The 'Haircut' of Public Creditors under EU Law

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Haircut of public creditors as next step in the escalation of the euro debt crisis? – Exploring the boundaries set by the EU Treaty on debt restructuring – Limitations imposed by no-bailout clause and prohibition of monetary state financing – Standards set in *Pringle* and *Gauweiler* – Haircut on nominal debt infringes no-bailout clause – Active involvement by European Central Bank violates ban on monetary state financing – Other forms of 'soft haircuts' may be compatible with EU law

Introduction

Over the past few years, the types of financial aid have gradually expanded. At the start, there were bilateral assistance loans from member states; then, the European Financial Stability Facility was created, as was the European Stability Mechanism at a later point; further types were the involvement of private creditors in the case of Greece and, finally, the European Central Bank's Securities Markets Programme, covering bond purchases since May 2010 and the announcement by the European Central Bank that it would purchase an unlimited number of government bonds if necessary.[1] The European Court of Justice subsequently approved these far-reaching interventions. Initially, the Court had paved the way, in the *Pringle* case,[2] for the establishment of the European Stability Mechanism.

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[1] Instructively, A. de Gregorio Merino, 'Legal Developments in the Economic and Monetary Union During the Debt Crisis: The Mechanisms of Financial Assistance', 49 *CMLRev* (2012) p. 1613-1646.

[2] ECJ 27 November 2012, Case C-370/12, *Pringle* v *Ireland* (henceforth: *Pringle* case); S. Adam and F. J. Mena Parras, 'The European Stability Mechanism through the Legal Meanderings of the Union's Constitutionalism: Comment on Pringle', 38 *ELRev* (2013) p. 848 at p. 860; V. Borger, 'How the Debt Crisis Exposes the Development of Solidarity in the Euro Area', 9 *EuConst* (2013) p. 7 at p. 16-34; *see also* J.-V. Louis, 'Guest editorial: The no-bailout clause and rescue package', 47 CMLRev (2010) p. 971; P. Athanassiou, 'Of Past Measures and Future Plans for Europe's Exit

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More recently, in *Gauweiler*, the Court found the European Central Bank's Outright Monetary Transactions programme to be compatible with EU law.[3]

The broad variety of financial instruments used in the European public debt crisis might soon be enhanced by another measure – the involvement of public creditors. While the situation on the bond markets has calmed down, the prospects with regard to debt sustainability are grim, for Greece in particular. In May 2016, the International Monetary Fund told Greece that its debt sustainability was no longer guaranteed.[4] The sinister combination of low primary surpluses and insufficient reforms made earlier prognoses obsolete, according to the International Monetary Fund. An unaided return to debt sustainability barely seems possible.

In this situation, a debt cut is more topical than ever before. Even the International Monetary Fund has spoken of the possibility of a so-called 'haircut' for Greece, let us remember that, as early as 2012, there had already been a debt cut for Greece. At the time, the debt was cut for private creditors.[5] The private-sector involvement was unprecedented in terms of restructured debt volume and aggregate creditor losses.[6] It implemented a new legal regime, crafting

from the Sovereign Debt Crisis: What is Legally Possible (and What is Not)', 36 *ELRev* (2011) p. 558; R. Palmstofer, 'To Bail Out or Not to Bail Out? The Current Framework of Financial Assistance for Euro Area Member States Measured against the Requirements of EU Primary Law', 37 *ELRev* (2012) p. 771 at p. 781.

[3] ECJ 16 June 2015, Case C-62/14, *Gauweiler and Others* v *Deutscher Bundestag* (henceforth: *Gauweiler* case). On the compatibility of Outright Money Transactions programmes with EU law, *see* A. Steinbach, 'The compatibility of the ECB's sovereign bond purchases with EU law and German constitutional law', 39 *Yale Journal of International Law Online* (2013) p. 15; V. Borger, 'Outright Monetary Transactions and the stability mandate of the ECB: Gauweiler', 53 *CMLRev* (2016) p. 139-196; H. Siekmann, *The Legality of Outright Monetary Transactions (OMT) of the European System of Central Banks* 20 (Institute for Monetary and Financial Stability, Working Paper Series No. 90 2015).

[4] IMF, Greece, IMF Country Report No. 16/30, May 2016, <http://www.imf.org/external/pubs/ft/scr/2016/cr16130.pdf>, visited 26 May 2016 *cf. also* Z. Darvas and P. Hüttl, *The Long Haul: Debt Sustainability Analysis* (Bruegel Working Paper 2014/06).

[5] A. Witte, 'Greek Bond Haircut: Public and Private International Law and European Law Limits to Unilateral Sovereign Debt Restructuring', 9 *Manchester J. Int'l Econ. L.* (2012) p. 307; I. Glinavos, 'Haircut Undone? The Greek Drama and Prospects for Investment Arbitration, Journal of International Dispute Settlement', 5 *Journal of International Dispute Settlement* (2014) p. 475; IMF, Sovereign Debt Restructuring - Recent Developments and Implications for the Fund's Legal and Policy Framework, 26 April 2013, <www.imf.org/external/np/pp/eng/2013/042613.pdf>, visited 17 May 2016.

