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ΕΥΡΩΠΑΪΚΟ ΚΕΝΤΡΟ ΟΙΚΟΝΟΜΙΚΟΥ ΚΑΙ ΧΡΗΜΑΤΟΟΙΚΟΝΟΜΙΚΟΥ ΔΙΚΑΙΟΥ

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CONTAINING THE SOVEREIGN DEBT CRISIS: EUROPEAN AND GREEK RESPONSES

by Professor Constantine A. Stephanou, and
Professor Christos Vl. Gortsos

May 2012

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Containing the sovereign debt crisis:
European and Greek responses

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May 2012

Abstract

The EU treaties and, specifically, the Treaty on the Functioning of the European Union (TFEU) embody no-bailout provisions which aim at deterring both sovereign borrowers and private creditors from irresponsible behaviour. The current sovereign debt crisis has demonstrated the limits of the system. The fall of interest rates expected to occur in high interest-rate countries after the establishment of the Eurozone, rather than benefiting these countries, led to irresponsible borrowing. The responses of the Eurozone to the sovereign debt crisis have been slow, yet, under continuous market pressure, it established sophisticated mechanisms for bailing-out members which are denied market access and for recapitalising banks exposed to bad debt. These mechanisms are examined in the present contributions, with special reference to the Greek case.

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Notice to the readers

The present ECEFIL working paper is based on the contributions of Professor C. A. Stephanou and Professor Ch. Vl. Gortsos to the forthcoming book, co-edited by Hieronymi, Otto & Constantine A. Stephanou (2012): *International Debt: Economic, Political and Regulatory Aspects*, London, Macmillan / Palgrave.

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PART I

European Responses to the Sovereign Debt Crisis

Constantine A. Stephanou

Introductory remarks

The financial crisis, originally affecting banks and subsequently sovereign borrowers, may be considered as an episode in the continuous confrontation between states and markets. Previous confrontations have led to major adjustments or even breakdowns of international regimes. Market forces have been successful at breaking down the Breton Woods system in 1973, thereby allowing exchange rates to fluctuate freely. In recent times governments have borne the cost of market failures. Financial innovation, including the securitisation of debt, its dispersion resulting from the development of secondary markets and the multiplication of financial derivatives, including credit default swaps (CDSs), have put added strains on governments and the management of public debt.

The current sovereign debt crisis constitutes a "novelty", because it involves members of a monetary union, thereby undermining trust in the union's currency. It is often argued that a monetary union goes hand in hand with an economic and fiscal union. Such a union involves a lender of last resort, along the lines of the U.S. Federal Reserve, committed to redeeming the debt of the Union and its members[1] in case of default. The EU treaties and, specifically, the Treaty on the Functioning of the European Union (TFEU) embody no-bailout provisions,[2] which can be read as absolute impediments to the creation of a fiscal union. These provisions and other constraints on government spending were actually founded on the moral hazard argument; they aimed at deterring both sovereign borrowers and private creditors from irresponsible behaviour. Profligate borrowers were expected to live within their means and strengthen their competitiveness, since they were no more in a position to devalue their currency. Investors were expected to reward the best and punish the worst performers; the latter were expected to adjust so that, in the end, the market mechanism would lead to a convergence of interest rates. From a political viewpoint the constraints aimed at soothing taxpayers in fiscally responsible countries who were worried that they might have to pay the debt of other members of the currency union.

When the provisions on Economic and Monetary Union (EMU) were introduced by the Maastricht Treaty (1992) into the European Community Treaty (TEC), it was unclear which countries would participate in the Euro Area. Moreover, it was understood that countries aspiring for membership would fulfill all the economic convergence criteria, including the levels of government deficit and debt. After joining the euro, it was

[1] The view that the Union is the ultimate guarantor of the debt of States and local authorities is contested. New York City was saved from bankruptcy with federal funds, although on 29 October 1975 President Ford had declared his opposition to a bailout.

[2] Article 123 TFEU precludes bailouts by the ECB and Article 125 TFEU precludes the "mutualisation" of debt among EU Member States.

expected that the no-bailout and economic governance provisions embodied in the Treaty would guarantee fiscal discipline. These expectations proved to be wrong.

Firstly, some countries were allowed to join the euro, even though their government debt exceeded not the reference value of 60% but 100% of their GDP.[3] Secondly, after accession to the Euro Area the key provision for ensuring fiscal discipline was the prohibition of excessive deficits, i.e. deficits exceeding 3% of the GDP. In contrast, however, to the bulk of EU law, in this specific case infringement proceedings could not be brought against a non-abiding Member State.[4] The Council could exert pressure against such State by imposing sanctions on it, including huge fines, at the end of a long and painstaking procedure. Very soon after the launching of the single currency, the threat of sanctions proved ineffective. The Commission recommended to the Council the enforcement of these rules against France and Germany but the Council refrained from doing so.[5] Compliance with the 3% threshold was an overwhelmingly political issue and most countries seemed to have valid excuses for exceeding it.[6]

The current sovereign debt crisis has demonstrated the limits of the system. The fall of interest rates expected to occur in high interest-rate countries, rather than benefiting these countries, led to irresponsible borrowing. On the other hand, the fact that Euro Area government bonds were zero-weighted for bank capital purposes encouraged investors to ignore the fundamentals of less competitive countries.

The reaction of the Euro Area has been slow, due to the inadequacy of economic governance, as well as political opposition to bailouts in the Northern members and to reforms in the Southern ones. The current process, described as one of muddling-through, is time-consuming and subject to challenges by impatient market players. Nevertheless,

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[3] Italy and Belgium participated from the outset (1.1.1999) and Greece from 1.1.2002, after the Commission had established, in accordance with Article 104 (2b) TCE that their government debt to GDP ratio "was sufficiently diminishing and approaching the reference value at a satisfactory pace". Actually, it was politically unthinkable to prevent Italy and Belgium from joining the Euro Area, bearing in mind that they were founding members of the original six-member EEC. The same flexible interpretation was subsequently applied to Greece whose corresponding ratio was better compared to the ratio of the aforementioned countries at that time. Later it was also found that the government deficit to GDP ratio of Italy and Greece had exceeded by 0.3 - 0.7% the 3% threshold for admission to the Euro Area.

[4] Article 126 (10) TFEU.

[5] Upon request of the Commission, the conclusions of the Council suspending the excessive deficit procedure against France and Germany were annulled, without, however, any practical outcome because the Commission cannot force the Council to adopt its recommendations. See ECJ 13.7.2004, case C-27/04 (Commission / Council), *ECJ Rep.* 2004 I-6649. For a comment of this case and its aftermath see Jean-Victor Louis (2004), "Economic and Monetary Union: Law and Institutions," *CML Rev.* Vol. 41, pp. 575-608 (577-579).

[6] Thus for example, since 1990 Germany carried the financial burden of its reunification. Greece was facing a continuous threat from Turkey's military establishment since the invasion and occupation of Northern Cyprus in 1974 and had the highest per capita defense expenditure - and the sixth in absolute terms - among EU Member States.

in response to market pressures, the Member States and, in particular, the members of the Euro Area, committed to the survival of the single currency, established mechanisms for bailing-out members facing liquidity problems although, in at least one case, the liquidity problem masked a solvency problem.

As long as sovereign borrowers kept their high ratings, the inadequacies of the EU treaties went unnoticed. The situation changed when the rating agencies started detecting the fiscal imbalances of Euro Area members. Up to 2009 all sovereign borrowers of the Euro Area were rated by the three American agencies with variations of A. Two years later, the sovereign debt of three members had been reduced to junk status and the Euro Area was racing to save these and other members from default. The rating agencies had failed to notice the deterioration of the public finances of the Euro Area peripheral members prior to the 2010 crisis. The rapid fall of interest rates which occurred in these countries following their incorporation into the Euro Area had led to irresponsible borrowing. In the case of Greece, government borrowing soared, being politically more acceptable than cutting government expenditure on the welfare state or extending income tax coverage to small business and the self-employed. On the other hand, rating agencies have also contributed to the sovereign debt crisis, by their hurried downgrading of the debt of the aforementioned countries; their predictions amounted to self-fulfilling prophecies.

1. The birth of the bailout mechanisms

1.1 The first Greek bailout

The first major test for the Euro Area came in the early weeks of 2010. Following the change of government that took place in Greece in October 2009 and the discovery of a hidden fiscal deficit,[7] the spreads on the interest rates of Greek government bonds skyrocketed. On 2 December 2009 the Council established in accordance with Article 126 (6) TFEU that Greece had taken no effective action to curb its deficit in response to a Commission report of 27 April 2009. On 16 February 2010 the Council adopted decision 2010/182/EU giving notice to Greece in accordance with Article 126 (7) TFEU to take measures to correct the excessive deficit by 2012. Greece announced deficit-cutting measures of over 2% of the GDP which were judged satisfactory by the European Council held on 25 March; in the relevant declaration it was also mentioned that Euro Area members were ready to provide coordinated bilateral loans at non-concessional interest rates and subject to strong policy conditionality. Nevertheless, markets were not convinced. By April, when it became a certainty that Greece would soon be unable to refinance its debt from the international bond market, the Greek government submitted a formal request for financial assistance. In early May, the Member States of the Euro Area and the IMF agreed to extend loan facilities of unprecedented amounts to Greece, described below.

Under a five year Loan Facility Agreement with a three year grace period, signed on 8 May 2010 by the European Commission on behalf of the Euro Area members, the latter agreed to extend to Greece pooled bilateral loans amounting to 80 bn euros; the agreement was subsequently ratified by them, with the exception of Slovakia. The loan facility carried floating interest rates, i.e. 3 month Euribor, plus a spread of 300 basis points rising to 400 points for amounts outstanding beyond three years; evidently, these interest rates, as opposed to those of the IMF, were non-concessional and very attractive for the lending nations, even more so for Germany whose bond offerings with similar maturities carried interest rates inferior to 2%. On 10 May the Council gave a revised notice to Greece under decision 2010/320/EU, based on Article 126 (9) TFEU, as well as article 136 TFEU on coordinated action by members of the Euro Area, extending by two years, i.e. 2014, the deadline set earlier to Greece for putting an end to its deficit and embodying the necessary implementing measures.

[7] The projected deficit under the country's revised stability and growth plan adopted on 5.2.2009 had been 3.7% and the final deficit sealed by Eurostat was 15.8%.

Whatever views one might have about the expediency of financial assistance to Greece, it constituted a major innovation in the governance of the Euro Area. It is true that the Treaty embodies a provision (article 143 TFEU) on mutual assistance to a Member State facing difficulties as a result of "an overall disequilibrium in its balance of payments, or as a result of the type of currency at its disposal". Such mutual assistance is granted by the Council or by other Member States subject to their agreement. This provision, which has been applied to Member States with balance of payments difficulties, is inapplicable to members of the Euro Area. Moreover, the Treaty does not provide for mutual assistance in the case of a sovereign debt crisis. It actually prohibits bailouts, as explained above.

IMF participation in the Greek bailout also constituted a novelty because, for the first time, a recipient of IMF assistance was a member of a currency union, which should normally be self-reliant; moreover the recipient was unable to implement a key element of IMF medicine for its recovery, i.e. the devaluation of its currency. The sum of 30 bn euros was extended to Greece under a Stand-by agreement approved on 9 May by the IMF Executive Board under the Fund's fast-track Emergency Financing Mechanism procedures. The expediency of IMF participation was questioned inside and outside the Euro Area. The Greek government was criticized for having contacted the IMF prior to the discussion in the Euro Area. Although elites committed to the European cause objected to IMF involvement in an intra-European problem, the German government supported IMF participation on the ground of its expertise in the management of policy conditionality. From the point of view of the IMF itself, the amount of 30 bn euros represented the largest access granted to a member country and was out of proportion with previous loans granted by the IMF, which were usually limited to 10-15 times the borrower's quota - 900 mo euros in the case of Greece.[8] The IMF rescue was questioned in the U.S. Senate, bearing in mind its potential implications - the United States being the largest shareholder of the IMF.

Strict policy conditionality meant that prior to the conclusion of the loan agreements, the Greek Parliament had to endorse a Memorandum of Understanding (MoU) containing three documents: a Memorandum of Economic and Financial Policies, a Memorandum on "Specific economic policy conditionality", setting forth the conditions for the quarterly loan disbursements, and a Technical Memorandum of Understanding.[9] Greece committed itself to implement dramatic deficit-cutting measures

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[8] IMF (2006), *Guidelines on Conditionality*, Decision No. 12864-(02/102), as amended by Decision No. 13812-(06/98), November 15, 2006, Section A.5 "The Fund will ensure consistency in the application of policies relating to the use of its resources with a view to maintaining the uniform treatment of members."

[9] **European Commission (2010)**.

for 2010, amounting to 6% of its GDP. Greece also accepted inspection at regular intervals by the so-called Troika, composed of representatives of the Commission, the ECB and the IMF. The three institutions were required to deliver an opinion before the disbursement of each installment. Entrusting the IMF, a non-EU institution, with the duty to monitor the economy of a Euro Area member was well received in the financial circles but was perceived as a failure in the governance of the Euro Area by the aforementioned elites. In Greece, the undertakings under the MoU were branded unconstitutional by opposition parties, though they were obviously related to the state of emergency of the Greek economy.

After a first period of successful implementation, involving very substantial cuts in civil servants' pay and state pensions, as well as public health expenditure, resulting in the reduction of the government deficit by one third - it declined from 15.8% to 10.6% of GDP in 2010 - the government embarked in a process of reorganization of the public sector, including the tax collection system, with an uncertain outcome. While the deficit of 2011 was further reduced in absolute terms, its ratio to GDP declined only slightly, from 10.6% to 9.2%, because of the unexpected recession of the economy reaching 7% of the GDP. It is now recognized that the austerity package has dramatically affected domestic demand and, by implication, tax revenue and social security contributions. On the positive side, the austerity package led to a dramatic decline of the balance of payments deficit from a world record of 15% of the GDP to less than 10%, with a declining trend.

The expediency of the financial package has been a controversial issue from the beginning of the crisis. Daniel Gross, the Director of CEPS observed that the package was designed to cover the financing needs of Greece for a couple of quarters and to contain the interest burden following the sudden rise of spreads; Gross pointed out that interest savings would make very little difference because as long as the public deficit remained high the financing needs of Greece would continue to rise; the real problem for Greece was not one of liquidity but one of solvency; the key was therefore whether Greece was willing to undertake the huge domestic effort required to achieve a sustainable fiscal position.[10] Greece's problem was eminently political – the country was living beyond its means; its insurance-based social security system was kept alive with annual subsidies amounting to 15 bn euros or, approximately, 6% of the GDP of 2009. On the other hand, the shock-therapy applied by the IMF to developing countries for reducing government deficits proved inappropriate in the Greek case, due to unforeseen

[10] **Gross (2010)**.

political opposition. The Greek bailout postponed default but, a year later a second bailout had to be arranged and political consensus for its implementation was uncertain.

1.2 The provisional stability mechanisms: the EFSM and the EFSF

The birth of the bailout mechanisms coincided with the Greek bailout. The reasoning behind their creation was the "severe deterioration of the borrowing conditions of several member States beyond what can be explained by economic fundamentals".[11] The Portuguese bailout, which occurred a year after the establishment of the bailout mechanisms, was the typical example of a country whose borrowing conditions deteriorated due to the successive downgrades by the credit rating agencies; its levels of public debt and deficit were far better than those of Greece.

