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Greece three years on

Three years ago, financial institutions and others planned for the contingency that Greece might leave the euro area. To everyone's relief, a solution was found and it didn't happen. But those contingency plans are now being dusted off as the risk of Greece defaulting invites daily comment in the press. But is the situation the same as it was in 2011 and 2012, or do plans need to be updated because of the changed circumstances?

In late 2011 and the first half of 2012, there was extensive public discussion of the possibility of Greece leaving the euro area (commonly referred as Grexit). Regulators required financial institutions to plan for the contingency, and anyone with exposure to or in Greece will have considered how Grexit would affect them and how they could manage the risks.

Grexit didn't happen. Instead, Greece agreed with its private sector creditors to reduce the level of its debt. It also obtained credit lines from its euro area partners, through the European Financial Stability Facility, and from the IMF. Over the subsequent period, Greece's governmental budget moved into surplus before interest payments and, in 2014, Greece's economy showed signs of growth. Greece even made a much over-subscribed bond issue on the international capital markets. More widely, the euro area enhanced its bailout fund (now the European Stability Mechanism, a permanent institution established by treaty), banking union has progressed, and banks worldwide have been forced to undertake stress tests to try to ensure that they can survive a crisis.

But concern as to Greece's situation has returned in 2015. Greece might have cut its indebtedness in 2012 but, since the financial crisis, its economy has shrunk by more than a quarter, leaving its debt to GDP ratio above the level it was before the 2012 restructuring and its unemployment rate very high. Greece's banks have seen deposits decline, with the result that they are heavily dependent on Emergency Liquidity Assistance provided, with the consent of the ECB, by the Bank of Greece. Greece itself is, in turn, similarly dependent on its banks holding and renewing T-bills. Greece's ability to access further official sector funding is conditional upon agreement with its euro area partners on reforms to the Greek economy, but a government has been elected that rejects austerity measures. Reaching agreement has so far proved difficult.

As a result, Greece faces a liquidity problem. Greece must make significant payments over the course of 2015, particularly to the IMF, as well as meeting its normal expenditure. Without EFSF-led funding, Greece might not be able to fulfil its commitments. In order to try to fill its funding gap, Greece has, for example, required state-owned entities, social security funds, and also Greek municipalities, to transfer cash to the central government and recently used its reserves at the IMF to make payments due to the IMF. Ultimately, if Greece were to be faced with a choice of paying pensions and salaries of public sector workers, the government might choose domestic payments over international creditors.

Key issues

- There are now more scenarios that Greece could follow than there were three years ago
- Contingency planning therefore needs to look beyond merely Grexit
- Greece's financial assistance arrangements with the official sector could raise some interesting legal issues

Plus ça change?

The circumstances now mirror to an extent the situation Greece faced in 2012, but there are significant differences. For example, the effect of the 2012 restructuring is that over three-quarters of Greece's debt is owed to EFSF, the ECB and the IMF, and Greece now has little access to the international financial markets. Private sector creditors (many of which are Greek banks subject to ECB limits on the amount of Greek debt they can hold) have a more limited role.

As a result of the changed structure, the scenarios that contingency

planners must consider now include not only Grexit. For example:

- Greece could default or delay on payments to the IMF (see the box headed *IMF "lending"*) but to no one else. This could, for example, lead to questions as to the consequences of this for sovereign credit default swaps and whether it would create a cross-default in other indebtedness.
- Greece could default to the IMF and (primarily though its central bank) the ECB but to no one else.
- Greece could default to the IMF, the ECB and its private sector creditors.
- Greece could avoid default but impose capital controls in order to stem the outflow of deposits, as Cyprus did in 2013. Capital controls could have a significant effect on the ability of Greek counterparties to pay private and commercial debts outside Greece.
- Greece could default to the IMF, the euro area and/or its private sector creditors, and impose capital controls.
- Greece could default to the IMF, the euro area and/or its private sector creditors, impose capital controls, and, while retaining the euro, introduce a parallel, second "currency" of some sort. The nature of the second currency and whether parties could be forced to accept payment in that second currency rather than in euros would depend upon the terms of its introduction and of the relevant contract.
- Greece could default to the IMF, the euro area and/or its private sector creditors, impose capital controls, leave the euro and introduce a new currency. This perhaps represents the core of the contingency planning work undertaken in 2011 and 2012.
- Greece could default to the IMF, the euro area and/or its private sector creditors, impose capital controls, leave the euro, introduce a new currency and leave the EU.

Whilst there are not significant sums due to the euro area in the immediate future a failure to pay the IMF might present some intricate legal questions in the context of financial support arrangements with Greece.

What will happen, and how it will play out, is anyone's guess. Greek opinion polls indicate a desire in Greece to remain in the EU and to retain the euro. Greece has recently made changes to the team that is negotiating with the euro area, which might indicate an acceptance of the need to secure agreement and the resulting funding. Last minute agreements (even fudges) are not unknown in the EU. There is, in any event, no obvious means under EU law for Greece to leave the euro area, but the EU has in the past shown

IMF "lending"

With exemplary openness, EFSF publishes on its website its agreements with Greece. The IMF publishes details of sums owed by its debtors, including Greece, and the repayment dates, but the precise terms of its arrangements with its debtors are closely guarded. It is, however, possible to infer from IMF publications what, in broad terms, the IMF's loan arrangements may look like.

The starting point is that the IMF does not generally make loans to its members even though it is commonly described as doing so. Instead, the IMF enters into a form of currency swap, involving the purchase by the debtor from the IMF of SDRs in return for a payment to the IMF in the debtor's own currency. SDRs (special drawing rights, representing a basket of currencies made up of US dollars, euros, sterling and yen) are neither a currency nor a claim on the IMF but rather enable the debtor to obtain useable currencies. This may be done either through voluntary exchange with other IMF members or through the IMF designating one or more members with strong external positions to purchase the SDRs.

Repayment of the "loan" takes place through the reverse transaction - the repurchase by the debtor of its own currency in return for SDRs. The IMF says of its arrangements that, "although the purchase-repurchase mechanism is not technically or legally a loan, it is the functional equivalent of a loan." The legal nature of the IMF's arrangements with Greece could be significant in assessing whether, for example, a failure to pay the IMF creates a cross-default with other indebtedness.

The IMF's description of its purchase-repurchase mechanism leaves an open question as far as Greece is concerned. In order to buy SDRs from the IMF, most countries can simply print the required amount of their domestic currency. Greece cannot do that (its fundamental problem is a shortage of its own currency). So, presumably, some other arrangement would have been necessary.

It is also not clear what law governs arrangements entered into by the IMF with its members, but it is likely that arrangements are subject to public international law rather than to any national legal system.

itself to be creative in the use of its legal framework when faced with a crisis. The EU - and, indeed, other states - might seek to pass laws that will affect the legal position in the light of whatever happens.

Despite the uncertainty - involving both known unknowns and unknown unknowns - regarding what will actually transpire, planning remains essential. The updated versions of Clifford Chance's previous briefings remain relevant (see the box for details of these briefings).

Clifford Chance briefings

- The Greek debt crisis and loan agreements (May 2015, an updated version of a briefing first published in November 2011)
- The Greek debt crisis and derivatives (May 2015, an updated version of a briefing first published in January 2012)
- The Greek debt crisis and eurobond documentation (May 2015, an updated version of a briefing first published in December 2011)
- The euro area and capital controls (May 2015, an updated version of a briefing first published in July 2012)

Copies of these briefings can be obtained from the Clifford Chance website.

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