European Financial
Markets Lawyers Group

Preferred creditor status of the future European Stability Mechanism (ESM)

Niall Lenihan

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In November 2010, the Eurogroup (euro area Finance Ministers) issued a statement to the effect that, in order to protect taxpayers' money, and to send a clear signal to private creditors that their claims are subordinated to those of the official sector, an ESM loan will, in all cases, enjoy preferred creditor status, junior only to the IMF loan

In March 2011, the European Council (Heads of State or Government of the EU Member States) issued a term sheet on the ESM which included a short statement on the preferred creditor status of the ESM.

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Noting that like the IMF, the ESM will provide financial assistance to a Member State when its regular access to market financing is impaired, the Heads of State or Government have stated that the ESM will enjoy preferred creditor status in a similar fashion to the IMF, while accepting the preferred creditor status of the IMF over the ESM.

It was also clarified that this will be effective as of 1 July 2013 since no assertion of preferred creditor status has been made with respect to the European official sector loan facilities for Greece, Ireland or now, Portugal.

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The IMF's preferred creditor status has traditionally been asserted in declarations, rather that explicit, legally binding texts.

The IMF's Articles of Agreement require the fund to establish adequate safeguards for the temporary use of the Fund's general resources, but do not make any reference to the Fund's preferred creditor status.

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A related market development is that a recent request was submitted to the ISDA Determinations Committee arguing that the preferential creditor status attached to the IMF's financing arrangement with Ireland triggered a credit event under the ISDA Credit Derivatives Definitions with respect to CDS contracts written on the Irish Government's obligations.

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Generally speaking, the ISDA Definitions require three relevant elements to be satisfied in order to establish such a restructuring credit event.

- **First, there must be a change in the ranking in priority of payment of a Government obligation as a result of the IMF's preferred creditor status.**
- **Second, that change must be in a form that binds all holders of such Government obligation.**
- **Third, there must be a contractual, trust or similar arrangement providing for one of two things:**
  1. **that the holders of the Government obligation will not be entitled to receive payments at any time that the Government is in arrears or default under the senior obligation, in this case the IMF financing arrangement, or**
  2. **on the liquidation or reorganisation of the reference entity – in this case a Government – the senior obligation (the IMF financing) will be satisfied ahead of the subordinated obligation (in this case the Government obligation).**

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The ISDA Definitions also state that for purposes of determining whether a subordination exists, priorities arising by operation of law must be taken into account where the reference entity is a sovereign.

The ISDA Determinations Committee unanimously agreed that the IMF's preferred creditor status in its financing arrangements with Ireland do not trigger a restructuring credit event under the ISDA Definitions.

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The IMF's preferred creditor status is not based on any explicit provisions under the IMF Articles of Agreement, but mere political declarations. While unilateral declarations can acquire some legal significance under public international law when the person making the declaration intends to be bound by it, the main significance of such declarations lies in the declarant's willingness to act in accordance with the declaration in practice.

The ISDA case also brings out the complexity of understanding what is meant by subordination in the context of a sovereign. A sovereign is not subject to any liquidation or reorganisation procedure. A sovereign's main asset is its ability to raise taxes, and this is an asset which cannot be realised or readily quantified. Of course sovereigns can participate in debt restructuring processes, and it is clear in practice that IMF claims, consistent with the IMF's preferred creditor status, are not subject to such processes.