Greece: the End Game?

In this briefing we consider the consequences of recent events in Greece, including:

- the Euro Summit's statement of 13 July 2015 (the "Statement") and the next steps arising from that statement (page 2);
- the current position of the Greek banking sector and the legal framework for its recapitalisation and restructuring (page 5);
- the official creditors' positions on the sustainability of Greek debt (page 6);
- the routes to bridge financing for Greece (page 8); and
- capital controls in Greece (page 9).

1. INTRODUCTION

In our client briefing Greece: the Months Ahead we described the victory of the Coalition of the Radical Left ("SYRIZA") and its formation of a government with the right-wing Independent Greeks on an anti-austerity mandate following the Parliamentary elections in Greece on 25 January 2015. Initially fired up with enthusiasm for debt restructuring and a break from the policies of the past, the coalition was forced to change tack following opposition from other Eurozone members and agreed with the Eurogroup on 20 February 2015 an extension to Greece's second bail-out until 30 June 2015. The background to the coalition and the policies of SYRIZA and the Independent Greeks are described in our earlier briefing, a copy of which may be found on our website.

Greece was subsequently tasked with agreeing and implementing a list of reforms following which the remaining funds in Greece's bail-out would be released. It was denied that a third bail-out would be required. Following tortuous negotiations a stand-off was finally reached in the negotiations on Friday 26 June. Greece interpreted the terms on offer to extend the bail-out beyond 30 June 2015 as an ultimatum and rejected them. The Greek Prime Minister, Alexis Tsipras, then called a referendum urging the Greek people to reject the terms. Meanwhile the Eurozone responded to the Greek referendum by withdrawing the proposed extension and announcing that Greece's second bail-out would expire on 30 June, following which Greece would be without official sources of funding. On 29 June Greece announced the imposition of capital controls and a bank holiday closing the banks, which have remained shut until the time of writing.

The referendum resulted in a 61% vote to reject Greece's creditors' terms, and a forced exit from the Eurozone beckoned. Greece was given a last chance by the creditor countries to apply for a third bail-out. However, this time the majority of the bail-out funds would be provided by the European Stability Mechanism ("ESM") which was set up in 2013 as the permanent bail-out mechanism for the Eurozone, and for future bail-outs took the place
of the European Financial Stability Facility ("EFSF") that had funded the second Greek bail-out. Having won the referendum, Tsipras changed policy and on 8 July submitted an application for a three year bail-out from the ESM based on a programme of reforms drafted with assistance from France. This was overwhelmingly backed by the Greek Parliament on 11 July with opposition party backing.

Later on 11 July a full day of negotiations by Eurozone finance ministers failed to reach an agreement on the Greek application. On 12 July, still without a deal, the Heads of State and Government of the Eurozone negotiated through the night an agreement that was significantly tougher than that originally presented to Greece on 26 June and that had been rejected in the referendum. The result was widely seen, especially in Greece, as a victory for Germany, although the negotiations both at the level of the finance ministers and the Heads of State and Government revealed significant fissures between member states in the Eurozone.

In the meantime Greece defaulted on 30 June on a repayment to the IMF thereby becoming the only developed country in arrears to the IMF. A further IMF default followed on 13 July.

In this briefing paper we assess the outcome of the negotiations for Greece in the short and medium term, the legal changes that are required to be implemented and the prospects for the Greek banking sector. We seek to highlight areas of uncertainty as well as potential opportunities for investment in Greece.

2. THE 13 JULY 2015 STATEMENT

As mentioned above, on 8 July the Greek Government submitted a request for a loan from the ESM. The result was a proposal to open discussions with Greece conditional on the passing and implementation of a set of measures.

Under Article 13 of the ESM Treaty an ESM Member may address a request for stability support to the Chairperson of the Board of Governors (currently, Jeroen Dijsselbloem). Such a request must indicate the financial assistance instrument(s) to be considered. On receipt of such a request, the Chairperson shall entrust the European Commission, in liaison with the ECB, with the following tasks:

• to assess the existence of a risk to the financial stability of the euro area as a whole or of its Member States;

• to assess whether public debt is sustainable. Wherever appropriate and possible, such an assessment is expected to be conducted together with the IMF; and

• to assess the actual or potential financing needs of the ESM Member concerned.

