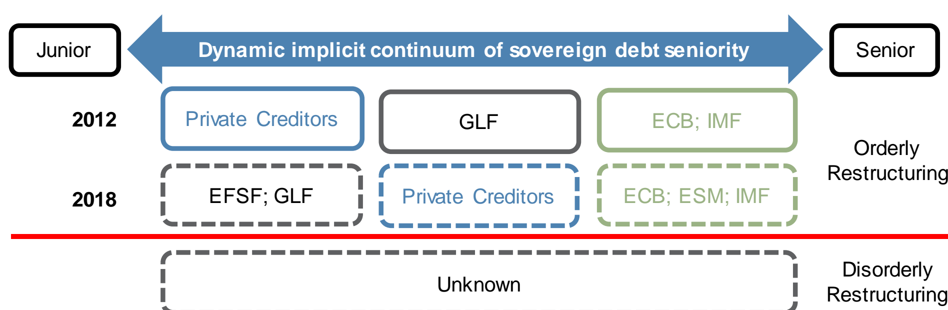
Eurogroup & Greece: A dynamic, implicit continuum of sovereign debt seniority

Based on recent Eurogroup announcements on Greece (B-/Stable), Scope questions whether the conventional wisdom that public creditors are always paid prior to private creditors, holds. Scope identifies an implicit seniority of Greek sovereign debt holders with potentially rating-relevant implications for Greece.

For Scope, despite the absence of a contractual seniority of sovereign debt, the discrimination of creditors, if any, matters, as its credit ratings apply only to the risks faced by private-sector creditors. The literature and events during the euro area crisis provide evidence of an implicit seniority by creditor type. In March 2012, prior to the Private Sector Involvement (PSI), private creditors held about 60% of Greece's debt. 97% of the privately held bonds were subjected to a 53.5% haircut, while the European Central Bank (ECB) and IMF were exempted from the restructuring. Loans under the Greek Loan Facility (GLF) were reprofiled, while the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM) were not yet exposed to Greece.

Private creditors currently hold around 20% of Greece's debt, compared to 70% controlled, directly or indirectly (and with differing composition), by the Eurogroup, which has noted its willingness to further reprofile Greece's repayments to the EFSF to limit the country's gross financing needs (GFN) to no more than 20% of GDP over the long-term, following the expected completion of its ESM programme in August 2018. The Eurogroup's *ex-ante* voluntary commitment to reprofile Greece's repayments to the EFSF according to a yet-to-be-defined growth-adjustment mechanism reduces the probability of a Greek default, and thus the credit risk to all Greek debt holders. This is because linking repayments to the EFSF to GDP developments, and thus Greece's repayment capacity, should result in quasi-automatic cash relief to Greece in the case of adverse economic shocks. In addition, as Greece's repayments to the ECB, ESM, GLF, IMF and private creditors are to be excluded from this forthcoming mechanism, it is Scope's opinion that EFSF debt would implicitly become more junior. This is due to the EFSF's implied acceptance to be repaid after (i.e. later than) other creditors to ensure Greece's GFN stay within the agreed limits.

Greece's dynamic implicit sovereign debt seniority



Source: Scope Ratings GmbH. NB. European Central Bank (ECB), European Financial Stability Facility (EFSF), European Stability Mechanism (ESM), Greek Loan Facility (GLF), International Monetary Fund (IMF).

However, given the Eurogroup's commitment to Greece, if needed, Scope believes the demonstrated flexibility for EFSF loans to be reprofiled would also extend to the GLF before private creditors face repayment risks. The degree of this likelihood depends on i) Greece's compliance with the terms of the European institutions and ii) the composition of Greece's debt holders, which alters the decision function if there is a need to modify existing debts in order to reinstate debt sustainability. Finally, in case of a disorderly restructuring or credit event, as almost occurred in the summer of 2015 when Greece missed a payment to the IMF, Scope does not assume any known debt seniority.

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No legal rules of priority but implicit seniority identified in literature

Seniority is a market convention not legally stipulated in a contract

Scope notes that the Preferred Creditor Status (PCS) of multilateral lenders such as the IMF and the ESM is not explicitly written into law. Unlike corporate debt markets, there are no legal rules of priority and seniority, nor have courts provided guidance on how to resolve these issues in the absence of actual law by applying and modifying existing laws. In fact, given the lack of any explicit, legally enforceable sovereign bankruptcy procedure – or any sort of institutional sovereign debt restructuring mechanism – any government so inclined may arbitrarily decide which creditor group to service, when and to which degree. Without legal subordination of government debt, seniority is primarily a convention that is widely accepted by market participants. This convention has been recently tested during the euro area crisis, with the rules of seniority evolving over time, reflecting the involvement of different multilateral lenders and rescue components.

Implicit seniority identified in the literature

Despite the absence of an explicit, contractual seniority, the economic literature provides some evidence of an *implicit* seniority. For Scope, the rating-relevant discrimination of creditors, if any, is that of official vs private creditors, regardless of their residence (domestic or foreign) or instruments (bonds or loans)[1] as Scope's ratings apply only to the risks faced by private-sector creditors. In this context, recent research[2], based on 116 developing countries covering the period 1979-2006, highlights an implicit ranking of creditors:

Figure 1: Implicit sovereign debt seniority – developing countries

1. IMF and multilateral creditors (mostly the World Bank)
2. Government bond holders
3. Bilateral government-to-government creditors (Paris Club)
4. Commercial banks
5. Trade creditors (exporters and suppliers)

Source: Schlegl, Trebesch and Wright (2016). NB. The Paris Club is an informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries.