[6] J. Zettelmeyer et al., 'The Greek Debt Restructuring: An Autopsy', 28 *Economic Policy* (2013) p. 513-563; *see also* A. von Bogdandy and M. Goldmann, 'Sovereign Debt Restructurings as Exercises of International Public Authority: Towards a Decentralized Sovereign Insolvency Law', in C. Esposito et al. (eds.), *Sovereign Financing and International Law* (Oxford University Press 2013) p. 39-70.

an orderly debt exchange in order to restructure debt dispersed among many private creditors.[7]

However, none of the previously mentioned financial assistance mechanisms or the private debt cut apparently succeeded in bringing Greek debt levels onto a sustainable path.[8] Currently, several kinds of debt relief involving public creditors are being debated: the extension of maturities of loans; the reduction of interest rates; a transformation of loans into interest-free bonds; and a debt cut on the nominal value either by the Member States, the European Stability Mechanism or with regard to the government bonds in the portfolio of the European Central Bank.[9]

This article examines, as they arise from European primary law, the conditions under which an involvement of the public creditors is admissible. The aforementioned Court judgments on the European Stability Mechanism and the Outright Monetary Transactions programme provide insights into the interpretation of, in particular, Articles 123 and 125 TFEU. The various instruments implying full or partial haircuts and other forms of debt relief shall be assessed and evaluated on this basis. The second section of this article examines the provisions of Article 125 TFEU, and the various guises of a possible public creditor involvement are assessed on this basis. The third section studies the particular case of the European Central Bank and the possibility of a debt cut on the government bonds purchased by the European Central Bank. The fourth section provides a conclusion.

The Compatibility of Involving Public Creditors with Article 125 TFEU

Applying Article 125 paragraph 1 TFEU to public debt cuts

Any financial assistance must be assessed with reference to the no-bailout clause set out in Article 125 TFEU. At first sight, Article 125 paragraph 1 TFEU does not appear to be pertinent in a case of debt relief. After all, the article merely stipulates that the European Union and its Member States are neither liable for nor assume the commitments of other Member States. The article thus primarily covers certain

[7] On the various episodes of debt restructuring in general *see* F. Sturzenegger and J. Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises* (MIT Press 2007).

[8] There remains, however, considerable disagreement on the methodology to compute the debt sustainability, *see* J. Schumacher and B. Weder di Mauro, *Diagnosing Greek debt sustainability: Why is it so hard?* (Brookings Papers on Economic Activity, 26 August 2015).

[9] Z. Darvas et al., *A Comprehensive Approach to the Euro-Area Debt Crisis* (IEHAS Discussion Papers MT-DP 2011/10); D. Gros and T. Mayer, *Debt reduction without default?* (CEPS Policy Brief, No. 233/February 2011). On further measures *see also* A. von Bogdandy et al., 'Verlustrisiko', *Frankfurter Allgemeine Zeitung*. 23 July 2015. p. 6.

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financial payments within a triangular constellation of the initial creditor, the debtor state and the debt-assuming state. The prohibition of 'liability' and of 'assuming the commitments' of another Member State seems to presume the existence of this triangular relationship.[10]

In consequence, a debt cut that occurs within the bilateral relation between the recipient country and the donor countries in the Eurozone is not covered at first glance. If Article 125 paragraph 1 TFEU were to be interpreted in such a formalistic manner, however, it would become practically useless, for in such a case financial aid could initially be granted, leaving the debt owed to creditors untouched and allowing the recipient state to pay its debts with this financial aid. In a second step, the financial aid could then be abated or otherwise privileged in the bilateral relationship of recipient and lender.

From this vantage point, the Court's statement on the European Stability Mechanism in *Pringle* gives guidance. The Court speaks of a 'new debt' arising as a result of financial aid from the European Stability Mechanism – that is, a new debt of the recipient Member State towards the European Stability Mechanism. This new debt arises in addition to the existing debt, for which the recipient Member State remains responsible.[11] In referring to the 'new debt' that arises, the Court substantiates its observation that the European Stability Mechanism, as a lending institution, is not at all liable for the debts of a recipient state. In other words: the arising of a new debt is a *sine qua non* for the donor state not being 'liable' in the sense of Article 125 paragraph 1 TFEU. In the case of debt relief (at least if the nominal debt is partially remitted), however, this debt would expire. Yet, it should not make any difference whether the new debt does not develop in the first place (in other words, the money is given to the recipient country as a gift) or whether it is remitted at a later point.

Based on the reasoning in *Pringle* on the emergence of a 'new debt', loans emitted under the European Stability Mechanism do not constitute an assumption of debt within the meaning of Article 125 TFEU. However, what is of interest here is the ensuing step, which is not requiring the *repayment* of a loan previously granted (under European Stability Mechanism or other financial aid instruments). Concerning the scope of Article 125 paragraph 1 TFEU, this provision is applicable in the bilateral relationship and in the bilaterally-granted debt relief simply because the debt-assuming country that agrees to the haircut is not only the creditor, but also assumes the debt of the recipient state vis-à-vis

[10] While the terms 'liable for' and 'assume' are used in Article 125 TFEU, the Court refers in *Pringle* to the term that countries 'remain responsible to its creditors for its financial commitments', *see Pringle* case, para. 138. Throughout this analysis we use the terms 'remain responsible', 'be liable for' and 'assume commitments' as synonyms describing when one country takes over or extinguishes the debt of another country.

[11] *Pringle* case, para. 139.

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the debt-assuming country itself.[12] These states are thus both creditors and at the same time debt assumers vis-à-vis another state. Through financial aid, the debt-assuming states have become the creditors of the programme countries, either directly (in the case of bilateral loans) or indirectly (in the case of financial aid from the European Stability Mechanism). If they cut the debt by not requiring repayment of the loan, they therefore assume the recipient state's debts to them. In the constellation of debt cutting, therefore, Article 125 paragraph 1 TFEU requires no triangular relationship.

