PERSPECTIVE

A defective default: keys to understanding the sovereign debt crisis – part 1[1]

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The sovereign debt crisis affecting several eurozone countries is a threat to Europe's financial stability and has had significant international repercussions. The fear of a default within the eurozone has spread from Greece to other states. The various summits that have taken place on the subject have provided only partial and insufficient responses to the problems confronted. For several months now, it has appeared that one of the main impediments to resolving the crisis has been the massive exposure of the financial sector to the debt of eurozone states. A fall in the value of this debt, owing to investor distrust, may lead to banks requiring financial injections to protect their capital positions. As a result, additional funds might well be required from eurozone states. Such support might come from the states directly or come from them indirectly via the European Financial Stability Facility: a double hit for eurozone members. The crisis has made clear the fundamental imbalances in the economies of European states that have, for many years, financed modest economic growth through a steady increase in public and private indebtedness. The eurozone's problems have also demonstrated that the risk of sovereign default is real and not merely theoretical. Because of a general failure, pre-crisis, to contemplate the possibility of a default in the eurozone, a satisfactory legal framework for sovereign debt on sovereign default has not been constructed, a consensus on accounting standards for assessing the value of risky debts has not emerged, and adequate rating methodologies which can be relied upon in unprecedented circumstances have not been devised. These three technical aspects of the sovereign debt matrix (the legal framework, assessment for accounting purposes and credit rating) have not been at the forefront of public attention. They are, however, critical to the effective management of the crisis. This article explores constraints on the policy options available for dealing with the eurozone crisis, explains the reasons behind certain policies which have already been adopted to tackle the crisis, and proposes a number of possible reforms which could help resolve the crisis.

A. Foreword

The sovereign debt crisis has, for several months, been at the centre of financial and economic news. The bailout plans of 21 July and 27 October 2011 have not served to bring about a lasting return of confidence in the eurozone and beyond. There are, however, reasons to be optimistic that the crisis can be brought under control.

It is true that economic growth in Europe remains weak. Several states, including some large ones, have high deficits and indebtedness levels. Markets are losing confidence in the ability of ever-larger countries to meet their debt obligations. There is a general feeling of uncertainty regarding the eurozone situation.

It should be remembered, however, that the European Financial Stability Facility (EFSF) has considerable firepower and has been authorised to use its resources for a range of purposes that is wider than had initially been agreed. The EFSF's successor, the European Stability Mechanism, will also have these advantages. The overall level of European indebtedness can also be controlled. Scenarios in which sovereign debt stabilises and then decreases, while a minimum of economic growth is maintained, are possible. That these scenarios can play out in some of Europe's major countries is not in doubt: Italy has a primary surplus, Ireland's indebtedness does not appear systemic or permanent, and France, though it has never seriously addressed the problems of its debt and deficits, has room to raise tax and cut public spending, albeit politicians are reluctant to discuss this.

It is therefore important to try to understand why the crisis has proved so difficult to resolve. The main reasons are economic and political but some are linked to the mechanics of sovereign debt.

The failure to put in place a system of European "economic governance" when the euro was created is a major reason for the crisis. Without such a system the Stability and Growth Pact was not effectively enforced and a number of countries were able to continue financing modest growth through public, or private and public, borrowing. The past two decades have been characterised by debt-lead growth in virtually every country of "old Europe".

High levels of borrowing have been encouraged by the willingness of buyers to purchase sovereign debt on terms favourable to sovereigns. Even the weaker eurozone states have benefited from low borrowing costs. Such easy terms provided little incentive for states to stop borrowing.

A number of factors have made sovereign debt attractive to buyers. Prudential regulation treated, and continues to treat, sovereign debt sympathetically. Large quantities of bonds consumed little capital and a small margin was enough to make the bonds profitable. In this context, it was easy for Greece and other "peripheral" states to find buyers for their debt. Risk was not considered an important issue given that it was assumed that the European Central Bank (ECB) would discount any eurozone debt at its nominal value. Modest fluctuations in spreads made bonds lucrative but not destabilising, however the debt was valued.

Banks and insurance companies both invested heavily in eurozone bonds. Banks have tended to focus on the debt of their home state and this has created serious difficulties for Greek and Spanish banks during the crisis.

A clear change in the sovereign debt market was signalled by the increased difficulty faced by Greece in meeting its borrowing needs. Other states, such as Ireland and Portugal, found themselves in a similar situation. European states need to borrow on a continual basis in order to service their existing debts. Concern about the ability to borrow has, however, spread to all but the strongest economies in Europe.

The legal framework for sovereign debt has not functioned as effectively as it could during the crisis. Because the drafting of issuance contracts has historically received little attention, these contracts are weakly standardised. In contrast, derivatives (credit default swaps (CDSs)), which are intended to provide protection against sovereign default, benefit from far greater standardisation. Even CDSs, however, leave room for interpretation and, during the autumn of 2011, doubts as to the effectiveness of CDSs have emerged.