According to the authors, this seniority structure of external creditors holds for payment arrears and haircuts. It cannot be explained by differences in the debt structure, fundamentals or fixed country characteristics pointing to the importance of creditor types and instruments[3].

Greek debt structure and Eurogroup statements

Greece's debt now mostly held by public creditors

This suggested implicit seniority of sovereign debt is relevant to all private creditors, and particularly those of Greece. Greece is a case in point testing the conventional wisdom that public creditors are always senior to private creditors. Not only did the country temporarily default on the IMF on 30 June 2015, but the three financial assistance programmes have also altered the country's debt structure, away from private to largely official creditors. In addition to the Private Sector Involvement in March 2012 and the debt-buy back in December 2012[4], Greece has already benefitted from the Eurogroup's[5] adjustments to GLF and EFSF loans by extending maturities and reducing interest

[1] Among private sector foreign creditors, sovereign bonds have often been treated preferentially to sovereign bank debt. Domestic creditors are often portrayed as being treated equally (no discrimination) or senior to foreign creditors. Both conclusions are case specific and do not always prevail however. For literature see Roubini and Setser (2003), Gelpern (2004), Sturzenegger and Zettelmeyer (2007), Bolton and Jeanne (2009), Broner et al. (2010), Erce and Díaz-Cassou (2010), Erce (2012), Broner et al. (2014), Steinkamp and Westermann (2014). https://voxeu.org/article/sovereign-debt-repayments-evidence-seniority

[2] Schlegl, M, C Trebesch and M Wright (2015), 'The seniority structure of sovereign debt'

[3] According to the authors arrears are highest for trade creditors. Scope notes that this may however also reflect technical reasons and further that defaults do not follow arrears automatically. Compared to missed bond payments, arrears in export finance are less visible for the markets.

[4] On 11 December 2012 Greece concluded the tendering process for a debt buy-back operation with a participation of EUR 31.9bn of the total new Greek government bonds of EUR 62bn ensuing from the PSI at an average price of 33.8% of the nominal value. Following the settlement, Greek debt was reduced by EUR 21.1bn.

[5] The Eurogroup is an informal body in which the ministers of the euro area member states discuss matters relating to their shared responsibilities related to the euro.

margins. Based on the latest available data, Greece's debt is approx. held by the following creditors (% of total): GLF (16.2%), EFSF (40.2%), ESM (14.1%), Eurosystem (3.8%), IMF (3.3%) and private creditors (22.4%). The Eurogroup's direct and indirect exposure to Greece via the GLF, EFSF and ESM therefore now amounts to around 70% of Greece's total sovereign debt[6].

Figure 2: Greek debt structure by creditor type

		Greece's creditors	Feb-12		Apr-18	
			EUR	% total	EUR	% total
Public	Eurogroup	GLF	52.9	15.1	52.9	16.2
		EFSF	--	--	130.9	40.2
		ESM	--	--	45.9	14.1
		Eurosystem*	56.5	16.1	12.3	3.8
		IMF	20.1	5.7	10.7	3.3
		Total public	129.5	37.0	252.7	77.6
Private		T-bills	15.1	4.3	14.2	4.4
		Repos	--	--	14.9	4.6
		Bonds**	205.6	58.7	44.0	13.5
		Total private	220.7	63.0	73.1	22.4
		Total	350.2	100.0	325.8	100.0

*2012 based on Trebesch and Zettelmeyer. Apr 2018: Eurosystem Securities Market Programme (SMP) holdings and loans from the Bank of Greece (Q4 2017). **Outstanding bonds adjusted for SMP holdings. Sources: ECB, EC, IMF, PDMA, own calculations.

Eurogroup commitment to cap Greece's gross financing needs at 20% of GDP over long-term

Scope notes that the Eurogroup's demonstrated and communicated flexibility regarding Greece's repayments is relevant in the context of an implicit debt seniority. Specifically, the Eurogroup has communicated on several occasions its willingness to consider debt measures aimed at ensuring that Greece's refinancing needs are kept at sustainable levels in the long-run, defined as below 15% of GDP during the post programme period for the medium term, and below 20% of GDP thereafter.

The May 2016 Eurogroup decision outlined short-, medium- and long-term measures to ensure that gross financing needs stay within these pre-defined limits to warrant the sustainability of Greek debt. The short-term measures smoothing Greece's repayment profile, reducing interest rate risk and waiving the step-up interest rate margin for 2017 have been implemented. The medium-term measures are scheduled to be implemented following the successful end of the Greek programme in August 2018 while the long-term measures are available if needed.

EFSF reprofiling according to a growth-adjustment mechanism

For the medium term, the Eurogroup committed to several measures[7], including EFSF re-profiling within the maximum Programme Authorised Amount[8]. For the long term, in the case of an unexpected, more adverse scenario, a contingency mechanism on debt could be activated. The activation of this mechanism would be considered subject to a decision by the Eurogroup and could entail measures such as a further EFSF reprofiling and capping and deferral of interest payments.

