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The Eurozone crisis and its impact on the international financial markets

How are current events in the Eurozone affecting the international financial markets? What are the likely outcomes ahead and how can market participants prepare for them? Clifford Chance partners from the firm's sovereign debt rescheduling, regulatory and leverage finance practices discuss the crucial issues. Journalist Brian Thompson reports.

From the election of a French president who has openly expressed his opposition to austerity without a greater focus on stimulating economic growth to the struggles to form a new Greek government that may or may not agree to abide by the conditions set out in the existing bailout plan, recent elections have enveloped the Eurozone in yet more uncertainty. With the desire for an alternative to a programme of strict austerity gathering increasing popular support, balancing the challenges of the Eurozone's rapidly escalating political crisis alongside the fiscal imperatives that need to be tackled has rarely been so difficult, or the path ahead for Europe's leaders so unclear.

In these circumstances few would dare to predict the future. But the ability to assess and anticipate potential market risks – from the impact of sovereign debt issues on an already weakened banking sector to the prospect of a country, or even countries, leaving the Eurozone – is crucial. Also crucial is the need to prepare for a variety of eventualities, whether through more stringent credit assessment, tighter documentation, careful counterparty choice or other tactics.

Learning from the past

This is not the first time that the Eurozone has faced such a serious challenge. Although the warning lights are now flashing, it is worth remembering that the Eurozone has stepped back from the brink before. "Despite great difficulties, the Greek restructuring was largely completed and a second financial rescue programme agreed," explains Deborah Zandstra, a Clifford Chance partner specialising in financial transactional and sovereign debt. Market sentiment was undoubtedly helped by the Long Term Refinancing Operations (LTROs) carried out by the European Central Bank in December 2011 and February 2012, which provided €1.3 trillion of cheap loans to the banking sector. In addition, the so-called financial stability firewall was increased and longer term foundations have been laid, particularly in the treaty establishing the European Stability Mechanism and the so-called Fiscal Compact.

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Michael Dakin, Partner, Clifford Chance

In Spain, while every treasury auction is being closely monitored by markets and the banking sector continues to be under pressure, the government is ahead of its funding programme for the year and, whatever the current problems, the LTROs were effective in providing Spanish banks with much needed liquidity. Ireland and Portugal are continuing with their macro-economic adjustments, although there is a concern that Portugal may need further funding from the Eurozone, especially if the government is unable to tap the markets again in 2013.

Debt markets and Eurozone troubles

Markets do not tend to wait for the outcomes of lengthy negotiations. Instead they react instantly. So their response during recent crises may provide a valuable guide to the future.

As was clearly seen during 2011, the Eurozone crisis has had a major market impact. Michael Dakin, Clifford Chance partner specialising in high yield debt, says that "sovereign downgrades resulted in corporate and bank credits suffering downgrades as well. This in turn caused the secondary markets, in particular high yield, to trade off, which in turn made it harder to price and sell new deals".

Although the EU stepped in and the Eurozone stepped back from the precipice, "the European high yield market only really came back in January 2012, supported by US liquidity and the LTROs, but now everything is effectively on hold pending the outcome of the Greek election and other issues," adds Michael.

As sovereign debt problems are inextricably linked with banking system weakness, European banks, already struggling under the weight of Basel III capital requirements, have found their liquidity, and confidence, constrained whenever the Eurozone crisis takes a turn for the worse.

One consequence of this issue has been for European banks to retrench from non-core geographies such as Asia, which has created a liquidity shortfall there – this is a global risk the International Monetary Fund has highlighted. Not for the first time, Europe has looked to the US in its hour of need, both to supply much-needed dollars to European banks, and to provide a ready market for European debt.

The US has so far provided much-needed liquidity. So-called 'Yankee bonds' – European high yield issuance for the US market – reached a record $8bn in the first quarter of 2012. However, any further deterioration in the Eurozone could make US investors think again, especially with the onset of the US presidential election, which is a period when US markets traditionally slow down. If US financing were to slow down, it could leave EU companies lacking money-raising options, at a time when Europe may be short of liquidity and up against the so-called refinancing wall (the more than US$4 trillion of debt coming due over the next four years).