The need to involve the EU as such and the Euro Area Member States in bailout operations led to the creation of two separate instruments. Thus, on 9 May 2010, the Council decided the creation of an EU instrument to be known as the European Financial Stabilisation Mechanism (EFSM) and a "Special Purpose Vehicle" among the members of the Euro Area, to be known as the European Financial Stability Facility (EFSF). The EFSM and EFSF were intended only as temporary bailout mechanisms (to expire in 2013), in part due to the lack of a legal basis in the EU treaties at that time.

On 11 May the Council adopted Regulation 407/2010 establishing the European Financial Stability Mechanism (EFSM)[12] with a capital of 60 bn euros. The EFSM is based on a solidarity clause in the Treaty which enables the Council to grant financial assistance to a Member State facing difficulties caused by "natural disasters or exceptional occurrences beyond its control" (Article 122 par. 2 TFEU). The possibility of grounding on this provision a derogation from the no-bailout provision of Article 125 TFEU has been a matter of controversy. The issue was raised in the context of an appeal before the German Constitutional Court which was dismissed following a stimulating exchange of arguments, the most important being that financial assistance from the EFSM carried non-concessionary interest rates and did not constitute a bailout.[13]

Moreover, under an agreement signed on 7 June, the Euro Area members established the European Financial Stability Facility (EFSF), in the form of a limited liability company incorporated in Luxemburg, with an issued capital of 440 bn euros. A Decision of the Representatives of the Governments of the Euro Area Member States meeting

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[11] See recital 4 of Regulation 407/2010 establishing the EFSM.
[12] Published in the O.J. 2010 L 118.
[13] On 7 September 2011 the German Constitutional Court dismissed the appeals against the German Law of 22 May 2010 enabling the participation of Germany in the EFSM and against the law enabling its participation in the Greek bailout. For the EU law aspects related to these cases see **Louis (2010)**.

within the Council of the European Union committed their respective governments to provide guarantees of up to 440 bn euros, in proportion to their share in the capital of the ECB.

The EFSM and the EFSF raised funds on the capital markets. Bond offerings by the EFSM were backed by collateral from the EU budget, whereas bond offerings by the EFSF were backed by guarantees given by the Euro Area members. The triple A rating and the effective lending capacity of the EFSF estimated at 250 bn euros very much depended on the triple A rating of its main guarantors, Germany and France.

The EFSM and the EFSF participated, together with the IMF, in the Irish and Portuguese bailouts. In the Irish case, the sovereign debt crisis was the outcome of the banking crisis that occurred in this country and was of direct concern to Britain's banking system. Prior to the bailout, the Irish government had injected considerable liquidity to the ailing banks, actually nationalising one of the biggest (Anglo-Irish bank). Moreover, Irish banks could refinance themselves from the ECB, by offering as collateral Irish government bonds. The ECB notified, however, Irish banks that this method of financing had reached a peak (approximately 115 bn euros) and the Irish government would have to seek alternative sources of financing. Ireland sought direct financial support for the bailout of its banks, rather than indirect financing through sovereign borrowing. The banking crisis deepened, however, as a result of massive deposit withdrawals. Following a request on 21 November a joint rescue operation was organized by the EFSM on behalf of the EU, the EFSF on behalf of the Euro Area, non-Euro area members (Britain, Sweden and Denmark), as well as the IMF. Under loan facilities providing for a four-year grace period and a seven-year repayment period, the EFSM agreed to extend 22.5 bn euros and the EFSF 17.5 bn euros, out of a total amount of 85 bn euros. A few months later, in April 2011 and in the context of the Portuguese bailout, the EFSM provided 26 bn euros and the EFSF 26 bn euros, out of a total amount of 78 bn euros. The 60 billion lending capacity of the EFSM was practically exhausted with its contribution to the Irish and Portuguese bailouts.

The EFSM and the EFSF were intended to provide loans to Euro Area members in distress, which sign up to financial support programs. The deterioration of the fiscal situation of Italy in the beginning of July 2011 led to important amendments to the EFSF during the second half of 2011, with a view to enhancing the capacity of this instrument. The Euro summit of 21 July decided to allow the EFSF to act on a precautionary basis by purchasing bonds of Euro Area members which were not finding buyers, thereby reducing interest rate spreads - subject, however, to a positive opinion by the ECB. Moreover, the EFSF could also provide loans to Euro Area members, including States outside bailout programmes, who could use the funds to redeem high-interest bonds or to recapitalise their banks. The ratification of the aforementioned amendments by the Euro Area Parliaments was completed on 13 October 2011.

The EFSF's limited "firepower" remained, however, a matter of concern. German opposition to a further increase of the capital guarantees led to alternative arrangements. At the Euro summit of 26/27 October it was agreed to leverage the resources of the EFSF by offering credit enhancements to purchasers of Euro Area members' debt in the primary market, on part of the value of the respective bonds. It was also agreed to create "Special Purpose Vehicles", which would combine EFSF resources with resources from private and public institutions for achieving the aims of the EFSF. The IMF and sovereign wealth funds of China and other economic powers were considered as potential participants. At the Euro summit of 8/9 December Member States decided to provide up to 200 bn euros to the IMF in the form of bilateral loans, to ensure that the IMF had adequate resources to deal with the crisis. Thus the IMF would be in a position to supplement EFSF assistance.

1.3 The European Stability Mechanism (ESM)

The provisional character of the aforementioned bailout mechanisms led to a decision by the European Council in December 2010 to establish a permanent stability mechanism. The new mechanism, to be known as European Stability Mechanism, was scheduled to assume the roles of the EFSM and the EFSF when these mechanisms expired. In order, however, to conclude the agreement among Euro Area members, an enabling clause had to be inserted in the Treaty. The European Council agreed to insert into Article 136 TFEU a paragraph 3 which reads as follows:

> *The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.*

In March 2011, the European Parliament approved the Treaty amendment after receiving assurances that the European Commission, rather than EU states, would play 'a central role' in running the ESM. Thereafter, the Treaty amendment was approved by a formal decision of the European Council[14] and submitted to the Euro Area members for approval by their Parliaments, in accordance with Article 48 par. 6 of the Treaty on European Union (TEU).

Moreover, the Treaty establishing the ESM was signed on 11 July 2011 among the Euro Area members, following difficult negotiations during the first semester of 2011.

[14] Published in the O.J. 2011 L 91.

According to this treaty, the ESM is an intergovernmental organisation under public international law located in Luxemburg. Its authorised capital amounting to 700 bn euros consists of paid-in shares amounting to 80 bn euros and callable guarantees amounting to 620 bn euros. Its effective lending capacity was estimated at approximately 500 bn euros. The large amount of paid-in capital in the form of cash deposits was a source of concern in a number of Member States. The distinguishing feature of the ESM is that its method of action combines financial assistance with debt restructuring through private sector involvement (PSI), described further below. Moreover, in addition to "stability support" the purchase of bonds of the beneficiary on the primary market is envisaged under the "primary market support facility".

At the Euro summit of 8/9 December it was decided to accelerate the entry into force of the ESM Treaty, as well as to adjust some of its provisions. Thus, the Treaty would enter into force as soon as Member States representing 90% of the capital commitments had ratified it; moreover, the trigger for bailouts was made more flexible with the replacement of unanimity by an 85% majority in case the Commission and the ECB conclude that an urgent decision related to financial assistance is needed. A clarification on private sector involvement (PSI) was also to be included in the preamble of the Treaty.

1.4 The second Greek bailout

Very soon after the granting of pooled bilateral loans to Greece it was realised that the country required further debt relief. The Euro summit decided on 25 March 2011 to reduce the floating interest rates applicable to the loans by 100 basis points and to extend their maturity to 7.5 years, in line with the IMF. On 12 July the Council gave a revised notice to Greece under decision 2011/734/EU (amended in November 2011 and in March 2012) with revised conditionality criteria. At the July 21 Euro summit it was decided that future EFSF loans to Greece would involve maturities of 15 to 30 years (with a grace period of 10 years) and would carry interest rates "close to, without going below, the EFSF funding cost"; the same terms were made applicable to the loans of Ireland and Portugal. More importantly perhaps, the summit decided for the first time a 21% voluntary "haircut" on the face amount of privately owned Greek debt estimated at 200 bn euros, with the granting of credit enhancements by the EFSF in order to ensure the voluntary character of the restructuring. Negotiations on private sector involvement (PSI) were launched in September 2011, but an IMF report endorsed by the Troika determined that the July package including the haircut would not ensure the long-term sustainability of the Greek debt.[15]

On the basis of the aforementioned report, the July bailout was revised at the October 26/27 Euro summit; the haircut was set at 50% of the face value of bonds in the hands of private investors and was to be achieved by means of a voluntary bond rollover. Finally, the Euro Area members undertook a political commitment regarding the participation of the official sector which, according to the declaration, "stands ready to provide additional programme financing of up to 100 bn euros until 2014, including required recapitalization of Greek banks";[16] the IMF contribution was expected to be equivalent to the previous one, although a large part of it had not yet been disbursed[17]. An important part of the new programme would help cover Greek government deficits, essentially debt servicing, until 2014 when it was estimated that the Greece would run a primary surplus. [18] The Eurogroup specified the conditions of the second bailout at its meeting on 21 February; on 14 March it decided that Greece had fulfilled the requirements described as "prior actions" for the disbursement of the first tranche of the loan facility.

1.5 Principles governing bailouts

1.5.1 Trigger mechanism

The wording on the trigger mechanism has varied. Thus, the European Council stated in its declaration of 25 March 2010, prior to the first Greek bailout, that the mechanism of coordinated bilateral loans "has to be considered *ultima ratio,* meaning in particular that market financing is insufficient". Later the ESFM Regulation stated that "financial assistance may be granted to a Member State which is experiencing, or is seriously threatened with, a severe economic or financial disturbance caused by exceptional occurrences beyond its control…"[19] Although the revised EFSF has made easier the access to its resources under the precautionary approach described above, the stigma attached to such access has deterred potential candidates from seeking EFSF assistance. The ESM Treaty allows on its part the provision of financial assistance to an ESM Member "when its regular access to the market financing is impaired".[20] In practice, bailouts have been decided when Member States in distress were unable to borrow on

[15] This determination entailed policy implications. According to its rules, the IMF can only be active when there is a refinancing guarantee for 12 months.
[16] According to the official statement, the maturities, grace periods and interest rates applied by the EFSF would be determined in accordance with the guidelines adopted at the 21 July Euro summit.
[17] Before the second bailout, 73 bn euros had been disbursed to Greece (including 20 bn from the IMF facility); 37 bn euros were still available (including 10 bn from the IMF facility).
[18] **European Commission (2012)**.
[19] See Article 1 of Regulation 407/2010.
[20] See recital 10 of the preamble.

markets at acceptable rates. Rates above 6% on 10 year bond issues are generally deemed unacceptable because they make debt servicing unsustainable.

1.5.2 Policy conditionality

A crucial element in financial assistance under the bailout mechanisms is "strict policy conditionality" under an economic adjustment programme which entails economic policy obligations for the sovereign borrower, in addition to the usual loan obligations. The conditionality principle, originally embodied in the "structural adjustment programs" accompanying IMF loan facilities, is now a key element of the bailouts in the Euro Area. Conditionality would be impossible to implement if bailouts were assigned to the ECB. As things stand today, the bailout mechanisms are activated after a country program has been negotiated with the European Commission and the IMF, and such program has been unanimously approved by the Eurogroup (Euro Area Finance Ministers) and, finally, a Memorandum of Understanding (MoU) embodying the policy conditionality has been signed. Policy implementation is monitored by the so-called Troika, consisting of representatives of the European Commission, the IMF and the ECB.

1.6 The ECB: A "hidden" lender of last resort

The ECB has played a crucial role in defending the euro from speculative attacks, by providing adequate liquidity to banks since the 2008 crisis and, later, by accepting as collateral, low-rated government bonds.[21] In doing so it saved the Greek banking system, and subsequently those of Ireland and Portugal from collapse. Moreover, on 10 May 2010 the ECB decided to buy bonds from the secondary market under its "Securities Market Program"[22] in order to stabilise the bond market. The decision was still in force when the ECB decided to intervene massively by means of the Long Term Refinancing Operations (LTROs) to contain speculative attacks against Italian and Spanish government bonds. LTRO 1 (December 2011) and LTRO 2 (February 2012) involved amounts of approximately 500 bn euros each, in the form of 3 year loans carrying a 1% interest rate. According to a BIS study, banks in Italy and Spain used the new funds to significantly boost their holdings of government bonds.[23] Thus the ECB's action achieved two goals: it prompted the banks to purchase bonds from the countries which were unable

[21] On lending to Eurozone credit institutions, see the contribution of Christos Gortsos in part II of the present Working Paper at Table 1.
[22] ECB, Decision of 14 May 2010 (ECB/2010/5). The ECB practice has been strongly challenged in Germany. Nevertheless, the Federal Government and the Bundestag took the view that only direct loans or purchase of bonds in the primary market were prohibited by the Treaty; see the joint cases before the German Constitutional Court, *supra*, note 13.
[23] **Bank of International Settlements (2012)**, especially graph 4.

to refinance their debt at sustainable interest rates, while also averting a banking crisis that would have resulted from the large exposure of European banks to these countries. George Magnus, the Senior Economic Adviser at UBS pointed out, however, that even though banks may have increased their lending to governments, much of their increased access to ECB liquid funds has ended up back at the ECB and there was no evidence that the European economy would benefit from an increase in credit.[24]

[24] **Magnus (2012)**.

2. Debt restructuring

2.1 The issue of private sector involvement (PSI)

The moral hazard argument leads to the conclusion that the way to deal with irresponsible behaviour by private bondholders is to make them incur losses on their investments. In the EU context, this view was vigorously promoted by Germany; it served as a *quid pro quo* for the setting-up of the permanent bailout mechanism under the ESM Treaty. Under Article 12 of the Treaty the beneficiary of ESM assistance is required to put in place an "adequate and proportionate form of private sector involvement (PSI)…in line with IMF practice". Depending on the outcome of the negotiations and the sustainability of the beneficiary's debt, the restructuring will be voluntary or compulsory. It is explicitly provided that ESM loans will enjoy preferred creditor status, junior only to IMF loans. The idea is to make default possible with only a minor risk to the budget of creditor nations.[25] On the other hand, the preferred status of official lenders (IMF, ESM) reduces the funds available for private creditors in case of default or restructuring, thereby increasing the risk premium and the cost of servicing the debt. It is worth noting that according to recital no. 10 of the preamble, preferred creditor status will **not** apply to an ESM financial assistance programme which follows a European financial assistance programme existing at the time of the entry into force of the Treaty, i.e. previous EFSM and EFSF sponsored programmes. Claims under such programmes will rank *pari passu,* i.e. on the same terms with private creditors' claims.