[6] Scope is aware that the structure and governance of the GLF, EFSF and ESM are distinct. However, as it is the euro area Ministers of Finance that decide on the terms of the Greek loans, in their varying capacities as bilateral loan providers or shareholders of the EFSF or the ESM, Scope argues for simplicity that the exposure to the GLF, EFSF and ESM is ultimately borne by the Eurogroup.
[7] Abolishing the step-up interest rate margin related to the debt buy-back tranche of the second Greek programme, using 2014 SMP profits from the ESM segregated account, restoration of the transfer of the equivalent of ANFA and SMP profits to Greece (as of budget year 2017), liability management operations within the current ESM programme envelope taking due account of the exceptionally high burden of some Member States.
[8] The maximum amount that the EFSF is authorised to borrow under the EFSF guarantees. The issuance of EFSF guaranteed debt is limited to a maximum principal amount of EUR 241 billion. The authorised amount for Greece was EUR 144.6bn.

Growth-adjustment mechanism still needs to be specified

In June 2017, the Eurogroup also clarified that in order to take into account possible differences between growth assumptions in the debt sustainability assessment and actual growth developments over the post-programme period, the EFSF re-profiling would be recalibrated according to an operational growth-adjustment mechanism. This mechanism will be fully specified as part of the medium-term debt relief measures, following the successful implementation of the ESM programme to make sure both the GFN benchmarks defined above and the ceiling established by the EFSF Programme Authorised Amount are respected. Finally, the January 2018 Eurogroup statement confirmed the start of the technical work on the growth-adjustment mechanism and, on 27 April, the Eurogroup President noted the good progress made to facilitate the exit of Greece from the ESM programme. Debt sustainability-relevant excerpts from the Eurogroup statements on Greece are included in this report in **Annex I**.

Key takeaways

In Scope's view, the Eurogroup statements on Greece highlight three critical issues:

- **Targeting gross financing needs, not debt levels**

  Greece's GFN are limited to 15% of GDP for the medium term and aimed at staying below 20% of GDP thereafter. This stands in contrast to the debt-to-GDP benchmark set in 2012, which stipulated that '*Greece must reduce its debt-to-GDP ratio to 120 percent by 2020 if its debt is to become sustainable in the medium term*'[9].

- **Willingness to reprofile EFSF debt only**

  The Eurogroup states its willingness to reprofile EFSF debt to ensure Greece's GFN do not exceed the abovementioned limits. However, the Eurogroup has to date refrained from stating its willingness to reprofile ESM debt or further reprofile GLF loans. Similarly, while the IMF advocates for debt relief, including nominal haircuts, the IMF never communicated its own willingness to reprofile or restructure the bilateral loans it provided to Greece.

- **No nominal haircuts: reprofiling, not restructuring loans**

  Debt relief measures explicitly exclude nominal haircuts. This reflects the legal constraint as per Article 125[10] ('no bailout clause') of the Treaty on the Functioning of the European Union (TFEU), justifying why loans provided by euro area Member States (via the GLF and EFSF) can be reprofiled (deferring principal and interest) but not restructured (nominal haircut). Debt, including EFSF repayments, are therefore deferred but not forgiven.

Growth-adjustment mechanism to lower Greece's risk of default

Linking EFSF debt repayments to GDP would reduce Greece's default risk

In Scope's opinion, the Eurogroup's statements on Greece, and specifically the commitment to limit gross financing needs at 20% of GDP over the long-term, combined with the willingness to reprofile EFSF debt according to a growth-adjustment mechanism, lowers the credit risk to all holders of Greek debt, including private ones. While it is yet unclear how the growth-adjustment instrument will ultimately function[11], Scope's understanding is that Greece's repayments to the EFSF could be linked, in one way or another, to GDP (growth) outcomes. This could be achieved, for instance, by adjusting Greece's interest payments and the timing of its principal repayments to the EFSF by deferring them in economically adverse times. The inherent risk of constant deferrals may

[9] http://www.imf.org/en/News/Articles/2015/09/28/04/53/socar031512b

[10] A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. TFEU.

[11] The features of the growth adjustment mechanism remain unknown, including its pay-out structure, treatment of data revisions and priority ranking relative to other sovereign bonds in case of a debt restructuring.

result in large refinancing needs over a sustained period of time – a risk that may increase for public creditors when the interest-rate cycle eventually turns[12].

Scope notes that this mechanism would therefore quasi-automatically provide cash relief to Greece in the event of adverse economic shocks or during a crisis. As the IMF notes, GDP-linked bonds tie the value of debt service to GDP developments, thus keeping it better aligned with the overall health of the economy. Since public-sector revenues are closely related to economic performance, linking debt service to economic growth acts as an automatic stabiliser for debt sustainability. GDP-linked debt contracts can therefore reduce the vulnerability to variations in debt ratios by aligning debt service to the sovereign's ability to pay, reducing the risk of default[13]. From a rating perspective, the introduction of the growth-adjustment mechanism, and specifically the link to EFSF repayments, would therefore reduce Greece's risk of default to all creditors.

