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The European Sovereign Debt Crisis – Paving the Way Towards Financial Stability

The current European sovereign debt crisis has principally emerged with the problems of Greece, where decades of misleading accounting and statistics have brought the country to the verge of collapse[1]. But financial difficulties have also arisen in Ireland and Portugal, and more recently in Spain and Italy, although in these countries the problems have different origins and characteristics. Portugal suffered from a prolonged period of low growth and low competitiveness and Ireland was hit by the consequences of a reckless financial boom and the burst of a real estate bubble. Similarly, the problems in Spain originated from the burst of a pronounced real estate bubble. The recent troubles in Italy stem from a prolonged period of low growth and high public debt, coupled with the lack of structural reforms and political credibility.

At the most recent Euro Summit, on October 26, 2011, the Heads of State and Government of the Eurozone Member States[2] agreed on an additional package of measures aimed at stabilizing the European financial markets[3]. However, back in Greece, the Greek Prime Minister Papandreou announced his intention to hold a referendum on the measures agreed during the Euro Summit, plunging the Eurozone into a deeper crisis. This idea was given up on November 3, 2011 in view of the broad opposition found by other EU and Eurozone Member States, but also by the G20[4]. A new coalition Government is now being set up in Greece to approve and implement the measures agreed on October 26, 2011. Loukas Papademos, the former Vice President of the European Central Bank until 2010, is designated Greek Prime Minister. The measures agreed at the Euro Summit are thought to be comprehensive enough to support Greece's reform efforts, but also to strengthen the European financial institutions and, above all, to overcome the current crisis in the Eurozone (i.e. the 17 EU Member States which have the Euro currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain).

In the following, we shall (i) summarize the key events preceding the Euro Summit, (ii) explain the measures adopted at the Summit, (iii) analyze legal issues associated with the financial support of Greece by other Member States, the voluntary restructuring of Greece's debt obligation and the potential consequences for credit default swaps (CDS), and (iv) draw a conclusion for investors[5].

[1] *The entering Greek government in 2009 revealed that its deficit was not 3.6 percent of their GDP as previously affirmed, but rather 12.5 percent. Later, it discovered it to be 13.6 percent.*

[2] *Eurozone, Euro Area Member States, Eurozone Member States and Eurogroup will be used interchangeably; Jean-Claude Juncker, prime minister and finance minister of Luxembourg, was appointed as speaker of the finance ministers of the Eurogroup.*

[3] *See "Main Results of the Euro Summit", concluded in Brussels on October 26, 2011.*

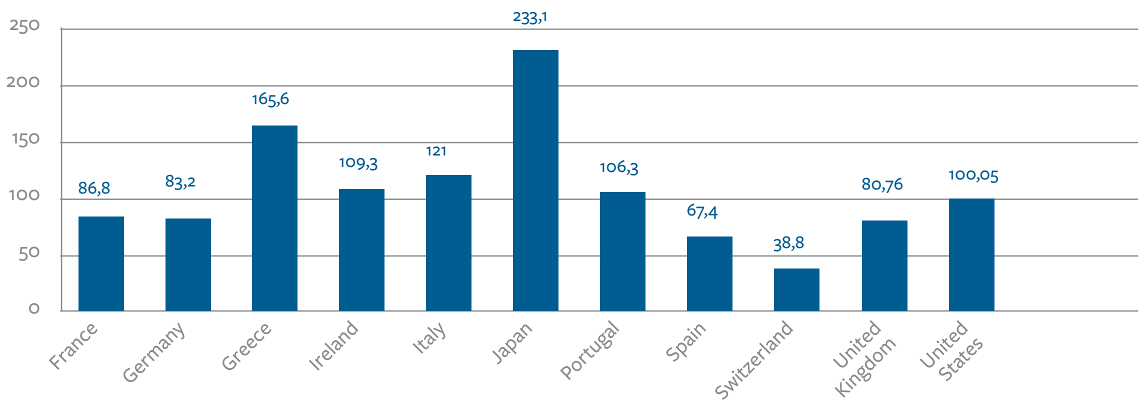
[4] *The leaders of the G20 group of major world economies met in Cannes on 3 – 4 November 2011. Most of the discussions concentrated on the Eurozone crisis. See "Final Communiqué G20 Leaders Summit – Cannes, 3 – 4 November 2011".*