The rating of sovereign debt has also presented problems. Rating agencies have for a long time published their methodologies. Nevertheless, investors seemed, perhaps wrongly, surprised by the way in which these methodologies were applied during the crisis. It would seem that, if the bailout of 27 October 2011 is implemented, the rating agencies will signal a default. Agencies signalling default in this way can prevent the ECB accepting some sovereign debt as collateral. An *ad hoc* solution to this problem is necessary.

Following agreement of the 21 July bailout plan, controversy arose regarding the International Financial Reporting Standards (IFRS), which provide the basis for the accounting treatment of sovereign debt, and the valuation of sovereign debt. At the heart of the controversy was a letter sent by the International Accounting Standards Board (IASB) to the European Securities and Markets Authority (ESMA). The letter argued that an exchange plan (a sort of voluntary restructuring agreement) could not be taken into account in the assessment of the value of sovereign debt. Since agreement of the 27 October bailout, the debate in accounting circles has moved on, with a number of practitioners and regulators coming to the view that market values must form the basis of assessments of the value of sovereign debt. In the view of the authors, however, this may not be the right approach.

The technical legal, rating and accounting issues outlined have served to restrict the options available to public authorities and financial institutions in reacting to the crisis. These technical issues have made it more difficult to elaborate responses to the contraction in the sovereign debt market and the fall in the value of sovereign bonds that prudential rules had previously encouraged buyers to purchase.

The relatively stable sovereign bond market (confidence in the stability of which had been reinforced by the initial success of the eurozone) has been shaken. Borrowing costs have fluctuated wildly and some states have effectively found the market closed to them.

Financial institutions have been left exposed to market fluctuations by accounting standards while capital requirements have become increasingly onerous. Moreover, like some states, a number of financial institutions have begun to find it difficult to meet their borrowing needs.

This paper looks at eurozone sovereign debt levels and the holding of this debt by eurozone banks and other financial institutions. The paper goes on to analyse the legal framework for sovereign debt and sovereign debt derivatives. The article considers the application of accounting standards to sovereign debt and assesses the methodologies applied by rating agencies to sovereign debt. The paper is intended to provide readers with a better understanding of some of the challenges in the present crisis and in the bailout plans intended to resolve it.

The paper also points to some possible routes out of the crisis. Given that the crisis results from a combination of factors, it seems clear that policy action on several fronts is required in order to bring about enduring stability. Though not considered directly in this paper, a number of necessary economic and political changes can be identified. There needs to be a move towards more sustainable debt levels amongst European states. The credit risk associated with sovereign debt, though still relatively limited, needs to be given more consideration by purchasers of sovereign debt. Buyers also need to take account of the market risk of sovereign debt which clearly has increased in recent times. Increased capital requirements need to be focused on market risk and adapted to sovereign debt.

This paper looks at technical legal, accounting and credit rating reforms which could assist in the resolution of the crisis. Sovereign debt contracts should be standardised and the default clauses therein should be aligned with the default clauses in sovereign debt derivative contracts. There also needs to be more clarity as to the criteria to be used for identifying "credit events" in derivative contracts.

The rules on classifying sovereign debt for accounting purposes should be applied with greater flexibility. For the purposes of assessing the value of sovereign debt, when a realistic restructuring plan is being implemented, it should be possible, using a "mark to model" approach, to reflect the impact of the plan on the value of the debt.

Credit rating methodologies need to be able to account for situations in which, irrespective of the structural solvency of the sovereign, circumstances precipitate the sovereign towards default. In other words, these methodologies need to cover situations in which a state that has a sustainable debt burden finds it impossible to borrow.[2]

B. Sovereign debt in euros: what issues for financial institutions?

Eurozone sovereign debt levels are high and have increased considerably following the financial crisis. A large part of this debt is held by European financial institutions such as banks and insurance companies. Attempts to resolve the debt crisis are complicated by these institutions' large holdings of sovereign debt.

1. The growing indebtedness of eurozone states

The financial and now economic crises have led to the adoption, by many states, of large financial sector and economy-wide bailout plans and stimulus packages. At the same time government receipts have decreased and budget deficits have increased. In some cases, such as Italy, the deficit has been aggravated by increased borrowing costs. Within the European Union, deficits reached 6.8% of GDP in 2009 and 6.5% in 2010. Within the eurozone, they reached 6.3% in 2009 and 6.0% in 2010.[3] The debt to GDP ratios of Member States, often already high, have thus increased significantly from an average of 55% (net debt) for the period 1995–2004, to 66% in 2010. The average is expected to reach 69% in 2011.[4] Moreover, most Member States have, for a number of years, suffered with a "primary deficit" (ie a deficit that excludes debt servicing costs). Of the major European states, only Italy does not have a "primary deficit".