An implicit continuum of sovereign debt seniority

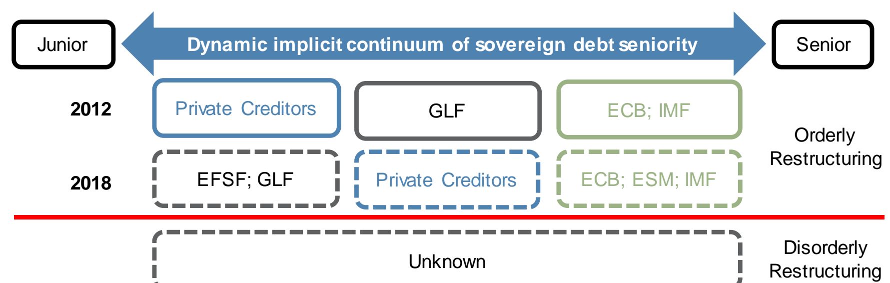
Additional reduction of credit risk to private creditors given implicit subordination of EFSF debt

In addition to this first effect benefitting all of Greece's creditors, including the EFSF, in Scope's opinion, the fact that only EFSF debt is currently foreseen to be subject to the reprofiling of debt according to a growth-adjustment mechanism amounts to a *de facto* (but not *de jure*) subordination of EFSF debt vis-à-vis all other public and private creditors. This is because Greece's remaining debt would be excluded from this quasi-automatic debt relief mechanism. Stated differently, on the basis that Greece's repayments to the ECB, ESM, the Greek Loan Facility, the IMF and private credit holders will not be subject to a debt reprofiling, and further, under the conditions that Greece remains compliant with the terms of the Eurogroup, it is Scope's opinion that EFSF debt, which would be subject to a reprofiling resulting in a later repayment than originally foreseen, would become more junior to all other creditors.

Implicit sovereign debt seniority only in case of an orderly restructuring

Scope is mindful that opining that EFSF debt would be implicitly junior to private creditors, despite its loans officially ranking *pari passu*, is a potentially controversial statement. The below paragraphs outline the rationale in the form of Scope's identified seniority continuum which, crucially, rests on the assumption that Greece remains compliant with the terms of the Eurogroup, thus ensuring, in case of need, an orderly restructuring of debt. In case of a disorderly restructuring or default event, as was almost the case during the summer of 2015, Scope does not presuppose any seniority. The fact that Greece missed a payment to the IMF, presumably one of the most senior creditors, underscores the unknown environment in this latter case. **Figure 3** summarises and highlights Scope's opinion on the implicit continuum of seniority of Greek sovereign debt.

Figure 3: Greece's dynamic implicit sovereign debt seniority



Source: Scope Ratings GmbH. NB. European Central Bank (ECB), European Financial Stability Facility (EFSF), European Stability Mechanism (ESM), Greek Loan Facility (GLF), International Monetary Fund (IMF).

[12] Walker, M. 'GDP-linked or similar instruments in sovereign debt restructurings', VOXEU, March 2018.

[13] If the interest rate is linked to GDP, the debt limit (the highest debt level that can be serviced at a finite interest rate) will be increased because the set of states in which the sovereign will be unable to service its debt without an extraordinary effort will be more limited than when the debt contract is in nominal terms. Kim, J. and J. Ostry (2018), 'Boosting Fiscal Space: The Roles of GDP-Linked Debt and Longer Maturities', IMF WPS, No. 18/04.

➢ Why the Greek Loan Facility is, like the EFSF, also implicitly junior

The Greek Loan Facility is the first financial support programme for Greece, agreed in May 2010. It consisted of bilateral loans from euro area countries, amounting to EUR 52.9bn, alongside a EUR 20.1bn loan from the IMF[14]. Contrary to the EFSF, the funds provided under the GLF not only had an adverse impact on debt levels of member states, as is the case for EFSF issuances[15], but also had a direct budgetary effect.

GLF had a direct budgetary impact on governments

It is Scope's opinion that, given the direct budgetary impact of the GLF loans, member states would be more sensitive to any further reprofiling of the loans provided under the Greek Loan Facility compared with those loans granted under the EFSF. In fact, to date, the Eurogroup has refrained from committing to any further reprofiling of GLF loans.

GLF loans front-loaded and more expensive than ESM

However, since the budgetary impact has already occurred, any further reprofiling of GLF loans which would not have an additional budgetary impact on member states, is not inconceivable in Scope's opinion. While the Eurogroup, to date, has not publicly communicated its willingness to any further reprofiling of GLF debt, Scope notes that GLF loans have been reprofiled in the past. Moreover, compared with ESM loans, they are front-loaded and relatively expensive, further increasing the likelihood that, in case of need and subject to Greece's compliance with the Eurogroup terms, they could be again reprofiled. This is the core reason that Scope aligns the GLF with the EFSF in terms of its implicit seniority as shown in **Figure 3**.

➢ Why private creditors are implicitly senior to the EFSF and GLF

Reprofiling of EFSF and GLF debt would ensure that debt relief is provided when needed without breaching contracts or causing great media attention, as would be the case with privately-held debt restructurings[16]. The Private Sector Involvement in Greece in 2012 was a highly-visible default event, resulting in significant market volatility and uncertainty.

A private debt restructuring would not achieve the Eurogroup's stated objectives

In Scope's opinion, the more silent nature of an additional reprofiling of EFSF and GLF debt in an adverse scenario would not only be economically less distressing to Greece's recovery, but also politically less costly and, in today's context, very much aligned with the Eurogroup's objectives of i) keeping Greece's gross financing needs at no more than 20% of GDP over the long-term and ii) ensuring Greece's market access at sustainable financing rates. Conversely, restructuring privately held debt would be unlikely to succeed at achieving the first objective, given the lower share of outstanding debt owed to the private sector, and certainly not the second.