[5] *The present note should not be understood as an investment advice or a financial analysis.*

The European Debt Crisis

As a result of the indebtedness of certain Eurozone countries, the entire Eurozone was at serious risk to run into a downturn of the economy. The indebtedness of certain states in comparison to the US and Japan can be shown by the following chart[6]:

Total central government debt % of GDP



Measures Adopted to Support Greece, Ireland and Portugal

The rising Government debt levels together with a wave of downgrading of European government debt have created significant alarm in financial markets across Europe and beyond, amid severe tensions in euro-area sovereign debt markets. This has led the EU and the Eurozone Member States to grant financial assistance to a number of countries in order to preserve the stability of financial markets and protect the Eurozone.

- Greece: on May 2, 2010 the Eurozone and the IMF agreed to provide financial assistance amounting to €110 billion to Greece[7]. On July 21, 2011 the Eurozone Member States announced their intention of implementing a second €109 billion-strong financial assistance programme including a €37 billion "voluntary" contribution from the private sector.

- Ireland: on November 28, 2010, a €85 billion assistance programme for Ireland was agreed by the 27 ECOFIN Ministers[8], the European Commission and the ECB[9].

- Portugal: on May 17, 2011, the Eurogroup and ECOFIN Ministers agreed on a €78 billion financial assistance programme for Portugal to be disbursed until 2014[10].

[6] *Overall indebtedness (including of corporates and individuals) shows an total debt overhang of about €6.1 trillion within the Eurozone as recently shown in a study of Boston Consulting Group entitled "Back to Mesopotamia?" (http://www.bcg.com/documents/file87307.pdf).*

[7] *The Eurozone Member States agreed to provide €80 billion through bilateral loans and the IMF compro-mised €30 billion via a stand-by arrangement. This so-called bailout is to be disbursed until June 2013 and as of November 2010, five tranches totalling €65 billion have been already distributed – in May, September and December 2010 and January, March and July 2011. A sixth tranche of €8 billion has not been paid out yet.*

[8] *The ECOFIN Council, or simply "ECOFIN", is composed of the Economics and Finance Ministers of the Member States, as well as Budget Ministers when budgetary issues are discussed.*

[9] *The programme will be financed via a €17.5 billion contribution from the Irish Treasury and National Pension Fund Reserve, a €22.5 billion contribution from the IMF, a €22.5 billion from the Commission managed EFSM, a €17.7 billion from the EFSF and additional €4.8 billion bilateral loans from the UK (€3.8 billion), Denmark (€0.4 billion) and Sweden (€0.6 billion). The programme is to be disbursed until 2013 and €50bn would address public finance needs while the remainder €35bn would be used for supporting the banking system.*

[10] *The EFSF, the EFSM and the IMF through an Extended Fund Facility will contribute to the programme with an equal €26 billion share.*

The Safety Net

The support for Greece, Ireland and Portugal are part of a wider safety net agreed between the EU, the Eurozone Member States and the IMF, amounting to amounting to €750 billion to contain contagion[11]. It consisted of:

(1) up to €440 billion from a newly created special purpose vehicle, the European Financial Stability Fund (EFSF),

(2) up to €60 billion loan from the European Financial Stabilisation Mechanism (EFSM); and

(3) a €250 billion loan backed by the IMF.

In addition to this, the European Central Bank (ECB) started to purchase sovereign debt and continued to accept sovereign debt as collateral without haircuts (reflecting the deteriorated credit ratings of some of the Member States).

European Financial Stability Facility

The EFSF is a special purpose vehicle devised to provide financial assistance to the Eurozone Member States in economic difficulties[12]. It issues bonds or other debt instruments on the capital markets and then uses the money to make loans. The EFSF is backed by guarantee commitments from the 17 Euro Area Member States for a total of €780 billion with an initial lending capacity of €440 billion. It has been assigned the best possible credit rating (AAA by Standard & Poor's and Fitch Ratings, Aaa by Moody's; short term rating: Standard & Poor's A-1+, Moody's P-1 and Fitch F1+).

The EFSF takes the form of a limited liability company (Société Anonyme) under Luxembourg law and was incorporated in Luxembourg on June 7, 2010[13]. Shareholders are the Euro Area Member States which subscribed capital in accordance with the subscription key of the European Central Bank.