Total eurozone sovereign debt reached approximately €6,500 bn at the beginning of 2011. Investor distrust of this debt was such that, in April 2011, 46% of the total amount, concerning six countries (Greece, Ireland, Portugal, Spain, Italy and Belgium), had a spread of more than 200 points. A year earlier, only one country (Greece) had spreads higher than 200 basis points, and this debt accounted for only 5% of the eurozone total.[5]

Owing to the maturing of debt and the need to refinance, the amount of debt which Member States need to issue each year is very high. According to International Monetary Fund (IMF) estimations,[6] in 2011, Greece, Italy, Portugal, Belgium and France will each have issued an amount equivalent to more than 20% of their GDP. Spain, Ireland, the Netherlands, the United Kingdom, Finland and Germany will need to issue the equivalent of between 10% and 20% of their GDP. If these states are unable to find investors willing to buy their debt at a sustainable price, the problems caused will clearly go beyond the financing of a single year's deficit.

2. Sovereign debt ownership by financial institutions

Most developed states are required to issue debt on a near permanent basis. The buyers of this debt include private individuals, other states and financial institutions such as insurers, pension funds and banks.

Quantifying the exposure of financial institutions to sovereign debt is not a simple task. Similar difficulties were encountered during the "subprime crisis" when it was several months before comparisons between banks and comparisons between states within the G20 were possible. That delay was, at least in part, explained by the fact that the subject matter was exceptionally complicated.

The situation for sovereign debt appears less complex because the products are simpler and easier to identify. On 15 July 2011, the European Banking Authority (EBA) published the results of its EU-wide "stress tests".[7] The report covered 90 banks and had a section devoted to sovereign debt. While focused on Greece, it also gave indications of exposure to Irish and Portuguese sovereign debt. The report showed that, at the end of 2010, the banks studied held €98 bn of Greek debt (of which two-thirds was held by Greek banks), €53 bn of Irish debt (of which 61% was held by Irish banks) and €43 bn of Portuguese debt (of which 63% was held by Portuguese banks).

The EBA's stress tests were widely criticised for failing to test the possibility of a sovereign default. Debt held in the trading book was assessed on the basis of losses in market value. Debt held in the banking book was, like any other credit risk, assessed on the basis of an estimation of the probability of default and, with reference to the exposure at default, an estimation of the losses on default. This methodology, which is not in line with accounting standards, was criticised as incomplete by a number of commentators. Nonetheless, the EBA's approach was consistent with its basic assumptions and, in particular, took account of the EU's commitment to prevent any of its members defaulting.

The July 2011 stress tests demonstrated that it is the banks of the most highly indebted states who have the highest exposure to their home states' sovereign debt. In spite of this, the EBA asserted that any recapitalisation that might be required by those banks, in the case of a depreciation of the debt they hold, would be satisfied by existing support mechanisms, such as those in place or being put in place for Greece, Ireland and Portugal.

Nevertheless, the stress tests made clear that, as far as Greece, Ireland and Portugal were concerned, any bailout plan leading to a substantial depreciation of sovereign debt would wipe out a substantial portion of their banks' capital. Moreover, notwithstanding the EBA's assertions, no mechanism to respond to this capital reduction existed in July 2011.[8] The 27 October bailout could lead to just such a reduction in the capital of Greek, Italian and Spanish banks. In contrast, German banks (with little exposure to "peripheral" debt) will not need to strengthen their capital positions significantly, benefiting instead from an increase in the value of Germany's sovereign debt.

A February 2011 study from the Organisation for Economic Co-operation and Development (OECD) used data from the European stress tests undertaken in June 2010 to calculate the potential cost, for Greek, Spanish, Irish and Portuguese banks, of a 30–50% decrease in the value of their home states' sovereign debt. When the decrease in value was 50%, at least one bank in each country lost more than half of its capital (10 in Spain, 7 in Greece, 2 in Portugal, 1 in Ireland). In the case of Greece, 4 banks lost more than the value of their capital.

Undertaking a similar exercise, the IMF concluded that the spillover effect of the Greek debt troubles might cost (in terms of pure losses or provisions) €60 bn. With Irish and Portuguese debt included, this rose to €80 bn and with

Belgian, Spanish and Italian debt included the amount reached €200 bn (*cf supra* Global Financial Stability Report). If bonds issued by banks were covered (the treatment of these bonds being closely correlated with the treatment of sovereign bonds) the sum would be €300 bn.

These figures were based on CDSs corresponding to the debt concerned (the values for the CDS spreads being essentially the same as for the sovereign bond spreads). The figures, therefore, rely on the market's measurement of value. The calculations do not take into account the probability of default, the losses that such a default would lead to, or the actuarial losses that a debt restructuring plan would imply. These issues are returned to later.

The data for insurance companies and pension funds is less detailed. Nevertheless, some headline figures should be borne in mind. At the end of 2010, eurozone insurance companies and pension funds held €1,215 bn of eurozone sovereign debt while their capital amounted to €439 bn.[9]

The IMF's analysis of the insurance sector was patchy but its September 2011 Global Financial Stability Report showed, based on a narrow definition of capital as "tangible common equity", that four insurers (two French and two Italian) might lose more than 70% of their capital as a result of their sovereign debt holdings.