Benchmarks of bailout prohibition for creditor involvement

There has been a controversial debate about how Article 125 TFEU should be interpreted.[13] This debate centred, on the one hand, around the interpretation of phrases such as 'be liable for' and 'assume the commitments of' in Article 125 paragraph 1 TFEU. On the other hand, it also considered the role of Article 122 paragraph 2 TFEU, according to which the EU can guarantee financial aid to a Member State in the case of 'exceptional occurrences'.[14] The opinion has also been voiced that voluntary help should not be covered by the wording of Article 125 paragraph 1 TFEU.[15] Furthermore, a state of emergency within the Union,[16] a 'teleological reduction'[17] of Article 125 paragraph 1 TFEU and the European solidarity principle were also brought into the debate.[18]

In *Pringle*, the Court substantiated the terms of this norm by finding that this clause was 'not intended to prohibit either the Union or the Member States from granting any form of financial assistance whatever to another Member State'.[19] The Court based its observation on an analysis that took account of both the

[12] It is admitted that from a purely positivistic viewpoint, a haircut is not equivalent to the assumption of debt as the debt ceases to exist. However, considering the aim of Article 125 TFEU to prevent debt relief in order to maintain market pressure, a haircut (i.e. renouncing of the repayment of debt) has the same effect as one Member States assuming the debt that another Member State has vis-à-vis a third institution.

[13] *See* Steinbach, *supra* n. 3; Louis, *supra* n. 2, p. 971; Athanassiou, *supra* n. 2, p. 558.

[14] Further instructive reading on this discussion can be found in Louis, *supra* n. 2, p. 971; Palmstofer, *supra* n. 2, p. 781; Adam and Mena Parras, *supra* n. 2, p. 860; Borger, *supra* n. 2, p. 16-34; B. Eichengreen, 'The Euro's Never-Ending Crisis', 110 *Current History* (2011) p. 91.

[15] P. Behrens, 'Ist ein Ausschluss aus der Euro-Zone ausgeschlossen?', 4 *EuZW* (2010) p. 121.

[16] F. Schorkopf, 'Gestaltung mit Recht', 136 *Archiv öffentlichen Rechts* (2011) p. 323 at p. 341.

[17] U. Häde, 'Die europäische Währungsunion in der internationalen Finanzkrise – An den Grenzen europäischer Solidarität?', 6 *Europarecht* (2010) p. 856.

[18] C. Calliess, 'Perspektiven des Euro zwischen Solidarität und Recht – *Eine rechtliche Analyse der Griechenlandhilfe und des Rettungsschirms',* 2 *Zeitschrift für europarechtliche Studien (ZEuS)* 2011, p. 213 at p. 250 ff.

[19] *Pringle* case, para. 130; *see also* V. Borger, 'The ESM and the European Court's Predicament in Pringle', 14 *German Law Journal* (2013) p. 113 at p. 117.

systematic interpretation of the treaty as well as the original intention of the drafters of the treaty.[20] The Court took recourse to the preparatory work of the Maastricht Treaty, where it found the intention to 'ensure that the Member States remain subject to the logic of the market' when they enter into financial assistance.[21] At the core of Article 125 TFEU, as it is interpreted by the Court, lies the encouragement of Member States to conduct sound budgetary policies, ideally incentivised by market pressure, but under certain circumstances also through conditionality if financial support is indispensable for financial stability.[22]

The Court did not see budgetary discipline diminishing as a result of the European Stability Mechanism, as any stability support may be granted 'only when such support is indispensable to safeguard the financial stability of the euro area as a whole and of its Member States and the grant of the support is subject to strict conditionality appropriate to the financial assistance instrument chosen'.[23] Hence, according to the Court, the market pressure logic enshrined in Article 125 paragraph 1 TFEU is not impaired, as long as one or several Member States provide financial aid to another Member State that remains liable for its own debts towards its creditors – and provided that the conditionality is suitable to incentivise it towards more solid budgetary policies.[24]

For a proper evaluation of a public debt relief it is important to consider how the Court characterises the conditions under which the financial aid from the European Stability Mechanism is admissible. Aside from 'strict conditionality',[25] every instance of financial aid has to be paid back to the European Stability Mechanism by the recipient state, and the sum that is due must be increased by an 'appropriate margin'.[26] The Court does not explicitly refer to the payment and margin (by which it means interest) as a necessary precondition for the legality of the financial aid. However, we must assume that this is what is meant, since the Court uses this point to solidify its claim that financial aid does not mean that the European Stability Mechanism is liable for the recipient state's debt. The obligation to repay and the necessity for interest are therefore both guarantees that the European Stability Mechanism is not assuming the debt of a recipient

[20] F. Fabbrini, 'The Euro-Crisis and the Courts: Judicial Review and the Political Process in Comparative Perspective', 32 *Berkeley Journal of International Law* (2014) p. 98.

[21] *Pringle* case, para. 136; Craig, 'Pringle: Legal Reasoning, Text, Purpose and Teleology', 20 *Maastricht Journal of European and Comparative Law* (2013) p. 3.

[22] *See also* Adam and Mena Parras, *supra* n. 2, p. 860; Borger, *supra* n. 2, p. 16-34; Eichengreen, *supra* n. 14, p. 91.

[23] *Pringle* case, para. 142.

[24] *Pringle* case, para. 137.

[25] *Pringle* case, para. 136.

[26] *Pringle* case, para. 139.