Headed by Mr. Klaus Regling, former Director-General for economic and financial affairs at the European Commission, the EFSF is intended to last until June 30, 2013 (or if loans are made, until the maturity of the financing instruments). The EFSF can provide financial assistance to Eurozone Member States through the following means:

- Provision of loans to countries in financial difficulties;
- Intervention in debt primary and secondary markets;
- Acting on the basis of a precautionary programme;
- Finance recapitalisations of financial institutions through loans to governments.

The activation of the EFSF is subject to appropriate conditionality. Accordingly, any loan is conditional to budgetary discipline and economic policy guidelines in accordance with a Memorandum of Understanding between the European Commission and the beneficiary Eurozone country.

So far, the EFSF has placed two bonds in support of Portugal (on June 15, 2011 – €5 billion until 2021; and on June 22, 2011: €3 billion until 2016). For Ireland, it has issued two bonds – one on January 25, 2011 amounting to €5 billion until 2016 – and a further €3 billion bond (2022) sold recently, on November 7, 2011, after this offering was delayed due to political and financial turmoil caused by the sudden announcement of a referendum in Greece.

During the European Council meeting of June 24, and the Euro Summit of July 21, additional measures to improve the effectiveness of the EFSF were adopted[14].

[11] *See Extraordinary Council meeting of the ECOFIN Ministers, May 9/10, 2010.*

[12] *See Extraordinary Council Meeting, Economic and Financial Affairs, Brussels May 9/10, 2010 (9596/10).*

[13] *The EFSF was constituted with a share capital of €30 billion (€28.44 billion subscribed plus €1.56 billion authorised capital). Shareholders are the 17 Eurozone Member States in accordance with the ECB capital subscription key (e.g. Germany 18.9 percent, France 14.2 percent, Italy 12.5 percent and Spain 8.3 percent).*

[14] *Respectively, Conclusions of the European Council of June 23/24, 2011, Brussels June 24, 2011 (EUCO 23/11); and Statement by the Heads of State or Government of the Euro Area and EU Institutions, Council of the European Union, Brussels July 21, 2011; see below Page 8 for further analysis of legal risks of EFSF bond issues.*

European Financial Stabilisation Mechanism

The EFSM provides financial assistance to any EU Member State in financial difficulties up to 60 billion euros in the form of loans or credit lines[15]. Based on Article 122(2) of the Treaty on the Functioning of the European Union (TFEU), it was set up to preserve the financial stability in the EU so any of the EU Member States which is experiencing, or is seriously threatened with, a severe financial disturbance, or which is in difficulties caused by exceptional circumstances beyond its control may ask for financial assistance. These circumstances could be a serious deterioration in the international economic and financial environment.

Under the EFSM, the Commission is allowed to borrow up to a total of € 60 billion in the financial markets on behalf of the EU, guaranteed by the EU budget. The Commission then on-lends the proceeds to the beneficiary Member State. This particular lending arrangement implies that there is no debt-servicing cost for the EU. All interest and loan principal is repaid by the beneficiary Member State via the Commission. The EU budget guarantees the repayment of the bonds.

The activation of the EFSM is subject to strict conditionality. This is aimed at preserving the sustainability of public finances of the beneficiary Member State and at enabling it to regain its capacity to finance itself on the financial markets.

The EFSM has currently been activated for Ireland and Portugal, for a total amount up to €48.5 billion (up to €22.5 billion for Ireland and up to €26 billion for Portugal), to be disbursed over 3 years.

European Stability Mechanism

The EFSF shall expire on June 30, 2013 and a new permanent crisis mechanism shall replace it. The European Stability Mechanism (ESM) will start to operate as of July 1, 2013, and will constitute the permanent crisis mechanism to safeguard financial stability in the Eurozone[16]. By contrast to the EFSF, the ESM will be an intergovernmental institution governed by public law.

The ESM will be able to provide assistance, up to €500 billion, to the Eurozone states in financial distress, but such assistance will be conditional on the implementation of a strict economic and fiscal adjustment programme, in line with existing arrangements. An overall evaluation of the new mechanism will be performed by the European Commission, in liaison with the ECB, in 2016.