The figures outlined have, of course, contributed to market stress and have put further pressure on the value of financial institutions during the summer and autumn of 2011.

In the context of the 27 October 2011 bailout plan, the EBA published a "preliminary and indicative" estimation of the amount of capital banks would need to raise in order to match their exposure to sovereign debt. The estimated figure was €106 bn.[10] Unlike the figures from July 2011, this estimate was based on the market value of the debt itself.[11]

The EBA report gave further detail on Greek banks and indicated that the €30 bn reserved for them in the EU/IMF rescue plan would be more than sufficient to cover their capital needs.

In sum, the figures available, even if incomplete and rather cautious (eg not taking account of very large falls in the value of the debt of major states), demonstrate that European banks and insurers are highly exposed to eurozone sovereign debt and that the EFSF might not, even with greater resources, be sufficient to recapitalise financial institutions affected by the depreciation of this debt.

As a result, where governments feel it necessary to ensure that banks and insurers who are highly exposed to sovereign debt do not fail, state deficits may be exacerbated. Shareholders and bondholders can contribute to saving these institutions but in order for banks and insurers to emerge from the crisis sufficiently capitalised, sufficient state resources may be required. It is not clear, however, that states have the necessary resources.

C. A poor-quality and poorly adapted legal framework for sovereign debt

Until recently, investors paid little attention to the debt issuance contracts of the eurozone, the EU and other major economies. There is now much greater attention on them but, owing to the previous neglect, issuance contracts remain poorly adapted and poor quality, leaving space for uncertainty and wide interpretation.

Default is a key concept in these contracts. Strictly speaking, default is the fact of a party to a contract not respecting, even temporarily, any of its contractual undertakings. In this sense, any contractual breach is a default. Anglo-American drafting custom, especially in financial markets and banking, is to provide, at the beginning of each contract, a list of defined terms. Thus, "default" is generally defined in banking or financial contracts. The contractual definition is sometimes made more restrictive in order to improve contractual efficiency by limiting breaches to events considered important. The parties define what events amount to a default under the specific contract.

Banking and financial markets contracts have become increasingly standardised. Indeed, in some fields, such as securities issuing, they are almost exclusively so. Professional associations such the International Swaps and Derivatives Association (ISDA) for derivatives, the International Capital Markets Association (ICMA) for securities, and the Loan Market Association (LMA) for syndicated loans,[12] propose standardised contracts to their members. In practice, these contracts reduce contractual freedom to the financial conditions of a transaction (though contractual freedom does in theory still exist).

It is, in this context, necessary to analyse the concept of default in issuance contracts and derivatives. It is striking therefore to note that, as regards the primary market, the legal debate has not (until summer 2011 at least) focused on the concept of default. The debate has instead centered on collective action clauses (CACs). The absence of these clauses from issuance contracts has been seen as creating an obstacle to restructurings. As regards the secondary market, the debate has focused on the concept of "restructuring" in ISDA documentation.

As far as CACs are concerned, they have now been widely adopted in Europe. A Eurogroup communication, dated 28 November 2010, provides that, from mid-2013, these clauses will be "standardized and identical" in all countries and will be equivalent to those found in issuance contracts submitted to English or US law (which raises the question as to which applicable law to choose for the contracts, a point to which we will return). CACs determine, amongst other things, the proportion of creditors who have to agree to a restructuring in order for it to be deemed accepted. The proportion recommended by the 2002 G10 working group on CACs was 75%. Some emerging countries have chosen an 85% "supermajority".

There are two legal approaches to managing a sovereign default:

1. The "contractual" approach. Debtor and creditors agree on a restructuring of the debt. Agreement is made difficult by the need, particularly when the issuance contract is submitted to English or New York state law, to obtain unanimous creditor agreement or, if a CAC is in place, to obtain the agreement of a predetermined majority of creditors.
2. The "judicial" approach. Creditors go before a court to ask for payment of sums due.

Historically, the second approach prevailed (having replaced "gunboat diplomacy" as a way for a state to protect its creditors – *cf* the France–Morocco relationship during the 19th century) which led to a great deal of litigation, especially regarding the conditions under which creditors could sue a state and seize property. This approach does not provide for the *a priori* treatment of default, but rather relies on arguments in court.

As a result, since the end of the 1990s, under the aegis of the IMF, particular emphasis has been placed on the preventative treatment of defaults, through the development of legal tools that allow restructurings to take place with the agreement of a majority of creditors. This approach is strongly inspired by bankruptcy law and especially Chapter 11 of the US Bankruptcy code.