Germany's crucial role in the crisis

As both the principal architect and financier of the Eurozone, Germany is expected to provide leadership during this period. So understanding Germany's position is vital to mapping the likely future of the Eurozone. Marc Benzler, a regulatory partner in Clifford Chance's Frankfurt office, notes that "at an official level, the euro means more to Germany than a means of payment, so any suggestions a country will leave the single currency will be resisted on an emotional level, almost regardless of financial considerations." However, the "Mann auf der Straße" may feel differently. In fact, the German voting public appears to be playing an increasingly vocal part in the outcome of the Eurozone troubles, and the ability of governments to maintain public support in the face of austerity will be vital.

Marc believes that there is no German 'master plan' for solving the Eurozone crisis but notes that Chancellor Merkel is "highly determined to save the euro and has proven extremely effective to date in pursuing her goals". As the growth versus

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Marc Benzler, Partner, Clifford Chance austerity debate continues, it is worth noting that Germany's 'Agenda 2010' austerity package, which was introduced in 2003, is widely regarded as an achievement in Germany. It is seen as the main reason for Germany's relative economic success since the financial crisis.

So it appears that there is neither the grand vision nor the 'magic fix' that the market appears to demand. Instead, at least for now, the markets should expect greater focus on fiscal convergence, alongside various new measures to address immediate problems. Which leads us nicely on to a brief summary of the measures intended to do just that.

New legislation for a stronger Europe

The Treaty on Stability, Coordination and Governance – the so-called 'Fiscal Compact' – strengthens earlier EU guidelines that governments should keep balanced budgets and not borrow unsustainable levels of debt. These provisions will now be enshrined in national law, preferably at constitutional level.

"The sanctions remain financial and there is no procedure for a more draconian sanction, such as expulsion from EMU, as some would have liked," adds Deborah Zandstra. In light of the increasing political disagreements within the Eurozone, it is worth noting that only 12 of the 17 euro area member states need to ratify the Fiscal Compact for it to come into effect.

Although implementation has been accelerated, the Fiscal Compact is essentially a medium to long-term solution. So measures have also been taken to increase the firewall available to protect and support vulnerable sovereigns. These measures include a scheme whereby the European Financial Stability Facility (EFSF) is able to provide partial protection certificates to newly issued bonds of a member state requiring some support. Another element is the establishment of one or more co-investment funds to allow the combination of public and private funding.

A new treaty has been signed to allow for the creation of the permanent European Stability Mechanism (ESM). Unlike the EFSF, which is a Luxembourg-based special purpose vehicle, the ESM will be an intergovernmental organisation and will be established under public international law. The ESM is set to enter into force in July 2012, assuming that member states representing 90% of its capital commitments have ratified it by that date. Its effective lending capacity will be increased to €500bn at least, with the EFSF remaining active until July 2013.

Although the markets have reacted positively to its creation, there continue to be questions as to whether the mechanism would be sufficient if a large economy such as Spain or Italy required financial assistance. Only those who sign up to the Fiscal Compact will be able to access ESM funding.

Legal challenges

A potential risk to the legislation and financial support necessary to keep Europe together is the spate of legal challenges by eurosceptic politicians and defenders of constitutional rights. For example, the German constitutional court has had to consider the validity of some of the financial stability measures and participation in the initial Greek financial rescue programme. According to Marc Benzler, the rulings indicate that such challenges are unlikely to derail the process. Challenges are also being made in other countries, such as Ireland and Estonia.

Thinking the unthinkable – departing the Eurozone

Despite the measures put in place to restore market confidence, many continue to contemplate the possibility of a country – or countries – leaving the Eurozone. According to Kate Gibbons, Clifford Chance partner and a member of the firm's Global and London Legal Opinions Committees, "it appears that time has been spent behind closed doors on contingency planning for different possibilities".

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So how would such an exit happen? Simon James, Clifford Chance partner and litigator, explains that "the Eurozone was designed rather like a lobster pot – easy for members to get in, but once in, there is no practical way out." There are no provisions under the existing treaties that allow for departure from the Eurozone, but these could be added via amendments, and then implemented. But this process is likely to take a significant amount of time. No amendment could be made overnight. And if the EU were to announce that it was embarking on a process designed to allow Eurozone members to depart, that would almost certainly cause similar problems to an actual default.