Moreover, the ESM Treaty stipulates that, after its entry into force, all new Euro Area government bond offerings should include standardised and identical collective action clauses (CACs).[26] CACs allow compulsory "haircuts" to be decided by qualified majorities of bondholders. Under English law, applicable to many bond issues, haircuts decided by qualified majorities of bondholders[27] at assemblies by bond series are binding on the minorities and do not constitute default events. Recourse to CACs allows for an orderly restructuring of government debt and has been recommended in the past by the G-10[28], the IMF[29] and the EU[30]. It does not necessarily increase the cost of borrowing;

[25] **Münchau (2011)**.
[26] The Euro summit of 8/9 December 2011, referring to PSI declared that "we will strictly adhere to the well established IMF principles and practices. This will be unambiguously reflected in the preamble of the treaty. We clearly reaffirm that the decisions taken on 21 July and 26/27 October concerning Greek debt are unique and exceptional; standardised and identical Collective Action Clauses will be included, in such a way as to preserve market liquidity, in the terms and conditions of all new euro government bonds."
[27] 2/3 majorities of those present and voting are required, subject to a quorum of 50%.
[28] **Group of Ten (1996)**, the report is usually referred to as the Rey Commission Report. See also, **Group of Ten (2002)**.
[29] See **IMF (2002),** and **IMF (2003)**.
[30] **European Union (2004).**

thus, the yield curve of new bonds issued in the context of Mexico's 2003 rollover was not affected by the inclusion of CACs in these bonds.[31]

The model CACs elaborated by the Economic and Financial Committee and approved in the form of a *Common Understanding* by the Ministers of Finance and the Governors of the central banks of the EU members at their meeting in Stresa on 13.9.2003 enable majorities of at least three quarters (75%) by face amount of a quorum of these bonds to approve exchange offers and amendments of redemption provisions.[32]

2.2 The Greek PSI

2.2.1 The context

Soon after the decisions of the Euro summit of 26/27 October 2011 on the PSI issue Greece entered into negotiations for the implementation of the PSI provisions with the International Institute of Finance (IIF), representing the major bondholders. The agreement reached by mid-February 2012 was the outcome of difficult negotiations regarding the interest rates and maturities of the new bonds.[33] These negotiations were carried out in a completely new context, outside the caucuses of the Paris and London Clubs involved in previous debt restructuring operations, and with the active support of the sovereign borrower by the IMF and the Euro Area whose primary concern was to ensure the long-term sustainability of the Greek debt.

Under the informal agreement reached in mid-February, a 53% haircut on the face amount of privately owned debt[34] or 75% in net present value terms was agreed. The haircut involved a write-down of over 100 bn and was the largest in history; the official lenders were not affected by the restructuring but the Greek State Pension Funds were included in the haircut. The ECB discreetly agreed to include in the haircut the bonds in its possession, which it had purchased from the secondary market at a substantial discount. ECB participation in the rollover led to a revised projection of Greek debt sustainability: by 2020 the debt to GDP ratio was expected to fall to 116% instead of 120% originally predicted. The success of the PSI relied on credit enhancements by the EFSF, amounting to 30 bn euros and, as regards Greek banks, which were the most exposed to the haircut, an amount of up to 35 bn euros earmarked for their recapitalisation.

The PSI process was triggered upon the finding by the Eurogroup on 21.2.2012 that Greece had fulfilled the so-called "prior actions" referred to in the new MoU on

[31] See **Gelpern (2003)** and **Jacklin (2010).**
[32] **European Union (2004)**.
[33] The new bonds had maturities from 11 to 30 years and carried an average interest rate of 4% depending on these maturities.
[34] In net present value terms, investors would incur losses amounting to 75% on their investment.

economic conditionality. The Greek government statement on the bond swap, embodying an exchange offer and a consent solicitation, was published on 24.2.2012 and set a deadline until 8.3.2012 for the acceptance of the offer.

2.2.2 The exchange offer

The exchange offer permitted private sector holders to exchange bonds for:

(i) new bonds issued by Greece on the PSI settlement date having a face amount equal to 31.5 % of the face amount of the exchanged bonds, to be governed by English law;

(ii) EFSF notes described in the PSI Liability Management Facility Agreement concluded with Greece as EFSF debt securities, with a maturity date of two years or less from the PSI settlement date and having a face amount equal to 15 % of the face amount of the exchanged bonds;

(iii) detachable GDP linked securities issued by Greece, having a notional amount equal to the face amount of each holder's new bonds.

Greece also committed itself to deliver short-term EFSF notes on the PSI settlement date (12.3.2012), in discharge of unpaid interest accrued up to 24.2.2012 on exchanged bonds, amounting to 5.7 bn euros.

2.2.3 The consent solicitation

The consent solicitation was applicable to Greek-law governed bonds issued prior to 31.12.2011 and having an aggregate outstanding amount of 177 bn euros, i.e. 93% of the total amount of 185 bn euros in private hands. The Greek government sought the consent of the affected bondholders to the amendment of these bonds, relying on the recently enacted Law 4050/2012 (the Greek Bondholder Act). The amendments provided for the redemption of the affected bonds in exchange for the PSI consideration mentioned above. Under the collective action clauses introduced by the Greek Bondholders Act with retroactive effect[35], the proposed amendments would become binding on the aforementioned bondholders if at least two thirds (66.6%) by face amount of a quorum of these bonds, voting in aggregate, without distinction by series, approved these amendments. One half (50%) by face amount of the aforementioned bonds would constitute a quorum for these purposes. It was also provided that the government would also solicit consents in favour of equivalent amendments from the holders of its foreign-law governed bonds, in accordance with the terms of these bonds.

[35] The International Securities and Derivatives Association (ISDA) determined that the retroactive introduction of CACs did not constitute an event of default. Subsequently, however, ISDA determined that the activation of the CACs constituted such an event.

2.2.4 The outcome

The exchange offer was accepted by bondholders representing 85.8% of the amount governed by Greek law, i.e. 152 bn out of a total of 177 bn euros. This acceptance rate above the 66.6% threshold enabled the Greek government to activate the CACs inserted in these bonds and to include the rest of these bonds in the swap. The exchange offer was also accepted by bondholders representing 69% of the amount governed by foreign law, i.e. 20 bn out of a total of 29 bn euros, although the period of acceptance of the offer was extended in order to comply with foreign law requirements. As for the remaining 9 bn euros, which included a 450 mo euros note expiring on May 15, there was some concern that under foreign applicable laws it might be possible for bondholders voting by series rather than in aggregate, as had been the case with Greek-law bonds, to block the exchange offers and pursue legal action in their respective jurisdictions.

2.2.5 Evaluation

Participation in the Greek PSI finally reached 97% of total bond issues and the write-down 103 bn euros, a historical record. With the help of CACs, its voluntary character had been safeguarded and the "free rider" problem adequately addressed.[36] The ISDA determined, however, that an event of default had occurred, triggering thereby the payment of credit default swaps.[37] A closer examination of the debt rollover leads to the conclusion that the net gains in terms of Greece's debt burden were significant but not as impressive as originally thought; practically, an important part of the debt owed to private creditors was converted into debt owed to official lenders.[38] On the other hand, the lower interest rates and the extended maturities of the new bonds were expected to relieve substantially, by up to 5 bn euros, the annual debt service burden, representing 2.5% of the GDP at the end of 2011.

Arguably, however, the most important outcome of the debt restructuring operation was the avoidance of a full-blown crisis involving Greek exit from the euro and the contagion effects that such a move would unleash. The official view was that the debt restructuring operation had given Greece valuable breathing space in order to restructure its economy and reduce its debt burden to 116% of the GDP by 2020 under the Troika's

[36] See **Kaeser (2012).**

[37] The amount of 3.2 bn euros were paid during 2011 for risk premiums. The value of the bonds covered by CDSs had been estimated at 4-5 times the amount of these premiums. Following, however, the auction that took place in London on 19.3.2012, the institutions which had issued the CDSs were called upon to pay 78.5 cents for each euro of the insured value.

[38] The new debt owed by Greece to the EFSF as a result of the debt rollover included up to 35 bn euros to be provided by the EFSF for the recapitalisation of Greek banks.

scenario.[39] Pessimists argued, however, that this scenario was unrealistic under the conditions of extreme austerity imposed on the country, entailing dismal effects on growth. At the time of writing, an economic recovery program for Greece, referred to as a Marshall Plan, was being considered by the Commission and official lenders, involving fast-track procedures for EU budget transfers under the structural funds and substantial guarantees from the EU budget for loans by the European Investment Bank (EIB).

[39] An essential element of the sustainability scenario was the implementation of a privatisation program, initially set at 50 bn euros, for the purpose of debt reduction.

3. Overall assessment of the European bailout mechanisms

3.1 The contested logic of bailout mechanisms

3.1.1 Moral hazard

The moral hazard argument is central in dealing with the issue of bailouts; bearing in mind moral hazard the Rey Commission report argued that "neither debtor countries nor their creditors should expect to be insulated from adverse financial consequences by the provision of large-scale official financing in the event of crisis."[40] The no-bailout provisions in the TFEU aim at deterring Euro Area members and their creditors from irresponsible behaviour. Private sector involvement (PSI) in bailouts aims at deterring and punishing the same creditors, although the idea of punishment, central in the moral hazard argument may not always be applicable.[41]

The decisions regarding the second Greek bailout have been declared "unique and exceptional" at the Euro summit or 8/9 December 2011. Nevertheless, the implementation of the massive Greek bond swap and the acceptance of the idea of losses by private bondholders under the ESM Treaty provisions on PSI have undermined the assertion that government bonds are risk-free. The spreads in interest rates between the German bund and the bonds of the other Euro Area members have increased. German insistence on preventing moral hazard and making creditors pay for their irresponsible behaviour has actually benefited Germany. In absolute terms, the interest rates of German bunds decreased, while those of the other Euro Area members increased.[42] Risk aversion towards the bonds of the European periphery made the fiscal position of the respective countries unsustainable.

A side-effect of the crisis - and of the acceptance of PSI - may be the reconsideration of the basic assumption regarding government bonds in the new EU capital adequacy directive, freeing until now the banks from the obligation of holding capital against sovereign bonds. Such a development would entail the restructuring of the international bond business, while also attaching quasi-permanent stigma to sovereign borrowers benefiting from debt relief of any kind. It is unlikely that EU sovereign borrowers will endorse a directive with such far-reaching consequences; on the other hand the British government may try to avoid full harmonization of the relevant national regulations, in order to establish compulsory risk assessment criteria for government bonds.[43]

[40] See the Executive Summary of the report cited *supra*.

[41] Thus, from the beginning of the crisis, Greek banks with excellent ratings were pressured to purchase Greek government bonds.

[42] Another factor that played in favour of the German bund was the growth performance and prospects of Germany.

[43] The British government's attitude towards harmonisation in the area of financial regulation reflects its commitment to promote the interests of the City of London. In some cases, it is opposed by way of principle to harmonisation, deemed to curtail the operation of financial markets

3.1.2 Risks of contagion

Arguably, any bailout mechanism creates moral hazard. Nevertheless, the counter-argument regarding risks of contagion has weighed heavily in the shaping of public policy. A prime example is that of the recapitalisation of banks which have invested in government bonds; if these banks are systemically important they will not be punished for their irresponsible behaviour, in order to avoid contagion. A related argument is about the contagion effect that would result if a Euro Area member was allowed to fail. Should it be allowed or even encouraged to leave the Euro Area? The voluntary restructuring of the Greek sovereign debt reflected a delicate assessment of risks of contagion. The Euro Area has apparently been spared contagion by a disorderly Greek default, but its peripheral members remained at risk.

3.2 The effectiveness of European bailout mechanisms

The Euro Area institutions have been running behind the markets - and Parliaments have been being held at hostage. The precautionary approach embodied in the EFSF following the 21 July 2011 Euro summit and the decision to leverage its resources taken at the October 26/27 summit were rightly perceived by the press as representing too little and coming too late to deal with the sovereign debt problem. By the end of 2011, renewed anxiety over the Italian debt prompted the ECB interventions described above. Arguably, the speculative attacks could have been contained at a lower cost, had the ECB not just acted as a lender of last resort to banks unable to access the markets but had also stated its intention to provide unlimited support to Member States in financial trouble. Such a statement would have gone, however, beyond a liberal interpretation of the no-bailout clause and would have been in breach of the Treaty (Article 123 TFEU). It seems therefore that, notwithstanding the ECB's role in containing speculative attacks against sovereign borrowers, effective European bailout mechanisms, able to impose policy conditionalities on sovereign borrowers, will be needed as long as the no-bailout provisions of the Treaty remain in force.

On the other hand, the problems faced by larger Euro Area economies could drain the resources of the bailout mechanisms and affect their lending capacity. If countries such as Italy or Spain became "stepping-out guarantors" and, more importantly, if France lost its triple A rating[44], the EFSF would also lose its triple A rating and its lending capacity

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while, in others, such as the one under consideration, it wishes to impose more stringent rules. These cases correspond to the well-known regulatory competition models of "race to the bottom" and "race to the top".

[44] At the time of writing, one of the rating agencies had downgraded France by one notch. The results of the forthcoming presidential election (6 May 2012) may very much affect France's rating.

would be reduced accordingly. The Commission has called for the co-existence of the EFSF and the ESM during a transitional period; the latter was originally perceived as a replacement of the former, taking up the previous EFSF commitments and effectively reducing its lending capacity.[45] On 30 March 2012 the Eurogroup decided to raise the ESM capacity from 500 bn euros to 700 bn euros.[46] This is still far from the goal of one trillion euros - or the doubling of the ESM capacity - recommended in the course of 2011, before the ECB's massive interventions.

Last but not least, in the early months of 2012 difficult negotiations were taking place regarding IMF participation in Euro Area bailouts. Although the IMF decided to participate in the second Greek bailout after the successful haircut of the Greek debt,[47] its response to the Euro Area request for a substantial increase of its lending capacity to cope with future challenges was cautious; the decision was linked to the outcome of the negotiations regarding the increase of the capacity of the ESM. Clearly, the risks of contagion were understood by the non-European members of the IMF but the Europeans were expected to assume the primary responsibility for bailouts in their realm. On 20 April 2012 it was decided at a special meeting in Washington to raise the resources "for crisis prevention and resolution" by 430 bn dollars, in addition to the quota increase under the 2010 reform which had not yet entered into force;[48] half of the amount was pledged by EU members of the IMF.

[45] These commitments included EFSF contributions of 17.5 bn euros for Ireland and 26 bn euros for Portugal. To these should be added EFSF commitments under the second Greek bailout amounting to 109.1 bn in loans and 35.5 bn in credit insurance in the context of the PSI.

[46] The commitments undertaken by the EFSF amounting to approximately 200 bn euros were included in the enlarged ESM capacity. On the other hand, it was decided that the 240 bn of unused funds of the EFSF could still be accessed during a transitional period during which the two funds will coexist (until 1.7.2013).

[47] The IMF agreed to provide 19.8 bn euros, which included an undisbursed amount of 10 bn from the previous facility. IMF exposure to Greece would not exceed the amount of 30 bn agreed under the first facility, because disbursements would coincide with repayments.

[48] See Joint Statement by the International Monetary and Financial Committee and the Group of 20 Finance Ministers and Central Bank Governors on IMF resources, IMF Press Release No. 12/144, April 20, 2012.

