

# The debt crisis

## Greece's orderly default - the first in a series

- The private sector involvement (PSI), the exchange offer for private holders of Greek bonds, achieved a voluntary acceptance rate of 83.7% in total and 85.8% on the bonds issued under Greek law. By activating collective action clauses (CACs), Greece achieves full participation on the Greek law bonds, equaling a 95.7% overall participation rate, and triggers credit default swaps (CDS).
- While the 53.5% nominal value haircut of the exchange reduces Greece's government debt by EUR 105bn, the 2012 net debt reduction for Greece, including the new loans required to finance the PSI, will only be about EUR 27bn, leaving the country on an unsustainable debt path.
- We close our Sell recommendation initiated in March 2010 for bonds that cease to exist after the PSI; **we expect a further event of default for Greece in the coming years, with first re-adjustments to the current plan expected to be necessary in as soon as six months' time.**

With the private sector involvement (PSI) concluded and the decision to exercise CACs, Greece officially defaults on its bonds issued under Greek law. Credit default swaps (CDS) are being triggered. We have maintained a Sell recommendation on Greek bonds since March 2010, first expressing the view that Greece would default by March 2012 almost a year ago. In our 17 October 2011 note "Debt cuts for Greece, more capital for banks," we concluded that a 70% haircut on Greece's total debt would be required for the country to return to a sustainable debt path. Below, we show that **the effective debt reduction resulting from the PSI in 2012 is less than 8%, and we conclude that a substantial additional debt haircut will be required on both the bilateral support loans from European countries and the Greek bonds newly issued in the PSI exchange. Such a second debt restructuring for Greece is unlikely to occur this year, but we think it is possible by 2013, and quite likely to happen before the end of 2014. In the course of such a second default event, Greece may even leave the Eurozone.**

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Source: Dreamstime

### WMR reports on Greece since inception of our Sell recommendation on 29 March 2010

Date	Title
29.03.2010	Greece: Default remote, sell long-term bonds
13.04.2010	A lifeline for Greece, but its bonds are a sell
28.04.2010	Greece and its EMU peers - our views
12.05.2010	Opportunity for portfolio shifts
23.11.2010	European sovereign debt update
05.01.2011	The Eurozone at the tipping point
18.01.2011	Sovereign debt in the age of austerity
16.02.2011	Eurozone: lost in transition
20.04.2011	Consequences of a Greek debt restructuring
09.05.2011	Greece unlikely to exit the Euro
26.05.2011	Rhetoric aside, a default is a default
17.06.2011	Greece and our equity and bond views on financials
18.07.2011	Timing of a Greek default and contagion effects
22.07.2011	Euro agreement buys time, but it is not the solution
14.09.2011	Next hurdles for the Eurozone
12.10.2011	Sovereign default in the Eurozone: Greece and beyond
17.10.2011	Debt cuts for Greece, more capital for banks
27.10.2011	EU summit: the seventh definitive plan
07.12.2011	EU summit: business as usual?
15.01.2012	The downgrade of Europe
31.01.2012	EU summit: stability is a great word
10.02.2012	Greece accepts an offer it cannot refuse
21.02.2012	Ten questions on Greece after the latest bailout
28.02.2012	Greek bond exchange: voluntary in name only

Source: UBS WMR

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When we initiated a Sell recommendation on Greek government bonds on 29 March 2010, five-year bonds traded at around 95%, and many other Greek bonds were trading above par value. As of today, most Greek bonds are trading below 20% of par value. We close our Sell recommendation for bonds issued under Greek law, as these will cease to exist after the settlement of the PSI. We maintain our Sell recommendation for all Greek foreign-law bonds that remain outstanding, and we will initiate a recommendation for the newly issued bonds from the exchange as soon as these are being traded. We expect the new EFSF bonds provided to investors in exchange for their old Greek bonds to be fairly valued and to trade close to par value.