Measures adopted at the October 26, Euro Summit

On October 26, 2011, Eurozone leaders meeting in Brussels agreed on an additional package of measures designed to prevent the collapse of Eurozone Member States' economies caused by the increasing sovereign debt. This included a proposal to voluntary write off 50 percent of Greek's debt owed to private creditors, increasing the EFSF resources to about €1 trillion and requiring European banks to achieve 9 percent capitalisation.

Greek Debt Restructuring

First and foremost, the Greek sovereign debt will be restructured with the aim at reducing the Greek ratio of debt to GDP from over 160 percent to 120 percent by the year 2020. Since such objective inevitably requires the participation of the banking sector, the Eurozone Member States have negotiated details with the Institute for International Finance (IIF), the global association representing more than 450 banks in more than 70 jurisdictions. The negotiated agreement includes a bailout of €100 billion of Greek debt meaning that banks will have to agree to voluntary write-off 50 percent of their debt. Such nominal discount of 50 percent on notional Greek debt held by private investors will be accompanied by a €30 billion package in order to finance guarantees for the private sector. This contribution will come from the EFSF and the Greek Government, which intends to raise the money via privatisation of state-owned assets.

[15] *See Council Regulation (EU) no. 407/2010 of 11 May 2010 establishing a European Financial Stabilisation Mechanism (Official Journal L 118, 12.05.2010, p.1).*

[16] *The Treaty establishing the European Stability Mechanism was signed on 11 July 2011 by the Finance Ministers of the 17 Eurozone countries, following the European Council Decision of 25 March 2011. It was based on an amendment of Article 136 TFEU (cfr. Mayer Brown, Legal Update: Managing the Euro Crisis - Are Changes to the EU Treaty Necessary? 28 October 2011).*

The specific terms and conditions of the agreement on the private sector involvement will be negotiated by Greece, the Eurozone states, the IMF and the IIF in the coming months. The structure of the new Greek claims will need to be based on terms and conditions that ensure a net present value loss for investors fully consistent with a voluntary agreement. Subject to the formation of the new Greek government such voluntary agreement should be finalised by the end of 2011, making possible that the first bonds are exchanged in early 2012.

Increased resources of the European Financial Stability Facility

The Eurozone leaders agreed to boost the funds of the EFSF to some €1 trillion in order to foster financial stability in the Eurozone. The technical details of the plan have not been decided yet, but are expected by the end of November. However, the Summit has broadly identified two possibilities for increasing the EFSF's funds. First, using the EFSF as insurance for sovereign bond-buying, i.e. providing a credit enhancement vehicle to bond purchasers that would receive insurance in case of default. Second, using special purpose vehicles for attracting investment from private and public financial institutions and investors, an option that would probably be channelled through the IMF with a key participation of China and other emerging economies. European officials are considering combining both options. The Euro Summit expressly ruled out the possibility of the European Central Bank (ECB) financing the EFSF.

The credit enhancement approach is basically a form of insurance, under which partial protection certificates would be attached to a Eurozone member state's bond issuance. The coupon on the sovereign bond should be lower than current market yields because of the protection afforded by the attached certificate, and thereby contribute to the sustainability of financial flows. It is the political intention to avoid separate trading of bonds and certificates and, hence, investors are supposed to claim under the insurance certificates only if they hold the bonds, but details will be announced during the course of November.

Under the second option, one or more special purpose investment vehicles (SPIVs) would be established, whereby each SPIV would have a mandate to facilitate funding of Member States of the European Union through loans, and invest in sovereign bonds of a specific country in the primary and secondary markets. This vehicle could be funded by different classes of instruments with distinctive risk/return characteristics. Such instruments could include a senior debt instrument and a participation capital instrument, both of which would be freely traded instruments in capital market. In addition, there would have to be an EFSF investment, which would absorb the first proportion of losses incurred by the SPIV in question. The SPIV structure could be set up so as to attract a broad class of international public and institutional investors. For that purpose, the senior debt instrument could be credit rated and targeted at traditional fixed income investors. The participation capital instrument could be junior to the senior debt instrument but rank ahead of the EFSF investment. This might attract sovereign wealth funds and other institutional investors. This tranche will potentially share with EFSF any upside generated by the investments.

The two options outlined above do not exclude each other and can be combined and it seems that the appetite for investors for the described structures and the extent of possible investment are currently under discussion with potential investors as well.

