Re-Define commentary on details of Private Sector Involvement in Greece

22nd July

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Background

The discussion on private sector involvement in Greece has grabbed many headlines over the past few months. Now that a decision has been taken at the Euro area leaders' summit yesterday, let us see what this really means.

The first thing to consider is, whether one believes that the Greek debt burden is sustainable or not. This very basic assumption will strongly drive whether one thinks the private sector involvement on offer is good or bad. There are three opinions on this 1) Greek debt is not sustainable at current levels and will continue to depress investment and thwart growth through a debt overhang 2) Greek debt is on the knife edge of sustainability but does not pose an overhang 3) Greek debt is sustainable. We will look at all three perspectives and our comments are in Italics.

IIF Financing Offer

The members of the IIF and other major financial institutions extend a financing offer to Greece. We welcome the intension of the EU to improve the terms of its financial assistance to Greece, including lower interest rates, extended maturities and a more flexible and a broader scope of operations for the EFSF. As part of a comprehensive plan, including additional support by the IMF and the redoubling of adjustment efforts by Greece, we are prepared to participate in a voluntary program of debt exchange and a buyback plan developed by the Greek government. In summary, the program involves an exchange of existing Greek government bonds into a combination of four instruments together with the Greek Debt Buyback Facility.

The key phrase of note here is 'voluntary debt exchange and buyback'. This already defines the main parameters of the deal and its limitations so any expectations that private sector participation is going to be substantial can be left at the door at this point.

Four Instruments: (Refer to the Term Sheet for details)

1) A Par Bond Exchange into a 30 year instrument
2) A Par Bond offer involving rolling-over maturing Greek government bonds into 30 year instruments
3) A Discount Bond Exchange into a 30 year instrument
4) A Discount Bond Exchange into a 15 year instrument

Making three different instruments available for a bond exchange and a fourth possibility of rolling over debt is not bad in terms of making the offer flexible and is consistent with our own suggestions on offering a menu of options.

What is notable here is the prevalence of the 30 year maturity (with one exception) and this is one of the very few positive features of this Private Sector Involvement deal. This seems to be a small victory for EU governments and the IMF which are likely to see their loans to Greece repaid before private bond-holders who have agreed to a maturity of 30 years are able to exit Greece.

The EU governments have promised that they will treat their loans to Greece as being of the same seniority as private bondholders. This also applies to EFSF loans to Greece. However, as seems likely under the current plan, if loans by the public sector to Greece are all repaid before the extended bonds held by the private sector mature, then this confers a kind of a seniority to the public loans by the backdoor. This is a good thing. There is however a catch as we will see in the next section.

For instruments, 1, 2 and 3 the principal is fully collateralized by 30 year zero coupon AAA Bonds. For instrument 4, the principal is partially collateralized through funds held in an escrow account.

This is the catch. It means that the private sector will enjoy guarantees from the public sector so enjoys seniority of the public sector not the other way round. Assume a scenario where all direct public loans to Greece are paid back in 15 years. All that is left now are the 30 year bonds held by the private sector. As the IIF suggests, the principal is fully collateralized by the EFSF. For the discount bonds which do not pay an interest rate, this means that they are fully guaranteed by the public sector so have full seniority over the public sector.

For the par bonds, the only part of the payout not guaranteed by the public sector at this point is the coupon payments between year 15 and year 30. The principal is guaranteed. The only funds at risk at this point are these coupon payments which at the interest rates discussed in these documents will amount to less than 10% of the overall value of the bonds. So, in actual fact, almost all the private bond-holdings will enjoy a de facto senior status over public loans, a far cry from the discussions on making public loans senior. This is a bad deal for EU taxpayers.

It is assumed that investors will select among the four instruments in equal proportions of 25% of total participation.

All instruments will be priced to produce a 21% Net Present Value (NPV) loss based on an assumed discount rate of 9%. The terms outlined in the Term Sheet are broadly comparable to those of the official sector. The interest rates are structured to maximize the benefits to Greece in the early years of the program as Greece regains access to global capital markets. For example, the coupon on the Par Bond will be 4% during the first five years, 4.5% during the next five years, and 5% for years 2011-2030. Based on a target participation rate of 90%, the private sector investors through this program will contribute €54 billion from mid-2011 through mid-2014 and a total of €135 billion to the financing of Greece from mid-2011 to end-2020. In addition to this assured financing, this program will also improve significantly the maturity profile of Greece's debt, increasing the average maturity from an average of 6 years to 11 years.