Linking EFSF repayments to GDP developments shows public creditors' willingness to be repaid later than private creditors

As noted previously, the change in the benchmarks for assessing debt sustainability – away from a debt-to-GDP target level[17] towards GFN limits – suggests that if Greece remains compliant with the terms of the Eurogroup, private creditors are likely to be repaid in full and on time. Linking debt repayments to the EFSF to Greece's repayment capacity over the long-term via the yet-to-be-defined growth-adjustment mechanism would be the clearest signal to date that, going forward, European public creditors, specifically, the EFSF and possibly the GLF, are likely to accept being repaid after (i.e. later than) private creditors.

In addition, even though the Eurogroup has, to date, not publicly committed to further reprofile loans granted under the GLF, it is Scope's opinion that, in case of need and

[14] https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/which-eu-countries-have-received-assistance/financial-assistance-greece_en and https://www.esm.europa.eu/content/what-greek-loan-facility-glf
[15] Debt issued by the EFSF for each support operation for a member of the euro area must be reallocated to the public accounts of States providing guarantees, in proportion to their share of the guarantees for each debt issuing operation. http://ec.europa.eu/eurostat/documents/2995521/5034386/2-27012011-AP-EN.PDF
[16] https://voxeu.org/article/structuring-versus-restructuring-sovereign-debts-eurozone
[17] Reducing Greece's debt stock was one of the reasons for the haircut on private creditors in March 2012.

subject to Greece's compliance with the Eurogroup terms, the reprofiling of GLF loans is also likely to take place before repayments to private creditors are at risk.

Eurogroup's exposure to and repayment flexibility with Greece

This is due to the Eurogroup's visible commitment to Greece. Specifically, Scope notes that the Eurogroup controls, directly or indirectly, around 70% of Greece's total debt which limits significantly the potential benefit of a private-sector restructuring. This stands in stark contrast to the situation in 2012, when the Private Sector Involvement, where approximately 97% of privately held Greek bonds (about EUR 197bn) took a 53.5% cut on the face value (principal) of bonds, resulted in an approximately EUR 107bn reduction in Greece's debt stock[18]. As noted previously, today's private sector exposure, excluding T-bills and repos, amounts to around EUR 44bn, or 14% of Greece's total debt.

Finally, the current political imperative of making Greece another 'success story' coupled with the observation that the Eurogroup is unlikely to be able to keep its commitment to maintaining Greece's gross financing needs to below 20% of GDP over the long-term without additional measures[19] suggests that, in case of need, the Eurogroup's demonstrated flexibility is also likely to extend to reprofiling GLF loans before repayment risks to private creditors increase. As a result, Scope views private creditors as more senior creditors compared with the EFSF and the GLF as shown in **Figure 3**.

- **Why the ESM is implicitly more senior**

Contrary to the EFSF, the ESM is a permanent, inter-governmental institution set up under international law, with subscribed capital of EUR 705bn, EUR 80.6bn of which has been paid in. The EFSF, in stark contrast, is a private company under Luxembourg law, backed by guarantees of euro area member states, whose loans to beneficiary member states officially rank *pari passu* with private creditors in case of a default.

Reflecting its role as lender of last resort to euro area sovereigns, *'ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM'*[20]. As a result, in Scope's opinion, ESM loans are implicitly more senior than those from the EFSF and GLF as well as private sector exposures.

ESM's PCS, growing mandate and legal status differentiate it from EFSF and GLF

In addition, given the Eurogroup's commitment to reinforce the ESM, further developing its role with additional tasks related to crisis management, Eurogroup statements have, to date, never mentioned the possibility of reprofiling ESM loans. After all, it would appear inconsistent, in Scope's opinion, to strengthen and develop an institution and, at the same time, burden its balance sheet with the debt reprofiling of its largest debtor. Finally, as stated previously, the terms of the ESM loans, compared with the GLF, are already very favourable, reducing the benefit of any potential reprofiling.

- **Why the IMF is implicitly more senior**

The IMF is the world's lender of last resort and insists on full repayment before any other creditor. Its Preferred Creditor Status *'refers to members' willingness to accord the Fund priority when paying debts, and the agreement or acquiescence of other creditors to this situation.'*[21] Greece's decision not to repay the IMF on 30 June 2015[22], despite its presumed Preferred Creditor Status, was a highly visible event, causing significant market volatility and uncertainty. In fact, the missed payment to the IMF brought Greece very close to a disorderly and unruly restructuring.

[18] https://www.esm.europa.eu/content/what-was-private-sector-involvement-psi-greece
[19] https://cepr.org/active/publications/policy_insights/viewpi.php?pino=92
[20] https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf
[21] http://www.imf.org/external/np/tre/risk/2004/020304.pdf
[22] http://www.imf.org/en/News/Articles/2015/09/14/01/49/pr15310

IMF's financial engagement in Greece is short-term and limited compared to European creditors

Scope notes that the IMF has not, to date, provided financial resources to the third Greek adjustment programme, reflecting, in Scope's opinion, a strained relationship between the European partners and the IMF, and possibly, the Fund's alternative view on the sustainability of Greek debt, despite a EUR 1.6bn precautionary Stand-By Arrangement for Greece[23]. Scope believes that using ESM funds to repay the comparatively costlier IMF loans could become an element of the forthcoming debt measures once the ESM programme comes to an end in August 2018.