On the basis of the request of the ESM Member and the assessment referred to, the Board of Governors may decide to grant, in principle, stability support to the ESM Member concerned in the form of a financial assistance facility.

The Statement makes clear that the process of negotiations under the ESM Treaty has not formally started, and that the proposals and requirements imposed on Greece described below "are minimum requirements to start the negotiations with the Greek authorities". However, the Euro Summit stated that the start of negotiations does not preclude any final possible agreement on a new ESM programme, which will have to be based on a decision on the whole package (including financing needs, debt sustainability and possible bridge financing).
Size of the New Programme
According to the Statement the possible programme needs are between €82 and €86 billion although the Institutions (Commission, ECB and IMF) were invited to explore the possibility to reduce these figures “through an alternative fiscal path or higher privatization proceeds”. This refers to the possibility of requiring Greece to maintain a higher primary surplus than planned (i.e. a budgetary surplus after repayment of debt of 3.5% of GDP from 2018) or privatisation receipts in excess of the €50 billion earmarked by the Statement (see below). Both targets appear to us to be ambitious. Greece is also required to request continued IMF support (monitoring and financing) from March 2016. The ESM has publicly stated that it expects that part of the financing will take the form of an IMF loan. Clearly, this requires Greece to clear its current arrears with the IMF as IMF policy is not to lend to a country that is in arrears with the Fund.

Timetable
Given the need to rebuild trust with Greece, the latter has committed to an ambitious programme of legislative reform as a precondition to opening negotiations. This includes commitments to legislate by 15 July:

• the streamlining of the VAT system and the broadening of the tax base to increase revenue. More items will be subject to the top VAT rate of 23%, including restaurants, while popular holiday destinations in the Greek islands will no longer benefit from a lower VAT rate. Corporation tax will go up to 28%;

• upfront measures to improve long-term sustainability of the pension system as part of a comprehensive pension reform programme. The retirement age will rise to 67 by the year 2022, while aid to the poorest pensioners will be phased out by the end of 2019;

• the safeguarding of the full legal independence of ELSTAT (the Greek statistics agency); and

• full implementation of the relevant provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

The Greek Parliament passed the measures on 16 July by 219 votes to 64. However, 32 SYRIZA members of Parliament voted against and 6 abstained with the result that Tsipras lost his parliamentary majority and was dependent on opposition parties to pass the measures. This may weaken the Government’s ability to pass further implementing measures.

By 22 July Greece is required to:

• adopt a Code of Civil Procedure which will overhaul procedures and arrangements for the civil justice system and significantly accelerate the judicial process; and

• implement the Bank Recovery and Resolution Directive. We return to this point when discussing the position of the Greek banking sector.

The MoU
The MoU is a prerequisite under Article 13(3) of the ESM Treaty as it details the conditionality attached to the financial assistance facility. The content of the MoU will cover the severity of the weaknesses to be addressed, and the financing instrument chosen (here, a loan). The MoU will be negotiated by the European Commission in liaison with the ECB and, where possible, the IMF. The possibility therefore remains that, even if the Greek Parliament passes all the relevant legislation and commitments set out in the Statement, financial assistance will not be forthcoming. Jeroen Dijsselbloem is on record as stating that conclusion of a MoU is likely to take up to one month. This raises the issue of bridging finance discussed below.
The Statement lists a number of measures that will be included in the MoU. These include:

- ambitious pension reforms;
- product market reforms with a clear timetable for implementation of measures on Sunday trading, sales periods, pharmacy ownership, milk and bakeries as well as opening of critical closed professions (e.g. ferry transportation);
- on labour markets, undertaking rigorous reviews and modernization of collective bargaining. On the basis of those reviews, labour market practices should be aligned with international and European best practice and not based on existing practices in Greece; and
- adopting steps to strengthen the financial sector.

The Greek Government is also required to put in place a programme to build the capacity of and de-politicize the Greek public administration. This is intended to target clientelistic practices by political parties in staffing the public administration. The Government is also required to further reduce the costs of the Greek administration in line with a schedule agreed with the Institutions.