This section is highly misleading. This is also where it is very important whether you believe that Greek debt is sustainable or not. If you believe that Greek debt is sustainable and will be repaid in full, then it makes sense to think of both loans from the EU public sector and IMF and the bonds that the financial sector is agreeing to extend the maturity for as equivalent low risk loans to Greece. Then all Greece needs is a loan, i.e. temporary liquidity support not solvency support in the form of debt cancellation.

From this perspective, the EU/IMF will provide Euro 109 billion of fresh loans to Greece 2011-2014 and the private sector will extend maturity on Euro 54 billion of bonds coming due during this time and this will amount to a Euro 37 billion contribution once the collateral commitment of the EFSF is subtracted from this. So one could think of this as the EU/IMF providing Euro 109 billion of loans and the private sector providing Euro 37 billion and this would be fair. Moreover, bonds maturing after 2014 until 2019 (75% of private Greek bonds will mature between 2011 and 2019) will also see their maturity extended showing a net total liquidity support from the private sector of Euro 106 billion (Euro 135 billion minus the EFSF collateral).

Now if you, like us, happen to believe that Greek debt is not sustainable or that it may not be sustainable, this approach which provides only liquidity support starts looking deeply flawed. Essentially, the EU has missed the opportunity to impose haircuts on private bondholders in order to bring the stock of Greek debt down to sustainable levels and is essentially locking itself into a position where any such future haircuts would be impossible. Also given the discussion we have had above on the effective seniority of private bonds over the EFSF (because of the guarantees provided) this means that there will a major shift of risk to taxpayers. If Greek debt does indeed turn out to be unsustainable after all, EU taxpayers will have to pay. This is bad.

The 21% NPV reduction touted above is highly misleading. The correct discount rate to use between Euro 100 payable today or payable next year by Greece if the purpose is to check the sustainability of Greek debt is Greece's growth rate. If Greece can afford to pay Euro 100 today and is growing at 2%, it will be able to afford to pay Euro 102 next year. However the IIF disingenuously assumes a discount rate of 9%, which makes no sense for Greece as Greece is not expected to grow at a nominal rate of more than 4% or so.

If you are a bank and you are given a choice of getting Euro 100 next year from Greece or Euro 92 today, you might choose the Euro 92 today because you are not sure if Greece will actually be able to pay you Euro 100 next year. So a 9% discount rate (implicit here) may well be appropriate for the bank, but as we have seen in the previous paragraph, Greece's perspective is very different.

From Greece's perspective, there will be no NPV reduction from the bond exchanges and bond rollovers and if its growth rate remains below 2.5% then in fact the sustainability of Greek debt may actually be worsened by the proposed deal. That is why the IIF's claim of NPV reduction that has been repeated by politicians is highly misleading.

In summary, the whole mechanism of private sector involvement does little to increase the sustainability of Greek debt and in fact imposes significant additional risks on EU taxpayers.

The size of the Buyback Facility will be determined after further discussions involving the official sector. It is expected to be of sufficient scale that when combined with the €13.5

billion debt reduction through the discount bond exchange, there will be a meaningful reduction in the stock of Greece's debt relative to GDP. This will be reinforced by Greece's new privatization program and prospects for higher growth which should emerge as the program takes hold.

Euro 13.5 billion out of Euro 350 billion of debt stock is less than 4% reduction in the stock. Now that private bondholders know that they will get a good deal and are almost surely protected against future losses by taxpayer guarantees the price of Greek bonds is likely to shoot up so any debt reduction through opportunistic secondary market purchases are likely to be negligible, less than Euro 10 billion by our estimates. So the whole fuss around private sector involvement would result in a Euro 20-25 billion reduction in the Greek debt stock or around 7% of the outstanding debt stock and will come at the cost of increased risks for tax payers. It is fair to ask what the point of all of this was.

