

**UBS Investment Research****Macro Keys**

## Q&A on the Greek debt restructuring

The IIF and Greece are approaching agreement on the Greek PSI, according to latest reports. We believe collective action clauses will be used to force a high participation rate, which means that credit default swaps will be triggered, but also that the ECB could be forced to take a loss. We look at the implications.

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### When?

**20 March is the deadline.**

The next major debt repayment Greece faces is a €14.5bn bond redemption on 20 March. In all likelihood, the Greek government will not have the cash to repay the bond, which means this is in effect the deadline for restructuring the country's debt.

There are two scenarios in which talks could nonetheless carry on after that date. First, if our above hypothesis is wrong and Greece does in fact have the cash to repay the maturing bond – we doubt this is the case. Second, if Greece receives external support from the IMF and/or other European countries. This would be akin to the Fund and/or European states bailing out investors – again, we doubt this will happen.

So, if the debt is not restructured before 20 March, Greece is very likely to default.

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### Is Greece on an IMF programme?

**No, it is not.**

The IMF adjustment programme launched in April 2010 was formally terminated in December 2011 with the payment of an €8bn tranche. Greece is therefore no longer under an IMF programme at present. A second programme will commence after Greece's debt has been restructured. One key reason for the timing is that two-thirds of the money from the first IMF bailout was used to repay existing bonds maturing; only one-third was actually used to support Greece. Restructuring Greek debt will reduce the proportion of the bailout package used to repay maturing bonds. The IMF actually has an incentive to back a solution in which the new bonds are very long (no redemption in the near future) and carry very low coupons, at least in the first few years (no debt service).

### What haircut?

**About 70%.**

In our view, a simple haircut – just reducing the value of the debt – will not work, as it would result in an insufficient reduction of the debt (please see our note “*Why a 50% haircut on Greek debt will not work*”, 14 October 2011). Rather, we think the debt will be restructured with existing bonds exchanged against new bonds with much longer maturities.

Sources close to the discussions are talking about 30-year bonds, whereas the initial offering in September proposed 15- and 20-year bonds. The new bonds could also offer a lower coupon, and potentially step up later, or the coupon could be indexed to Greek GDP. Assuming the usual 9% discount rate, which was used in the first version of the PSI, we would assume a haircut in the neighbourhood of 70%.

### Will it be indeed “voluntary”?

**We doubt it. We think CAC clauses will be imposed.**

The current talks between the IIF and Greece seem to be nearing agreement. But even if an agreement is reached, we very much doubt that the participation rate of investors in a “voluntary” haircut will be high. In the first PSI deal, the Greek government wanted at least an 80% participation rate, and this would indeed be necessary to be consistent with the opening of a second IMF package – hence the likely need to force investors to participate.

Although there are a number of ways to force a higher participation rate, we believe the most likely option will be to use collective action clauses (CACs). Because more than 90% of Greek debt is under Greek jurisdiction, these CACs would retroactively apply to existing bonds, and hence drive the participation rate up to 100%.

### Will CDS be triggered?

**Yes, if CACs are imposed.**

If CAC clauses are indeed imposed, the exchange of bonds becomes coercive for a number of investors. This would almost inevitably trigger credit default swaps.

According to the ISDA, net open positions in CDSs are about €3.3bn currently, and we do not see that as a major risk. By contrast, not triggering the CDSs would wipe out the credibility of this market, which would be very detrimental, in our view. Triggering the CDSs is the right decision.

### Will the ECB participate in the haircut?

**If CAC clauses are used, we think the ECB will likely have to participate and take losses.**

The official narrative for the time being is that the ECB will not be involved in the PSI. However, if CAC clauses are used, we think it will be difficult for the ECB to avoid involvement. There are several ways of doing so. For instance, the ECB could exchange its portfolio of bonds against a new Greek bond, then Greece could propose a coercive PSI on all bonds except the one held by the ECB. This would, however, be very questionable from a legal point of view and would almost certainly be challenged in court by investors.