Member State.[27] On top of this, it is decisive that the donor institution (either the European Stability Mechanism or Member States) does not act as a guarantor for the debts of the recipient Member State. This state must remain liable for its own financial obligations towards its creditors.[28]

However, the Court remains fairly vague with regard to the conditions of financial aid being lawful. Such aid has to be 'indispensable'[29] for maintaining financial stability within the eurozone. This macroeconomic criterion is not described in any further concrete fashion and should offer wide leeway in line with the well-established jurisprudence of the Court. There is case law that sets high thresholds for the legality review of discretionary economic policy decisions, as has been the case, for example, in the area of trade policy and competition law. In these cases, which can, by analogy, also apply to monetary and financial stability considerations, the Court undertakes a substantial legality review only where there have been obvious and manifest errors or an abuse of discretion.[30]

The Court, in sum, stipulates that the following conditions be prerequisites for financial aid using Article 125 paragraph 1 TFEU:

(i) the recipient state must remain liable towards its creditors;

(ii) the financial aid must be repaid as well as an additional appropriate margin. The creation of 'new debts', which the recipient country owes the lending institution as a result of the financial aid, ensures that the lending institution does not burden itself, even indirectly, with the recipient country's debts;

(iii) the financial aid must be indispensable for maintaining financial stability within the eurozone. For this prerequisite, it is likely that the acting institutions have a significant assessment prerogative. In view of the macroeconomic nature of this condition, the Court would have to limit itself to a review of evident or manifest error. Either way, the Court has in the past left the EU Commission plenty of leeway in other cases concerning financial policy. Similarly, in *Gauweiler*, the Court has acknowledged the broad discretion of the European Central Bank, particularly given the technical nature and complex assessments at stake;[31]

(iv) financial aid is illegitimate if it leads to an impairment of the incentive for a recipient Member State to pursue a solid budgetary policy. This prerequisite

[27] On this, *see also* C. Calliess, 'Der ESM zwischen Luxemburg und Karlsruhe', 32 *NVwZ* (2013) p. 103.

[28] *Pringle* case, para. 138.

[29] *Pringle* case, para. 136.

[30] ECJ 17 September 2007, Case T-201/04, *Microsoft* v *EC Commission*; *see also* ECJ 16 March 2004, Case T-118/96, para. 67 (anti-dumping measures); Steinbach, *supra* n. 3, p. 27.

[31] *Gauweiler* case, para. 68.

> replaces the market logic behind Article 125 paragraph 1 TFEU. In order for it to be secured, 'strict conditionality' must be in place, which is suitable to move the Member State to work towards 'sound budgetary policies'. The condition, too, is so abstract and vague[32] that its interpretation is left to the margin of assessment that the acting organs have; a Court examination of the suitability of the conditions for attaining the goal cannot be overly strict given that the Court would typically require a 'manifest error of assessment'.[33]

With these conditions, the European Court of Justice is entirely in line with the German Constitutional Court, which outlined criteria for the compatibility of financial aid with the German constitution. For the Constitutional Court, too, maintaining market logic and its disciplining measure of pressure by requiring interest payments is central. However, it observes that financial aid somehow diminishes the principle of national budgets being independent and subject to market pressure.[34] Instead of a country's market dependence with regard to its refinancing possibilities, financial assistance between the eurozone Member States is granted – only, however, if this is indispensable for the stabilisation of the eurozone as a whole.[35] Despite the national budgets losing their independence, the Constitutional Court still sees the most important condition – the stability character of the monetary union – as fulfilled, in particular because the obligation to exercise budgetary discipline still remains in force, according to the stipulations laid down in Articles 126 and 136 TFEU, and the 'exceptional' nature still remains in place, according to which financial aid must serve currency stability and may only be activated once the step becomes indispensable for the stabilisation of the eurozone as a whole.[36]

Consequences for the 'haircut' of public creditors

With such a backdrop, doubts arise concerning individual forms of creditor involvement, namely with regard to the compatibility with the principles laid down in the case law.

First, the connection between the incentive for a solid budget and strict conditionality is in doubt whenever the conditions for debt reduction are

[32] M. Nettesheim, 'Europarechtskonformität des Europäischen Stabilitätsmechanismus', 66 *NJW* (2013), p. 16.

[33] *Gauweiler* case, para. 74.

[34] BVerfG 7 September 2011, Case No. 2 BvR 987/10, 2 BvR 1485/10, 2 BvR 1099/10, para. 181.

[35] BVerfG 12 September 2012, Case No. 2 BvR 1390/12, paras. (1-319), para. 232.

[36] BVerfG 12 September 2012, Case No. 2 BvR 1390/12, paras. (1-319), para. 233. By contrast, the German Constitutional Court does not explicitly mention conditionality as a prerequisite.

gradually relaxed. To put it in simple terms, the incentive for budget discipline is lower the more substantial the acquittal is to repay debts. There are, at most, merely gradual differences. Prolonged repayment terms and interest-rate reductions mean that the nominal debt remains, and with it the pressure to facilitate repayment through budget consolidation. In the case of a (partial) nominal debt reduction, on the other hand, the incentive effect takes the form of a heightened moral hazard.[37] While the state, in the worst-case scenario, could count on financial aid from the other Member States, it can now even speculate on full debt remission, which will likely reduce the incentive to consolidate its budget.

Depending on the kind of debt relief, it becomes increasingly difficult to argue that conditionality-based financial aid represents a functional equivalent to market-based refinancing. The Court's line of argument in the European Stability Mechanism judgment suggests that it acted on the assumption of precisely this equivalence between the disciplining effect of market mechanisms on the one hand, and the steering effect of conditionality on the other.[38] More specifically, the interest rate for bilateral and European Stability Mechanism loans to Greece is already significantly below the market-based level. Any further easing of interest payments would weaken the functional equivalence, assumed by the Court, between regular interest-based market pressure and conditionality-based state pressure. It would completely dissolve in the case of a debt cancellation. As long as both the terms and the interest are set at least in the vicinity of the refinancing conditions that markets require, we might still be able to speak of comparable market conditions and thus functional equivalence.[39] This appears more and more doubtful, however, the more the interest payment standard is lowered. Should the credits be transformed into long-term, interest-free loans, it would be increasingly questionable to speak of a comparability of market conditions and restrictions.