We consider this offer to be unique given the exceptional circumstances of Greece. Not withstanding the progress made by Greece during the last one and a half years, the scale of Greece's economic imbalances and the inefficiencies that have been embedded in its economic structures require a special approach that can enhance debt sustainability and restore confidence in the future of the Greek economy.

They make it sound generous, it is anything but. Also, this implies that there will be no private sector participation in Ireland and Portugal. To be fair, at these generous terms it would make little sense for other countries to seek involvement from the private sector.

The offer is already supported by the financial institutions listed in Annex 2, and we expect support to build as the offer and the comprehensive program surrounding it is more widely disseminated.

Our offer is conditioned on the comprehensive economic reform program of Greece, the strong support of the EU, which has just been reinforced and additional support by the IMF.

Annex 1 - Term Sheet

Instruments and Technical Aspects
1. A **Par Bond Exchange** into a new 30 year instrument with the principal collateralized by 30 year zero-coupon AAA rated bonds. The zero coupon bonds are purchased using EFSF funds.

Greece pays the funding costs to the EFSF. The principal is repaid to the investor using the proceeds of the maturity of the zero-coupon bonds.

The coupon paid to the investor has the following structure:

Period Coupon
Years 1 – 5 4%
Years 6 – 10 4.5%
Years 11 – 30 5%

This is equivalent to a 4.5% fixed coupon rate. Assumed *participation rate*: 25% of total exchange.

2. A **Par Bond offered at par value** as a Committed Financing Facility to roll into new 30 year par bond at the time the current claim matures. The principal is collateralized using the same mechanism as for instrument 1.

The coupon paid to the investor has the following structure:

Period Coupon
Years 1 – 5 4%
Years 6 – 10 4.5%
Years 11 – 30 5%

This is equivalent to a flat 4.5% fixed coupon rate.

Assumed *participation rate*: 25% of total exchange.

3. A **Discount Bond Exchange** offered at 80% of par into a new **30 year** instrument. The principal is collateralized using the same mechanism as for instrument 1.

The coupon paid to the investor has the following structure:

Period Coupon
Years 1 – 5 6%
Years 6 – 10 6.5%
Years 11 – 30 6.8%

This is equivalent to a flat 6.42% fixed coupon rate. Assumed *participation rate:* 25% of total exchange

4. A **Discount Bond Exchange** offered at 80% of par value for a 15 year instrument. The principal is partially collateralized with 80% of losses being covered up to a maximum of 40% of the notional value of the new instrument. The collateral is provided by funds held in escrow. These funds are borrowed by Greece from the EFSF. The EFSF funding costs are covered by the interest earned on the funds in the escrow account so there is no funding cost to Greece of this collateral. The funds in escrow are returned to the EFSF on maturity, if not used, and the principal on the bond is repaid by Greece.

The coupon paid to the Investor is 5.9%. Assumed *participation rate*: 25% of total exchange.

The rates **presented here are** indicative only based on today's market conditions. Final pricing will be based on a fixed margin over the relevant Euro mid-swap rate at the time of execution. All instruments will be priced to be economically equivalent at 21% NPV discount calculated at a discount rate of 9%.

Coupons quoted are fixed, annual rates.

Annex 2 – Financial Institutions in Support

Name	Country
Allianz	Germany
BNP Paribas	France
Munich Re	Germany
Swiss Re	Switzerland
Zurich Financial	Switzerland
AXA	France
Generali	Italy
Dexia	Belgium
Deutsche Bank	Germany
HSBC	United Kingdom
Société Générale	France
ING	Netherlands
Commerzbank	Germany
Standard Chartered	United Kingdom
Intesa SanPaolo	Italy
SEB	Sweden
Bayern LB	Germany
BBVA	Spain
Alpha Bank	Greece
National Bank of Greece	Greece
Eurobank EFG Group	Greece
Piraeus Bank	Greece
Bank of Cyprus	Cyprus
Hellenic Bank	Greece
AK Bank	Turkey
Scotiabank	Canada
Credit Suisse	Switzerland
Banco de Credito de Peru	Peru
National Bank of Kuwait	Kuwait
KB Financial Group	Korea