Greece is to "fully normalize working methods with the Institutions, including the necessary work on the ground in Athens, to improve programme implementation and monitoring" reversing SYRIZA’s policy of requiring the Institutions (formerly called the Troika) to operate outside Greece. Also, and with the exception of the humanitarian crisis bill, Athens must amend legislation introduced by SYRIZA counter to prior commitments made by Greece under its second bail-out, or identify clear compensatory equivalents. The latter two commitments are likely to prove a bitter pill to SYRIZA and its supporters.

Privatizations
Greece is required to "develop a significantly scaled up privatization programme with improved governance". Greek assets worth €50 billion are to be transferred to an independent fund that will monetize the assets through privatizations and other means. The monetization of assets will be applied as follows:

- €25 billion to recapitalize the banking sector (see below);
- €12.5 billion to reduce the debt-to-GDP ratio; and
- €12.5 billion for investments to repay the ESM.

Germany wanted the fund to be located in Luxembourg, and one of Tsipras’ only successes in the negotiations was for it to be established in Greece, and to be managed by the Greek authorities, albeit under the supervision of the relevant European institutions.

It remains to be seen where the assets to meet the tally of €50 billion will be found. So far Greek privatizations have raised very limited sums of money, and while there are a number of strategic assets that could be sold (e.g. ports and airports), some doubts remain as to the viability of the privatization fund in the light of recent history. The appetite to invest in Greek assets is also linked to the political and economic backdrop, and prospects for recovery.
The IMF noted in its preliminary draft debt sustainability analysis\(^1\) that there is deep-seated political resistance to privatization in Greece. Against this background, the IMF considered that a realistic and robust debt sustainability analysis should assume privatization revenues totalling €500 million per year. This is difficult to square with the €50 billion figure agreed at the Euro Summit.

Greece is also required to proceed with the privatization of the electricity transmission network operator (ADMIE) unless replacement measures can be found that have the equivalent effect on competition.

3. **THE POSITION OF THE BANKING SECTOR**

In our previous publication, we noted that the Greek banking system is in many respects the Achilles heel of the Greek economy. The capping of emerging liquidity assistance ("ELA") forced the Greek Government to impose capital controls that have resulted in a further deterioration in the financial position of the banks. Although €25 billion of the privatization fund is earmarked for recapitalization of the Greek banking sector, given the uncertainties surrounding the composition of the fund and the speed with which it is capable of realising assets this is unlikely to help with the immediate capital needs of the banking sector. Moreover it is a priority for the Greek Government to enable the reopening of the banks, while maintaining capital controls for the time being. However, on 15 July a board member of the ECB’s Single Supervisory Mechanism stated that Greek banks could only reopen once they have been "sufficiently recapitalized within the framework of a new aid program".

The Statement recognises that a rapid decision on a new programme is a condition to allow banks to reopen, thus avoiding an increase in the total financing needs of the banking sector. A comprehensive assessment of the four systemic banks, Alpha Bank, Eurobank Ergasias, National Bank of Greece and Piraeus Bank, will not, however, be undertaken by the ECB until "after the summer". It seems clear that the required implementation of the Bank Recovery and Resolution Directive ("BRRD") will play a part in that process.

Currently Greece has a fairly comprehensive toolkit for the resolution of banks including mandatory capital raising, the appointment of a Commissioner, a good bank/bad bank split and the establishment of a bridge bank to hold some or all of a bank’s balance sheet items, as well as a special liquidation procedure\(^2\). However, the existing power to bail-in is very limited, being restricted to shares, additional Tier 1 capital and subordinated debt in the context of a recapitalisation effected by the Hellenic Financial Stability Fund ("HFSF")\(^3\). Further legislation would be required to allow bail-in of senior bondholders, derivatives counterparties or non-protected depositors.

We therefore anticipate that Greece will be required to implement the bail-in provisions of the BRRD before the deadline for transposition of 1 January 2016 in order to enable the exercise of the full range of powers in the BRRD in respect of the Greek banking sector. This would enable the merger of struggling banks as well as the bail-in of existing shareholders, capital providers and other non-protected creditors, as occurred in Cyprus, as a precondition to the recapitalisation of the banking sector.

