluntary" basis. For its part, the ECB saw any contribution of its holding of GGBs to the proposed debt exchange as inconsistent with its previous and public stance against a PSI.

b. In favour of participation in the exchange:

a) GGBs in Eurosystem portfolios were marketable bonds fungible with GGBs held by private investors, and therefore had the same rights and conditions. An exemption to the Eurosystem would contradict such fundamental fungibility.

b) An exemption to the Eurosystem may be seen as a "preferred creditor status" recognition having no legal basis, perhaps even contrary to pari passu clauses. Preferred creditor status (PCS), although not enshrined in law, is globally recognised for public sector lenders that lend where the market is unable to do so (eg long-term, low interest rates, unprofitable public infrastructure or social projects, fragile political environment etc). The IMF, regional development banks,[23] and the new European rescue funds are generally recognised as benefiting from PCS. Because of the monetary financing prohibition, the Eurosystem was not – and could not be – a lender to the Greek state, it lends only to banks. Also, the Eurosystem was a bondholder, not a lender, whereby fungibility and equal treatment were fundamental. Thus, it could not ask for PCS, and in fact never did ask for it.

c) If the ECB were to be granted exemption from the PSI, this would have negative market effects for EMU states, as the Bank could be perceived to have created a precedent case of "subordination" of normal investors vis-à-vis Eurosystem portfolios, making future borrowings by sovereigns more expensive.

d) An exemption of the Eurosystem's Greek-law GGBs would not extend to the English-law GGBs held by the Eurosystem, although in small amounts. English-law GGBs had been acquired with the built-in CACs, whereby like any other bondholder the ECB had implicitly accepted the possibility of their activation.

The final decision by ECB's Governing Council sought to balance all the above arguments.

The Eurogroup accepted the exemption of the Eurosystem GGBs from the PSI. In parallel, the ECB accepted to earmark the profits arising from its GGBs portfolios to fund euro area Member States under an agreement to reduce the interest rates charged to Greece in the EFSF loans, so that the Eurosystem's profits would ultimately be used to facilitate the servicing of EFSF loans.

[23] At least six international financial institutions were identified as lenders to Greece with PCS: the IMF, EIB, EBRD, Eurofima (railways financing), the Black Sea Community Development Bank, the Council of Europe Development Bank.

Annex

Eurogroup Statement 21 February 2012

- The Eurogroup *takes note* that the Eurosystem (ECB and NCBs) holdings of Greek government bonds have been held for public policy purposes.
- The Eurogroup *takes note* that the income generated by the Eurosystem holdings of Greek Government bonds will contribute to the profit of the ECB and of the NCBs. The ECB's profit will be disbursed to the NCBs, in line with the ECB's statutory profit distribution rules. The NCBs' profits will be disbursed to euro area Member States in line with the NCBs' statutory profit distribution rules.
- The Eurogroup *has agreed* that certain government revenues that emanate from the SMP profits disbursed by NCBs may be allocated by Member States to further improving the sustainability of Greece's public debt. All Member States have agreed to an additional retroactive lowering of the interest rates of the Greek Loan Facility so that the margin amounts to 150 basis points. There will be no additional compensation for higher funding costs. This will bring down the debt-to-GDP ratio in 2020 by 2.8pp and lower financing needs by around 1.4 bn euro over the programme period. National procedures for the ratification of this amendment to the Greek Loan Facility Agreement need to be urgently initiated so that it can enter into force as soon as possible.
- Furthermore, governments of Member States where central banks currently hold Greek government bonds in their investment portfolio commit to pass on to Greece an amount equal to any future income accruing to their national central bank stemming from this portfolio until 2020. These income flows would be expected to help reducing the Greek debt ratio by 1.8pp by 2020 and are estimated to lower the financing needs over the programme period by approximately 1.8 bn euro.