4. The reform of the Stability and Growth Pact

4.1 Addressing fiscal indiscipline

The asymmetry between weak economic governance and strong monetary governance has been a matter of concern ever since the adoption of the Maastricht Treaty provisions on Economic and Monetary Union (EMU). The Stability and Growth Pact (SGP) implementing the treaty provisions on economic policy[49] is embodied in two regulations and a resolution of the Council adopted in 1997.[50] The regulations, as amended in 2005,[51] did not address the weaknesses of the system. Jean-Victor Louis observed that these weaknesses "are not due to the Pact or its reform. They concern the loose concept of coordination and the weight given to peer pressure in the treaty itself, for the sake of preserving national sovereignty;"[52] moreover, according to the same author, "the soft procedures of surveillance and the hard procedures of correction are both relying on peer judgment, i.e. ministers are in a situation of conflict of interest.[53]

The facts seem to confirm the view that the revised SGP and, indeed, its "hard" part, implementing the provisions of Article 126 TFEU and the Protocol (no. 12) to the Treaties on the 'excessive deficit procedure' (EDP) have not deterred fiscal indiscipline. The implementation of the EDP reached a climax in the case of the Greek, Irish and Portuguese deficits entailing the application to these countries of the provisions of Article 126 (9) which involve binding measures for the correction of excessive deficits and apply only to Euro Area members.[54] Interestingly, the application of the EDP, rather than being an exception became the rule. In the middle of the international financial crisis several Member-States were forced to take fiscal measures that induced them to deviate boldly from their budgetary plans.[55] According to the latest assessment by the Commission services, the 2011 Autumn Forecast, published on 10.11.2011, all the Member States with the exception of Estonia, Finland, Luxemburg and Sweden were subject to the EDP. Five among them - Greece, Ireland, Portugal, Romania and Latvia - were benefiting from a financial assistance programme; the balance of payments programme for Latvia was successfully implemented and expired in January 2012. The assessment showed that the

[49] Articles 120-126 TFEU.
[50] Council Regulations (EC) 1466/97 and (EC) 1467/97 were published in the O.J. 1997 L 209 and the Resolution of the European Council on the Stability and Growth Pact was published in the O.J. 1997 C 236.
[51] Council Regulation (EC) 1055/2005, amending Regulation (EC) 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and Council Regulation (EC) 1056/2005 amending Regulation (EC) 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure. They were published in the O.J. 2005 L 174.
[52] **Louis (2006),** pp 104-105.
[53] *Ibid*. at p. 105.
[54] Article 139 par. 1 indent b TFEU.
[55] **Gortsos (2011d)**.

majority of countries had implemented the Council recommendations under Article 126 (7) TFEU for the correction of their excessive deficits, but for Belgium, Cyprus, Hungary, Malta and Poland the assessment indicated that a timely and sustainable correction of their excessive deficit was clearly at risk, as the deadline for correction was imminent or close. On 11.11.2011, the Economic Affairs Commissioner Olli Rehn addressed letters to the Member States concerned to treat as a matter of urgency the adoption of a 2012 budget that would include additional measures, so as to ensure a timely and sustainable correction of their excessive deficit. In order to avoid the imposition of sanctions, the aforementioned Member States adopted or announced additional measures, which in most cases - for Belgium, Cyprus, Malta and Poland - were considered sufficient enough. Nevertheless, two cases deviated retained the attention of the EU institutions. At the Council meeting in Copenhagen on 12-13 March the Council dealt differently with the cases of Hungary and Spain. In the case of Hungary, the ECOFIN Council determined, upon the recommendation of the Commission and in accordance with Article 126 (7) TFEU, that no effective action has been taken in order to bring an end to the situation of an excessive government deficit and decided in accordance with Council Regulation 1084/2006 to suspend as of 1.1.2013 Cohesion Fund handouts to Hungary amounting to 495 million euros, if the country failed to present by 22.6.2012 convincing measures for the correction of its deficit. In the case of Spain, whose government deficit had reached 8.51% in 2011, the Council conceded that it would be impossible for Spain to fulfill the goal of 4.4% set in this country's stability plan; it set the target for 2012 at 5.3%, while insisting that Spain should reduce its deficit under the 3% threshold in 2013. The Council declined to give a retroactive effect to the recently revised EDP provisions applicable to Euro Area members, which require the imposition of a fine (see *infra*).

4.2 The "six-pack" legislation on European Economic Union

4.2.1 General outline

The two regulations implementing the Stability and Growth Pact (SGP) adopted in 1997 and substantially amended in 2005 came up for a further revision at the outset of the sovereign debt crisis. The so-called "six-pack" on the European Economic Union, also involved the adoption of three new regulations and a directive. All these legislative acts, which entered into force on 13 December 2011[56], entail a substantial strengthening of the instruments of economic governance of the EU and the Euro Area; three regulations and a directive aim at promoting fiscal discipline while two regulations aim at effectively

[56] They were published in the O.J. 2011 L 306.

preventing and correcting emerging macroeconomic imbalances within the EU and the Euro Area. The former introduce major improvements in the budgetary surveillance of Member States but the latter are the most innovative, in the sense that they impose for the first time on the Euro Area members binding commitments on non-fiscal aspects of their economic policy. In a common recital in the preamble of the five regulations, reflecting a holistic approach to economic and financial governance, it is stated:

> "The improved economic governance framework should rely on several interlinked and coherent policies for sustainable growth and jobs, in particular a Union strategy for growth and jobs, with particular focus on developing and strengthening the internal market, fostering international trade and competitiveness, a European Semester for strengthened coordination of economic and budgetary policies, an effective framework for preventing and correcting excessive government deficits, a robust framework for preventing and correcting macroeconomic imbalances, minimum requirements for national budgetary frameworks, and enhanced financial market regulation and supervision, including macroprudential supervision by the European Systemic Risk Board."

4.2.2 Fiscal discipline

(a) Regulation 1175/2011 "on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies" amends Regulation 1466/97 which constitutes the legislative underpinning of the preventive part of the SGP, based on Article 121 TFEU. It embodies the new rules on the so-called European Semester for Economic Policy Coordination which aim at aligning national budgetary frameworks with the objectives of multilateral surveillance in the Union. The amended regulation enables the Council to provide "timely and integrated policy advice on macrofiscal and macrostructural policy intentions"[57] to Euro Area members implementing stability programmes, as well as non-Euro Area members implementing convergence programmes. Member States have to adopt prudent fiscal policies in 'good times' (i.e., during economic growth) in order to build up the necessary buffer for 'bad times' (i.e., during a recession). Country specific 'medium-term objectives' have to be included in the national medium-term budgetary frameworks, in accordance with Directive 2011/85 (see *infra*). These objectives are implemented by means of "adjustment paths" monitored by the Commission. Faster adjustment paths are required for Member States faced with a debt level exceeding 60% of GDP or with pronounced

[57] The European Semester procedure is described in Section 1-A, article 2-a, inserted in Regulation 1466/97 by Regulation 1175/2011.

risks in terms of overall debt sustainability. Temporary departures from adjustment paths are allowed on very strict terms.

(b) Regulation 1177/2011 "on speeding up and clarifying the implementation of the excessive deficit procedure" amends Regulation 1467/97 which constitutes the legislative underpinning of the corrective part of the SGP, based on Article 126 TFEU. According to recital 4 of the preamble, the amendments build on "the experience gained and mistakes made during the first ten years of the economic and monetary union."

In accordance with the amended regulation, the evolution of government debt to GDP ratio should be followed more closely and put on an equal footing with deficit developments as regards decisions related to EDP. Henceforth, Member States will be benchmarked as to whether they can sufficiently reduce their debt. Those whose debt exceeds 60% of their GDP have to take steps to reduce it at a satisfactory pace, defined in the amended Article 1 of the Regulation as a reduction of 1/20th of the difference with the 60% threshold over the last three (3) years. Moreover, under amended Articles 3 and 5 of the Regulation, Council recommendations and decisions pursuant to Article 126 (7) and (9) TFEU respectively, shall provide for a minimum annual improvement of at least 0.5% of GDP as a benchmark in the cyclically adjusted balance, net of one-off and temporary measures. Finally, the amended Article 11 of the Regulation facilitates the application of Article 126 (11) TFEU regarding the imposition of sanctions to Euro Area members whose deficit exceeds the 3% threshold; in this case "a fine shall as a rule be required" comprising of a fixed component equal to 0.2% of the GDP and a variable component.

(c) The abovementioned amendments of the SGP are backed up, through the provisions of the Regulation 1173/2011 "on the effective enforcement of budgetary surveillance in the euro area" by a new set of financial sanctions and fines aimed at ensuring compliance with the recommendations and decisions addressed to Euro Area members, before resorting to Article 126 (11) described by Jean-Victor Louis as the "atomic bomb" of sanctions.[58] The gradual imposition of sanctions to ensure early compliance is envisaged in the context of both the preventive and the corrective parts of the SGP. In the case of the preventive part, they take the form of an interest-bearing deposit which is released once the Council has been satisfied that the sanction-related situation has come to an end; in the case of the corrective part, a non-interest bearing deposit, amounting to 0.2% of GDP would follow a decision to place a Member State in excessive deficit. This non-interest bearing deposit would be converted into a fine in the

[58] **Louis (2006)**, p.103.

event of non-compliance with the recommendation to correct the excessive deficit. Fines are finally envisaged for the punishment of the manipulation of statistics by Member States.

In substance, the revision of the EDP by the aforementioned regulations addresses to a considerable extent the weaknesses of the procedure. The EDP has become more rule-based and sanctions will be the normal consequence for the Euro Area members' failure to implement the measures decided by the Council.[59] Equally important, however, is the strengthening of the Commission's role in the implementation of EDP; thus, under the provisions of the so-called economic dialogue between the institutions "the Council is as a rule expected to follow the recommendations and proposals of the Commission or explain its position publicly;"[60] moreover, under the decision-making process of 'reversed qualified majority voting' the Commission's proposal for a sanction will be considered adopted, unless the Council overturns it by qualified majority.[61]

(d) Finally, in accordance with Directive 2011/85 "on requirements for the budgetary frameworks of the Member-States," each Member State shall by the end of the period of transposition of this directive (31.12.2013) have in place numerical fiscal rules which effectively promote compliance with its obligations deriving from the TFEU in the area of budgetary policy over a multi-annual horizon for the general government as a whole. Recital 18 of the preamble to the directive underlines that such rules will help avoid pro-cyclical fiscal policies and promote fiscal consolidation in good times. The aligning of national fiscal rules with the provisions of the TFEU reflects the idea that compliance can be promoted by the "national ownership" of the relevant rules.

4.2.3 Macroeconomic imbalances

The two innovative regulations on macroeconomic imbalances are based on the enabling clause of article 121 (4) TFEU added by the Lisbon Treaty which empowers the Commission and the Council to intervene when it is established that the economic policies of a Member-State are not consistent with the broad economic policy guidelines or that they risk jeopardising the proper functioning of the economic and monetary union.

[59] **Gortsos (2011d)**,and comment in *ECEFIL Reporter* 5/2011 (www.ecefil.eu).
[60] Article 2a inserted in Regulation 1467/97 by Regulation 1177/2011.
[61] Reversed QMV applies to sanctions in the preventive and corrective parts of the SGP (Articles 4, 5 & 6 of Regulation 1173/2011). The threshold of qualified majority is amended upon every accession to the EU. Nevertheless, as of 1.11.2014 the qualified majority will be 55% of Member States representing 65% of populations of the Euro Area members (Article 238 par. 3 indent a) TFEU).

(a) Regulation 1176/2011 "on the prevention and correction of macroeconomic imbalances" introduces a new element in the EU's 'economic surveillance framework': the 'excessive imbalance procedure' (EIP). This procedure comprises a regular assessment of the risks of imbalances in a Member State based on a 'scoreboard' composed of economic indicators. According to the provisions of this regulation:

- Once an alert has been triggered for a Member State, the Commission will launch a country-specific, in-depth review in order to identify the underlying problems and submit recommendations to the Council on how to deal with the imbalances;
- For Member States with severe imbalances or imbalances that put at risk the functioning of the EMU, the Council may open the EIP and place the Member State in an 'excessive imbalances position';
- A Member State under EIP would have to present a 'corrective action plan' to the Council, which will set deadlines for corrective action;
- Repeated failure to take corrective action will expose the Euro Area member concerned to sanctions.

(b) Under Regulation 1174/2011 "on enforcement measures to correct excessive macroeconomic imbalances in the Euro Area," if a Euro Area member repeatedly fails to act on Council EIP recommendations to address excessive imbalances, it will have to pay a yearly fine equal to 0.1% of its GDP. The fine can only be stopped by a reversed qualified majority vote.

4.3 Further reforms designed to apply to the Euro Area

On 23 November 2011, the day of publication of the aforementioned six-pack in the Official Journal, the Commission submitted two proposals for further reforms:

(a) A proposal for a regulation "on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficits of Member States in the euro area".[62] The provisions on the draft budgetary plans complement the European Semester provisions by requiring the submission of the medium term fiscal plans by Euro Area members, together with their stability programmes by 15 April and their budgetary plans and independent macroeconomic forecasts for the forthcoming year by 15 October, enabling the Commission to deliver its opinion by

[62] **European Commission (2011)**.

30 November. The draft regulation also provides for the submission of reports on in-year budgetary execution and related information on a six-month basis for Member States at the Article 126 (7) stage of EDP and on a quarterly basis for those at the Article 126 (9) stage of EDP.

(b) A proposal for a regulation "on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area."[63] In the preamble it is explicitly stated that "the economic and financial integration of the Member States whose currency is the euro calls for a reinforced surveillance to prevent contagion from a Member State experiencing difficulties with respect to its financial stability to the rest of the euro area." The proposed regulation provides for enhanced surveillance, commensurate to the severity of financial difficulties. Such surveillance will take due account of the nature of the financial assistance received which may range from a mere precautionary support to a full macroeconomic adjustment programme involving strict policy conditionality. In the former case, the proposed regulation provides for wider access to the information needed for a close monitoring of the economic, fiscal and financial situation whereas, in the latter case, the draft regulation provides for the suspension of other processes of economic and fiscal surveillance, including the submission of stability programmes and the monitoring and assessment provisions of the European Semester under amended Regulation 1466/97.

[63] **European Commission, (2011)**.

5. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

5.1 Treaty objective

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, hereafter referred to as the "Fiscal Compact Treaty,"[64] was signed on 2 March 2012 by the EU members except the UK, after difficult intergovernmental negotiations carried out under the chairmanship of the President of the European Council Herman van Rompuy. The Treaty is not part of EU law but accepts the primacy of the latter. It aims at further enhancing fiscal discipline and facilitating the governance of the Euro Area. As mentioned in the introductory remarks, in contrast to the bulk of EU law, in the case of economic policy, infringement proceedings cannot be brought against a non-abiding Member State. The compliance issue emerged as a central topic in the debate on economic governance following the suspension of the EDP procedure against France and Germany in 2004. The reform of the SGP in 2005 did not solve the compliance problem which ultimately required a redefinition of the fiscal autonomy of Member States in the context of a monetary union. The sovereign debt crisis presented a unique opportunity for such an exercise: the setting-up of the bailout mechanisms served as a token of solidarity that could be used as leverage by the main guarantors of these mechanisms, Germany and France, to push with the necessary reforms on economic governance and fiscal discipline. On the other hand the revision of the EDP in the context of the aforementioned six-pack and, more specifically, France's reluctant acceptance of decision-making by reversed qualified majority, had shown the limits of further transfers of powers to European institutions.