In the latter connection the Statement refers to the ESM Programme including the establishment of a buffer of €10 to €25 billion for the banking sector in order to address potential bank recapitalisation needs and resolution costs,

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\(^1\) 26 June 2015.

\(^2\) Law 4261 of 5 May 2014.

\(^3\) Law 4254 of 7 April 2014.
€10 billion of which would be made available immediately in a segregated account at the ESM. It is unclear what this €10 billion will consist of and whether it could be loaned to Greece for recapitalisation purposes prior to the comprehensive review in the autumn by the ECB of the capitalisation of Greece’s four systemic banks.

It is clear, however, that returning Greece’s banks to health – whether through mergers, recapitalisation or resolution – is essential to the recovery of the Greek economy, firstly, through the lifting of capital controls, and then by the resumption of lending to the real economy. The Statement also highlights the need for “decisive action” on non-performing loans (“NPLs”). Whatever happens, therefore, there is likely to be consolidation in the Greek banking sector as well as opportunities for investments in non-performing loans. In relation to NPLs, a range of options exist including:

- establishing one or more asset management companies;
- a good bank/bad bank split;
- the creation of a bad bank within the surviving good bank to manage the NPL portfolio; and
- structured portfolio sales on a targeted basis.

We expect that it will be some weeks or months before the proposals for banking reform are clarified.

Disposals of NPLs below book value will (if the banks have not marked the NPLs properly) impair capital further, and any purchase of assets by a state entity (such as an AMC) above market value will need to be compliant with State Aid rules.

4. THE SUSTAINABILITY OF GREEK DEBT

Article 13(1)(b) of the ESM Treaty requires the European Commission, in liaison with the ECB, to assess whether Greece’s public debt is sustainable. Wherever appropriate and possible, such an assessment is expected to be conducted together with the IMF as debt sustainability is a prerequisite for the IMF to lend.

The Statement acknowledges that “[t]here are serious concerns regarding the sustainability of Greek debt”. However it then states “nominal haircuts on the debt cannot be undertaken”. Instead the Statement reiterates that “the Eurogroup stands ready to consider, if necessary, possible additional measures (possible longer grace and payment periods) aiming at ensuring that gross financing needs remain at a sustainable level”. It notes that these measures will be conditional upon full implementation of the measures and will be considered after the first positive completion of a review of Greece’s programme of reforms.

It is unclear if this position is shared by the IMF or reflects the reality of the Greek economy. In its 26 June preliminary draft debt sustainability analysis the IMF stated that “debt relief is needed now on official sector (rather than private) claims”. The IMF continued that “If grace periods and maturities on existing European loans are doubled and if new financing is provided for the next few years on similar concessional terms, debt can be deemed to be sustainable with high probability”. However, if growth were lower, or primary surpluses below the target the debt-to-GDP trajectory would be unsustainable.
A subsequent IMF debt sustainability report released on 14 July was considerably more critical. It states that:

Greece’s public debt has become highly unsustainable. This is due to the easing of policies during the last year, with the recent deterioration in the domestic macroeconomic and financial environment because of the closure of the banking system adding significantly to the adverse dynamics. The financing need through end-2018 is now estimated at Euro 85 billion and debt is expected to peak at close to 200 percent of GDP in the next two years, provided that there is an early agreement on a program. Greece’s debt can now only be made sustainable through debt relief measures that go far beyond what Europe has been willing to consider so far.

The report adds that the IMF’s projections remain subject to considerable downside risk, suggesting that there could be a need for additional further exceptional financing from member states with an attendant deterioration in the debt dynamics. In particular, the IMF notes:

(i) **Medium-term primary surplus target**: Greece is expected to maintain primary surpluses for the next several decades of 3.5 percent of GDP. Few countries have managed to do so.

(ii) **Growth**: Greece is still assumed to go from the lowest to among the highest productivity growth and labour force participation rates in the euro area, which will require very ambitious and steadfast reforms.