From this perspective, the IMF's financial exposure to Greece is more short-term compared to that of the European public creditors, reflecting that the Eurogroup has a closer and more long-term relationship with Greece than the IMF (also as per loan maturities). As a result, Scope expects the IMF to be repaid earlier. In addition, regarding the Fund's PCS, it is Scope's opinion that, so long as Greece remains compliant with the terms of the Eurogroup, the IMF's PCS will also remain unquestioned.

- **Why the ECB is implicitly more senior**

Scope's considerations regarding the ECB's implicit seniority balance its lack of Preferred Creditor Status against its monetary financing prohibition as well as the systemic implications a sovereign default on the ECB would have on a country's banking system. Currently, the Eurosystem exposure to Greece is limited to the Securities Markets Programme (about EUR 9.5bn) and loans from the Bank of Greece (about EUR 2.8bn).

ECB not a lender of last resort

The ECB, contrary to the ESM or the IMF, does not have Preferred Creditor Status. However, it is the prohibition of monetary financing[24] that, in the case of the Securities Markets Programme, led to a *de facto* senior treatment of bonds held by the Eurosystem. In fact, back in 2012*, 'because of the monetary financing prohibition, the Eurosystem was not – and could not be – a lender to the Greek state, it lends only to banks. Also, the Eurosystem was a bondholder, not a lender, whereby fungibility and equal treatment were fundamental. Thus, it could not ask for PCS, and in fact never did ask for it'*[25]. At the same time, had the Eurosystem participated in the restructuring in 2012, it *'would have had the economic effect of a monetary financing in breach of the Treaty'*. As such, the ECB was reluctant to accept haircuts, and the Eurogroup agreed to the exemption of Eurosystem-held Greek government bonds from the PSI.

Failure to repay ECB would have systemic impact on banking sector

In addition to these considerations, Scope notes that defaulting on the ECB would render the collateral pledged by banks to the Eurosystem valueless, effectively shutting the country's banking sector out of the ECB's liquidity facilities[26] with distressing results. This view is also supported by the extraordinary measures taken in the summer of 2015 to avoid this scenario. On 17 July 2015, after the second Greek programme had come to an end on 30 June 2015 but before the ESM programme started in August that year, the EU Council adopted a decision granting a short-term loan of up to EUR 7.16bn with a maximum maturity of three months under the European Financial Stabilisation Mechanism to allow Greece to clear its arrears with both the IMF and the Bank of Greece, and to repay the ECB[27]. Given the systemic implications of a missed payment to the Eurosystem, Scope believes debts owed to the ECB under the Securities Markets Programme and to the Bank of Greece are among the most senior positions.

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[23] https://www.imf.org/en/News/Articles/2017/07/20/pr17294-greece-imf-executive-board-approves-in-principle-stand-by-arrangement

[24] Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments. Article 123 TFEU.

[25] https://www.bis.org/publ/bppdf/bispap72t.pdf

[26] This would likely also be the case under the Outright Monetary Transactions programme which has to date not been activated as well as the Public Sector Purchase Programme for which Greece is not yet eligible even though the Eurosystem clarifies that it accepts pari passu treatment vis-à-vis private investors. https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html and https://www.ecb.europa.eu/ecb/legal/pdf/en_dec_ecb_2015_10_f_.sign.pdf

[27] http://www.consilium.europa.eu/en/press/press-releases/2015/07/17/efsm-bridge-loan-greece

- **Unknown seniority in case of disorderly restructuring**

Scope stresses that the *implicit* debt seniority identified in this analysis applies only so long as Greece remains compliant with the terms of the Eurogroup and the European institutions. While the Eurogroup's potential measures enhance Greece's debt sustainability, and therefore would reduce the risk of default, the fundamental risk of default itself is certainly not eliminated.

Non-compliance with terms of official lenders could result in private-sector losses

In Scope's opinion, private sector creditors could thus still face losses in case i) Greece were to face a stressed scenario which could not be sufficiently alleviated by the reprofiling of EFSF and, potentially, GLF debt and/or ii) the Greek government chooses not to comply with the terms of the official lenders.

Possible credit implications

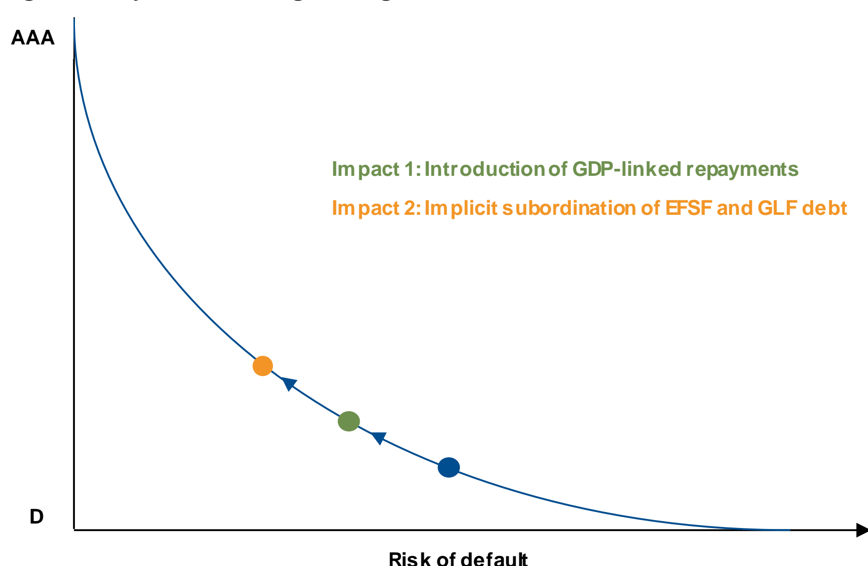
Further debt relief would be credit positive

As Scope noted in its most recent rating decision on Greece in June 2017, 'further debt relief measures, as indicated by official creditors, would materially improve the long-term sustainability of Greek public-debt dynamics, increase confidence, and thus strengthen Hellenic Republic's ability to handle its debt burden'.

