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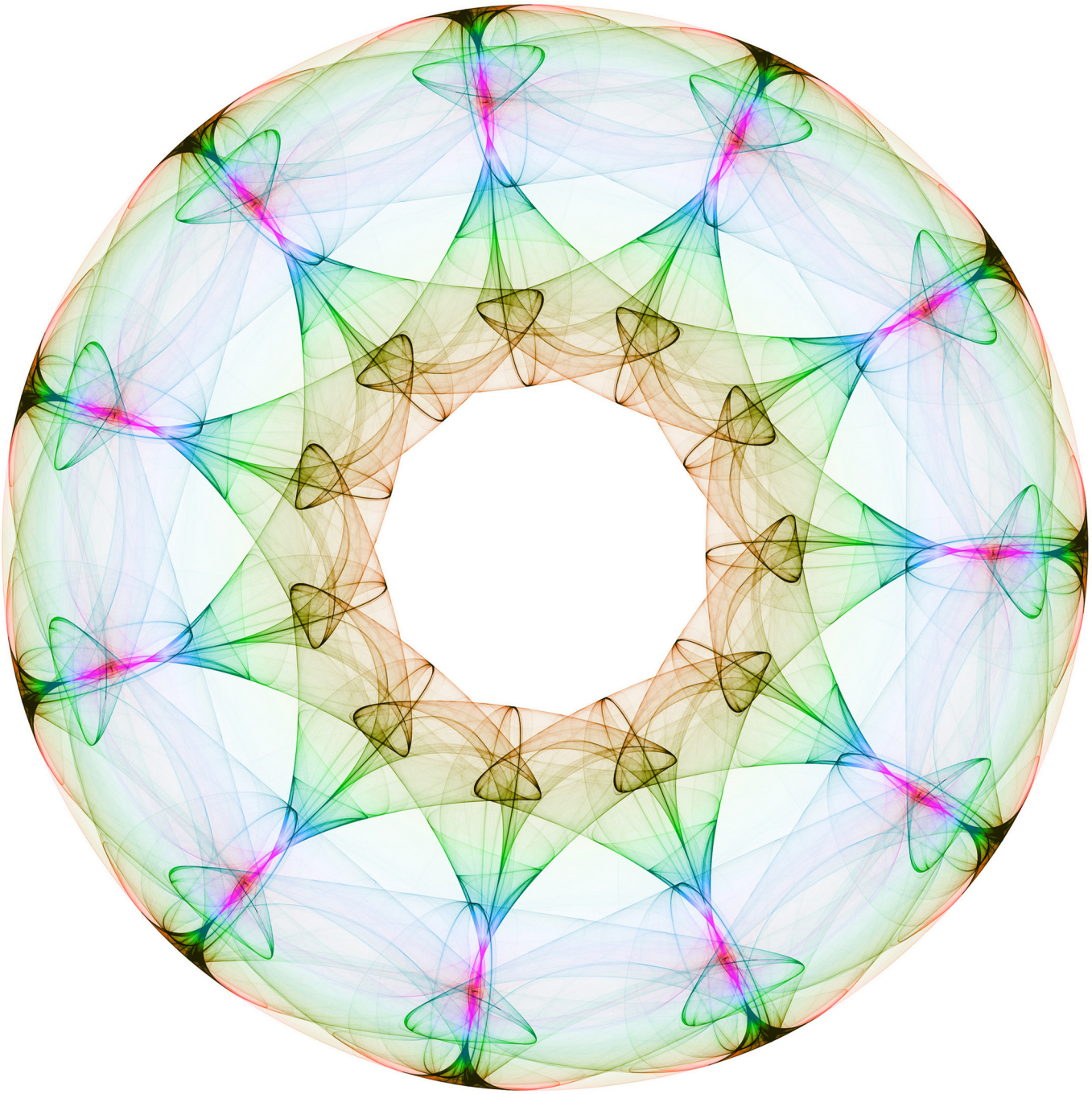