Bank Recapitalisation

A fundamental measure to restore confidence and address the current tensions concerns the banking sector. Eurozone members agreed on a recapitalisation plan for banks to raise confidence in the sector and avoid future turbulences in the Eurozone. In order to achieve this goals, banks in Europe will be required to build up a temporary buffer for the Core Tier 1 capital ratio to reach 9 percent (compared to the 5 percent of now) by the end of June 2012.

The Summit's plan foresee a three-step method for financing the capital increase: First, banks should raise capital from the private sector and find additional capital by retaining profits and restricting the use of dividends and bonuses until the target is achieved. Only if the banks cannot satisfy their needs this way, they may rely on national governments' support – complying with the state aid crisis framework introduced by the Commission in 2008. If such national support is not directly available, the recapitalization can be funded via a loan from the EFSF to Eurozone states who then in turn can support the banks.

In the aftermath of the Euro Summit, the European Banking Authority (EBA) estimated that the EU's major banks would need approximately €106 billion recapitalisation. This figure will however be revised at the end of November. To be able to calculate this figure EBA has requested banks to disclose their capital and sovereign debt positions[17].

Other measures

The Eurozone leaders committed to implementing a number of other measures that aim at strengthening economic and fiscal coordination and surveillance, including the following ten measures in order to improve the economic governance of the Eurozone:

- Regular future Euro Summit meetings between the heads of states or government of the Eurozone and the President of the Commission to define strategic orientations for the conduct of economic policies and for improved competitiveness and increased convergence in the Eurozone.

- The President of the Euro Summit will be designated by the Eurozone heads of states or government at the same time the European Council elects its President and for the same term of office.

- The President of the Euro Summit will inform the non-Eurozone states and the European Parliament of the outcome of the Summits.

- The Ecofin-Counsel, which is the meeting of the economic and finance ministers of the Eurozone, will ensure closer coordination of the economic policies and promoting financial stability. It promotes strengthened surveillance of Member States' economic and fiscal policies as far as the Eurozone is concerned.

- Details of the election of the President of the Eurogroup, and its involvement with the Euro Summits. Clear lines of responsibility and reporting between the Euro Summit, the Eurogroup and the preparatory bodies will be established.

- The Presidents of the Euro Summit, the Commission and the Eurogroup will meet at least once a month, and the President of the ECB may be invited to participate. The Presidents of the supervisory agencies and the EFSF CEO and ESM Managing Director may be invited on an ad hoc basis.

- The Eurogroup Working Group will continue to prepare Eurogroup meetings. It should benefit from a more permanent sub-group consisting of alternates/officials representative of the Finance Ministers, meeting more frequently, working under the authority of the President of the Eurogroup Working Group.

- The Eurogroup Working Group will be chaired by a fulltime Brussels-based President.

- The existing administrative structures will be strengthened and co-operate in a well coordinated way to provide adequate support to the Euro Summit President and the President of the Eurogroup.

- Clear rules and mechanisms will be set up to improve communication and ensure more consistent messages.

Legal Issues

EU framework to deal with future bank failures

There is a broad consensus that the Eurozone states should not be expected to foot the bill of future bank crisis. Hence, the European Commission has considered that a framework has to be put in place for crises prevention. A number of topics need to be implemented to achieve such a goal, including a greater prevention, intervention tools, cross-border coordination and resolution tools.

The envisaged EU framework for bank recovery and resolution considers all of these aspects and use a couple of concepts which have been implemented already in the German Bank Restructuring Act (*Gesetz zur Reorganisation von Kreditinstituten*) such as the restructuring and reorganization procedure and the bridge institution concept.

[17] *Effective 1/2011 a new European financial market supervisory structure was established: European Banking Authority (EBA) for banking supervision, European Insurance and Occupational Pensions Authority (EIOPA) for supervision of the insurance industry, European Securities and Markets Authority (ESMA) to supervise the stability of the financial markets and for investor protection and the European Systemic Risk Board (ESRB) for macro-economic oversight of the EU financial system.*

International investors have to take the current debate into account when they invest in creditinstitutions (and the pricing of such an investment) since the EU framework discusses a partial transfer of assets of the institution in question as well as possible approaches to the design of debt write-down as a resolution tool. Such tools, of course, have an influence of the respective investor position.