Enhancing fiscal discipline without further transfers of powers seemed totally unrealistic before Germany came out with the idea of embedding a fiscal break, also known as "balanced budget rule" and an automatic correction mechanism in the constitutions of Member States. The innovations amounted to an application of the "national ownership" principle, in the sense that the responsibility for the enforcement of the fiscal break would be entrusted to the political system of each Member State, without prejudice, however, to the implementation of the EDP by EU institutions.

The final wording of the undertakings by the Contracting Parties takes into consideration the particular situation of Member States which do not have written constitutions or whose constitutional revision procedures are time-consuming. Thus, the provisions on the fiscal break described in Article 3 of the Treaty under the heading fiscal

[64] Although the original title of the Treaty was "International agreement on reinforced economic union," the Euro summit of 8/9 December 2011 used the term "fiscal compact" to describe the focus of the new treaty.

compact "shall take effect in the national law of the Contracting Parties at the latest one year after the entry into force of this Treaty through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes."

Germany's insistence on the introduction of a fiscal break or "balanced budget rule" in the constitutions or equivalent legislation of Euro Area members could have been implemented by means of an EU directive addressed to these countries, in accordance with Article 136 TFEU. The idea, however, that a constitutional amendment may be sought by a directive, rather than an international treaty was bound to raise delicate legal and political issues in many, if not all, the Euro Area members. Alternatively, an amendment of the TFEU would have required unanimity; Britain would have availed itself of the opportunity to include in the package the repatriation of powers to national parliaments or the return to the unanimity rule in various areas where its interests were at bay. Thus, the idea of an intergovernmental agreement compatible with the EU Treaties and making use, as far as possible, of the Commission and the ECJ for its enforcement came to be seen as the only realistic alternative. To facilitate its entry into force the unanimity principle was put aside. After some hesitations it was decided that the Treaty would enter into force on 1.1.2013, provided that twelve Euro Area members have ratified it, or after twelve have ratified it, whichever is the earlier; moreover, to enhance participation, access to ESM funds was made dependent on the ratification of both the ESM and the Fiscal Compact Treaty.

5.2 Treaty implementation

Article 3 of the Treaty commits the Contracting Parties to put in place at national level the balanced budget rule and the automatic correction mechanism. The balanced budget "shall be deemed to be respected if the annual structural balance of the general government at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0.5% of the GDP at market prices." As regards the correction mechanism the Treaty provides that the Contracting Parties shall put it in place "on the basis of common principles to be proposed by the European Commission, concerning in particular the nature, size and time-frame of the corrective action to be undertaken, also in the case of exceptional circumstances, and the role and independence of the institutions responsible at national level for monitoring compliance…Such corrective mechanism shall fully respect the prerogatives of national Parliaments." The Commission is actually requested to draft a fiscal compact embodying the common principles to be inserted in the constitutions or equivalent legislation, prior to any action by the Contracting Parties.

Many treaty provisions correspond to the recently revised legislation on the Stability and Growth Pact. Thus, for example, the required speed for reducing government debt (by a twentieth a year of the portion of the debt exceeding 60% of GDP) is exactly the same as the speed required under the revised SGP. Worth mentioning, however, for their novel character are Articles 5, 6 and 11 of the Treaty which provide respectively for the adoption of budgetary and economic partnership programmes detailing structural reforms for Member States under an excessive deficit procedure, *ex-ante* reporting of public debt issuance programs and *ex-ante* discussion - and, where appropriate, coordination, of all major economic policy reforms planned by the Contracting Parties.

5.3 Treaty enforcement

The Treaty does not avoid transfers of sovereignty; it provides for the judicial review of its application by the European Court of Justice (ECJ), under a special arrangement in the framework of Article 273 TFEU. The Commission is assigned the task of monitoring compliance of the Contracting Parties with the provisions of Article 3 (2), but only the Contracting Parties will be able to institute infringement proceedings before the ECJ for failure to comply with the aforementioned provisions. Subsequently, upon a request of a Contracting Party the Court may impose on the Contracting Party in breach of its obligations, a lump-sum or penalty payment "that shall not exceed 0.1% of the GDP".

Concluding remarks

Solidarity

The containment of the sovereign debt crisis is a typical example of reactive policy-making in the EU context. Martin Wolf rightly pointed out that "the scale of the crisis has made it necessary to remedy what can be remedied, under huge pressure. At every stage, the eurozone has done more than one might have expected, yet it has not done enough."[65] The crisis has been contained by means of bailout mechanisms which reflect the Euro Area's acceptance of the solidarity principle. Nevertheless, solidarity was not open-ended: it was linked to fiscal discipline and structural reforms. Thus, at the time of writing, three economies of the European periphery (Greece, Ireland and Portugal) were implementing strict policy conditionalities, in exchange of financial support programmes; Spain and Italy were under enhanced budgetary surveillance. Arguably, however, self preservation and risks of contagion were the determining factors in the setting-up of the bailout mechanisms. Moreover, private sector involvement in debt restructuring, implemented in the second Greek bailout and embodied in the permanent stability mechanism, the ESM, reflected a new approach to state insolvency, involving a delicate balancing of moral hazard and risks of contagion.

The bailout programmes, as well as ECB's role as a "hidden" lender of last resort departed from the spirit but not from the letter of the Maastricht Treaty. The same cannot be said of various formulas and ideas that were recently submitted for the purpose of alleviating the sovereign debt problem, such as the gradual and/or partial "mutualisation" of the debt of Euro Area members and the issuance of European "stability bonds"[66] or Jacques Attali's proposal on the establishment of a European Debt Agency, able to access markets on behalf of Euro Area members. [67] Nevertheless, moving towards a debt union, prior to other policy adjustments, may be premature. More feasible, because it would not require a treaty amendment, would be the issuance of European "project bonds" - they are actually foreseen in Europe's 2020 Strategy for the purpose of complementing the funding of Trans European projects by the EU and member state budgets.

Sovereignty

Participation in the Euro Area is usually perceived as entailing the surrender of monetary sovereignty to the ECB and far-reaching restrictions in the exercise of fiscal sovereignty. From a formal / legal point of view, sovereignty is safeguarded, to the extent that Euro Area members may recall the transfers and constraints affecting their

[65] **Wolf (2012)**.
[66] **European Commission (2011).**
[67] *Agence européenne du Trésor* is the term used by **Attali (2010),** pp. 201-205.

sovereignty and may even exit the EU, in accordance with an explicit provision (Article 50 TEU) inserted by the Lisbon Treaty. Nevertheless, from a substantive / political point of view, fiscal sovereignty, in the sense of decision-making autonomy, has been curtailed to a point where national budgets now have to be approved by the Commission prior to being approved by national parliaments, putting thereby at risk the political consensus on participation in the Euro Area. Cynics would argue that the whole concept of fiscal sovereignty is irrelevant in the era of financial globalisation, to the extent that borrowing conditions are determined by rating agencies and speculators. It should rather be admitted that in our post-modern world the concept of sovereignty is changing and adapting to the current conditions of global interdependence, where state and non-state actors promote more or less successfully their goals and interests. State interests may be served by participation in international regimes, as well as by staying out of them. Weak economies benefit the most from international regimes, although strong economies may benefit too. In the European context, Germany chose to participate in the Euro Area, while Britain remained outside. George Magnus rightly observed, however, that "Germany has displayed a continuing ambivalence, torn between its own sovereign interests and its interests in preserving the integrity of the Euro Area, from which its export industries and people derive enormous benefits."[68]

Policy adjustment

As mentioned above, fiscal discipline came to be regarded as a precondition for fiscal solidarity. Under German guidance, fiscal discipline was drastically enhanced by means of the revised SGP and the Fiscal Compact Treaty. Distinguished economists have challenged this policy orientation by pointing out that debt sustainability, especially in the peripheral members of the Euro Area, very much depends on these countries' growth prospects. Paul Krugman recently argued that "because investors look at the state of a nation's economy when assessing its ability to repay debt, austerity programs haven't even worked as a way to reduce borrowing costs;" he then went on to criticize the European leaders who signed a fiscal treaty "that in effect locks in fiscal austerity as the response to any and all problems." [69] France and Italy are not in a hurry to ratify this treaty. Their leaders have underlined the need of adopting a clear commitment to growth. Such a commitment could take the form of a separate intergovernmental treaty, complementing the Fiscal Compact Treaty. To the extent, however, that intergovernmental treaty provisions cannot derogate from the EU treaties, it would be necessary to amend the latter and related protocols and regulations, allowing for example

[68] **Magnus (2012)**.
[69] **Krugman (2012)**.

public investment in excess of the fiscal break provisions and redefining the ECB's mandate to include growth, in addition to price stability, as a determinant of monetary policy. Growth could also benefit from a treaty amendment allowing the EU budget to be funded by Europe-wide taxes.[70]

In conclusion, the sovereign debt crisis provides clear evidence that in the era of financial globalisation, European integration is a market-driven and reactive, rather than proactive, process. On the other hand, the bailout and austerity programmes have raised sensitive redistribution issues which make a new "grand bargain" necessary for the survival of the Euro Area.

[70] A Europe-wide income tax has been proposed by Guy Verhofstadt, former Prime Minister of Belgium and co-chairman of the ALDE group at the European Parliament.

PART II

Greek Responses to the Sovereign Debt Crisis

Christos Vl. Gortsos

Introductory remarks*

The present study examines the impact of the current Eurozone fiscal crisis on the Greek banking sector and the measures adopted to preserve its stability. It is divided into 6 Sections:

(a) Section 1 deals with the causes of the current Eurozone fiscal crisis.

(b) Section 2 deals with the impact of the current crisis on the Greek banking sector.

(c) Finally, Sections 3-6 deal with the measures adopted to preserve the stability of the Greek banking sector in 2008 (amidst the recent international financial crisis), and the institutional measures, micro-prudential supervisory and regulatory measures, as well as the reorganisation measures and resolution tools adopted after the Eurozone fiscal crisis.

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1. The causes of the current Eurozone fiscal crisis

1.1 The recent (2007-2009) international financial crisis

Despite the existence of an extensive international regulatory financial framework, which was established gradually in the course of the last three decades,[71] a major international financial crisis erupted recently (2007-2009). This crisis:

- was triggered by events in the financial system of the United States,
- spilled over to the world economy seriously affecting the stability of the financial system in several other states around the globe, and
- had a serious negative impact on the real economy worldwide.[72]

The author uses the term 'recent' (and not 'current') to denote that this crisis lasted from 2007 to 2009 and came to an ending. This is without prejudice either to the fact that the financial systems of certain states remain vulnerable as a result of this crisis, or that in certain cases (especially in the Eurozone periphery) the current malfunctioning of the banking system is a corollary of the current 'Eurozone fiscal crisis' which occurred, at least to some extent, as a result of the recent international financial crisis.

The analysis of the causes of this crisis is beyond the scope of the present study. Very briefly, it can be pointed out that the crisis mainly relates to the following aspects:[73]

(a) The implementation of inadequate monetary and fiscal policies in several states.[74]

(b) Failures by financial services providers, in particular[75] with regard to:

[71] On this see, by means of indication, **Lastra (2006),** pp. 447-501, and **Giovanoli (2010),** pp. 3-39. On the evolution of the European financial law during that period see, *inter alia*, **Lastra (2006),** pp. 297-342, and **Gortsos (2011a)**.

[72] On this see various relevant reports of the International Monetary Fund, available at: http://www.imf.org.

[73] There is a vast existing bibliography on this issue. See, by means of indication, **Kiff and Mills (2007), Borio (2008)**, pp. 1-13, **Calomiris (2008), Eichengreen (2008), Goodhart (2009)**, pp. 2-29, **Norberg (2009), Rajan (2010), Posner (2010)**, pp. 13-245, **Lastra and Wood (2010)**, pp. 537-545, **Tirole (2010)**, pp. 11-47, the report of The Financial Crisis Inquiry Commission (2011): *The Financial Crisis Inquiry Report,* Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, U.S. Government Printing Office, Washington, D.C., January, as well as the reports of the Committee on the Global Financial System
For a comparison of the recent crisis with the international financial crisis of 1931 (both in terms of causes and in terms of regulatory reaction), see **Allen and Moessner (2010)**.

[74] The primacy of this aspect is illustrated in the just abovementioned studies of **Norberg (2009)** and **Rajan (2010).**

[75] **Lastra and Woods (2010),** *op.cit.*, correctly point out the 'usual suspects', i.e. greed and euphoria in periods of rapid growth and extensive credit provision.

- excesses in the asset securitisation processes according to the ‘generate and distribute’ banking model,[76] and excessive complexity of transactions,
- poor lending practices (especially in the United States with regard to the household sector),
- excessive leverage,
- inefficient management of liquidity risk by banks, and
- imprudent (*ex post* at least) remuneration policies adopted by several institutions.

(c) Inefficiencies and failures in the regulatory framework of the financial system, such as:

- lack of macro-prudential policies (both in terms of regulation and oversight),
- lack of a regulatory framework for the operation of the ‘shadow banking system’ (especially in the United States),[77] credit rating agencies and alternative investment vehicles (such as hedge funds),
- other failures in the micro-prudential regulation of financial firms,
- lack of transparency in trading of certain categories of financial instruments (namely bonds and financial derivatives),
- inadequacy of certain valuation methods for financial instruments in accordance with international accounting standards, and
- inadequacy of corporate governance rules for listed companies.

(d) The subsequent extensive scope for regulatory arbitrage among financial products, markets and states.

(e) Last but not least, major failures in the conduct of micro-prudential supervision of financial service providers in several states.

1.2 The impact

The consequence of this crisis was that several banks and other financial institutions around the world (small or big, even ‘systemically important’ institutions[78]) were not able to absorb the losses from their risk exposure. This resulted, *inter alia*, in negative effects on the real economy, obliging several governments (especially in the United

[76] On this model, see analytically **European Central Bank (2008)**.
[77] According to the **Financial Stability Board**’s report (**2011**): “*The ‘shadow banking system’ can broadly be described as credit intermediation involving entities and activities outside the regular banking system*”.
[78] There is an extensive literature on systemically important financial institutions. For more details see, by means of indication, **Claessens, Herring and Schoenmaker (2010)**, and the various contributions to **Lastra (ed.) (2011)**.

States and the European Union) to adopt rescue packages and recovery plans[79] in order to support or even bail out individual banks (and, in some cases, the entire banking system[80]). Such government interventions weighed on state budgets and, in some cases, created serious fiscal imbalances, some of which evolved to fiscal crises,[81] which, in turn, spread to become financial crises.[82]

The study of the CGFS identifies four (4) main channels of transmission:

- ***(i)*** *the impact of negative sovereign ratings on (individual) bank ratings,*
- ***(ii)*** *losses incurred by banks from their sovereign debt holdings,*
- ***(iii)*** *the 'collateral/liquidity channel', and*
- ***(iv)*** *losses from state guarantees granted to banks (explicit and implicit).*

Adding to these channels is the negative impact on the performance of bank loans (in the event of recession).