Eurozone crisis

The risks facing banks

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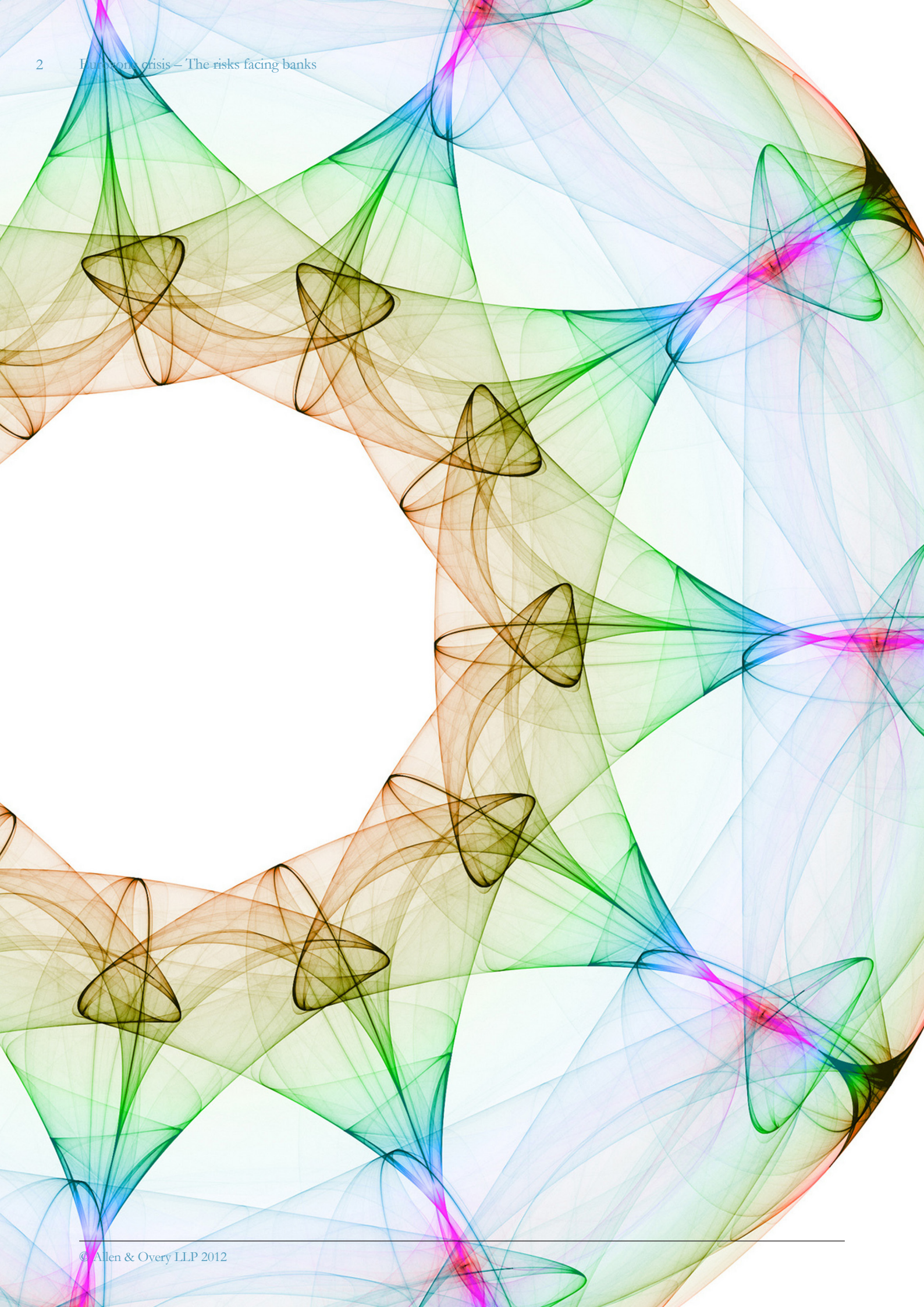

Eurozone crisis: The greatest risk presently facing banks

This publication adds to the Allen & Overy collection on this issue, which can be found on our website. Here, we include an opinion article by Philip Wood QC, together with a series of shorter articles focusing on certain practical and legal issues that arise in the context of any analysis of the consequences of an exit by a Member State from the euro.

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Currency unions, the euro and the bankruptcy of Member States

An opinion by Philip R Wood QC, Head of the Allen & Overy Global Law Intelligence Unit

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"One of the rules of a currency union is that rich regions transfer resources to poor regions."

All sovereign states in the world of any reasonable size are effectively a currency union. One of the rules of a currency union is that rich regions transfer resources to poor regions. Thus, New York and California transfer resources to the very many poor states in the U.S., the north of Italy transfers to the south, the south of Britain transfers to the west and north, and in China and India the rich regions transfer resources to impoverished regions.

The most basic transfer comes in the form of nationally provided universal services to citizens, such as defence, law and order, the health service, state pensions, social security and the rest.

The biggest risk for a currency union is the bankruptcy of a region. Inevitably, if a region becomes insolvent, in the sense of being unable to pay its debts as they fall due, the rich part of the country has to bail out the region. Strictly, they do not have to, but if several regions become insolvent, then this can threaten the currency and the solvency of the state itself.