Although the option of exiting the EU altogether (and by definition also leaving the Eurozone) is contemplated in existing treaties, the problem is, again, the issue of timing. Article 50 of the Treaty on European Union articulates a "gentlemanly" process of negotiation, involving all the member states as well as the European Parliament, so the chances of keeping it confidential are non-existent. However, legalities may not matter. If a state were to leave the Eurozone and enact domestic legislation to put that into place, "departure would be the reality on

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Kate Gibbons, Partner, Clifford Chance the ground and the EU would have a strong incentive to sort the matter out retrospectively," adds Simon.

The first step for a country exiting the Eurozone would be establishing a new currency or re-establishing an old one – a huge logistical challenge in itself. It would then redenominate certain existing obligations. The most favourable method of redenomination for the departing state would be to redenominate internal debts and debts payable by locals to foreigners, while debts payable by foreigners to locals remained in euros. This kind of one-sided redenomination would, however, be open to challenge on the grounds of discrimination.

The legal effect of redenominating existing debts

For holders of debt that relates to a state withdrawing from the euro, what would be the impact? This would depend, essentially, on four factors:

- If the **governing law** of the debt is that of the departing state, the debt is effectively at the disposal of the departing state. If the departing state wants to change the currency of payment, it can do so.
- If the **currency of payment** is the currency of the departing state, it can redefine the currency as it sees fit.
- The third factor is **place of payment**. If the place of payment is in the departing state, and the state makes it illegal to pay in euros, then even foreign courts have discretion to give effect to the departing state's law.
- And in terms of the **place of any litigation**, if you end up in the departing state's courts, the assumption must be that those courts will give effect to the departing state's redenomination laws.

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As Simon James explains, "the bottom line to everything is practicality. If you are owed money and have to go to the departing state in order to enforce that debt, whatever other factors there are in your favour, the odds are the departing state's courts will give effect to its redenomination legislation."

Planning for the worst – documentation

These uncertainties are being reflected in market documentation, with the focus on the four points above. There is also a trend towards greater credit analysis, with a particular emphasis on credit providers located outside affected jurisdictions. Kate Gibbons highlights another issue that she has addressed for clients. "Requests have been made by borrowers to change the governing law of the facility agreement to that of the home state of the borrower. But for some facilities this is only a majority bank decision. So, when acting for banks, we have proposed amending loan documents to make it clear that changes of governing law and jurisdiction require all-bank consent," adds Kate.

Although there have been discussions about fall-back currencies, in the event that two or more member states exit the euro, these have yet to translate themselves into documentation.

Marc Benzler points out there is a provision in the German Civil Code stating that, in cases of doubt, a debtor who owes a payment in a foreign currency may also fulfil its obligations by paying in the valid German currency. There is also some concern over the operation of 'set-off rights' so parties are advised to modify the provisions of the Civil Code by agreement.

In the bond markets generally, Deborah Zandstra is seeing documentation in which Eurozone risk factors are tailored to the issuer's business without any wholesale changes to the standard terms and conditions of bonds. In the case of derivatives, Deborah says that she has encountered an increase in the insertion of more downgrade triggers in documents. These downgrade triggers are designed to act as a warning signal to counterparties. And in high yield specifically, where New York law has traditionally been the preferred choice, Michael Dakin notes that "the indenture structure appears to hold up well in the event of a state departing from the euro. At least, until you seek to enforce a judgment in the departing state." And local law deals involving European periphery issuers, although relatively rare, are likely to be considered more carefully so long as there remains a risk to the euro.

Outlook

The austerity versus growth debate appears to be reaching a climax. Whether the political head of steam building up will blow the Eurozone apart, or be gently let off by the release of some funding and a new strategy to promote growth, as well as additional financial stability measures, remains to be seen.

To meet demands for an alternative to strict austerity, there would need to be a European-driven growth strategy plan. Although there are some suggestions for possible funding sources for this, it is likely that most of the growth objectives will still need to be met through improved competitiveness in the euro area periphery. Competitiveness, both in absolute terms and relative to each country's principal trading partners, will need to be rebalanced. Therein, perhaps, lies both the nub of the problem and the real long-term challenge.

Deborah Zandstra also believes that there will be increased financial regulation and willingness by governments to intervene. "I think we are going to end up with an increasingly complex EU governance structure, which in many respects the UK will not be part of, which raises other concerns for the City," says Deborah.

While politicians move slowly towards an answer, the markets are able to move at lightning speed, putting more pressure on politicians already struggling under the weight of that ancient Greek invention, democracy. While more drama looks certain, we can only hope it is not joined by that other great Greek invention, tragedy.

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