Democratic legitimacy

In Germany, there is an intense debate as to the extent the parliament has to be involved to approve measures addressing the financial crisis. Chancellor Merkel indeed sought legitimacy by the German parliament before she went to the head of states summit in Brussels. In this context, a decision by the German Federal Constitutional Court dated October 27, 2011[18] is notably where the Court has decided by way of interim adjustment that the delegation of the parliamentary responsibility for the budget cannot be shifted to the so called "9 members special committee" (Committee) pursuant to the German Mechanism of Stabilisation Act (Act), until the final decision in this court proceeding has been rendered[19]. Under the Act, the Committee shall be entitled to take measures in case of urgency under the EFSF regime. Some members of the German parliament however claimed a possible infringement of Art 38 paragraph 1 Sentence 2 of the German Constitution[20] and that the Act reveals certain lack of structural democratic legitimacy. As the Federal Constitutional Court wanted to avoid a possible irreversible infringement of such parliamentary rights, it preliminary ruled that the Committee may not act in accordance with the Act until its final decision in the so called dispute procedure between organs of the state (*Organstreitverfahren*) has been issued. However, this preliminary decision cannot be taken as an index for the possible outcome of the final decision. Hence, the impact of this decision has to be considered in the course of the German implementation of solutions found by the European head of states.

Voluntary debt restructuring and credit events under the CDS

One of the goals of the Summit was to provide a form of restructuring of Greek's debt where the consequences of the restructuring are adequately controlled. Besides the need to recapitalise banks after a substantial write-off of Greek's debt, there is some uncertainty to which extent outstanding CDS triggered by a credit event could cause further turbulences on the financial markets which is why there was always the need to find a solution to restructure sovereign debt without affecting the CDS.

The idea of a voluntary restructuring is that a restructuring which is not binding for all noteholder does not constitute a credit event under a standard CDS for Western European sovereign states. The 2003 ISDA Credit Derivatives Definitions define a "Restructuring" (which would cause a "Credit Event" under the CDS and entitle the protection buyer to receive compensation payments from the protection seller), inter alia, as a number of events (described in the 2003 ISDA Credit Derivatives Definitions) which "occur in a form that binds all holders of such Obligation". The idea of the voluntary restructuring is that it does not bind all noteholders of sovereign debt.

ISDA[21] has commented recently in a number of statements on these proposed measures[22]. On the one hand ISDA deemphasizes the impact of a potential credit event under the CDS, stating that the net exposure of protection sellers on Greek sovereign debt is approximately USD 3.7bn as of October 21, 2011 (according to Depositary Trust & Clearing Corporation's CDS data warehouse) alleviated again by recovery values of underlying obligations and collateralisation between 70 percent and 90 percent.

[18] *(2 BvE 8/11) (BVerfG).*

[19] *Gesetz zur Übernahme von Gewährleistungen im Rahmen eines europäischen Stabilisierungsmechanismus/Stabilisierungsmechanismusgesetz as amended on 14 October 2011.*

[20] *Article 38 (Elections) paragraph 1 of the German Constitutional Act (Grundgesetz) stipulates the following: „The deputies to the German Bundestag shall be elected in general, direct, free, equal, and secret elections. They shall be representatives of the whole people, not bound by orders and instructions, and shall be subject only to their conscience."*

[21] *International Swap and Derivatives Associates, Inc.(ISDA).*

[22] *See e.g. http://isda.derivativiews.org/ and Greek Sovereign Debt Q&A http://isda.informz.net/z/cjUucD9taT0xMzUyMTY3JnA9MSZ1PTc1NjYyNTQ1OCZsaT02MDM4NjEw/index.html.*

On the other hand ISDA concludes that there is not yet enough information available to judge whether the roughly described restructuring measures would trigger a credit event or not, but from a current analysis it does not appear to be the case, because the restructuring plan has a non-binding nature. However, ISDA leaves it open whether the concrete restructuring measures will be regarded as a credit event (and would trigger further payment obligations between banks and cause potential turbulences) and refers to the ISDA EMEA Credit Derivatives Determination Committee which is a committee independent from ISDA competent (in certain cases) to decide whether a credit event has occurred or not.