In conclusion:

The dramatic deterioration in debt sustainability points to the need for debt relief on a scale that would need to go well beyond what has been under consideration to date—and what has been proposed by the ESM. There are several options. If Europe prefers to again provide debt relief through maturity extension, there would have to be a very dramatic extension with grace periods of, say, 30 years on the entire stock of European debt, including new assistance. … Other options include explicit annual transfers to the Greek budget or deep upfront haircuts. The choice between the various options is for Greece and its European partners to decide.

On 15 July the Commission took a less dramatic view considering that Greek debt would rise by less than that predicted by the IMF.
5. BRIDGING FINANCE

Greece has already defaulted on two payments to the IMF on 30 June and 13 July. Greece has the following significant debt repayments falling due in July through September.

**GREEK DEBT TIMELINE**

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<td>20.07.2015</td>
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<td>27.07.2015</td>
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The ECB expects Greece to remain current on its debts to the ECB if its banking sector is to continue to benefit from the currently capped ELA. The Statement refers to the urgent financing needs of Greece which it estimates as amounting to €7 billion by 20 July and an additional €5 billion by mid-August. Bridging finance was discussed by the EU foreign ministers on 14 July with a reported majority of the member states agreeing to tap the EU budget to lend money to Greece.

The Commission’s preferred method is a three month bridging loan by the European Financial Stabilisation Mechanism (“EFSM”). This was established under Council Regulation (EU) No. 407/2010 and is based on Article 122(2) of the TFEU. This Article facilitates financial assistance to states in “exceptional circumstances beyond [the member state’s] control”. It is arguable whether Greece’s current financial problems are caused by such circumstances. Moreover the European Council Conclusions of 16-17 December 2010 stated that the ESM would replace the EFSM.
and “agreed that Article 122(2) TFEU will no longer be needed for such purposes”. This was repeated in recital (4) of the European Council Decision 2011/199/EU amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro.

It is therefore an open question whether the EFSM is still available for this purpose. However, the Commission views these conclusions as operating only at a political level and therefore not preventing future EFSM programmes. After initial opposition, the UK Government appears to have accepted the use of the EFSM if collateral or guarantees can be provided by the Eurozone member states.

A member state seeking to borrow from the EFSM must submit a request comprising an assessment of its financial needs and an economic and financing adjustment programme setting out the measures that will be taken to restore financial stability. The Council then decides by a qualified majority whether to grant the assistance.

The general economic policy conditions are the subject of a memorandum of understanding agreed between the member state and the Commission. According to the proposed Commission decision extending short-term EFSM assistance, Greece is required to:

- adopt the measures mentioned in the Summit Statement as having 15 July as the deadline for adoption;
- taking unambiguous steps for preparing the implementation of the other policy conditions listed in the programme; and
- obtaining the agreement in principle from ESM members under Article 13(2) of the ESM Treaty to provide financing assistance to Greece.

In order to fund loans made under the EFSM the Commission is authorised to borrow on the capital markets or from financial institutions. Loans totalling €48.5 billion have previously been extended under the EFSM to Ireland and Portugal. It is reported that an agreement in principle on using the EFSM was reached on 16 July.

6. CAPITAL CONTROLS IN GREECE

The capital controls were implemented on Sunday 28 June following a slow bank run that had depleted the cash reserves of the Greek banks. The banks had been able to obtain ELA from the Central Bank of Greece with the consent of the European Central Bank. This essentially involves the Greek banks pledging Greek government bonds and other assets to the Central Bank of Greece in return for cash. Following a decision by the ECB to cap the level of ELA on 28 June the banks’ ability to access this funding was restricted. The controls apply to all banks operating in Greece, including Greek branches of foreign banks, and payment institutions. The controls prohibit all banking operations in Greece other than:

- cash withdrawals from ATMs of up to €60 per day. Persons with a bank card issued outside of Greece (e.g. tourists) may withdraw up to €600 per day or whichever is the lower limit imposed by their card issuer;
- transactions with credit and debit cards for payments credited to an account in Greece; and
- electronic or telephone banking services for payments crediting an account in Greece.
Transactions of the Hellenic Republic and specific transactions which are deemed necessary by the Committee for the Approval of Bank Transactions are exempted from the prohibition provided these are deemed necessary for the safeguarding of a public or social interest, including, among other things, transactions for medical expenses or imports of pharmaceutical products. We understand that, in practice, most applications for permission have been rejected.