Second, debt relief calls into question the Court's criterion that there must not be liability of the European Stability Mechanism (or of the Member States) for the debts a recipient state has towards its creditors. As mentioned above, every debt reduction occurs within a bilateral framework between the debt-reliever and the

[37] For a general take on the moral hazard implications of Article 125 TFEU, *see* A. Steinbach, 'Effect-based analysis in the Court's jurisprudence on the euro crisis', *European Law Review*, forthcoming. M. C. Kerber and S. Städter, 'Ein Beitrag zum Individualrechtsschutz gegen Rechtsverstöße der EZB', 14 *EuZW* (2011) p. 536; W. Frenz and C. Ehlenz, 'Europäische Wirtschaftspolitik nach Lissabon', 9 *GewArch* (2010) p. 329.

[38] Nettesheim, *supra* n. 32, p. 16, who casts doubt on this connection with regard to the European Stability Mechanism.

[39] Clearly, difficulties in drawing such a comparison result from the fact that market-based bond spreads do not reflect a state's fundamentals but are rather determined by negative self-fulfilling market sentiments, *see* P. De Grauwe and Y. Ji, 'Self-fulfilling crises in the Eurozone: An empirical test', 34 *Journal of International Money and Finance* (2013) p. 15-36.

recipient state, ignoring the relationship to third parties. However, this means that the debt-relieving countries themselves become creditors of the programme countries by means of the financial aid. If the debt-relieving countries waived repayment, they would assume liability for the loans owed to them, implying incompatibility with Article 125 paragraph 1 TFEU.

Third, the obligation to repay is revoked – at least in the case of the (partial) debt waiver; and it is this obligation that the Court, in its European Stability Mechanism judgment, presented as proof that the financial aid would not waive an existing debt of the recipient country, but instead create a new one.[40] The 'appropriate margin' referred to in the European Stability Mechanism judgment is also increasingly called into question, as a result of interest rate cuts and term extensions, and done away with entirely in the case of debt relief.

Fourth, and finally, (public) creditor involvement is less obviously justifiable through the argument of a necessity for the 'safeguarding of the stability of the euro area', as is the case with financial aid under the European Stability Mechanism. Financial aid granted under the European Stability Mechanism is tied to instances where a country's refinancing ability is at stake and the debt default the alternative to not granting financial support. By contrast, debt relief does not serve to ensure short-term solvency, but rather rests on the long-term forecast of whether the prospective growth path of a country allows a repayment of its debts.[41] However, we can suppose from a political-economy perspective that all forms of future debt reduction, from interest rebates to a complete haircut, would be enacted on the claim that it would be indispensable to safeguard the stability of the euro area as a whole. The restoring of Greek debt sustainability and the prior involvement of private creditors are likely to be used as arguments for the inevitability of such a step.[42] Since by the mere nature of the situation we are dealing with hardly verifiable economic assessments, this opinion ought at least not to be vitiated by a manifest error of assessment.[43] We can also expect an attempt to use the maintenance of conditionality as proof that these measures ensure the adhesion to budget discipline. However, this line of argument remains unconvincing. While financial aid is supposed to prevent harmful consequences for the financial stability of the euro area, it is difficult to see how a debt relief would likewise be indispensable for the stability of the euro area. At the core rather lies the securing of debt sustainability and hence a fuzzy, discretionary criterion

[40] *Pringle* case, para. 139.

[41] On the concept of debt sustainability, *see*, for instance, IMF and World Bank, *The Challenge of Maintaining Long-Term External Debt Sustainability*, 20 April 2001, <www.imf.org/external/np/hipc/2001/lt/042001.pdf>, visited 17 May 2016.

[42] On debt cuts for private creditors, *see* A. C. Porzecanski, *Behind the Greek default and restructuring of 2012* (MPRA Paper No. 44178 2012).

[43] *Gauweiler* case, para. 74.

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that is turned into a prerequisite mainly by the International Monetary Fund to become involved in the financial aid.[44]

Against this backdrop, it becomes clear why an interpretation of the *Pringle* judgment, which would permit a haircut if it was indispensable for the stability of the euro area, should be rejected.[45] The Court held that, by this interpretation, the Treaties allow bailouts to bring a country back on track and to make market forces operative again. One might apply the same reasoning if the bail-out turns out to be unsuccessful, bringing the country into a situation where it needs debt relief to get back on track. However, in light of the above analysis this seems to be untenable both in view of the clear wording of Article 125 TFEU and the Court's reasoning in *Pringle*. First, while credits granted through the European Stability Mechanism lead to an additional debt of only temporary nature, debt relief through haircut extinguishes debt and does so permanently – this is a significant qualitative difference encroaching upon the no-bailout principle. Second, reading *Pringle* to mean that conditionality renders any kind of support or haircut admissible overburdens the conditionality requirement, the function of which is to be an equivalent to market-based refinancing. Third, from an effect-based perspective, the greater the potential for debt relief, the lower the incentives to pursue solid budgets, further undermining the intention of the no-bailout clause.[46] And fourth, it remains unclear how the long-term concern of fiscal sustainability can jeopardise the financial stability of the eurozone as such.

Debt relief on the basis of the solidarity principle?