The Eurozone fiscal crisis was triggered by the exceptionally severe fiscal imbalances in Greece,[83] which were then transmitted to other EU Member States of the 'Eurozone periphery'.[84] This crisis is the main cause of the current severe instability in the European banking sector, which cannot be fully assessed yet, neither as to the severity of its implications nor as to its potential spillover effects on a global scale.[85]

Amidst this crisis, apart from the initiatives undertaken at the European level in order to enhance the existing institutional and regulatory framework governing the operation of the 'economic pillar' of the European Economic and Monetary Union (the 'EMU'),[86] governments and central banks in several Eurozone Member States resorted to institutional, supervisory and regulatory measures in order to preserve the stability of their domestic banking sectors (and, more generally, financial systems). The case of Greece will be discussed in more detail in Sections 3-6 of the present part of this study.

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[79] For an assessment of these measures, see **Panetta et. al. (2009)**, **Gortsos (2009)**, pp. 9-46, **Petrovic and Tutsh (2009)**, and **De Meester (2010)** (as to their compatibility with the provisions of the General Agreement on Trade in Services, known as 'GATS').

[80] The most striking example in this case is Iceland (see **Claessens, Herring and Schoenmaker (2010),** pp. 51-53).

[81] The most striking example is that of Ireland. With a sole exception, all Irish credit institutions were technically bankrupt after the financial crisis and needed to be recapitalised. For a more detailed discussion, see the references under footnote 79.

[82] For more details see **Committee on the Global Financial System (2011)**.

[83] On the causes of the Greek 'fiscal indiscipline', see, by means of indication, **Alogoskoufis (2012)**. See also the contribution of **Haritakis (2012)**.

[84] See, *inter alia*, **Eichengreen, Feldmann, Liebman, Hagen and Wyplosz (2011)**, pp. 47-64.

[85] The only conclusion drawn at present is that the gravest impact was suffered by banks with sovereign debt holdings from countries severely affected by this crisis (namely Greece, Ireland and Portugal, and also – to a lesser extent – Italy and Spain).

[86] For a thorough discussion of this aspect, see the contribution of Stephanou in part I.

2 The impact of the current crisis on the Greek banking sector

2.1 The Greek banking sector

In April 2012, the Greek banking sector consisted of 53 credit institutions[87] with 4,005 branches and 63,400 employees.[88] There are four main categories of credit institutions operating in Greece:

- seventeen (17) commercial banks incorporated in Greece and operating under a license by the Bank of Greece, and thirteen (13) cooperative banks incorporated in Greece and operating under a license by the Bank of Greece (both of which are hereinafter referred to as 'Greek credit institutions'), as well as
- branches of nineteen (19) credit institutions incorporated in other EU Member States, and branches of four (4) credit institutions incorporated in third countries (outside the EU).

Credit institutions in Greece:

- manage an equivalent of 128% of the Greek GDP (loans to households and enterprises),[89]
- hold an equivalent of 96% of the Greek GDP in deposits and repos,[90] and
- lend €113.4 billion for mortgage and consumer credit, an equivalent of €10,200 per inhabitant.[91]

With aggregate on-balance sheet assets at 217% of GDP, the Greek banking sector is not oversized compared to other economically developed countries.[92] In January 2012, the average loan-to-deposit and repos ratio was 146.5% (January 2011: 132.3%, January 2010: 119.9%), a development which is mainly due to the shrinking deposit base.[93]

[87] **Bank of Greece (2012d)**. The term 'credit institution', rather than 'bank', is used hereinafter given its use in Greek (and European) banking law (unlike US law, which uses the equivalent term 'depository institution'). According to the provisions of Article 2(1), of the principal Greek banking Law (3601/2007, Government Gazette A 178, 1.8.2007), a credit institution is defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant loans or other credits for its own account.
[88] **European Central Bank (2001)**.
[89] **Bank of Greece (2012c),** p. 157. Credit institutions in the Eurozone manage an equivalent of 170% of its GDP (loans to households and enterprises).
[90] *Ibid.*
[91] **Bank of Greece (2012b)**.
[92] **Bank of Greece (2012a)**, and **Hellenic Statistical Authority (2012)**.
[93] **Bank of Greece (2012a)**. For the average ratio, total loans, as well as total deposits and repos to (domestic) residents and non-residents are taken into account.

2.2 The impact of the crisis

Greek credit institutions were not exposed to the risks that triggered the recent (2007-2009) international financial crisis. As a result, the spillover effects on the Greek banking sector were limited. Accordingly, there was no need for a bank rescue package. However, liquidity conditions were strained during this crisis, since Greek credit institutions had restricted access to wholesale market liquidity for their lending operations, while maturing interbank liabilities put additional pressure on their liquidity position, thus rendering necessary the adoption of a recovery program.[94]

Despite these problems, Greek credit institutions have shown remarkable resilience and were able to overcome adversities thanks to a number of factors, such as, *inter alia*,:

- a strong capital base and steadily increased provisions (more than 40% on a year-to-year basis),
- liquidity-support measures by the European Central Bank and the Greek government, and
- effective micro-prudential supervision by the Bank of Greece, which ensured the stability of the Greek banking sector.

As a result, the Greek banking sector remained healthy, adequately capitalised, and highly profitable amidst the international financial crisis.

On the other hand, the Greek banking sector was negatively affected by the current Eurozone fiscal crisis. All the abovementioned channels[95] for the transmission of problems from the government to the banking sector were set in motion. In particular:

(a) The successive downgrades of Greece's sovereign debt since late-2009 resulted in cuts also in the ratings of Greek credit institutions and severely tightened their liquidity position:

(aa) Bank deposits and repos have declined by 19% since the end of 2010 (29% since the end of 2009).[96]

(ab) Greek credit institutions' ability to raise liquidity on the international interbank market, as well as international bond markets has been almost totally constrained.

(ac) Accordingly, there is a need to rely heavily on the Eurosystem credit facilities (see Table 1 below). ECB financing represents 18% of credit institutions' total

[94] On this see below under 3.
[95] On this see above under 1.2.
[96] **Bank of Greece (2012b),** Table IV.9, p. 96.

liabilities.[97] Currently, Greek banks are also heavily reliant on the 'Emergency Liquidity Assistance' (ELA) mechanism of the Bank of Greece, which acts as a lender of last resort to Greek credit institutions.[98]

TABLE 1

Financing of Eurozone credit institutions related to monetary policy operations denominated in euro

(Source: Bank of Greece, Financial Statements)

	December 2008	**December 2009**	**December 2010**	**June 2011**	**December 2011**
Main refinancing operations	22.765.300.000	2.355.000.000	18.023.000.000	28.439.000.000	15.177.500.000
Longer-term refinancing operations	15.584.000.000	47.300.100.000	78.382.800.000	74.600.600.000	60.942.000.000
Fine-tuning reverse operations	5.600.000	0	1.263.000.000	0	0
Total	**38.354.900.000**	**49.655.100.000**	**97.668.800.000**	**103.039.600.000**	**76.119.500.000**

It is also worth noting that, as of February 2012, interest rates on household deposits with an agreed maturity of up to 1 year were the highest (4,86%) in the Eurozone (2.90%).[99] Interest rates on new deposits of non-financial corporations with an agreed maturity of up to 1 year were also the highest (4,08%) in the Eurozone (1.22%).[100]

(b) Greek credit institutions suffered extremely severe losses from their participation in the Private Sector Involvement ('PSI') as far as their holdings of Greek government bonds are concerned. In this context, the following should be pointed out:

(ba) The July 2011 support programme for Greece, aimed at strengthening economic policy coordination for competitiveness and convergence on condition of

[97] **Bank of Greece (2012a)**, as well as the Bank of Greece's monthly balance sheet. On the role of the ECB as a 'hidden lender of last resort' to credit institutions, see the contribution of Constantine Stephanou in part I.

[98] In principle, there is no legislation on this issue area (according to the long-established principle of 'constructive ambiguity'). The national central banks – as members of the Eurosystem – act as lenders of last resort at their discretion and in close cooperation with the European Central Bank, with adequate collateral. This should be distinguished from 'unconventional monetary operations' conducted by the ECB. On this see **European Central Bank (2007)**, pp. 80-81.

[99] **European Central Bank (2012)**.

[100] *Ibid.*

commitments by Greece, provided for total official financing of an estimated €109 billion.[101]

(bb) On 14 March 2012, Eurozone Finance Ministers approved additional financing under the second economic adjustment programme amounting to €130 billion until 2014, including an IMF contribution of €28 billion. They also authorised the EFSF to release the first installment of a total amount of €39.4 billion, to be disbursed in several tranches. The release of the tranches will be based on observance of quantitative performance criteria and a positive evaluation of progress made with respect to the policy criteria contained in Council Decision 2011/734/EU of 12 July 2011 (as amended in November 2011 and March 2012) and the Memorandum of Understanding on economic policy conditionality, which was signed on 14 March 2012.[102]

(bc) The private sector involvement (PSI) in Greece's debt exchange offer was high. Out of a total of €205.5 billion in bonds eligible for the exchange offer, approximately €199 billion (96.9%) have been exchanged with a nominal discount of 53.5%. On 20 April 2012, the four (4) largest Greek credit institutions (representing more than 60% of the Greek banking sector's assets) announced losses of €27.9 billion.[103]

(c) The 'collateral/liquidity' channel has also been activated, since the European Central Bank has gradually been cutting the market value of Greek government bonds and the other assets provided as collateral by Greek credit institutions and currently referring them mainly to the ELA mechanism of the Bank of Greece.

(d) Greek credit institutions also suffer losses on account of (explicit or implicit) Greek government guarantees granted to them, which cannot be honoured in full given the current fiscal strains.

(e) Finally, from the point of view of non-performing loans, the situation seems to deteriorate consistently: they increased to 14.7 % in September 2011 (from 10.5% at end-2010 and 7.7% at end-2009),[104] and the trend seems to worsen due to the ongoing

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[101] **Council of the European Union (2011)**.

[102] Council Decision 2011/734/EU of 12 July 2011 addressed to Greece with a view to reinforcing and deepening fiscal surveillance and giving notice to Greece to take measures for the deficit reduction judged necessary to remedy the situation of excessive deficit, OJ L 296, 15.11.2011, pp. 38-52 (recast), Council Decision 2011/791/EU of 8 November 2011 amending Decision 2011/734/EU (…), OJ L 320, 3.12.2011, pp. 28-31 and Council Decision of 13 March 2012 amending Decision 2011/734/EU (…), OJ L 113, 25.4.2012, pp. 8-10.
See also **European Commission (2012)**.

[103] *Ibid*. On the key terms of the PSI following the 26 October 2011 Euro Summit, see **Hellenic Republic, Ministry of Finance (2012):** *PSI Launch*, Press Release, February, available at: http://www.minfin.gr/portal/en/resource/contentObject/id/7ad6442f-1777-4d02-80fb-91191c606664. For the final settlement of the PSI, see **Hellenic Republic, Ministry of Finance (2012),** *Press Release*, 25 April. See also the contribution of Constantine Stephanou in part I.

[104] **Bank of Greece (2011)**.

economic recession in Greece, as 76% or €24.9 billion this year, (December 2010: 74% or €18.7 billion) of non performing loans are secured loans – mainly loans to non-financial corporations and mortgage loans).[105]

It is also worth mentioning that there is minimal demand for new loans (with the exception of business loans for working capital).

[105] In the second half of 2012 the relevant regulatory framework is expected to be amended in view of the restructuring of credit institutions' non-performing loans. The main principles governing this new regulatory framework will be to conduct targeted interventions (in line with fiscal and financial sector capacity), preserve the payment culture, avoid strategic loan defaults, maximise asset recovery, and facilitate the distinction between rehabilitation of viable borrowers and the efficient exit from the economy of non-viable borrowers. On this **see IMF Country Report No. 12/57 (2012)**, p. 27.

3. Measures adopted to preserve the stability of the Greek banking sector in 2008 (in the middle of the recent international financial crisis)

As already mentioned,[106] the recent (2007-2009) international financial crisis did not have a severe impact on the Greek banking sector, since Greek credit institutions were not exposed to the risk of holding 'toxic assets' or other crisis-related risks.[107] Thus, the negative effects of the international crisis on the Greek banking sector were limited and, accordingly, there was no need for a bank rescue package, in contrast to several other countries, including EU Member States.

Nevertheless, in late 2008, in order to enhance the solvency and especially the liquidity of the Greek banking sector amidst the crisis,[108] following the bankruptcy of the investment bank *Lehman Brothers Holdings Inc.* (the 'LBHI') on 15 September 2008,[109] the Greek government was urged to take initiatives, which led to the adoption of two legal acts by the Hellenic Parliament:

(a) By virtue of Law 3714/2008, adopted immediately after LBHI's bankruptcy, the level of deposit guarantees provided by the then existing Hellenic Deposit Guarantee Fund[110] was raised to €100,000 (from €20,000 previously) per depositor (for each credit institution), in order to enhance depositors' confidence in the banking sector (successfully averting a potential bank run).[111]

(b) In addition, in December 2008 the Greek government adopted a 'recovery program' (widely known as 'the 28bn euro package') under Law 3723/2008 *"For the enhancement of liquidity of the economy in response to the impact of the international financial crisis"*.[112]

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[106] See above under 2.2.

[107] As a matter of fact, 2008 was the year in which most Greek credit institutions (including major ones) managed to achieve a historically high level of profitability. See the published annual reports of these credit institutions for the period 2000-2010 (available on their internet addresses).

[108] At that time, the main problem was that the international interbank market remained "closed" for several months (since there was no trust among banks as to their crisis-related risk exposures), a condition which impacted negatively on liquidity conditions for Greek credit institutions as well. The situation was gradually normalised at the beginning of 2009.

[109] On this see, by means of indication, **Claessens, Herring and Schoenmaker (2010)**, pp. 42-45.

[110] The Hellenic Deposit Guarantee Fund was established in 1995 pursuant to Law 2324/1995 (Government Gazette A 146, 17.7.1995) which incorporated into Greek law the provisions of Directive 94/19/EC of the European Parliament and of the Council *"on deposit guarantee schemes"* (OJ L 135, 31.5.94, pp. 5 -14). Law 2324/1995 was repealed in 2000 by Law 2832/2000 (Government Gazette A 141, 13.6.2000) and then amended in 2009 with the currently applicable Law 3746/2009 (see just below).

[111] Law 3714/2008 (Government Gazette A 231, 7.11.2008), Article 6, amending Article 5, para. 2, of Law 2832/2000.

[112] Law 3723/2008, Government Gazette A 250, 9.12.2008.

This program was mainly aimed at the enhancement of liquidity conditions in the banking system.