1. Obligations under issuance contracts

There is, today, no standardised legal framework for issuance contracts and therefore no common definition of "default". In response to what the ICMA's president called (in a letter to his members dated 21 May 2010) a "severe market failure" in the organisation and functioning of the primary and secondary markets for sovereign debt, the ICMA has taken several actions. Notably, the ICMA has made propositions for changing issuance contracts. As stated by the ICMA president (in a letter to ICMA members dated 5 July 2011) this change is intended to promote market transparency and efficiency. The professional members of the ICMA Sovereign Bonds Working Group, the European Commission and certain Member States have worked together on these changes.

The legal problems for sovereign debt creditors relate to the determination of the applicable law and to the substance of the rights under the contract.

(a) The law applicable to sovereign debt issuance contracts

The question of whether and when a sovereign issuer has defaulted depends, amongst other things, on the law applicable to the issuance contract. In a situation of dispute on this issue, before CACs were adopted, it was up to a judge to interpret the contract. This was a time-consuming process and an inefficient way to cope with a crisis. It should be noted that the law applicable to the issuance contract may not be the law of the issuer's country and the court having jurisdiction may not be a court of the issuer's country. This explains why creditors need full awareness of the jurisdictional and applicable law clauses in an issuance contract.

There are two categories of state in this context:

1. Those who submit contracts to their domestic law and jurisdiction – this is the case for the large industrialised countries and the eurozone; and
2. Those who submit contracts to the law and jurisdiction of a third country (essentially New York state or English law but also, sometimes, German, Swiss or French law).

In either case, the concern for creditors is whether they can bring a claim and, if necessary, seize the sovereign's property to pay the outstanding debt. The answer differs depending on whether the law and jurisdiction chosen are those of the issuer or not. It will, no doubt, be easier for a creditor to obtain a favourable judgment from a court in a large industrialised country for breach of contract but it will be more difficult for that creditor to have a foreign decision recognised and enforced in the country of the issuer (the *exequatur* problem). Creditors can be suspicious of certain legal systems and may believe that their rights are better protected if their contract is submitted to New York state or English law. As far as Greece is concerned, a large majority (90%) of issuance contracts refer to Greek law and courts. Some creditors, however, have doubts as to the impartiality of Greek judges when deciding sovereign debt cases.

Key to this area is "immunity" theory (or similar theories). Traditionally, the law provided a quasi-absolute protection to sovereign borrowers through the principle of "immunity" or "act of state". For a number of years, however, English and US courts have been limiting the scope of these principles in order to protect creditors. Issuance contracts now increasingly contain immunity exemption clauses.[13]

(b) The classical approach: obligations of the issuer state

The manner in which sovereign debt is issued remains varied. Market practice in this area is little standardised. Since the crisis of 2010/2011 some more rationality has begun to be introduced to the system. The ICMA Sovereign Bond Consultation Paper, dated 23 November 2010, proposed improving transparency by putting in place best practice standards for contracts. The ICMA's intention is for these standards to become normalised so that, when deviated from, issuers will be obliged to inform the market.

The historic lack of standardisation of issuance contracts results from the treatment of issuances by legislators. In EU countries, the obligations imposed on private issuers have not been imposed on states and other entities that issue public debt. Neither the Prospectus Directive nor the Market Abuse Directive, to take but two, are applicable to sovereigns. Member States are, therefore, not under an obligation to publish a prospectus document. The Directive states that it does not apply to

> "non-equity securities [ie debt securities] issued by a Member State or by one of a Member State's regional or local authorities, by public international bodies of which one or more Member States are members, by the European Central Bank or by the central banks of the Member States."[14]

The Market Abuse Directive states that it does not apply

> "to transactions carried out in pursuit of monetary, exchange-rate or public debt-management policy by a Member State, by the European System of Central Banks, by a national central bank or by any other officially designated body, or by any person acting on their behalf. Member States may extend this exemption to their federated states or similar local authorities in respect of the management of their public debt."[15]

The rationale behind this exceptionalism for sovereigns is that monetary policy cannot be treated in the same way as commercial borrowing because it is a domain of the state. It also reflects a historic tendency to provide derogations from general legal rules for public bodies (an approach one sees

the limits of in the context of the crisis). EU Member States do publish an "offering circular" but the content of these is far from harmonised. Indeed, their harmonisation is one of the recommendations of the ICMA working paper of 23 November 2010.

The observations made by the ICMA in 2010 with regard to the issuance of sovereign debt were severe and worrying.

> "During the sovereign debt crisis, it appears that some investors did not know whether the sovereign bonds they had bought were issued under national law or under foreign law and the implications for their holdings; and that they were not familiar with the specific rights afforded to them as bondholders."

One could blame this on investors. In many cases, however, the bond documentation is unhelpful. For example, in so far as issuance contracts refer to national laws (which set out the rights and obligations of bondholders), the principles of that law are generally not reproduced in the contract. Thus, bondholders must look to the original national legislation, which is often available only in the language of the issuer. The contract itself may also only be available in the language of the issuer. There is clearly a need to improve the transparency of issuance contracts. The ICMA recommends that complete terms and conditions be published in English on issuers' websites. The ICMA also proposes a model for the important clauses in issuance contracts.[16] Though the ICMA does not advocate submitting all future issuance contracts to English or New York state law, as some had wished, it recommends that the standards of international issues be followed in all cases.