During the bank holiday, as a matter of Greek law, no overdue interest is payable on claims of any nature falling due during the bank holiday, and the maturity, presentation for payment and payment of negotiable instruments are suspended. The same applies to payments under derivative contracts where the business day definition is caught by the bank holiday.

Are the Capital Controls Legal?
The Treaty on the Functioning of the European Union guarantees the free movement of capital. However, member states are allowed to impose restrictions “which are justified on grounds of public policy or public security”. Under the case law of the European Court of Justice (“ECJ”) controls must meet the requirements of the principle of proportionality. However, we consider that the maintenance of financial stability and preventing the collapse of the Greek banking system is “a genuine and sufficiently serious threat to a fundamental interest of society” and cannot be characterized as an economic difficulty caused by the elimination of barriers to intra-EU trade.

Iceland imposed capital controls following the collapse of its banking system in 2008. These controls were upheld by the EFTA Surveillance Authority under the EEA Agreement (which similarly protects free movement of capital):

The functioning of a country’s banking system is of systemic significance for the proper functioning of the state’s real overall economy and that of society. The existence of a banking system is of vital importance not only for the economy of the state but also for society as a whole, since payment systems of the country depend thereon. Therefore, the objective of the emergency measures is an overriding requirement in the general interest capable of justifying restrictions to the free movement of capital, provided that the measures taken can be regarded as proportionate to the attainment of the objective pursued.

Moreover:

The existence of a banking system is of vital importance not only for the economy of the state but also from a public security point of view, since the payment systems of the country depend thereon. Conversely, bank runs would lead to the collapse of these systems, which could potentially lead to the collapse of the whole economic system and jeopardise the functioning of society at large.

The EFTA Court considered the matter in Pálmi Sigmarsson v. Seðlabanki Íslands upholding the Icelandic controls:

For a restriction on the free movement of capital to be justified, the national rules adopted must be suitable for securing the objective they pursue and must not exceed what is necessary in order to achieve it, so as to accord with the principle of proportionality … The Court has not been provided with information to suggest that the...

4 Article 63 TFEU.
5 Article 65(1)(b) TFEU.
6 Case C-54/99 Association Église de Scientologie de Paris and Scientology International Reserves Trust v. the Prime Minister [2000] ECR I-1355, para 17.
7 [2011] EFTA Court Reports 430.
measures taken are not in conformity with the principle of proportionality. On the contrary, it appears that it was only when the rules prohibiting inbound transfer of offshore krónur were enacted that the króna and the foreign exchange reserves were stabilised. This suggests that the measures did not go beyond what was necessary to attain the objective pursued. Moreover, as noted by the Commission, the prohibition on the transfer of offshore krónur to Iceland does not render it impossible for individuals, such as the Plaintiff, to pay off debt in Iceland. It merely entails that more favourable exchange rates for Icelandic krónur on the offshore market cannot readily be obtained. Finally, the argument advanced by the Plaintiff, to the effect that the amount of funds in question is small, and that, consequently, it is disproportionate not to grant him an exception, is flawed. If all holders of offshore krónur were to carry out the same type of transaction as the Plaintiff, this would, taken together, have a major impact.

Following its banking crisis Cyprus also imposed capital controls. The Commission accepted that Article 65(1)(b) justified the measures. According to the ESM "in current circumstances, the stability of financial markets and the banking system in Cyprus constitutes a matter of overriding public interest and public security justifying the imposition of temporary restrictions on capital movements". Various legal challenges are understood to have been brought against the capital controls before the ECJ which were finally lifted in 2015.