According to this Law's provisions, the government took the following liquidity-support measures in aid of Greek credit institutions:

- **(i)** A capital support of €5 billion, through capital increases with the issue of preference shares rendering a fixed annual return of 10% (the 'first pillar').[113]
- **(ii)** Issuance of bank bond guarantees (with commission[114]) worth €15 billion in order to facilitate fund-raising on international markets and bolster their liquidity (the 'second pillar').
- **(iii)** Issuance of 'special' Greek government bonds (also with commission[115]) worth €8 billion, in order to further bolster their liquidity and to ensure competitive terms for the financing of small and medium enterprises, and also housing loans for households (the 'third pillar').[116]

All these support measures fall into the category of state subsidies under European competition law and were authorised without objections by the Commission as compatible aid under Article 107, paragraph 3(b) of the Treaty on the Functioning of the European Union.[117]

It is also worth mentioning that in February 2009 the Hellenic Deposit Guarantee Fund was transformed into the Hellenic Deposit and Investment Guarantee Fund (hereinafter the 'HDIGF') pursuant to Law 3746/2009.[118] The major development was the establishment of an 'investor compensation scheme', alongside the 'deposit guarantee scheme', in order to ensure that the customers of Greek credit institutions providing investment services would be adequately covered in accordance with the provisions of Directive 97/9/EC of the European Parliament and of the Council "on investor compensation schemes".[119] The HDIGF contains currently (i.e. in April 2012)

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[113] *Ibid.*, article 1. This support was deemed necessary on the ground of micro-prudential considerations, since no Greek credit institution was exposed (or was threatened to be exposed) at the time to insolvency.
[114] The commission was set up, depending on the rating of each credit institution that made use of this pillar, by Decision of the Minister of Finance.
[115] This commission was set up by Decision of the Minister of Finance.
[116] Law 3723/2008, Articles 3 and 5. Beneficiaries of the measures provided for under (ii) and (iii) above could be only credit institutions fulfilling the minimum capital adequacy requirements as determined by the Bank of Greece (see also Article 1, para. 1, with regard to measures under (i)).
[117] Decision of the European Commission N 560/08, OJ C/125/6/5.6.2009, as continuously prolonged, available at: http://ec.europa.eu/competition/state_aid/register/ii/doc/N-560-2008-WLWL-en-19.11.2008.pdf. For references, see **Boudghene, Buder, Dellidou, Galand, Iftinchi, Lienemeyer, Malamataris and Malvolti (2011)**, pp. 45-49.
[118] Law 3746/2009, Government Gazette A 27, 16.2.2009.
[119] Directive 97/9/EC of the European Parliament and of the Council, OJ L 84, 26.3.1997, pp. 22-31. On the contrary, the clients of Greek investment firms and Greek credit institutions which are members of the Athens Stock Exchange are covered by a separate investor

three pillars (or 'schemes'). For more details on the third pillar or 'resolution scheme', see below under 6.4.[120]

After the onset of the Eurozone fiscal crisis in 2010, however, the need to reinforce the stability of the Greek banking sector became imperative. This triggered important initiatives, which made use of:

- ear-marked institutional measures (see below, under 6.4),
- micro-prudential supervisory and regulatory measures (under 6.5),
- reorganisation measures and resolution tools (under 6.6).[121]

In addition, the 'second pillar' of Law 3723/2008 (mentioned above under 6.3) has been further reinforced on three (3) occasions, in 2010 with €15 billion[122] and in 2011 with an additional €25 billion,[123] and another €30 billion.[124]

compensation scheme (the "Athens Stock Exchange Members' Guarantee Fund", according to the provisions of Law 2533/1977, Government Gazette A 228, 11.11.1997).

[120] On the functioning of the HDIGF, see at: http://www.hdigf.gr.

[121] For a detailed analysis of the provisions of Greek administrative banking law (as of February 2012), see **Rokas and Gortsos (2012),** pp. 11-177.

[122] Law 3845/2010, Government Gazette A 65, 06.05.2010, Article 4, para. 8.

[123] Law 3872/2010, Government Gazette A 148, 03.09.2010, Article 7.

[124] Law 3965/2011, Government Gazette A 113, 18.05.2011, Article 19, para. 1.

4. Institutional measures adopted after the Eurozone fiscal crisis

4.1 The Hellenic Financial Stability Fund

The Hellenic Financial Stability Fund (hereinafter the 'HFSF') was established in 2010 by Law 3864/2010 as a legal person of private law.[125] This Law has repeatedly been amended by Laws 4021/2011,[126] 4051/2012[127] and 4056/2012, [128] as well as the Act of Legislative Content of 19.4.2012.[129]

The HFSF has full legal capacity and the right to bring an action in court (*locus standi*) and it does not come under the public sector. It enjoys administrative and financial independence, and operates exclusively in accordance with the rules of private economy.[130]

Its capital has been set at €50 billion from the financial support mechanism for the Greek economy by euro area Member States, the European Central Bank and the International Monetary Fund.[131] An amount of €25 billion has already been disbursed in April 2012.[132]

The objective of the HFSF is to maintain the stability of the Greek banking sector by strengthening the capital adequacy of Greek credit institutions (including the subsidiaries of Greek credit institutions whose parent company is established abroad), in case such a credit institution faces capital adequacy problems as laid down in Law 3864/2010.[133] In pursuing this objective, the HFSF has to manage its capital and assets

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[125] Law 3864/2010 "*Establishment of a Hellenic Financial Stability Fund*", Government Gazette A 119, 21.7.2010.
[126] Law 4021/2011 "*Enhanced measures of supervision and resolution of credit institutions – Regulation of financial issues – Ratification of the Framework Convention of the European Financial Stability Fund and its amendments and other provisions*", Government Gazette A 218, 03.10.2011.
[127] Law 4051/2012 "*Regulation of pensions and other urgent implementing measures of the Memorandum of Agreement of Law 4046/2012*", Government Gazette A 40, 29.2.2012.
[128] Law 4056/2012, Government Gazette A 52, 12.3.2012.
[129] Government Gazette A 94, 19.4.2012.
[130] Law 3864/2010, Article 1. According to the same provision it is expressly stated that the purely private-law nature of the HFSF is not prejudiced by the fact that its capital shall be paid up in full by the Greek State or by the issuance of the decisions of the Minister of Finance contemplated in Law 3864/2010. See also Commission Decision of 3 September 2010 on State Aid Case No 328/2010 *"Recapitalisation of Credit Institutions in Greece under the Financial Stability Fund (FSF)"* (OJ C 316, 20.11.2010, p. 7) (as prolonged).
[131] Act of Legislative Content, 19.4.2012, Article 1, para. 1(a).
[132] For the requests, conditions to disbursements, financing and any other detail see the Annex to the Act of Legislative Content, Government Gazette A 55, 14.3.2012 (*"Master Financial Assistance Facility Agreement between the European Financial Stability Facility, the Hellenic Republic as Beneficiary Member State, the Hellenic Financial Stability Fund as Guarantor and the Bank of Greece"*).
[133] Law 3864/2010, Article 2, para. 1. See also article 6 of this law with regard to the procedures for the activation of the HFSF.

and exercise the rights ensuing from its capacity as shareholder of credit institutions in a way that:

- preserves the value of its assets,
- minimises risks for Greek taxpayers, and
- does not hamper or distort competition in the banking sector.[134]

On the other hand, it is not up to the HFSF to provide liquidity to Greek credit institutions, which is exclusively granted by the European Central Bank and the Bank of Greece (through the 'Emergency Liquidity Assistance') in their capacity as lenders of last resort.[135]

Despite the fact that five (5) Ministerial Decisions determining the exact role of the HFSF in the recapitalisation of Greek credit institutions underway (especially after the PSI exercise) were still pending issuance on 22 April 2012, the Fund is already fully operative,[136] since the seven (7) members of its initial Board of Directors were elected in September 2010.

According to the amendments introduced by Law 4051/2012, the governance of the HFSF has been delegated to two bodies: the General Board and the Executive Committee. The General Board consists of five (5) members and the Executive Committee of three (3) members (including its General Manager).[137]

4.2 The Hellenic Council of Systemic Stability

The Hellenic Council of Systemic Stability was established by virtue of Article 20 of Law 3867/2010.[138] Its objective is to analyse the dynamics between the various sectors of the financial system and continuously monitor them in order to proactively address stress situations and crises.

The Council consists of seven (7) members, including the Minister of Finance, the Deputy Minister of Finance, the Bank of Greece's Governor and Vice-Governor responsible for financial stability issues, the President of the Hellenic Capital Markets

[134] *Ibid.*, Article 2, para. 1.
[135] On this, see above under 2.2 (a-c).
[136] As a matter of fact, the HFSF has already been set in motion through the necessary funding for the operation of the bridge bank 'New Proton Bank'. See below, under 6.3(c).
[137] Law 3864/2010, Article 4, as amended by Article 9, para. 3, of Law 4051/2012. According to para. 10 of Article 9 of this Law, the HFSF is governed by its existing Board of Directors until a General Board and Executive Committee are designated.
[138] Law 3867/2010 "*Supervision of private insurance, establishment of a guarantee fund for private life insurance, Credit Rating Agencies and other provisions of the competence of the Ministry of Finance*", Government Gazette A 128, 3.8.2010.

Commission, and two (2) persons with specific knowledge of the financial sector designated by the Minister of Finance.[139]

The Council has already convened on several occasions that were deemed necessary over the last three years in order to take decisions on the stability of the currently fragile Greek financial system.

The Hellenic Council of Systemic Stability is definitely distinct, with regard to its scope, from the Bank of Greece as a macro-prudential oversight body in Greece, according to the provisions of the European Systemic Risk Board's Recommendation of 22 December 2011 "on the macro-prudential mandate of national authorities".[140] The European Systemic Risk Board (the 'ESRB'), which was established by virtue of Regulation (EC) 1092/2010 of the European Parliament and of the Council,[141] and is part of the European System of Financial Supervision (the 'ESFS'),[142] has been entrusted with the macro-prudential oversight of the European financial system. The Governor of the Bank of Greece is a member of the General Council of the ESRB.[143]

[139] Currently these members are the Presidents of the HFSF and the Hellenic Bank Association.
[140] OJ L 41, 14.2.2012, pp. 1-4.
[141] OJ L 131, 15.12.2010, pp. 1-11.
[142] See on this **Gortsos (2011b**), Section A (under 1 and 2).
[143] Regulation (EC) 1092/2010 of the European Parliament and of the Council, OJ L 331, 15.12.2010, pp. 1-11, Article 6.

5. Micro-prudential supervisory and regulatory measures adopted after the Eurozone fiscal crisis

5.1 Micro-prudential supervisory measures

5.1.1 Stress tests

(a) According to the results of the EU-wide stress-testing exercise – which was conducted in 2010 by the Committee of European Banking Supervisors (hereinafter the 'CEBS')[144] and national supervisory authorities in close cooperation with the European Central Bank in order to assess the overall resilience of the EU's banking sector to major economic and financial shocks – the results for the six (6) largest Greek banking groups which participated in the exercise (representing more than 90% of the Greek banking sector's assets as a whole) indicated a net surplus of Tier 1 capital of €3.3 billion above the 6% ratio of Tier 1 capital that was agreed as a benchmark solely for the purpose of the stress test (the 'baseline scenario'). Under the adverse scenario, including sovereign shock, five of the six credit institutions passed the test. Four out of six credit institutions was above the benchmark, one achieved the benchmark of 6%, while the Tier 1 capital ratio of the remaining one was 4.4% at the end of 2011, indicating a shortfall of €242 million.[145]

(b) The 2011 EU-wide stress-testing exercise[146] conducted under the coordination of the European Banking Authority (hereinafter the 'EBA') which succeeded the CEBS in January 2011,[147] in cooperation with the national banking supervisory authorities of the EU Member States, the European Central Bank, the European Commission and the European Systemic Risk Board, concluded that the above six (6) largest Greek banking groups had a capital surplus of €2.44 billion above the amount that corresponds to the Core Tier 1 capital ratio threshold of 5%. Under the adverse scenario, before taking into consideration additional mitigating measures, four out of six Greek banking groups were above the 5% threshold, one was marginally below the 5% threshold and one was significantly below the 5% threshold.[148]

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[144] See CEBS's press release on the results of the 2010 EU-wide stress testing exercise, 23 July 2010, available at: http://stress-test.c-ebs.org/documents/CEBSPressReleasev2.pdf.

[145] See *"EU-wide Stress Testing 2010, Results for Greece"*, available at: http://www.bankofgreece.gr/Pages/en/Supervision/stresstest.aspx.

[146] See EBA's Press Release on the results of the 2011 EU-wide stress test, 15 July 2011, available at: http://stress-test.eba.europa.eu/pdf/2011+EU-wide+stress+test+results+-+press+release++FINAL.pdf.

[147] On the work of the EBA see, by means of indication, **Gortsos (2011b)**, section A (under 1 and 2), pp. 24-44.

[148] See *"EU-wide Stress Testing Exercise 2011, Results for Greece"*, available at: http://www.bankofgreece.gr/Pages/en/Bank/News/PressReleases/DispItem.aspx?Item_ID=3682&List_ID=1af869f3-57fb-4de6-b9ae-bdfd83c66c95&Filter_by=DT.

Two (2) key features distinguished the 2011 exercise from the stress tests performed in 2010:

- *firstly, the threshold was set at 5% in 2011, compared to 6% in 2010, and*
- *secondly, the definition of capital used for the 2011 exercise was a Core Tier 1 capital ratio, compared to a broader Tier 1 capital ratio used in 2010.*

However, following the completion of BlackRock's audit of Greek banks (see just below under 5.1.2) and the PSI exercise (see above under 2.2(b)), these conditions have been totally reversed and the majority of Greek credit institutions need to resort to capital increases (and, as a last resort, to the HFSF for recapitalisation) in the course of 2012.

5.1.2 Other supervisory measures

(a) In 2011 the Bank of Greece resorted to BlackRock, a specialised external expert company, for a diagnostic study on the loan portfolios of Greek credit institutions in order to identify their exposure to credit risk from non-performing business, mortgage and consumer loans.[149] The study was completed at the end of 2011.

(b) In addition, the principal banking Law (3601/2007), as amended by the abovementioned Laws 4021/2011 and 4051/2012, contains, *inter alia*, provisions on strengthening the Bank of Greece's micro-prudential supervisory powers and measures taken by the Bank of Greece. More specifically, if a Greek credit institution does not meet, according to the Bank of Greece, or if there are strong indications that it will not meet the requirements of the principal banking Law (3601/2007) and the relevant Bank of Greece Governor's Acts, it may be required to:

(i) hold own funds in excess of the minimum level laid down in its generally applicable decisions on capital adequacy,

(ii) seek prior approval by the Bank of Greece of transactions which may be detrimental to its solvency,

(iii) perform a recovery plan, and

(iv) increase its capital according to the provisions of Article 62A of that Law.[150]

[149] Bank of Greece Governor's Bank of Greece Governor's Act2643/6.9.2011. Bank of Greece Governor's Acts are available at: http://www.bankofgreece.gr/Pages/el/Bank/legal/Acts.sspx.

[150] Law 3601/2007, Article 62, paras. 1 and 2.

5.2 Micro-prudential regulatory measures

(a) The framework on the micro-prudential regulation of Greek credit institutions has been shaped in accordance with the provisions of European banking law and is included in the principal banking Law (3601/2007) and in the relevant Bank of Greece Governor's Acts. In 2011, this framework was amended when two Directives of the European Parliament and of the Council (2009/111/EC[151] and 2010/76/EU[152]), amending Directives 2006/48/EC and 2006/49/EC, were transposed into Greek law, respectively, by Law 4002/2011[153] and the abovementioned Law 4021/2011, as well by several Bank of Greece Governor's Acts.