Potential credit implications subject to Greece remaining compliant with Eurogroup terms

In this context, Scope notes two potential interdependent implications for private credit holders of Greek debt: first, the introduction of the growth-adjustment mechanism would reduce the risk of default to all creditors, given that EFSF repayments would be linked to Greece's repayment capacity. Second, the Eurogroup's commitment to Greece and the resulting implicit continuum of debt seniority as outlined in this analysis implies that risks to private-sector creditors are further reduced as debts owed to the EFSF and, potentially, the GLF are likely to be reprofiled before the risk of repayments to private creditors increases. Scope notes that both effects are subject to Greece remaining compliant with the Eurogroup terms. **Figure 4** shows the stylised non-linear relationship between sovereign ratings – which speak only of the risk to private creditors – and the risk of default. The first effect (introduction of GDP-linked repayments) is captured in the green dot while the second effect (implicit subordination of the EFSF and, potentially, the GLF) is shown with the orange dot.

Figure 4: Stylised sovereign ratings and risk of default



Source: Scope Ratings GmbH. NB. The green dot shows the positive impact of linking EFSF debt repayments to Greece's GDP developments via the forthcoming 'growth-adjustment mechanism'. The orange dot indicates the additional risk reduction to private creditors due to the implicit subordination of EFSF (and potentially GLF) debt on the basis that Greece remains compliant with the Eurogroup terms.

The materiality of both impacts on Greece's sovereign rating (B-/Stable) would depend, together with the fundamental factors as outlined in Scope's sovereign methodology, on Scope's assessment of the likelihood that EFSF debt – and potentially loans provided under the GLF – would be reprofiled by the Eurogroup before repayments to private creditors were to be at risk.

Based on the arguments outlined in this paper, Scope will continue to monitor the Eurogroup's deliberations on its relationship with Greece, particularly, the flexibility and extent of adjusting repayments to the EFSF and, potentially, the GLF. On this basis, Scope will review and update its opinion on the rating of Greece, which captures only the risks faced by private-sector creditors.

No credit risk implications to EFSF investors

Finally, while Scope does not yet rate supranational institutions such as the EFSF or the ESM, Scope stresses that the EFSF's creditworthiness is derived from the strength and quality of the guarantees and over-guarantees provided by its guarantors, not the credit quality of its assets, including its loans to Greece.

Appendix: Selected excerpts of Eurogroup statements on Greece

9 May 2016

The Eurogroup stands ready to consider, if necessary, possible additional debt measures aiming at ensuring that Greece's refinancing needs are kept at sustainable levels in the long-run. These measures will be conditional upon full implementation of measures agreed in the context of the ESM programme, and will be considered after the completion of the first review, once all prior actions have been fully implemented.

The Eurogroup agrees on the following general guiding principles for the possible additional debt measures: (i) facilitating market access; (ii) smoothening the repayment profile; (iii) incentivising the country's adjustment process even after the programme ends; and (iv) flexibility to accommodate uncertain GDP growth and interest rate developments in the future.

The Eurogroup also agrees to establish a benchmark for assessing sustainability of the Greek debt, according to which under the baseline scenario of a debt sustainability analysis (DSA), Greece's gross financing needs should remain on a sustainable path.

The Eurogroup foresees a sequenced approach, whereby a package of debt measures could be phased in progressively, as necessary to meet the agreed benchmark on gross financing needs and subject to the pre-defined conditionality of the ESM programme. The Eurogroup reconfirms that nominal haircuts are excluded.

http://www.consilium.europa.eu/en/press/press-releases/2016/05/09/eg-statement-greece/pdf

25 May 2016

The Eurogroup agrees to assess debt sustainability with reference to the following benchmark for gross financing needs (GFN): under the baseline scenario, GFN should remain below 15% of GDP during the post programme period for the medium term, and below 20% of GDP thereafter.

The Eurogroup recalls the medium-term primary surplus target of 3.5% of GDP as of 2018 and underlines the importance of a fiscal trajectory consistent with the fiscal commitments under the EU framework.

For the short-term, the Eurogroup agrees on a first set of measures which will be implemented after the closure of the first review up to the end of the programme and which includes:

- Smoothening the EFSF repayment profile under the current weighted average maturity
- Use EFSF/ESM diversified funding strategy to reduce interest rate risk without incurring any additional costs for former programme countries
- Waiver of the step-up interest rate margin related to the debt buy-back tranche of the 2nd Greek programme for the year 2017.

For the medium term, the Eurogroup expects to implement a possible second set of measures following the successful implementation of the ESM programme. These measures will be implemented if an update of the debt sustainability analysis produced by the institutions at the end of the programme shows they are needed to meet the agreed GFN benchmark, subject to a positive assessment from the institutions and the Eurogroup on programme implementation.