In the near term, we do not expect risk premiums for bonds of other peripheral countries to experience contagion effects from Greece's default, but rather to remain dependent on developments within national borders. Contagion effects from Greece could arise again, however, should an exit from the Eurozone reenter discussion. While short-term yields for peripheral government bonds remain supported by the Long Term Refinancing Operation (LTRO) liquidity from the ECB, longer-term risk premiums should continue to remain sensitive to the execution of the individual fiscal consolidation plans, implying higher volatility on the longer end of the curve and particularly steep yield curves for these countries. We maintain our general Avoid recommendation for medium- and longer-term bonds of peripheral European countries and our Sell recommendation for Portuguese bonds maturing beyond mid-2013.

### Low impact of triggered CDS

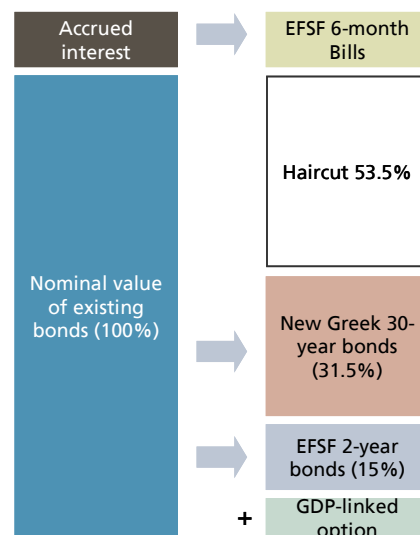
Triggering CDS is generally perceived as problematic; most investors remember the consequences of the 2008 Lehman collapse and the panicky atmosphere that ensued. We think it would indeed have been problematic if Greek sovereign CDS would have been triggered by 2011. However, the case of Greece now offered at least long preparation time for counterparties involved in the CDS market, and due to more detailed disclosures on an individual bank level (see Fig. 2) there is much less uncertainty with respect to possible knock-on effects of a CDS trigger event on institutions which sold protection. Therefore, we think European finance ministers were much more relaxed about Greece exercising the CACs and triggering CDS. In addition, we believe that not triggering CDS in one of the largest debt restructurings in history, which was not really accepted voluntarily by banks subject to political pressure, would have harmed investors' trust in the effectiveness of the sovereign CDS market substantially. As a consequence, we think risk premiums for bonds of weaker countries would have become much more volatile, since holders of government bonds concerned about credit risk would prefer selling their bonds in the cash market to buying possibly ineffective CDS protection.

### Details of the PSI settlement

The aggregate principal value of bonds subject to the PSI was EUR 205.6bn, and holders representing EUR 172bn (83.7%) accepted the exchange offer. For bonds issued under Greek law (EUR 177bn), the participation rate was 85.8% (or EUR 152bn). By exercising the CACs and forcing holdouts to exchange their bonds, Greece will increase the participation on Greek law bonds to 100%. For foreign-law bonds, the participation is currently at EUR 20bn, but the acceptance period for the exchange has been extended until 23 March; Greece will hold bondholder meetings to ascertain if CACs on some of these bonds can be executed. Therefore, the overall amount of bonds being exchanged in the PSI will reach at least EUR 197bn (172bn voluntary acceptance plus 25bn per CACs on Greek law bonds).

**Fig 1: Greek bond exchange**

Exchange process based on nominal values



Source: UBS WMR, see 28 February 2012, "Greek bond exchange: voluntary in name only" for a detailed explanation and valuation of the new securities.

**Fig. 2: Largest CDS exposures of European banks (in million EUR)**

	Net seller	Net buyer	Net exposure
BARCLAYS	4'451	4'372	-79
DEUTSCHE BANK	4'420	4'324	-96
RBS	3'152	3'375	223
SOCIETE GENERALE	2'457	2'454	-3
HSBC HOLDINGS	1'482	1'725	243
UNICREDIT	1'116	817	-299
COMMERZBANK	825	825	0
DZ BANK	806	636	-170
WestLB AG	403	326	-77
BPCE	353	212	-141
BNP PARIBAS	306	214	-92
BANCA MONTE DEI PASCHI	275	264	-11
LBBW	216	271	55
BANCO SANTANDER	214	214	0
BCP	148	148	0
INTESA SANPAOLO	142	167	25
Erste Group Bank	110	111	1
NORDLB	92	0	-92
CREDIT AGRICOLE	48	9	-39
BBVA	46	33	-13

Source: EBA, UBS WMR; Net sellers, which show a negative net exposure, suffer costs from CDS being triggered.