While a haircut on nominal debt runs counter to Article 125 paragraph 1 TFEU, one could consider a justification based on the solidarity principle, which is rooted in the EU Treaties.[47] It has been suggested, in the context of financial aid, that the solidarity principle should gain more relevance within the interpretative scope of Article 125 paragraph 1 TFEU.[48] In accordance with Article 4 paragraph 3 EUT,

[44] On the diverging approaches in assessing debt sustainability *see* J. Schumacher and Beatrice Weder di Mauro, *Diagnosing Greek debt sustainability: Why is it so hard?* (Brookings Papers on Economic Activity, 26 August 2015).

[45] In this vein, *see* A. von Bogdandy et al., *supra* n. 9, p. 6.

[46] For an analysis of the Court's effect-based approach see A. Steinbach, 'Effect-based analysis in the Court's jurisprudence on the euro crisis', *European Law Review*, forthcoming.

[47] On the basis of Art. 2 TFEU, solidarity is a foundational value of the EU. For express references to the principle of solidarity, see Arts. 21 and 24 paras. 2 and 3 TFEU, as well as Arts. 67, 80, 122, 194 and 222 of the TFEU; C. Boutayeb, 'La solidarité, un principe immanent au droit de l´Union européenne', in C. Boutayeb (ed.), *La solidarité dans l´Union européenne* (Dalloz 2011) p. 5-37.

[48] On this, *see* Calliess, *supra* n. 18, p. 222 and 268; *see also* I. Domurath, 'The Three Dimensions of Solidarity in the EU Legal Order: Limits of the Judicial and Legal Approach', 35 *European Integration* (2013) p. 459-475.

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the solidarity principle creates an effect, via its procedural dimension (loyalty to the Union), of the Member States and the EU working together loyally with a view to maintaining the monetary union.[49] On that basis, a solidarity principle thus understood produces a teleological reduction of the scope of the prohibition of Article 125 paragraph 1 TFEU, allowing for temporary financial aid in the interest of maintaining the monetary union subject to certain conditions.[50]

This approach seems plausible to the extent that it constitutes a kind of 'practical concordance' between the different interpretations of Article 125 paragraph 1 TFEU and the solidarity principle.[51] The previous financial assistance programmes are in accordance with this. However, the approach has its limits in the case of debt relief. If the solidarity principle were used to justify any financial support, including a complete debt cut, thus releasing the recipient state from its obligations, then Article 125 paragraph 1 TFEU would be completely undermined. The solidarity principle cannot be used as to disregard the aim and wording of other treaty provisions. This would be the case here: the market logic inherent in Article 125 paragraph 1 TFEU and the express prohibition of liability for the debts of other Member States would at least be breached by debt relief in the guise of a cut of the nominal debt.

A Debt Waiver on the Part of the European Central Bank

Another way of involving the creditors is an involvement of the European Central Bank through the government bonds it holds in its portfolio. In reaction to the debt crisis, the European Central Bank Governing Council had initially activated its Securities Markets Programme, in May 2010.[52] Then, the decision of the European Central Bank Governing Council on technical features of the Outright Monetary Transactions programme was taken on 6 September 2012 following Draghi's 'whatever it takes' message. According to this decision, the European Central Bank would, if necessary and under strict conditions, lift the market pressure on struggling euro states through bond purchases on the secondary market provided these states accept conditionality under the European Financial

[49] More generally *see* M. Klamert, *The Principle of Loyalty in EU Law* (Oxford University Press 2014).

[50] On the solidarity dimension of the relevant norms in Art. 122 TFEU and Art. 125 TFEU, *see* P. Hilpold, 'Understanding solidarity within EU law: An analysis of the "islands of solidarity" with particular regard to Monetary Union', 34 *Yearbook of European Law* (2015) p. 257-285.

[51] On the relationship of the solidarity principle and the interpretation of Art. 125 TFEU, *see* Opinion of Advocate General Kokott in the *Pringle* case, paras. 142-143. In her view, a wide interpretation of Art. 125 TFEU banning all kind of financial support would lead to undesirable results.

[52] ECB, Decision of 14 May 2010 (ECB/2010/5), OJ 2010, L124/8.

Stability Facility/European Stability Mechanism programme.[53] With such measures, the European Central Bank aims at securing the implementation of a fiscal policy directed at price stability.

One may consider haircuts involving the European Central Bank in light of the European Court of Justice's *Gauweiler* judgment, which found secondary market purchases motivated by monetary policy considerations to be in line with Article 123 TFEU (enshrining the ban on monetary financing).[54] The main dispute between the Court and the German Constitutional Court concerned the nature of the bond purchases, falling either in the monetary policy domain (European Court of Justice) or into Member States' economic policy competence (German Constitutional Court).[55] In addition, and possibly relevant for the issue of debt restructuring, we have the Court's acknowledgement in *Gauweiler* of the broad discretion of the European Central Bank, particularly given the technical nature and complex assessments at stake.[56] Hence, the Outright Monetary Transactions programme was not vitiated by a manifest error of assessment,[57] and the European Central Bank could reasonably take the view that the Outright Monetary Transactions programme was appropriate for the purpose of contributing to the Bank's objectives and therefore to maintaining price stability.