Another option would be to transfer the ECB’s portfolio to the EFSF or some other European entity, which then would be involved in the exchange. This option again is fraught with legal complications.

A further legal consideration is that the ECB might be forbidden to participate in a haircut as this could be seen as a breach of the Lisbon Treaty, specifically the clause preventing money financing of government. We do not think this is a valid argument, however.

## What are the potential losses for the ECB? Could it cope?

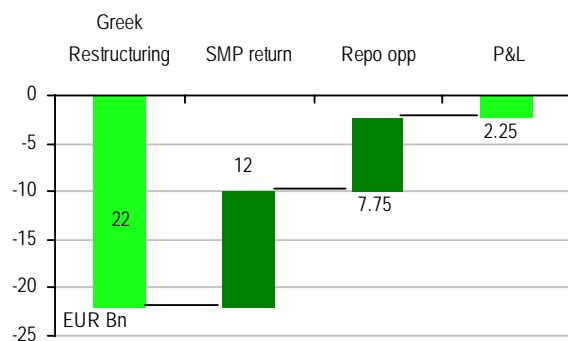
**About €2bn. And yes, it could cope with that.**

We estimate the ECB holds close to €5bn of Greek bonds. So a haircut of 70% would reduce the value of the bonds by €3.5bn, to €1.5bn. However, the ECB did not buy these bonds at par; we believe the average cost was around 70 cents, hence the ECB spent €3.5bn on buying the bonds. After any exchange it would receive bonds worth €1.5bn – a €2bn loss.

This looks like a lot of money, but actually the P&L of the ECB is likely to look much better. Firstly, because the ECB's Securities Markets Programme (SMP) will generate a large carry trade. Assume that the SMP ex-Greece averages €200bn this year. This is a conservative assumption; indeed, the SMP currently amounts to about €180bn (the official €220bn minus our estimate of €38.5bn in Greek bonds). Now assume this portfolio yields 6% – again, arguably a conservative hypothesis – then the ECB would gain €12bn this year. And that is not all. Repo operations currently amount to about €900bn, and banks are paying 1% on those funds – a €9bn profit for the ECB this year. This number should be lowered, though, because the ECB deposit facility of about €500bn receives a 0.25% return, which costs the ECB €1.25bn a year. So the real profit would actually be €9bn minus €1.25bn, i.e. €7.75bn.

We again stress that these are extremely conservative assumptions. Expectations for the next three-year repo operations are for several hundred billions of euros, which would boost the ECB P&L. But using our numbers, the ECB's P&L from monetary operations would be a €2bn loss on Greece, minus the €12bn profit on the SMP portfolio, minus the €7.75bn from repo operations, leaving a €2.25bn loss – ten times lower than the original number.

**Chart 1: ECB P&L due to monetary operations**



Source: UBS

Not convinced yet? Let's look at the ECB's balance sheet. Strictly speaking we should be referring here not to the "ECB" but to the "Eurosystem"; indeed, the SMP has been implemented by the ECB at about 8%, the rest is implemented by the national central banks *pro rata*, in line with their share of ECB capital. So the loss proceeding from a Greek restructuring will be borne not by the ECB alone but by the entire Eurosystem. The table below summarises the Eurosystem's balance sheet. This is important, firstly because of the last line at the bottom of the liability side, "capital and reserves". Many commentators compare the potential losses with the capital of the ECB, which is €6bn, while it should actually be compared with the Eurosystem capital, which is €81bn.

Also, the line just above "Revaluation Accounts" is also interesting. This account is used to book the capital gains from assets; for instance, gold is marked to market regularly, and any increase in gold value on the asset side will be compensated by an increase in the "Revaluation Accounts" line. So this account should be regarded as latent profits, and can be used to offset losses. The number on this line is a far from negligible €383bn, considerably more than any estimates of potential losses from a Greek restructuring.