From an investor perspective this means the following: Firstly, a voluntary restructuring will likely not involve individuals and as long as there are concerns to proceed with binding restructurings and efforts to avoid other credit events, it appears that individual investor shall not be affected by the envisaged restructuring which opens some room for arbitrage. Secondly, the 50 percent voluntary debt release is presently nothing more than a declaration of intent by some representatives of the banking association. The debt release by the creditors themselves needs to be approved by each single creditor bank. For some of those banks, in particular those which have sound hedging strategies in place, it might be a hard pill to swallow. If a bank has taken care of its sovereign risk and has hedged its sovereign exposure via a CDS, it will probably loose money by accepting the voluntary restructuring. In a situation where the restructuring would have been binding for it, it would have received money under the CDS (as protection buyer) whereas in the situation of the voluntary restructuring the CDS is technically not triggered which means that even if the bank looses 50 percent of its claims it does not get any compensation payment under the CDS. Some board member may wish to analyse first which fiduciary duties they have before accepting such a debt release.

Investing in the EFSF as a foreign public or institutional investors

EFSF bond currently yield significantly above German government bonds (Bunds) (3.6 percent vs. 1.8 percent) although both issuers benefit from the highest rating of the three major rating agencies. The reasons for such spread are certainly market aspects such as a better liquidity of Bunds, the "Bund" as an established brand for investors and the significance of Germany as the largest economy in Europe. However, such a significant spread seems to be attractive and spreads should come down unless there is a significant difference in credit risk between EFSF bonds and Bunds.

In order to assess credit risk it is worthwhile to analyze in a little more detail the guarantees provided by the Euro Area Member States in favor of EFSF issues. Under the guarantees each Euro Member State (other than Greece, Ireland and Portugal as the beneficiary states of EFSF funds, and any other state receiving funds in the future) guarantees up to 120 percent of its guarantor contribution key (which is modeled after the subscription keys of the European Central Bank, e. g. the present contribution key of Germany is 28.385 percent, France is 21.3161, Spain 12.4468 etc). Such guarantor contribution keys may be adjusted as other Euro States become beneficiaries or will be leaving the support of the EFSF funds. However, the guarantee obligations of the Euro Area Member States are several and not joint. Payments of guarantors are on a *pro rata* and *pari passu* basis but the primary source for investors are always the funds payable by the beneficiary state under its loan (plus certain cash reserves which may be requested by the trustee). As a consequence, there is performance risk on each guarantor and also the beneficiary state. The beneficiary of the guarantees is the EFSF, not the investors. Demands are made by the trustee which is Deutsche Trustee Company Limited. Deutsche Bundesbank acts as issuing and paying agent, the German Finance Agency provides back-office support. The legal conclusion, however, is that full payment under EFSF notes depends to a certain degree on the weakest guarantor and this is legally a difference compared to AAA issuers such as Germany, France, The Netherlands or Finland.

Legal Implications of Greece Leaving the Eurozone

Following Greek Prime Minister Papandreou's announcement to call for a referendum on the agreed October 26, Euro Summit agreement, several EU leaders referred to the possibility of Greece leaving the Eurozone. However, the EU Treaties do not allow for such a possibility and such an option could only be understood as a way to increase the political pressure on the Greek Government for desisting from the referendum, as it finally happened.

In fact, legally speaking, the only possible way for a Eurozone Member State to leave the Euro and quit the Eurozone is to leave the European Union altogether. Article 50 of the Treaty on the European Union (TEU) introduced the possibility that an EU Member State withdraws from the Union in accordance with its own constitutional requirements. Despite this being a unilateral action, such an option would still require the agreement of the other Member States and take significant time. Article 50.2 TEU requires that such a withdrawal would have to be communicated to the European Council. An agreement would then have to be negotiated with the Member State wishing to withdraw in accordance to Article 218(3) TFEU, setting out the arrangements for its withdrawal and taking account of the framework for its future relationship with the EU. Such an agreement would need to be concluded by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.

Outlook

The European sovereign crisis is far from over. The agreement concluded during the Euro Summit of October 26, 2011 constitutes a start to resolve problems in a coordinated and organized way. It is essential that the Eurozone Member States get their respective budget deficits under control and adopt credible reforms. But substantial work now needs to be undertaken in order to implement the restructuring plan adopted at the Euro Summit and pave the way towards financial stability in Europe.

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