Ultimately, the legality of the Greek restrictions under EU law will depend on an assessment of their proportionality. However, given the dire liquidity situation of the Greek banking system after the ECB’s decision not to raise the limit on ELA, we consider that it would be an uphill task to persuade a Greek court, or the ECJ, that the controls were not justified. This view has already been expressed by the European Commission:

As guardian of the Treaties and with a view to safeguarding the integrity of the single market, the Commission has made an immediate, preliminary assessment of the Greek measures that introduce the controls and finds them to be, prima facie, justified. In the current circumstances, the stability of the financial and banking system in Greece constitutes a matter of overriding public interest and public policy that would appear to justify the imposition of temporary restrictions on capital flows. Maintaining financial stability is the main and immediate challenge for the country. While the imposed restrictive measures appear necessary and proportionate at this time, the free movement of capital will however need to be reinstated as soon as possible in the interest of the Greek economy, the Eurozone, and the European Union’s single market as a whole. The Commission will closely monitor the situation and the implementation of the imposed restrictive measures on capital movements.

The IMF Articles of Agreement
Greece is a member of the IMF and bound by the IMF Articles of Agreement. The IMF Agreement draws a distinction between current and capital payments. Under Article VI(3) of the IMF Agreement:

Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b) and in Article XIV, Section 2.

Current transactions are defined in Article XXX(d):

Payments for current transactions means payments which are not for the purpose of transferring capital, and includes, without limitation:

(1) all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities;
(2) payments due as interest on loans and as net income from other investments;

(3) payments of moderate amount for amortization of loans or for depreciation of direct investments; and

(4) moderate remittances for family living expenses.

The IMF Agreement does not contain a definition of what a capital account transaction is, although Article XXX(d) adds "The Fund may, after consultation with the members concerned, determine whether certain specific transactions are to be considered current transactions or capital transactions". In effect, responsibility for policing this distinction is given to the IMF. In terms of the exceptions to the prohibition on restrictions on current transactions, Article XIV(2) allows IMF members to maintain restrictions on payments and transfers that were in effect when it became a member of the IMF. This is not relevant to Greece. Article VII(3) enables the IMF to declare that a member’s currency is "scarce", although this is not the case in respect of the euro.

However, the prohibition is not absolute. According to Article VIII(2)(a) members may impose restrictions on current payments with the approval of the Fund. Given their breadth, the capital controls imposed by Greece could cover current transactions as well as capital transactions. Iceland sought IMF approval for its capital controls. We are unaware whether Greece has sought approval under the IMF Agreement for those aspects of its capital controls that may affect current transactions. Breach of the IMF Agreement will not, however, result in the controls necessarily being not recognized by an English court as public international law is not, without more, effective in the English courts: this would require implementation through national legislation.

Enforceability of Greek Capital Controls

An English court will recognize the Greek capital controls in respect of contracts governed by the law of Greece. This follows from Article 10(1) of the Rome 1 Regulation (for contracts entered into on or after 17 December 2009) and Article 8 of the Rome Convention for earlier contracts. There are three possible exceptions to this rule: first, where the capital controls are contrary to EU law it is possible an English court would hold that recognition of the controls is barred; second, an English court will refuse to recognize capital controls if doing so would be contrary to public policy; and, finally, an English court will not do so if it would be contrary to statute or a statutory instrument. In our opinion, none of these exceptions apply in this case.

Greek law will also be relevant if the place of performance of the payment obligation is within Greece. For contracts entered into on or after 17 December 2009 the Rome 1 Regulation provides that:

*Effect may be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be or have been performed, in so far as those overriding mandatory provisions render the performance of the contract unlawful. In considering whether to give effect to those provisions, regard shall be had to their nature and purpose and to the consequences of their application or non-application.*

This essentially codifies the English common law position that illegality under the place of performance of a contract is a defence to performance of the contract. Put another way, an English court is unlikely to order performance of a contract, or payment of damages for breach of contract, that involves an illegal act in Greece under Greek capital controls regardless of the governing law of the contract. The position for contracts entered into

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8 The Rome Convention applied to contracts made after 1 April 1991 but before 17 December 2009. The common law rules that applied before 1991 were the same.
prior to 17 December 1999 is less clear, but the better view is that if the contract is governed by English law then an English court will not enforce performance of the contract.

Effect on Exchange Contracts
Finally, Article VIII section 2(b) of the IMF Agreement (which has the force of law in England) states that:

Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained consistently with this Agreement shall be unenforceable in the territories of any member.