As regards the concept of default, the ICMA provides a fairly restrictive definition. Default is either a failure to pay an amount due or a failure to abide by an essential clause. These are "trigger events" (it is thus, in the meaning of "trigger" that a case-by-case assessment must be made).[17] In the case of a default, a special majority of 25% of the holders of the outstanding principal can ask, after a 30-day grace period, for an acceleration of the contract (the 25% threshold remains the subject of discussion today).

Regarding negative pledge clauses, a reading of recent issuance contracts from the eurozone (Spain, Italy, Ireland, etc.) identifies a classical approach to their drafting that makes them increasingly similar to *pari passu* clauses.[18] Cross-default clauses are notable in their absence from issuance contracts.

2. Definitions chosen by derivatives issuers

As we noted earlier, the definition of default in an issuance contract is limited to the obligations under said contract. An investor will only rarely be able to rely on this term. A broader definition of default can be found in CDSs.

The essence of a CDS can be found in the set of definitions in the documentation signed by the parties. Unlike in the primary market, the contracts for CDSs are highly standardised. In practice, most CDSs are drafted on the basis of the Credit Derivatives Definitions of the 2003 ISDA contract and its July 2009 supplement.

Some clauses which are left to be decided by the parties. Standard definitions are reverted to unless the parties indicate otherwise. The parties can therefore decide which events represent credit events and which elements are relevant to the determination of whether a credit event has taken place. This is the concept of a "trigger" which is typical of credit derivatives contracts. A CDS is triggered when a credit event takes place. In practice, three kinds of credit event are selected in sovereign debt derivative contracts: (i) failure to pay, (ii) repudiation/moratorium and (iii) restructuring.[19] It appears that the definition that most closely matches "default", within the meaning of an issuance contract, is "failure to pay". Failure to pay is therefore not, *a priori*, a problematic concept.

The meaning of "repudiation/moratorium" and, above all, "restructuring" remain problematic. In the case of Greece or other eurozone countries under "preservation plans", the question is not whether the issuer (called the "reference entity" in ISDA documentation) fails to pay, but rather whether the exchange of securities directed by the EFSF constitutes a case of "restructuring" (the meaning of which is very wide). In a document dated 27 July 2011, ISDA underlined, in relation to CDS on US sovereign risk, that a downgrading by a credit rating agency was not an event of default or, more precisely, was not a credit event. ISDA noted that "it is possible that the same set of facts might give rise to both, but it is also possible that one might occur but not the other".

Despite the precision of ISDA definitions, there can remain doubt as to whether given situations amount to credit events. In order to reduce this uncertainty, ISDA created Derivatives Determination Committees which, in relation to specific contracts, pronounce on whether credit events have occurred. It is believed that no such committee has yet been asked to pronounce on the Greek situation. A case did arise which led to discussions by a Committee but no decision was taken.[20] The case in question focused on whether the default of a Greek hospital could be considered a credit event in the context of Greek issuance contracts. A similar question arose during the Argentine sovereign debt crisis, when English and New York state courts considered the default of Argentine public entities.

It was to avoid lengthy and expensive trials that ISDA set up Derivatives Determination Committees. The Committees are regulated by precise rules. Their composition reflects the composition of ISDA's membership (banks, investors, companies). Ultimately, experts and technicians are entrusted with taking decisions that often have political consequences. These professionals may not have the democratic legitimacy to take such decisions. Markets, however, do not like a vacuum or the unpredictability and slow pace of courts. Derivatives Determination Committees therefore represent a practical solution for CDS buyers who want to be able to trigger their CDSs as soon as possible once a trigger event has taken place.

Whether the CDSs on Greek sovereign debt can be triggered by the present negotiations regarding Greece depends on the interpretation of the definition of "restructuring" in Article 4.7 of the ISDA contract. There is, unfortunately, no obvious precedent which can help with the interpretation of this definition (when Ecuador defaulted, CDSs were enforced but as a result of a "failure to pay").

Under Article 4.7, one can say that two conditions have to be satisfied for an event to be a restructuring:

- any one or more of the events listed in the contract occurs in a form that binds all holders of the obligation; and
- sufficient number of holders give their agreement to the restructuring to bind all holders of the obligation.

It is this second condition which is currently under debate because it raises the question of whether the ISDA documentation conceives of restructuring as a voluntary or involuntary operation.

To return to the first condition, the ISDA definition lists the following events in this order:

(i) a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals;
(ii) a reduction in the amount of principal or premium payable at maturity or at scheduled redemption dates;
(iii) a postponement or other deferral of a date or dates for either (a) the payment or accrual of interest or (b) the payment of principal or premium;
(iv) a change in the ranking in priority of payment of any obligation, causing the subordination of such obligation to any other obligation; or
(v) any change in the currency or composition of any payment of interest or principal to any currency which is not a permitted currency.