- Abolish the step-up interest rate margin related to the debt buy-back tranche of the 2nd Greek programme as of 2018
- Use of 2014 SMP profits from the ESM segregated account and the restoration of the transfer of ANFA and SMP profits to Greece (as of budget year 2017) to the ESM segregated account as an ESM internal buffer to reduce future gross financing needs.
- Liability management - early partial repayment of existing official loans to Greece by utilizing unused resources within the ESM programme to reduce interest rate costs and to extend maturities. Due account will be taken of exceptionally high burden of some Member States.
- If necessary, some targeted EFSF re-profiling (e.g. extension of the weighted average maturities, re-profiling of the EFSF amortization as well as capping and deferral of interest payments) to the extent needed to keep GFN under the agreed benchmark in order to give comfort to the IMF and without incurring any additional costs for former programme countries or to the EFSF.

For the long term…the Eurogroup would consider the activation of the [contingent] mechanism provided additional debt measures are needed to meet the GFN benchmark defined above and would be subject to a decision by the Eurogroup confirming that Greece complies with the requirements under the SGP. Such mechanism could entail measures such as a further EFSF re-profiling and capping and deferral of interest payments.

http://www.consilium.europa.eu/en/press/press-releases/2016/05/25/eurogroup-statement-greece/pdf

5 December 2016

Today the Eurogroup discussed again the sustainability of Greek public debt with the objective to regain market access. In this context, the Eurogroup endorsed today the full set of short-term measures on the basis of proposals by the ESM and preparatory work by the EWG, which will be implemented by the ESM following this meeting. Those measures will consist of:

- The smoothening of the EFSF repayment profile within the current weighted average maturity of up to 32,5 years;
- The waiver of the step-up interest rate margin amounting to 200 bps related to the debt buy-back tranche of the 2nd Greek programme for the year 2017;
- The use of the EFSF/ESM funding strategy as markets allow to reduce interest rate risk without incurring any additional costs for former programme countries. This measure will be implemented through: (i) exchanging the EFSF/ESM back-to back notes supporting the bank recapitalization loans to Greece, (ii) the ESM entering into interest rate swaps to mitigate the risk of higher market rates and (iii) introducing matched funding for future disbursements to Greece under the current programme.

The short-term debt measures will have a significant positive impact on the sustainability of Greek debt.

http://www.consilium.europa.eu/en/press/press-releases/2016/12/05/eurogroup-statement-greece/pdf

15 June 2017

The Eurogroup welcomes the commitment of Greece to maintain a primary surplus of 3.5% of GDP until 2022 and thereafter a fiscal trajectory that is consistent with its commitments under the European fiscal framework, which would be achieved according to the analysis of the European Commission with a primary surplus of equal to or above but close to 2% of GDP in the period from 2023 to 2060.

The Eurogroup recalled the assessment of debt sustainability with reference to the agreed benchmarks for gross financing needs: GFN should remain below 15% of GDP in the medium term and below 20% of GDP thereafter so as to ensure that debt remains on a sustained downward path.

The Eurogroup recalls that it stands ready to implement a second set of debt measures to the extent needed to meet the aforementioned GFN objectives, in line with the Eurogroup statement of 25 May 2016. This includes abolishing the step-up interest rate margin related to the debt buy-back tranche of the 2nd Greek programme, the use of 2014 SMP profits from the ESM segregated account, the restoration of the transfer of the equivalent of ANFA and SMP profits to Greece (as of budget year 2017), liability management operations within the current ESM programme envelope taking due account of the exceptionally high burden of some Member States, and EFSF re-profiling within the maximum Programme Authorised Amount[28].

The Eurogroup stands ready to implement, without prejudice to the final DSA, extensions of the weighted average maturities (WAM) and a further deferral of EFSF interest and amortization by between 0 and 15 years.

As agreed in May 2016, these measures shall not lead to additional costs for other beneficiary Member States. In order to take into account possible differences between growth assumptions in the DSA and actual growth developments over the post-programme period, the EFSF re-profiling would be recalibrated according to an operational growth-adjustment mechanism to be agreed. This mechanism will be fully specified as part of the medium-term debt relief measures, following the successful implementation of the ESM programme to make sure the GFN benchmarks defined above are respected and to ensure that the ceiling established by the EFSF Programme Authorised Amount is respected. The Eurogroup mandates the EWG to work further on this as of 2018.

[28] The maximum amount that the EFSF is authorised to borrow under the EFSF guarantees. The issuance of EFSF guaranteed debt is limited to a maximum principal amount of EUR 241 bn. The authorised amount for Greece was EUR 144.6bn.

For the long term, the Eurogroup recalls the May 2016 agreement that in the case of an unexpectedly more adverse scenario a contingency mechanism on debt could be activated. The activation of this mechanism would be considered subject to a decision by the Eurogroup and could entail measures such as a further EFSF re-profiling and capping and deferral of interest payments.

http://www.consilium.europa.eu/de/press/press-releases/2017/06/15/eurogroup-statement-greece/pdf

22 January 2018

The Eurogroup will now turn its attention to the final stages of the ESM programme, which is expected to end in August 2018. The Eurogroup confirms the start of the technical work by the EWG on the growth-adjustment mechanism, as part of the medium-term debt relief measures to be implemented, if needed, following the successful conclusion of the programme, in line with the agreement in the Eurogroup of 15 June 2017. The Eurogroup invites the European institutions and the IMF to take into account the holistic Greek growth strategy when updating the DSA.

http://www.consilium.europa.eu/en/press/press-releases/2018/01/22/eg-statement-on-greece/pdf

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