We would note an important detail, though: the accounting rules are complex and not all of the losses can be offset by latent profits, so only part of the Greek losses might be absorbed by this account. We do not have sufficient granularity on this account to push our analysis any further.

**Table 1: Eurosystem BALANCE SHEET (1 December 2011)**

ASSETS		LIABILITIES	
Gold and Gold Receivables	420	Banknotes in Circulation	874
Claims on Non-Euro Reserves in Foreign Currency	232	Liabilities to Euro-Area Credit Institutions in EUR	708
Claims on Euro Reserves in Foreign Currency	32	<i>Curr Accts (Min Reserve System)</i>	181
Claims on Non-Euro Reserves in EUR	28	<i>Liabilities: Deposit Facility</i>	333
Lending to Credit Institutions in EUR	656	<i>Liabilities: Fixed-term Deposits</i>	194
<i>MRO</i>	265	<i>Fine Tuning Reverse Operations</i>	0
<i>LRO</i>	383	<i>Deposits Related to Margin Calls</i>	0
<i>Fine-tuning Reverse Operations</i>	0	Other Liabilities to Euro-Area Credit Institutions in EUR	2
<i>Structural Reverse Operations</i>	0	Debt Certificates Issued	0
<i>Marginal Lending Facility</i>	7	Liabilities to Other Euro-Area Residents in EUR	63
<i>Credit Related to Marginal Calls</i>	1	Liabilities to Non Euro-Area Residents in EUR	51
Other Claims on Euro-Area Credit Institutions in EUR	92	Liabilities to Euro-Area Residents in Foreign Currency	4
Securities of Euro-Area Residents in EUR	606	Liabilities to Non Euro-Area Residents in Foreign Currency	9
<i>Securities held for monetary policy purposes, EUR</i>	268	Counterpart of SDRs Allocated by IMF	54
<i>Other securities, EUR</i>	338	Other Liabilities	205
Gen Govt Debt Denominated in EUR	34	Revaluation Accounts	383
Other Assets	335	Capital and Reserves	81
<b>Total Assets</b>	<b>2436</b>	<b>Total Liabilities</b>	<b>2436</b>

Source: ECB

## Should the ECB participate in restructuring?

**If the ECB participates, it would be a bad decision. If the ECB does not participate, it would be a bad decision. On balance, we think the ECB should participate.**

If the ECB participates it will lose money together with the national central banks. This might be politically difficult to sell to voters, especially in some countries. It could then reduce the appetite of the ECB to use the SMP, or it could increase public pressure in some countries to avoid putting central banks further at risk. The second risk is more legal: if the Bundesbank loses money on the SMP, it is ultimately taxpayers' money. This is where a legal problem could arise. In September, the German constitutional court clearly ruled that any taxpayer involvement has to be approved by parliament. This has not hitherto been the case for the SMP, as its use is decided on by the ECB board. Hence the SMP could be considered to be in breach of the constitutional court's ruling. Needless to say, this would be unsettling for markets.

If the ECB does not participate, then the bonds held are senior to the market. This means that almost €200bn of Italian and Spanish bonds purchased via the SMP would be senior to the market: in effect, the market would have just been downgraded. This is clearly not a message that should be sent out while Italy and Spain are facing heavy issuance schedules. Additionally, if the ECB indeed avoids involvement in the PSI, we think there is a high probability that this would be challenged in court – which would put the ECB in an unpleasant position.

On balance, we think the ECB should take a haircut. The constitutional argument is not compelling, in our view, and the losses, as explained above, are not that large. By contrast, downgrading the market to junior to the ECB could cause considerable damage and would make any SMP intervention self-defeating.

## Would the restructuring make the Greek situation sustainable?

**No.**

Sorry, but no is the answer. Even with full repudiation of the Greek debt, the situation would not be sustainable. In that event, the deficit would move to the primary balance, 5-6% last year. Not sustainable. And the current account deficit would be in the high single digits. Not sustainable either.

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