Following the 21 July bailout plan, discussions seemed to centre on an extension of the maturity of the facility through an exchange of securities. This would seem to correspond to point (iii). It would also conform to point (i) if the plan led to a reduction of the amount due. It could not match point (iv) because securities are generally unsecured. Case (v) would apply if the plan provided for a currency other than the euro. Case (ii) is rather more complex to analyse.

To return to the second condition, its drafting (now widely criticised) suggests that all holders must be bound *and* a sufficient number of holders must consent to the restructuring. The ambiguity comes from the difference between the requirement to bind all holders and the need for the consent of a sufficient proportion of them.

An example will clarify the issue. There is a debt issue in which 90% of the holders agree to amend the maturity date and accept a five-year extension. This qualifies as an example of point (iii) of the first condition but, because not all holders have consented, does not constitute a credit event within the meaning of the ISDA definition. Those who consented will receive new securities against the old ones. The principal of the original obligation will thus be reduced for 90% of the holders. The 10% who have not agreed will keep their obligations under unchanged conditions. Since not all holders have accepted the exchange, there is no restructuring within the ISDA meaning, and thus no CDS can be triggered. This explains the debate amongst CDS buyers regarding the proportion of buyers called to take part in the exchanges. Taken to the extreme, it would appear that if 99.9% of holders accept an exchange there is no credit event but if 100% accept there is.

Recognising the difficulty of defining "restructuring", the USA and Canada removed the term from their ISDA contracts a number of years ago. This remains a fundamental difference between credit derivatives in Europe and North America.

While the ICMA has decided to address problems affecting the primary market by setting up working committees, ISDA seems reluctant to tackle the restructuring issue. It has chosen to leave decisions as to whether events of default have occurred to its European Determination Committee to decide on a case-by-case basis.

After the 27 October bailout agreement, ISDA published two communications. In the first, the association indicated that

> "the determination of whether the eurozone deal with regard to Greece is a credit event under the CDS documentation will be made by ISDA's EMEA Determinations Committee when the proposal is formally signed, and if a market participant requests a ruling from the DC. Based on what we know it appears from preliminary news reports that the bond restructuring is voluntary and not binding on all bondholders. As such, it does not appear to be likely that the restructuring will trigger payments under existing CDS contracts."

In the second, published on 31 October 2011, in which the association underlined that

> "it does not appear to be likely that the eurozone proposal will trigger payments under CDS contracts. However, whether or not it does so will be decided by the DC on the basis of the specific facts, if a request is made to them."

The world could stop holding its breath; Greece would not be "defaulting", from a legal point of view.

To provide some perspective, the total value of CDSs on Greek debt reached $75 bn (sum of par values covered) at the beginning of 2011. Taking into account each issuers' positions covered, the total value of net exposures goes down to $3.7 bn. If the Committee was to identify an event of default, the situation would therefore appear to be on a manageable scale.

The decision would, however, constitute a precedent. The amounts at stake regarding other states' sovereign debt are considerable. If the Committee recognises an event of default, CDS issuers will have to pay out. If the Committee does not identify an event of default, those who have bought CDSs may start to doubt whether the protection they have bought is effective. This will no doubt be a key issue for the end of 2011 and for 2012. Doubts regarding the interpretation of CDSs will have to be taken into account in analyses of the financial position of CDS buyers and sellers.

3. The concept of "selective default"

The ECB and the Council of the European Union do not seem to want to entertain the idea of a default by Greece. They are, however, less categorical as regards a "selective default". Selective default is an economic and political concept which does not have a clear legal meaning. Under issuance and CDS contracts, a debtor is either in default or not (even if the default only relates to a very small fraction of the debt and a relatively insignificant repayment).

The expression is often used by credit rating agencies. It is also used by the ECB. The ECB's president has stated that "a credit event, selective default or default should be avoided". Jean-Claude Trichet has also said:

> "[W]e have three very clear messages. First, we said that any participation had to be voluntary. As far as this is concerned, our advice has been followed. Second, we said that it was necessary to avoid a 'credit event', and at the moment, it looks as though we have done so. Lastly, our third message was that a 'selective default' should be avoided."[21]

What exactly is meant by selective default? It appears that it refers to a situation where an issuer is in default as regards some but not all of the instruments issued by it. There is, however, a lack of official precision on this point.

If this is the meaning of the word, a problem arises regarding the assessment of the value of the securities issued by that sovereign. This issue is problematic for the ECB itself. The ECB accepts, in its refinancing operations with banks, all securities issued by eurozone states without discount. It does so on the basis of the political principle that it is not possible to differentiate between the debts of the members of the eurozone. As soon as a state is in a situation of selective default, however, the message from the ECB is very clear

> "[I]n case of a 'selective default', the ECB and the Eurosystem would ask for a recapitalization of the banks and for credit enhancement of our collateral in order to have sound counterparties and eligible collateral."[22]

Selective default therefore appears to be of most concern to banks and the private sector.