(b) In addition, based on the timetable for the implementation of the *"Memorandum of Economic and Financial Policy"*,[154] the Bank of Greece is currently requiring Greek credit institutions to:

- develop and implement medium-term funding plans, and
- maintain a minimum Core Tier 1 capital ratio of 9% (as of 1 October 2012) and 10% (as of 1 July 2013).[155]

[151] Directive 2009/111/EC of the European Parliament and of the Council, OJ L 302, 17.11.2009, pp. 97-119.
[152] Directive 2010/76/EU of the European Parliament and of the Council, OJ L 329, 14.12.2010, pp. 3-35.
[153] Government Gazette A 180, 22.8.2011.
[154] Greece – Memorandum of Economic and Financial Policies, May 3, 2010, p. 66.
[155] Bank of Greece Governor's Act 2654/29.2.2012.

6. Reorganisation measures and resolution tools adopted following the Eurozone fiscal crisis

6.1 Introductory remarks

The abovementioned Law 4021/2011 also reinforced the provisions of the principal banking Law (3601/2007) on the reorganisation of Greek credit institutions, while it also introduced for the first time legal provisions on resolution tools for credit institutions in Greece.

The provisions of this law on bank resolution (Articles 1-4) were adopted on the basis of the "Fourth Review Under the Stand-By Arrangement and Request for Modification and Waiver of Applicability of Performance Criteria" of IMF Country Report No. 11/175 (July 2011). In page 18 of this report the following is stated: "However, the Greek legal framework lacks specific bank resolution tools – used in other countries with more comprehensive frameworks – which can provide a more orderly framework for dealing with bank problems, towards lowering the cost of resolving banks. In particular, there are no techniques to allow the continuity of banking operations, including sustained depositor access (e.g. the ability to undertake a purchase and assumption and to conduct resolution through a bridge bank). Reforms are also needed to ensure that the deposit insurance fund can be used to fund such techniques, and to establish depositor preference over unsecured creditors to better ensure recovery of guarantee funds".

In particular, Law 4021/2011 (as further amended by Law 4051/2012) introduced provisions with regard to:

- the conditions under which a Commissioner to a distressed credit institution (as the main reorganisation measure under Greek administrative banking law) has to or may be appointed by the Bank of Greece, along with a definition of his/her powers (see below under 6.2),
- resolution tools which may be implemented by the Minister of Finance and/or the Bank of Greece (under 6.3),[156] and
- the creation of a 'resolution fund' (under 6.4).[157]

[156] Any bank resolution tool must be based on legislation, since the taking of the courses of action on 'bank resolution' without a solid legal basis would negatively affect the rights of the existing shareholders, in breach of the provisions of European company law. This is undoubtedly an international practice (see, by means of indication, the provisions of UK law in: **Look (2011)**, pp. 276-381).

[157] In addition, pursuant to the Bank of Greece Governor's Act 2653/29.2.2012 (which has been amended by Act 2657/20.3.2012), a 'Resolution Measures Committee' has been established within the Bank of Greece.

In this respect it is worth mentioning that the European Commission has taken initiatives for the creation of a European 'bank resolution framework'. Its most recent initiative is based on the Communication on: "An EU Framework for Crisis Management in the Financial Sector",[158] and it is strongly expected that in the course of the coming months it will submit a proposal for a Directive of the European Parliament and the Council on this issue area.[159]

In this Communication it is stated that the resolution tools should include, inter alia, "a sale of business tool which will enable authorities to effect a sale of the credit institution or parts of its business to one or more purchasers without the consent of shareholders".[160] *Footnote 21 of the Communication notes also: "The Commission recognises that there will be circumstances in which a sale must be completed in a very short period to preserve financial stability".*[161]

6.2 The enhanced role of the Commissioner

The new legislation distinguishes between conditions under which a Commissioner to a distressed credit institution *has to be* appointed or *may be* appointed by the Bank of Greece.[162] The Commissioner's powers are significantly strengthened, also with the ability to exercise (or collaborate to) the management of the credit institution.[163]
The Commissioner, who is subject to control and supervision by the Bank of Greece, is appointed for a period not exceeding twelve (12) months. However, the appointment may be extended up to six (6) months.[164]

6.3 Resolution tools

The relevant provisions of Law 4021/2011 introduce three (3) resolution tools, which may be initiated by the Bank of Greece for the sake of protecting financial stability and boosting public confidence in the banking sector.[165] The Law contains detailed provisions on the conditions under which these tools can be activated, such as the impossibility of taking alternative measures of equivalent effect:

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[158] COM (2010) 579 final, 20.10.2010. See also the very recent (April 2012) European Commission's discussion paper on the debt write-down/bail-in tool (available at: http://ec.europa.eu/internal_market/bank/docs/crisis-management/discussion_paper_bailin_en.pdf).
[159] *Ibid.*, p. 3 (under 1, *in finem*)
[160] *Ibid.*, pp. 9-10.
[161] *Ibid.*, p. 10.
[162] Law 3601/2007, Article 63, paras. 2 and 1, respectively.
[163] *Ibid.*, Article 63, paras. 6 and 10.
[164] *Ibid.*, Article 63, para. 13.
[165] *Ibid.*, Article 63B.

(a) A capital increase of the credit institution by decision of the Commissioner following a request by the Bank of Greece.[166] Existing shareholders will not be allowed to exercise their right of preference in this case.

(b) The sale of specific assets and liabilities of an insolvent credit institution to another credit institution or another legal entity and, in principal, the withdrawal of the former's authorisation (which is under liquidation).[167]

This provision was enacted, for the first time, in December 2011 in the case of the 'T-Bank' and the transfer of certain of its assets and liabilities to the 'Hellenic Postbank'. The licence of the 'T-Bank' was withdrawn and the credit institution was set under liquidation.[168]

In this case, the European Commission stated that: "(…) where such funds intervene to assist in the rescue and/or restructuring of failing financial institutions, their intervention may constitute state aid. Whilst the funds in question may derive from the private sector, they may constitute aid to the extent they come within the control of the state and the decision as to the funds' application is imputable to the state".[169] This remark of the European Commission seems to contradict, in essence, its statement in its abovementioned Communication on "An EU Framework for Crisis Management in the Financial Sector" (see above, under 6.1), according to which: "In many jurisdictions resolution authorities are appropriately separately from supervisors and (…) such separation is important to minimise the risk of forbearance".

It is also worth mentioning that the Commission has to make a case on which there will be no precedent. There is no doubt that in the case of T-Bank there was:

- *neither a state subsidy, since the financing was not provided by the state,*
- *nor a 'control of the state', since it cannot be reasonably established that the Bank of Greece, being an independent supervisory authority according to its Statute (Article 5A), acted 'within the control of the state'.*

In March 2012 this provision was also enacted with regard to three cooperative credit institutions (the deposits of which were transferred to the National Bank of Greece).[170]

(c) The establishment of a 'bridge bank', by decision of the Minister of Finance, upon a proposal of the Bank of Greece on grounds of public interest.[171] The bridge bank, which

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[166] *Ibid.*, Article 63C.

[167] *Ibid.*, Article 63D. According to the provisions of this Article: *"If the value of the liability items transferred is higher than the value of the asset items, the Bank of Greece is determining the amount of the difference, which is covered (…) by the resolution scheme of the Hellenic Deposit and Investment Guarantee Fund is providing the additional amount".*

[168] Decisions 25/1/17.12.2011, 26/1/17.12.2011 and 26/2/17.12.2011of the Bank of Greece's Credit and Insurance Committee.

[169] European Commission, Case SA.34115 (201/CP), Resolution of T-Bank (31.1.2012), p. 2.

[170] Decision 34/18.3.2012 (items 1-3) of the Committee of Credit and Insurance Issues of the Bank of Greece, as well as Decision 1/23.3.2012 (items 1-9) of the Resolution Measures Committee of the Bank of Greece.

receives specific assets and liabilities of an insolvent credit institution (while the latter's authorisation is withdrawn and it is set under liquidation) will receive own funds by the HFSF and may not operate for a period of more than two (2) years.[172]

Its main objective is to ensure the continuity of provision of crucial banking services in order to maintain financial stability and protect depositors and investors. The sale of the bridge banks' shares has to take place through auction, to be determined by its Board of Directors following an assessment by an independent agency also designated by that Board.[173] This provision was activated immediately after Law 4021/2011 entered into force with regard to 'Proton Bank', whose licence was withdrawn, and the bridge bank 'New Proton Bank' was simultaneously set up. 'Proton Bank' is currently under liquidation.[174]

6.4 The 'resolution scheme' of the HDIGF

In accordance with the provisions of Article 7 of Law 4021/2011, a 'resolution scheme' was established in 2011, as the third pillar of the HDIGF. This scheme is the only pillar of the HDIGF which is not (yet) premised on provisions of European law.

The resolution scheme, which is independent from the other two pillars (the deposit guarantee scheme and investor compensation scheme), provides funding, either in the case of the transfer of a credit institution's assets to another credit institution or another entity, or if a bridge bank is established under the provisions of Articles 63D and 63E of Law 3601/2007 (as mentioned above, under 6.3). The participation of all the Greek credit institutions (as well as Greek branches of credit institutions from third countries, non-EU Member States) in the resolution scheme is mandatory, as well as the payment of contributions to it.[175]

In this context, it is also worth mentioning that according to paragraph 12 of Article 9 of Law 4051/2012 (amending Law 3864/2010 on the HFSF), for a transitional period of twelve (12) months from the date of enactment of that Law, it is the HFSF which will cover the difference referred to in paragraph 13 of Article 63D and in paragraph 7 of Article 63E of Law 3601/2007 rather than the HDIGF.[176]

In the author's view, this provision is adequate, taking into account that imposing additional contributions on credit institutions for funding the 'resolution scheme' of the

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[171] Law 3601/2007, Article 63E.

[172] A derogation is permitted for another two (2) more years, by decision of the Minister of Finance, upon a recommendation by the Bank of Greece for reasons of financial stability (*ibid.*, Article 63E, para. 9).

[173] *Ibid.*, Article 63 F.

[174] Decision of the Minister of Finance 9250/9.10.2011 and Decision 20/9.10.2011 (items 1-3) of the Bank of Greece's Credit and Insurance Committee.

[175] With the sole exception of the New Proton Bank which is a bridge bank.

[176] Law 3864/2010, Article 16B, para. 12.

HDIGF (given the current liquidity strains) would not be appropriate (especially if the Ministry of Finance, Bank of Greece and HFSF decided, in the course of the recent restructuring of the Greek banking sector, to apply existing resolution tools laid down in Articles 63D and 63E of Law 3601/2007 to several credit institutions). Nevertheless, if the new Directive of the European Parliament and of the Council on deposit guarantee schemes (recast) (once finalised) requires 'deposit guarantee schemes' to act also as 'resolution funds', a new arrangement should be made.[177]

[177] COM (2010) 368 final.

TABLE 2 **Chronological list of major institutional, supervisory and regulatory measures taken since 2008 in order to preserve the stability of the Greek banking sector** *(apart from measures relating to the implementation of European banking law Directives)*		
Date	**Legal act**	**Content**
A. The period before the current Eurozone fiscal crisis (2008-2009)		
November 2008	Law 3714/2008	increase of the deposit guarantee level to €100,000 per depositor (per credit institution)
December 2008	Law 3723/2008	enhancement of liquidity of the economy in response to the impact of the international financial crisis (three 'pillars')
B. The period after the current Eurozone fiscal crisis (2010-2012)		
July 2010	Law 3864/2010	establishment of the Hellenic Financial Stability Fund ('HFSF')
July 2010	CEBS stress-testing exercise	
August 2010	Law 3867/2010	establishment of the Hellenic Council of Systemic Stability
July 2011	EBA stress-testing exercise	
September 2011	Law 4021/2011	• enhanced micro-prudential supervisory powers and measures of the Bank of Greece (amendments to the principal banking Law 3601/2007), • enhanced powers for the Commissioner of troubled credit institutions (amendments to principal banking Law 3601/2007), • introduction of three (3) resolution tools (amendments to the principal banking Law 3601/2007), • amendments to Law 3746/2009 on the HDIGF (including the introduction of a 'resolution scheme'), • amendments to Law 3864/2010 on the HFSF
September 2011	Decisions of the Minister of Finance and of the Bank of Greece	• withdrawal of Proton Bank's license (currently under liquidation) • granting of license to the first bridge bank ('New Proton Bank')

B. The period after the current Eurozone fiscal crisis (2010-2012) *(continued)*		
December 2011	Decisions of the Bank of Greece	• withdrawal of T-Bank's license (currently under liquidation) • transfer of specific assets and liabilities of the T-Bank to the Hellenic Postbank
December 2011	Bank of Greece Governor's Act 2643/6.9.2011	diagnostic study on Greek credit institutions' loan portfolios conducted by BlackRock on behalf of the Bank of Greece
February 2012	Bank of Greece Governor's Act 2653/29.2.2012	establishment of a Resolution Measures Committee within the Bank of Greece
February 2012	Bank of Greece Governor's Act 2654/29.2.2012	imposition of higher 'Core Tier 1' capital requirements on Greek credit institutions
February 2012	Law 4051/2012	amendments to Laws: • 3601/2007 (principal banking Law), • 3746/2009 on the HDIGF, and • 3864/2010 on the HFSF
March 2012	Law 4056/2012	amendments to Laws: • 3746/2009 on the HDIGF, and • 3864/2010 on the HFSF
March 2012	Annex to Act of Legislative Content	Master Financial Assistance Facility Agreement between the European Financial Stability Facility, the Hellenic Republic as Beneficiary Member State, the Hellenic Financial Stability Fund as Guarantor and the Bank of Greece
March 2012	Decisions of the Bank of Greece	• withdrawal of the license of three cooperative banks (currently under liquidation) • transfer of the deposits (only) of these credit institutions to the National Bank of Greece
April 2012	Act of Legislative Content	amendments to Laws: • 3601/2007 (principal banking Law), and • 3864/2010 on the HFSF

Conclusions

(a) In the current conjuncture, the main challenges for the Greek banking sector are as follows:

(aa) The first is the preservation of its solvency, with adequate recapitalisation from the private sector and, as a last resort, the Hellenic Financial Stability Fund. Decisions on this will be taken in the coming months. In this respect, Greek credit institutions will also have to take deleveraging initiatives with regard to:

- disposing assets,
- selling non-core foreign assets,
- cutting claims on foreign financial institutions, and
- reducing debt security holdings.[178]

In any event, the primary objective is for "*private ownership [to] be maintained to the extent possible*".[179]

(ab) The second is maintaining its liquidity, while creating conditions for gradual independence from European Central Bank and Bank of Greece financing.

(ac) The third is granting credit to viable enterprises in order to support, as much as possible, the Greek economy's growth.

(b) In the medium term, however, the Greek banking sector will also have to adapt to the European regulatory 'tsunami' underway. More specifically, Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (known as 'CRD'), already amended by Directive 2009/111/EC (known as 'CRD II') and Directive 2010/76/EC (known as 'CRD III'), will be repealed in the coming months by a Regulation and a Directive transposing into European law the Basel III regulatory framework[180] (known as 'CRR IV and 'CRD IV', respectively).[181] In light of this, it can be rightly argued that the current business model of EU credit institutions is in the process of a radical review.

[178] IMF Country Report No. 12/57 (2012), *op. cit.*, p. 7.
[179] *Ibid.*, pp. 1 and 118.
[180] On this see **Gortsos (2011c)**.
[181] COM (2011) 452 final and COM (2011) 453 final, respectively.

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