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Capital Markets

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ITC Markets Training: A look at the options

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Another Eurogroup- another opportunity for rumours scaremongering and good volatility. Merkozy initially said that by the 23rd of October a comprehensive solution would be presented that includes Greece and the rest of Europe. Later the Germans dampened the optimism and suggested a more sober approach. Lets see then what is on the table and what solutions the market participants are discussing.

- 1. Bazooka option for Europe**
- 2. The agreement signed on the 21st July with Greece. PSI, etc.**
- 3. Recapitalization of European Banks**
- 4. EFSF leverage**
- 5. Faster implementation of ESM**
- 6. Eurobonds or measures towards fiscal Union.**

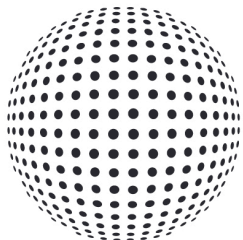
The ECB Bazooka Option

The original idea of the Bazooka option was for the ECB to start buying bonds of the European periphery once they hit a certain yield (say 5%). There are many reasons why the ECB refused to go down such a road and here at ITC we have written on it before (see Attachment). Currently, this option is out of favour both by bankers and many influential politicians (mostly German). Needless to say that there are numerous proposals, which in essence all come down one way or another into the ECB printing money or taking the risk on its balance sheet. Some, are structured so that the legal hurdles are overcome (Maastricht treaty) others are more cunning in disguising the ultimate risk taker in a complicated structure.

We therefore do not see a high probability of this option being exercised.

Greece and Restructuring the Restructuring

It is no longer a secret that Greece is insolvent whichever way you cut its debt. The truth is that the agreement of the 21st of July addressed more the concerns of the European banks rather than the solvency and sustainability of the Greek debt. Now the market is trying to restructure this agreement by demanding a full solution for the Greek Gordian knot. Hardly a day passes without someone proclaiming a figure for the haircut (21%, 35%, 50%, 60%, 100% have been mentioned). Lets recap the deal currently on the table and see what is feasible rather than talk a number out of our head.



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The deal was based on the assumptions of **avoiding a credit event (proper default)**, saving the European banks (including the ECB) from writing big losses and easing the cash-flow burden for Greece for few years. The hidden assumption was that given all these, Greece would be able to grow out of recession and ultimately be able to sustain the debt payments.

The IIF presented four bond exchange options to the bondholders. Three involved a 30Y bond with capital guaranteed by a AAA security and one 15Y with partial capital guarantee at maturity. If one discounted these new bonds with a 9% yield then a price of 79% came out. Why 9%? Why not 10% or more, after all, the Greek yield curve is far above the 9% figure. The 9% is arbitrary but this is where the IIF thought the Greek bonds would be trading **after** the exchange. It couldn't possibly be in double figure (more than 10%) as it looks ugly in the eye and very emerging market, not at all European.

How can we alter this 21% haircut without triggering a credit event. i.e. without a proper default. Well, it can be done by a combination of things:

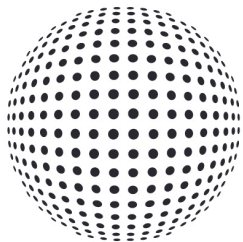
- Altering the coupon. By reducing the average coupon by 1% we can go to 31% (in option 1)
- If we reduce the capital guarantee to 80% instead of 100% to all options we gain another 5%.
- Extending the maturity to 40Y could possibly bring some more, depending on the coupon.
- One could assume 10% yield (say) instead of 9% yield. That would add another 3% of haircut.

In other words, without triggering too much objection from the bond holders we could have voluntary haircut of around 36%. Anything more than that would risk the participation in the PSI, which currently stands close to 90% (according to press reports).

Any talk of 50% or more then carries the big risk of a coercive offer, namely a default that Europe is trying to avoid all this time.

There are however, other aspects of the deal struck on the 21st of July that can be improved. For example,

- They can allocate more money in buying back some of the bonds now trading close to 50% (or less).
- They could extend the eligible bonds to 2030. Currently, only bonds maturing up to and including 2020 are eligible.
- They may also find a way to include the ECB holdings (around 45bil), which are currently immune from the restructuring.
- A more detailed Marshall plan could be structured



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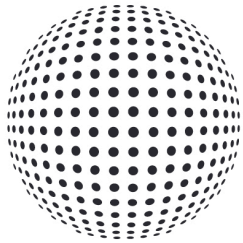
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Even after the PSI exchange, Greece would be liable to pay for the interest in the new bonds. According to our calculations this is around 6bil (assuming original PSI deal), which presupposes a 3% **primary surplus** for Greece. As this is hard to achieve in the current recessionary environment then further bailout funds or grace period may be negotiated given that Greece comes clean in their commitments.