# The debt crisis

## Greek debt declines by merely EUR 27bn

It is often claimed by officials that the PSI reduced the Greek debt burden by more than EUR 105bn, which is in fact not true. Even to finance the exchange of EUR 197bn of old bonds, Greece needs to tap the second bailout package for a total of EUR 85bn. This includes:

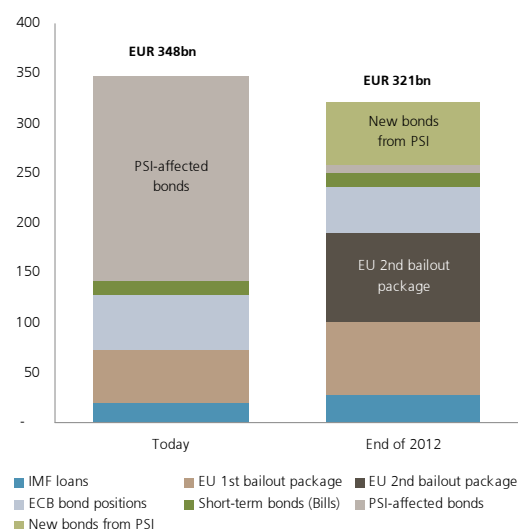
- EUR 29.6bn to buy two-year EFSF bonds, which are issued in exchange for 15% of the nominal value of old bonds ( $0.15 \times 197\text{bn} = 29.55\text{bn}$ )
- EUR 5.5bn to pay for the accrued interest of exchanged bonds in the form of six-month EFSF Bills
- EUR 50bn to recapitalize the Greek banks following their losses taken in the PSI exchange

So overall, the Greek debt stock declines by EUR 197bn as the old exchanged bonds disappear, but at the same time, the newly issued Greek bonds ( $0.315 \times 197\text{bn} = 62\text{bn}$ ) and the costs of the exchange (85bn) result in new debt of EUR 147bn. Including the financing of the expected 2012 Greek budget deficit and payments on bonds held by the European Central Bank (ECB), we expect the net debt reduction for Greece in 2012 to be only EUR 27bn, or less than 8% (see Fig. 3).

## Why Greece remains a default candidate

The second bailout plan aiming at a 120% debt-to-GDP ratio by 2020 rests broadly on unrealistic assumptions, including remarkably positive economic growth and fiscal surpluses from 2013 onwards, and even then, the second package of EUR 130bn would be used up by 2014, requiring at least an additional EUR 50bn in new funding to reach 2020. Under more realistic assumptions, the Greek debt ratio will be higher by 2014 than it was before the PSI, and it may only decline to 150% of GDP by 2020. We think in order to achieve the 120% debt-to-GDP target, a 50% haircut on the EU loans would be required within the next two years. However, a debt-to-GDP ratio above 100% can, in our view, only be financed by wealthy and strongly growing economies in the absence of inflationary policies; this is difficult as long as a country is unable to execute independent monetary policy. Therefore, we refer to our previous reports, indicating that a 70% haircut on all Greek bonds would be required for the country to return to a sustainable debt path. Such a sizable voluntary waiver of loan claims representing European taxpayers' money is politically unlikely in the near term, so we expect several program re-negotiations to occur, including loan maturity extensions, interest rate reductions and other measures to postpone an almost inevitable write-off on official support loans. Besides the financial aspects, we think that the Greek populus will not accept suffering still more austerity measures for many additional years, which could drive an ultimate decision by Greece to exit the Eurozone and restructure its debt into a newly introduced Hellenic currency.

**Fig. 3: Greek debt reduced by EUR 27bn**  
Before the PSI and by the end of 2012



Source: UBS WMR, official Troika reports

### Appendix

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