In light of the broad discretion granted to the European Central Bank[58], one may also consider the Bank's leeway when thinking about participation in debt restructuring. However, the Court's insistence in *Gauweiler* on the motivation of the Outright Monetary Transactions programme being based on monetary policy considerations makes clear that any discretion held by the European Central Bank would have to be tied to its monetary policy mandate. In other words, agreeing to a haircut must be driven by monetary policy purposes and not by fiscal policy considerations. Consequently, a monetary policy rationale is needed, according to which a high overall debt burden (but not only high short-term refinancing costs as expressed by bond spreads and justifying the Outright Monetary Transactions programme) is an impediment to the smooth functioning of monetary policy. In principle, in *Gauweiler* the Court seems to accept the theoretical possibility that government bonds purchased by the European Central Bank can lose value in the

[53] European Central Bank, Press Release, Technical Features of Outright Monetary Transactions, 6 September 2012, <www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html>, visited 17 May 2016.

[54] *Gauweiler* case; Steinbach, *supra* n. 3; differently Siekmann, *supra* n. 3.

[55] Borger, *supra* n. 3; Steinbach, *supra* n. 3.

[56] *Gauweiler* case, para. 68; on the wide margin of the European Central Bank *see also* Steinbach, *supra* n. 3, p. 27.

[57] *Gauweiler* case, para. 74.

[58] More generally on the marginal review standard of the proportionality analysis undertaken by the ECJ, *see* Türk, *Judicial Review in EU Law* (Edward Elgar Publishing 2010) p. 137.

case of a debt default – a typical market risk.[59] The Court is referring here to standard European Central Bank open market operations, for instance, which do carry a market risk and a loss risk, but always have (or should always have) a monetary policy motivation.[60]

By contrast, if the European Central Bank initially purchases government bonds for monetary policy purposes in order to ensure the transmission mechanism, and if a debt cut on purchased bonds occurs later for fiscal reasons, improving a Member State's debt sustainability, this would have to be viewed as forbidden monetary financing of governments.[61] A debt waiver would then be tantamount to redefining the initial reason for the purchase (the monetary policy motivation), if the purchase is used retroactively to save states from bankruptcy by financially stabilising them.[62]

It then turns out to be an empirical question whether monetary policy or fiscal policy motivations would be driving the motive behind a haircut. At this stage, fiscal policy looms prominently in the public debate, which focuses mainly on Greece's debt unsustainability without reference to monetary policy concerns.[63] This would thus be a situation where debt relief is actively and purposefully pursued by the European Central Bank for fiscal policy reasons, the goal being an improvement of debt sustainability rather than having its primary motivation in monetary policy. Such a debt cut would seem to be inadmissible for the Court, given the Court's lengthy justification of the Outright Monetary Transactions programme due to the monetary policy aim pursued by the European Central Bank. Advocate General Villalón was even clearer on this point. For him, for the compatibility with Article 123 TFEU it was decisive that 'the ECB will not actively contribute to bringing about a restructuring but will seek to recover in full the claim securitised on the bond'.[64] With the Advocate General's abundantly clear rejection of any involvement of the European Central Bank in a haircut, the statement should be restrictively interpreted as to debt restructurings pertaining to fiscal policy and sustainability motives – an European Central Bank that actively pursues a debt cut for fiscal policy purposes acts unlawfully.[65]

[59] *Gauweiler* case, para.125.

[60] *Cf.* Art. 18.1 ECB Statute.

[61] *See also* F. Schorkopf, Stellungnahme Europäische Zentralbank, 16 January 2013, p. 52; P. Sester, 'Die Rolle der EZB in der europäischen Staatsschuldenkrise', 3 *EWS* (2012), p. 85.

[62] F. Gianviti et al., *European Mechanism For Sovereign Debt Crisis Resolution: A Proposal* (Bruegel Blueprint 10 2010) p. 10.

[63] IMF, Greece, IMF Country Report No. 16/130, May 2016, <www.imf.org/external/pubs/ft/scr/2016/cr16130.pdf>, visited 26 May 2016.

[64] Opinion of Advocate General *Villalón* in *Gauweiler* case, para. 235.

[65] This analysis extends to the Eurosystem's expanded asset purchase programme. The programme was launched on 22 January 2015 and foresees combined monthly purchases of € 60 billion in

The question remains what the term 'actively' could mean and how it relates to the practical implementation of haircuts, particularly given the relevance of collective action clauses. In this regard, in the course of the private haircut undertaken during the financial crisis of 2011-12, the Greek government introduced a retroactive collective action clause setting a majority threshold of 66.67% to agree to a debt restructuring that is conclusive and legally binding on all holders of the bond. However, the European Central Bank was exempted from this haircut, perpetuating the mutual dependency between Greece and its public lenders, including the European Central Bank.[66] Also, euro area model collective action clauses requiring a supermajority of 75% have been introduced on the basis of the European Stability Mechanism Treaty and made compulsory for euro area government securities with a maturity of over one year.[67] While it will take a number of years before euro collective action clauses are contained in the majority of euro area sovereign bonds, there is some likelihood that the European Central Bank could be involved in a haircut involving collective action clauses. It is at least a possible scenario that the European Central Bank would hold less than 25% and would thus not be able to block the debt restructuring. This may be precisely the situation where the term 'actively' as used by Advocate General Villalón becomes relevant – the European Central Bank would be obliged to block the haircut where possible but would have to accept it where its vote is overridden by other bond holders.[68]

Another issue in this context is the role of the national central banks of the eurosystem. This issue raises the question of the independence of national central banks both from the European Central Bank and national governments. A distinction must be made between bond purchases that national central banks undertook within their tasks under the eurosystem and those they performed outside the eurosystem within the ambit of Article 14.4 of the European Central Bank Statute – national central banks may purchase bonds under this provision on their own account for reasons other than monetary policy.[69] In principle, and as stated above, Article 123 TFEU would prohibit any consent to a haircut if aiming at debt relief, as even under the national central bank's independent leeway there must

public and private sector securities including the public sector purchase programme of marketable debt instruments issued by euro area central governments. All these entities are public sector entities and are thus subject to the ban of monetary financing under Article 123 TFEU, which prohibits the extension of direct credit to public sector entities or sovereigns.