In line with the ECB President's statements, if we assume that the bailout of 27 October is implemented (i) Greece should not be in default, in the meaning of issuance contracts, (ii) the plan should not trigger a credit event under CDSs and (iii) Greece should not be treated as being in a situation of selective default. ■

The views expressed are those of the authors and do not necessarily reflect those of their institutions.

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1 This is a translation of the French article "Les défauts du défaut – Quelques clefs pour comprendre la crise de la dette souveraine", published by the French think-tank, En Temps Réel. The article is available in French at http://entempsreel.com/2011/11/18/les-d%C3%A9fauts-du-d%C3%A9faut-quelques-clefs-pour-comprendre-la-crise-de-la-dette-souveraine-cahi. The article was translated by Manuel Fernandez and Roland Susman.

2 The circumstances and the issues considered by this article are continuing to evolve and develop. The drafting of this article was completed on 16 November 2011.

3 See, eg, IMF, Regional Economic Outlook, Europe, October 2011 or IMF Fiscal Monitor, September 2011.

4 IMF, World Economic Outlook, September 2011, 192.

5 IMF, Global Financial Stability Report, September 2011, 16.

6 IMF, Fiscal Monitor, September 2011, table 3, 10.

7 EBA, 2011 EU-Wide Stress Test Aggregate Report. A similar exercise, though leading to a less detailed publication, was led by the European Insurance and Occupational Pensions Authority. The results of this study have also been published (*cf* communication from the ACP, the French Banking Regulator, 4 July 2011). This study is based on the assumption of an increase in yields on each Member State's debt, as well as an increase in yields on the debt of a certain number of non-Member States.

8 *Cf* A Blundel-Wignall and P Slovik, "A Market perspective on the European Sovereign Debt and Banking Crisis" [2010] *Financial Market Trends*, issue 2, pre-publication version, February 2011.

9 ECB, 4 October 2011 communication, "Statistics in Euro Area Insurance Corporations and Pension Funds", second quarter 2011.

10 This figure takes into account the positive effect on banks' capital positions of the rise in value of better rated debt (such as German debt). Some, therefore, consider the figure to be too low.

11 EBA, 26 October 2011 communication. Definitive figures should be published in November, based on 30 September bank figures (banks are to have published their capital position and exposure to sovereign debt on this date. This would allow the EBA to publish figures by bank and by country, as it did in July).

12 These are international bodies which tend to take an Anglo-American approach to legal practice.

13 Generally, they have the following, or similar, content: "To the extent that the Republic may in any jurisdiction claim for itself or its assets or revenues immunity from suit, execution, attachment (whether in aid of execution, before judgment or otherwise and whether on the grounds of sovereignty or otherwise) or other legal process and to the extent that such immunity (whether or not claimed) may be attributed in any such jurisdiction to the Republic or its assets or revenues, the Republic agrees not to claim and irrevocably waives such immunity to the full extent permitted by the laws of such jurisdiction".

14 Prospectus Directive, 2003/71, Art1, para 2(b).

15 Market Abuse Directive, 2003/6, Art 7.

16 Publicity of the issue, tax, negative pledge clause, default and acceleration, securities buy-back by the issuer, collective action clause, applicable law and jurisdiction.

17 ICMA suggested standard clause: "The bonds should entitle the bondholders to demand immediate repayment, prior to te contractual maturity date, if : (i) the Issuer fails to pay any amount due under the bonds within 30 days of the due date for such payment; or (ii) the Issuer defaults in the performance of any of tis other obligations under the bonds and (if the default is capable or remedy) fails to remedy the default within 30 days of being notified of it by any bondholders. Acceleration of payment should be permitted provided holders of at least 25 per cent of the outstanding principal amount of the bonds vote in favour or such action."

18 For instance: "The Notes constitute direct, unconditional, unsecured and unsubordinated obligations of the Republic and will at all times rank pari passu and without any preference among themselves. The full faith and credit of the Republic is pledged for the due and punctual payment of the principal of,

and interest on, the Notes and the performance of the Republic's obligations under the Notes. The payment obligations of the Republic under the Notes will at all times rank at least equally with all the other present and future unsecured and unsubordinated indebtedness of the Republic."

[19] All these concepts are defined in detail by the ISDA contract.

[20] ISDA, press release, 31 October 2011: "Neither of these has yet occurred with regards to the Greek sovereign debt situation. No debt issued by the Hellenic Republic has been modified to date, nor have the formal terms for any such modification under the Eurozone proposal yet been released. No market participant has yet made such a request to the DC."

[21] Interview, JC Trichet, *Le Point*, 22 July 2011.

[22] Interview, JC Trichet, *Süddeutsche Zeitung*, 23 July 2011.

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