It follows that if the centre is to mitigate the risk of the bankruptcy of regions, then they have to stop the regions from borrowing or incurring any financial liabilities. In Britain, this is more or less the result since "local authorities" have virtually no borrowing powers other than those controlled by the central government. In the case of Canada, on the other hand, the provinces have a significant degree of autonomy as regards borrowing. The main reason that Canadian provinces have not been insolvent since the 1930s is that they have been prudent about finance. The reasons for this deserve study. In the U.S., on the other hand, although the borrowing autonomy of municipalities and states is perhaps less than in Canada, there have been many bankruptcies.

This analysis of course applies to the eurozone as the currency union carries with it a risk of having to bail out bankrupt regions. A bailout has a high probability similar to the probability that banking systems have to be bailed out every 50 years or so.

It follows that if you wish to reduce the risk of a bailout, then you have to stop all members of the currency union from incurring any liabilities. This was out of the question in the U.S. and it is out of the question in the European Union.

It does not seem appropriate to us that rich members of a currency union should try and shift the risk away from themselves on to their banks, who are therefore requested to foot the bill for the fiscal negligence of sovereign states.

Why? Because it is not appropriate as the Member States are responsible for the maintenance of their own currency union.

A second reason is that rich states should not be haircutting banks, insurance companies and other members of the capital markets. These states have enormous resources.

A third reason is related to the role of banks and insurance companies. Banks hold the wealth of the citizens, their savings and their future. If you seek to push risk onto banks, ultimately you put that risk onto the depositors with the banks.

Similarly, insurance companies, who together with banks are the main participants in capital markets, have important creditors, namely pensioners and holders of life insurance policies. It is these pensioners and life policy-holders who will similarly end up taking this risk.

It follows that, when sovereign states in financial difficulties seek to haircut bondholders, the people who are really being punished for the fiscal negligence of the sovereign states are their citizens.

Sovereign states in a currency union can carry out bailouts in two ways. They can make loans and provide guarantees, which go on their balance sheets. Alternatively, the central bank can directly or indirectly buy up the obligations of the bankrupt regions and pay for them by the creation of money.

The creation of money for current expenditure devalues the currency. However, if a currency is threatened by the bankruptcy of members of the currency union, or if there is a danger of extreme financial instability and meltdown, then the fundamental duty of a central bank is to protect and defend the currency. They are the lenders of last resort. That is ultimately what they are there for, which is why they are given huge powers.

Until politicians accept this reality, banks will be faced with harsher and harsher criticism, regulation and remuneration constraints as political angst about the risk of a break-up in the currency union increases and public reaction to austerity measures hardens. This means banks will have to lobby hard and more publicly for politicians to be more forthcoming with the electorate.

"The biggest risk for a currency union is the bankruptcy of a region."

Governing law

An issue in focus

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"Our recommendation is for the place of performance to be outside of vulnerable jurisdictions."

One critical issue for commercial parties considering the implications of the exit of a Member State from the euro (or indeed, the break-up of the eurozone) is the extent to which their contracts will be insulated from changes in local law imposed by a withdrawing State. Parties who are contractually obliged to litigate under the laws of a vulnerable Member State are highly likely to be impacted by any redenomination or exchange control legislation passed in that State (subject to the proviso that the courts of some jurisdictions might refuse to give effect to such legislation on public policy grounds). For parties considering contracts which would permit them to litigate outside vulnerable Member States and under the laws of a non-vulnerable State, however, the analysis is broadly more positive (although more complex).

One notable aspect of any such analysis is that Rome I, the principal European instrument setting out the rules on governing law (and largely dictating the extent to which a choice of the law of a non-vulnerable State will insulate parties from local law changes) is relatively new and untested in the courts. This inevitably gives rise to uncertainty as to how it will be applied in practice.

The starting point under Rome I is that Member State courts will generally apply the law chosen by the parties to govern their contract and so contracts governed by non-local law (eg English or New York law), for example, will largely be insulated from changes to the local law of an exiting State. However, there are limits to the insulation achievable under Rome I and both the scope and applicability of those limits are unclear. For example, Article 9(3) provides that a Member State court may give effect to the overriding mandatory provisions of the law "of the country where the obligations arising out of a contract have to be or have been performed insofar as those overriding mandatory provisions render the performance of the contract unlawful". This gives rise to a host of questions. What does "unlawful" mean in this context? In what way might a Member State court "give effect" to such provisions? What factors will impact on a Member State court's decision whether or not to exercise its apparent discretion under this rule? Our recommendation is therefore to ensure that parties contractually agree for the place of performance to be outside of vulnerable jurisdictions.