The nightmare scenario for Europe is the proper credit event. Let me explain why I call it a nightmare:

- Banks including the ECB would have to write down their losses immediately. No longer the option to have them in the banking book marked to fiction. Some banks have taken that road already but many have not.
- ECB would not only write losses on their 45bil portfolio but would no longer accept Greek bonds as collateral. They could alter that internal rule but it is highly unlikely, as it would damage the reputation of the ECB even further.
- European banks (non Greek) would have to replace this with other acceptable collateral. Given the recent funding stress, it would only add to the problem.
- Greek banks would need to find alternative sources of funding or go bust causing further social unrest in Greece. One possibility is for the Bank of Greece to use the full ELA tool with the approval of the ECB. However, even in this case, the run on deposits may stress the physical currency reserves (need to issue paper money to satisfy withdrawals). Accessing the ELA that is a liability of the state (in default in this case) may cause some philosophical concern.
- As there are no Collective Action Clauses (CAC's) in the bonds under Greek law, it may take 6months or more to reach an agreement that satisfies the creditors. All this time Greece would need to finance pensions and salaries.
- The risk of other countries, in particular Ireland asking for a proper haircut is great. Peripheral debt would suffer. This would probably force more losses on the European banks who hold Peripheral debt. EU must have a recapitalisation plan in place and not expect the market to come up with the equity.
- If Europe decides a Credit event, then the Greeks might feel emancipated to deal with their debt themselves, rather than leaving it to Europeans. For example, they could pass a law transforming all GGB's into 40Y zero coupons. Bondholders would then need to go to Greek courts to argue their case. This is not something that they would want to do. As Greece does not deny payment but only moves the repayment date it is not an appropriation of funds.
- CDS contracts would have to be paid out. Although the net volume is small we do not know were the losses would hit adding to the unpredictability factor.

Thus unless the European leaders have concrete answers to the above risks, a credit event seems highly improbable. In conclusion, we believe that the deal struck on the 21st July would be altered but not as some suggest drastically.



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Recapitalization of European Banks

There are various estimates on how much capital the European banks are short. The summer EBA stress tests suggested 3.5bil. The IMF calculated that 200bil are needed, whereas others have placed the figure in between.

Nationalising Banks is actually more expensive than saving the country so it is not an option that one can seriously consider, unless of course, you bite all senior bondholders (on top of the subordinate ones) before the nationalisation.

The options that seem to be considered are a version of the American TARP. The original thought was for the respective countries to foot the bill (Germany suggested) but this looks hard from the perspective of the less well off countries that want Germany to take the bill. Another suggestion was to use the EFSF funds. However, Germany opposes the cash increase of the available EFSF, which now stands at 440bil. They instead seem to be accepting a more “efficient” use of this money.

EFSF Leverage

Various forms have been suggested in order to increase the “efficiency” of the 440bil that are currently available to the EFSF (actually less, around 250billion, as money are already committed to Ireland and Portugal and possibly Greece). The idea of transforming the EFSF into a bank and using the ECB funding was dropped very fast. The current flavour involves the usage of the EFSF as almost a monoline insurance.

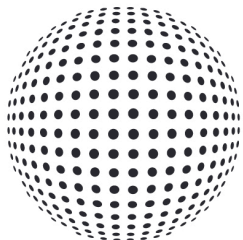
Under this insurance scheme, the EFSF would insure the first 20% of losses given default of the new bonds issued in the Euro area. This, proponents say could increase the effectiveness of the EFSF to 1.25trillion (250bil times 5). Although details of this proposal are not known with accuracy or certainty there are some concerns:

- One of the fundamental principles of insurance is diversification of risk. You simply do not insure all the flats in the same building against fire risk. In the case of Europe, Italy and Spain represent a huge chunk of EU debt (more than 2.5trillion).
- The EFSF insurance is like a father selling protection against death for his own his family including himself. There is very high correlation as 130billion out of the 440billion in the EFSF come from Italy and Spain (Greece, Portugal and Ireland account for 30billion). This effectively means that Germany and France would foot again the bill. This may cause further downgrades from the rating agencies.
- The PSI idea was to share the burden with the private sector. The current insurance scheme moves this back to the official sector.

Article 125

(ex Article 103 TEC)

1. The Union 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 any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. 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.



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- For the past 2 years, the EU is trying hard to avoid default and credit event. They did not allow Irish banks to default neither Greece to haircut their debt back in may 2010. Now they would be insuring bonds against default that they vowed to prevent?
- This 20% insurance would be given to all regardless their solvency position? That is certainly not a prudent insurance policy from the point of view of the insurer.
- Markets may take the opposite view and start their pricing with a 20% portion as a AAA and the rest much lower. This would force the bonds of unsuspecting countries much lower than they are trading now.
- Under which credit events, would the 20% be triggered? Lets assume that “Failure to pay” is acceptable, would restructuring be an event that would trigger the insurance? Given that Greece is restructuring “voluntarily” would it be insured?
- Some say that this insurance policy may contravene article 125 of the TFEU (see box)

At the moment we have no details of how this insurance can be implemented, however, my guess is that it is not something that can be implemented efficiently and fast enough to address the current crisis.

ESM brought forward

Another idea that is being put forward is to bring forward the implementation of the ESM. The ESM would certainly have more money to deal with the current crisis (lending of 500billion) but it also means testing for solvency all the countries at an earlier stage. In other words before the austerity plans had any time to work properly. It may then cause more volatility than ever before.

Eurobonds and Fiscal Union

Given the reluctance of policy makers to leak anything on Eurobonds and Fiscal Union we should expect very little progress on that front. However, back in august they EU charged the president Mr Van Rompuy to come up with suggestions. We have not heard much since then and in his speech at the LSE he refused to release any details. It seems however, that Germany would come up with some sort of sanctions and measure against fiscal profligacy and much closer monitoring of budgets than ever before. This direction is potentially the only viable long-term solution to Europe’s problems. However, it depends how it is implemented. If for example is just an imposition of a Franco/German fiscal will, then it would cause far more problems than it would solve.