Courts in different states have taken conflicting views as to the meaning of an "exchange contract". Essentially there are two approaches: a "broad" interpretation that holds that an exchange contract is any contract that affects in any way the country's exchange resources and a "narrow" approach that considers an exchange contract to be any contract for the exchange of one currency for another. The English and American courts apply a narrow approach to Article VIII section 2(b) limiting its scope to contracts for the exchange of currency or equivalent transactions. It is understood that the French courts apply the broad approach. The difference is significant as a broad interpretation could potentially catch all transactions with Greek counterparties whereas the narrow approach would seem to be mainly limited to swaps, forward and futures transactions in euro with Greek counterparties. General contracts for the sale of goods and services would not be caught under English law. If the Greek capital controls affect current transactions and have not been approved by the IMF then Article VIII section 2(b) would not provide a defence as they would be contrary to the IMF Agreement.

The Future of Capital Controls
The original capital controls were supposed to be in place until 6 July, although they have subsequently been extended. The Cypriot controls were in place for two years and it seems possible that the Greek controls may remain in place for a period of time even after the banking system is able to reopen.

7. CONCLUSION

It is beyond the scope of this briefing to comment on the programme’s likelihood of success. However, we note that the demands placed on Greece exceed those required of it previously, or actually achieved under the first and second bail-outs or other EU/IMF programmes. It remains to be seen whether the political will exists in Greece to take the steps required and, even if so, whether the measures will command assent from Greek society. Without political support and acceptance by the broader population that the reforms are necessary, policy slippage seems likely. And with policy slippage the financing needs of Greece will increase. It may possibly be significant that in a television interview on 14 July Prime Minister Tsipras admitted that he did not believe in the plan that "I am obliged to implement". In his view "this one-way street for Greece was imposed on us".

10 Under the Bretton Woods Agreements Order in Council 1946 SR&O No. 36.
12 Act of Cabinet Having the Effect of Law – Bank Holiday of Short Duration, Article 1.
The most likely flashpoints appear to us to be the viability of the privatization fund and the predictions for a primary surplus of 3.5% of GDP from 2018. On the latter, the Statement seeks to regulate policy slippage requiring “quasi-automatic spending cuts in case of deviations from ambitious primary surplus targets … subject to prior approval of the Institutions”. In effect, any deviation from the primary surplus target will trigger spending cuts, or tax rises, in an economy expected to contract by up to 3% this year. Such cuts would, in an economy in recession, deepen the recession and could result in a negative spiral resulting in debt deflation where each attempt to reduce the deficit (or increase the surplus) fails as the measures result in a greater contraction of economic activity.

There is also the political dimension. Tsipras won the initial vote in Parliament and, according to opinion polling, remains Greece’s most popular politician. However, it is unclear whether the current, or future Greek governments, will remain committed to the full implementation of the plan. Given the scale of defections from the vote by SYRIZA dissidents the current Greek Government appears vulnerable. The future election of an anti-austerity government – whether SYRIZA under a different leadership or a different party altogether – cannot be discounted. Finally, the question remains of where growth will come from. The ostensible aim of the programme is to enable Greece to regain market access within three years. If not, the Eurozone will face in two or three years time a similar dilemma regarding whether to retain Greek membership of the single currency. Moreover, by placing Grexit firmly on the table, Germany has made clear that euro membership is not, in the final analysis, irreversible. The implications of that realisation are likely to play out in the years and possibly decades that follow.

For further information and guidance please refer to our website.

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Our Sovereign Debt and Euro Zone group includes lawyers with sovereign debt, restructuring, financing, financial regulation and litigation expertise. We have provided advice to a range of public and private sector clients around the world on sovereign debt, restructuring and Euro Zone-related issues. Our disclosable experience includes advising HM Treasury on the Government support given to the UK banking and finance industry, the Irish Government on the reorganisation and recapitalisation of certain Irish banks and on legislation relating to the Irish banking crisis, the Portuguese Ministry of Finance in connection with the recapitalisation of certain systemically important banks, and the Central Bank of Cyprus on the emergency resolution of the Cypriot banking sector. In addition, we have been advising clients on the possible implications of the current Euro Zone crisis, including considering the impact of a break up of the euro or a withdrawal from the euro by one or more Euro Zone member states.