[66] Zettelmeyer et al., *supra* n. 6, p. 550, 554.

[67] This was based on the conclusions of the European Council of 24/25 March 2011 and developed by the Economic and Financial Committee (EFC) on 18 November 2011, *see* <europa.eu/efc/sub_committee/cac/cac_2012/index_en.htm>, visited 17 May 2016.

[68] Similarly, Zilioli, 23 *MJ* 1 (2016) p. 171 at p. 176.

[69] On the task-sharing among the ECB and the national central banks *see* A. Steinbach, 'The Lender of Last Resort in the Euro Area', 53 *CMLRev* (2016) p. 361 at p. 365-366.

be no infringement of EU law. In fact, according to Article 14.4. of the European Central Bank Statute, the European Central Bank Council can prohibit any measure of a national central bank in case of incompatibility with the goals and tasks of the European Central Bank. In addition, there is an issue of independence if national central banks are instructed by their national governments to cast their votes on a modification of the bond terms.[70] In this case, Article 130 TFEU should shield the national central banks' autonomy from any national influence. However, since national central banks cannot perform monetary policy, which lies exclusively with the eurosystem, any debt restructuring would be of a fiscal policy nature and thus incompatible with Article 123 TFEU. It should therefore be prohibited by the European Central Bank Council.

Lawful participation of the European Central Bank in a debt restructuring on the sovereign bonds it holds in its portfolio is, in sum, limited to the unlikely scenario (until now, that is) that this would be necessary for primarily monetary policy purposes – the sole purpose of boosting fiscal debt sustainability does not meet the standards of the ban on monetary financing.

Conclusion

The toolkit used so far to fight the public debt crisis, consisting of bilateral loans, lines of credit from the European Financial Stability Facility and the European Stability Mechanism, private creditor involvement and European Central Bank bond purchases, could soon be extended to include public creditors. It seems that only in this way can Greece's debt sustainability be restored in the long term. Rate cuts, extended credit periods, interest-free borrowings and a debt cut are all different forms of involving creditors. From a legal point of view, a (partial) cut of the nominal debt, a transformation into long-term, interest-free loans and a debt cut in the case of the government bonds in the European Central Bank portfolio all present cause for concern.

A (partial) cut of the nominal debt violates the bailout prohibition, as this causes the debt-assuming euro states to enter into obligations that debtor states have with them. Furthermore, the functional equivalence between conditionality and interest-based market pressure, as imputed by the Court, no longer exists. Also, the repayment obligation, highlighted in the European Stability Mechanism judgment, would be rescinded, along with the interest. The moral hazard problem created as a result of financial aid would worsen. As for interest-free debt securities, the Court's margin requirement would be abandoned, which means an element would be lost that permits the assumption of an equivalence of the conditionality

[70] C. Hofmann, 'Sovereign-Debt Restructuring in Europe Under the New Model Collective Action Clauses', 49 *Texas International Law Journal* (2014) p. 383 at p. 417.

and the market conditions. However, there is room for the argument that it makes no difference to the analysis whether the programme country pays only minimal interest – as is the case today – or no interest at all. Neither one case nor the other is in line with regular market conditions, but it could still be argued that the logic of functional equivalence between market pressure and conditionality is upheld to the extent that the obligation to repay loans at nominal value remains in place. Small modifications of the financial aid, in the guise of interest rate reductions, deferral of interest payments and term extensions, which have been granted to programme countries in the past, are less critical.[71] The basic structure – i.e., the obligation to repay with interest – remains unaltered by this.

From a political-economy perspective, significant barriers seem to result from (German) politicians' resistance to take on debt cuts openly, to the detriment of national taxpayers. In turn, this makes creativity in searching for legitimate alternatives to the kinds of debt cuts described above even more urgent. This may imply making it easier to access EU structural funds (potentially expanded through the newly-established European Fund for Strategic Investments[72]), or using profits made by the European Central Bank through bond purchases and paid to Member States. To that end, the eurozone Member States have passed on to Greece the profits made by the European Central Bank through its monetary policy operations in relation to the purchase of Greek government securities.[73] Finally, significant debt relief would be achieved by using the European Stability Mechanism for the bailouts hitherto undertaken by the crisis states to save their banks. This kind of direct capitalisation of the banks through the ESM, however, is highly controversial in many Member States. This led to the establishment of a Single Resolution Mechanism funded by a Resolution Fund intended to shield taxpayers from costly bank bailouts.[74]

[71] *See* the Eurogroup statement on Greece, 27 November 2012, <www.consilium.europa.eu/en/workarea/downloadAsset.aspx?id=19043>, visited 17 May 2016, p. 2.

[72] Regulation (EU) No. 2015/1017 of the European Parliament and of the Council of 25 June 2015 on the European Fund for Strategic Investments, the European Investment Advisory Hub and the European Investment Project Portal and amending Regulations (EU) No. 1291/2013 and (EU) No. 1316/2013 – the European Fund for Strategic Investments, OJ 2015, L 169/1.

[73] Eurogroup statement, 21 February 2012, <www.efsf.europa.eu/attachments/2012-02-21%20Eurogroup%20statement%20Bailout%20for%20Greece.pdf>, last visited 25 October 2015.

[74] A. Kern, 'European Banking Union: A Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism', 2 *European Law Review* (2015) p. 154-187.