



Guest post

Euro area Redenomination Risk - Déjà vu



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by: Guest writer

In this guest post, law professors Mark Weidemaier & Mitu Gulati evaluate the risk that euro area sovereign debt could be redenominated into new local currencies. The places to worry about are France and Italy, not Greece.

Our work centers around questions related to sovereign debt, and lately we have heard from a number of industry friends who wanted to talk about redenomination risk for Euro area sovereigns.

We expected them to talk about Greece. After all, the IMF has recently suggested that the Greek debt stock is “[highly unsustainable \(https://www.wsj.com/articles/imf-assesses-greek-debt-as-highly-unsustainable-1485541474?mod=wsj_nview_markets\)](https://www.wsj.com/articles/imf-assesses-greek-debt-as-highly-unsustainable-1485541474?mod=wsj_nview_markets).” That, along with the apparent unwillingness of the German Finance ministry to lend more to Greece absent IMF involvement, the likely unwillingness of the Trump administration to support more IMF loans, and IMF rules prohibiting lending where the debt is unsustainable, make it unsurprising that [talk of Grexit has begun again \(https://www.theguardian.com/world/2017/feb/03/grexit-greece-debt-crisis-eu-germany-us\)](https://www.theguardian.com/world/2017/feb/03/grexit-greece-debt-crisis-eu-germany-us). And Grexit talk, back in 2011, was what prompted [discussions of redenomination risk \(https://ftalphaville.ft.com/2011/11/21/754711/the-legal-aspects-and-abstractions-of-a-euro-redenomination/\)](https://ftalphaville.ft.com/2011/11/21/754711/the-legal-aspects-and-abstractions-of-a-euro-redenomination/).

From a legal perspective, however, Greece is an odd example to use in discussions of redenomination risk.

That risk is based on the argument that, when a country issues bonds under its own law, it implicitly reserves the right to repay investors in its new currency after a redenomination. This argument is not a slam-dunk for any country, but it seems especially ill-suited for Greece. The Greek bonds coming due this summer are governed by English law, which means payments will likely have to be made in Euros even if Grexit occurs.

Instead, our industry friends were concerned about Italy and France. Italy, with its anemic growth, the rise of the Five Star party, and gargantuan debt stock, was at the [top of the list of candidates for exit \(http://marcello.minenna.it/wp-content/uploads/2017/01/Italy-2017-01-19.pdf\)](http://marcello.minenna.it/wp-content/uploads/2017/01/Italy-2017-01-19.pdf). And fast on its heels was France, with Marine Le Pen's talk of [returning to the franc \(http://uk.reuters.com/article/uk-france-debt-idUKKBN14Q17F\)](http://uk.reuters.com/article/uk-france-debt-idUKKBN14Q17F).

Here, the question of redenomination is legally trickier. Most French and Italian debt is governed by local law. If one accepts the argument above, this implies that the governments could pass legislation redenominating their bonds from euros to francs or lira.

To complicate matters further, however, some French and Italian bonds — bonds issued after January 1, 2013, with maturities over a year — have Collective Action Clauses (CACs). These CACs were put in place by euro area policy makers in the wake of the Greek debt crisis at least in part to assure investors that future restructurings would occur in an [orderly and predicable fashion \(https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2332296\)](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2332296). Importantly, these CACs require a super-majority of investors (in principal amount) to approve any changes to the currency of the bond.

This creates something of a conflict. The fact that the bonds are governed by local law makes them vulnerable to changes in that law, potentially including changes to the currency of payment. But the bonds also contain explicit contract provisions — mandated by a euro area decree — that require a super-majority of creditors to approve changes to the currency of the bond.

So, which of these clauses governs: the CACs or the local law?

Creditors with CAC bonds will surely file lawsuits challenging any redenomination that occurs without super-majority approval. Since countries with institutions — such as an independent judiciary — that will stand up to sovereign expropriation [benefit economically \(http://pages.ucsd.edu/~ssaiegh/pampas.pdf\)](http://pages.ucsd.edu/~ssaiegh/pampas.pdf), this suggests investors in OATs and BTPs may be protected from redenomination. And if investors can bring lawsuits outside the euro area — say, in courts in New York or London — their position may be even stronger.

But it's also possible a local law bond is no different than a local law bond with a CAC. After all, both are ultimately subject to the whims of the local legislature, and the courts may side with them.

The markets seem to have a view, though: CAC bonds in the countries with heightened redenomination risk seem to be [valued significantly more \(http://marcello.minenna.it/wp-content/uploads/2017/01/Italy-2017-01-19.pdf\)](http://marcello.minenna.it/wp-content/uploads/2017/01/Italy-2017-01-19.pdf). Someone is betting they will be treated better when push comes to shove.