A further complication in this analysis is that, for contracts entered into prior to 17 December 2009, Rome I will not apply and Member State courts must look to their pre-existing national conflicts of laws rules when considering whether a contract is insulated from legislative changes in a particular Member

State. Many Member States have incorporated parts or all of the Rome Convention (the predecessor to Rome I) into their national law, so there is likely to be some similarity in the approach taken in each of those States in considering contractual insulation. However, as the States in question have not incorporated the Rome Convention uniformly into national law, the analysis of whether contracts are insulated from changes to the law in any exiting Member State will differ depending on which courts are considering the question and must therefore be carried out on a jurisdiction by jurisdiction basis. For example, significantly in the context of the eurozone crisis, in England there is no provision equivalent to Article 9(3) of Rome I in the legislation applicable to contracts entered into before 17 December 2009 (although there is a common law rule to the same effect that may apply to English governed contracts only).

"Rome I is relatively new and untested in the courts."

Finally, it is also worth recognising that the risks arising in this area are likely to differ depending on the nature of any exit from the euro. The analysis if there is a unilateral and unlawful exit by one or more Member States is likely to be different to the analysis if the withdrawal is consensual and pursuant to a new EU Treaty and different again to the analysis if the eurozone breaks up entirely. For example, the English courts are perhaps more likely to find that contracts governed by the law of a country other than the exiting Member State will be insulated where any exit is unlawful than where the exit is lawful. Whether or not legislation is passed at EU or UK level following any exit will also have a significant impact, as such legislation might purport to override or disapply contractual terms or existing legislation/common law principles and the English courts would probably give effect to that new legislation (no matter what the governing law). Furthermore, if there is a complete break-up of the eurozone, obligations to pay in euro would of course have to be redenominated (perhaps into new national currencies, perhaps into a new euro), no matter what law governs the contract and no matter which courts might consider the question.

Exchange controls

An issue in focus

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It seems generally accepted that, should a Member State exit the euro and redenominate its currency, it will impose exchange controls to prevent capital flight. If that happens, the IMF Agreement, originally known as the Bretton Woods Agreement, will come into play. The IMF Agreement is part of English law and has been incorporated into the laws of most developed states, including all Member States. Under the IMF Agreement, each IMF member effectively agrees to respect the currency laws of the other members. In this regard, a crucial provision of the Agreement is Article VIII(2)(b) which provides that exchange contracts which involve the currency of any member, and which are contrary to the exchange regulations of that member maintained or imposed consistently with the IMF Agreement, are unenforceable in the territories of other members. This has proved to be a hugely controversial provision and there remains much uncertainty as to its scope, application and impact. What is clear is that the recognition by the courts in IMF member states of the exchange controls imposed by an exiting Member State may have an adverse impact upon a party's ability to insulate itself from risks associated with an exit from the euro (see below). This is because an English court (for example) may be required as a result of Article VIII(2)(b) to refuse to enforce a contract which falls within this provision irrespective of the governing law of the contract, the nationality of the parties or the place of performance. The adverse impact of Article VIII(2)(b) is however probably limited at least in the English and certain U.S. courts where historically the term "exchange contract" has been construed narrowly and (although the matter is not free from doubt) where the courts may not consider the provision to have retrospective effect; ie not to render unenforceable contracts entered into prior to the imposition of the currency controls.

"This has proved to be a hugely controversial provision and there remains much uncertainty as to its scope, application and impact."

Practical steps to achieve insulation

An issue in focus

There has been much discussion as to how best to insulate oneself from a redenomination by an exiting eurozone country.

There is concern that, following a eurozone exit by one or more States, there may be pan-European legislation which would seek to allocate the risks of that exit across Europe. Such legislation may seek to require Member State courts to recognise the exiting country's redenomination and/or any exchange controls. This action could be particularly onerous where certain legs of currency or interest rate products were redenominated, leaving institutions in non-exiting States (and potentially those outside Europe) exposed to future devaluations of the exiting country's new currency. Theoretically this could occur notwithstanding the fact that the exposure on the previous euro trades was fully collateralised with euro cash or euro debt securities. The likelihood of any such pan-European legislation, the timing and terms are all uncertain. Even absent pan-European legislation, there is concern that in certain circumstances Member State courts would give effect to local redenomination or exchange controls.

Inevitably, any exercise in attempting to alleviate all or part of this risk is by necessity attempting to legislate for the unlegislatable. When sovereign states legislate (whether at a European or national level) they will probably be able to see what financial parties have done and, if they are so minded, legislate around it.

Nevertheless, there are certain measures that should be considered (although there are no guarantees as to their efficacy) including:

– making clear that euro means euro, not the domestic currency of the departing State;

– avoiding any mandatory place of performance in the exiting State;

– introducing prospective termination rights around any steps to redenominate;

– consideration of the governing law and jurisdiction clause and their potential insulation benefits; and

– conversion of currencies at spot rates and indemnities.

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