

An evaluation of the French proposal for a restructuring of Greek debt

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Summary

1. French commercial banks are proposing a swap of €85.5 billion in Greek government bonds maturing between 2011 and 2014 into a combination of new long-term Greek bonds with principal guarantee and cash payments. If this initiative were implemented under the proposed parameters, private creditors would only suffer a minimal haircut and official lenders would be provided with cash-flow relief of around €20 billion over the next three years, but the solvency of the Hellenic Republic would worsen significantly.

Details of the French proposal

2. Earlier this week, representatives from European commercial banks and insurance companies met with policy-makers in Rome, at the Italian Treasury. In this meeting, the Fédération Bancaire Française made a proposal for a restructuring of Greek government debt. The original text of this “long-term investor initiative for Greece” has been published on the internet¹ and thus constitutes public information (reproduced in an annex to this note).

¹ Fédération Bancaire Française, “Long-term investor initiative for Greece”, 24 June 2011 (<http://www.scribd.com/doc/58960145/Crise-grecque-la-proposition-de-la-FBF>).

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3. French banks are proposing that holders of Greek government bonds coming due between July 2011 and June 2014 should receive:

- 70% in new 30-year Greek government bonds with a 5.5% coupon plus a GDP-linked surcharge of up to 2.5%, and a full principal guarantee in the form of AAA-rated zero-coupon bonds.
- 30% in cash.

Evaluation from the perspective of private creditors

4. Under the French proposal, Greece would be obliged to purchase 30-year zero-coupon bonds from the EFSF or another AAA-rated issuer to fully guarantee the principal repayment of new 30-year Greek government bonds. This collateral would be placed with the ECB as trustee, and released to bondholders in case of Greece's default on its new government bonds. The new Greek government bonds with principal guarantee thus constitute a combination of two financial instruments that need to be valued separately. For every €100 original face value in Greek government bonds, holders would receive:

- a) €70 face value in 30-year annuities with a 5.5% coupon plus a GDP-linked surcharge of up to 2.5%. These annuity payments are subject to Greek default risk.

- b) €70 face value in a 30-year risk-free zero-coupon bond.
- c) €30 in cash.

5. The present value (PV_a) of the string of annuity payments (a) is defined as:

$$PV_a = \frac{C \cdot P}{r} \left(1 - \frac{1}{(1+r)^n}\right) + \sum \frac{W}{(1+r)^n}$$

with C denoting the coupon rate, P the new principal as percentage of original face value, W payments from the GDP warrant, r the exit yield and n the maturity in years. Under the French proposal, $C = 5.5\%$, $P = 70\%$ and $n = 30$. For the sake of simplicity, we assign a value of zero to W . We will show below that a restructuring under these lines will not contribute to restoring sovereign debt sustainability for Greece. Therefore, we assume an exit yield r of 12%. Under these assumptions, the economic value of the annuity payments (a) is €31 for every €100 in original face value.

6. The second component of the package is designed to provide a guaranteed principal payment in 30 years. In order to achieve this, the Hellenic Republic would purchase zero-coupon bonds from the EFSF or another AAA-rated issuer. The present value of this zero-coupon bond (PV_b) is given by

$$PV_b = \frac{P}{(1+rf)^n}$$

with rf denoting the interest rate of risk-free investments. If we take the 30 year zero-coupon rate that is derived by bootstrapping the euro swap curve as risk-free rate, then we can set $rf = 3.78\%$. Under this assumption, PV_b amounts to € 23 for every € 100 in original face value.

7. Under an exit yield of 12%, the total value of the package is thus €31 + €23 + €30 = €84 for every €100 in original face value. The haircut for bondholders would be very small. If we assume an exit yield of 14.5%, which is the discount rate the market currently applies to three-year Greek government bonds, then we can assign an economic value of €79 for every €100 in original face value. On top of this, some value should be assigned to the GDP warrants which would be attached to the new securities. In any case, holders that have currently marked their holdings of three-year Greek government bonds to market would be able to record significant gains from

current prices of around 60% of face value if they participated in the debt exchange.

Evaluation from the perspective of official lenders

8. Greece has been using multilateral loans to repay maturing market debt after losing market access in the spring of 2010. Since the inception of the current programme, €29 billion out of total disbursements of €53 billion in international loans have been paid out to holders of maturing medium- and long-term government bonds. Official lenders have now accepted that Greece won't regain market access in the foreseeable future because private creditors view the country as insolvent. The IMF and the EU would have to provide Greece with additional loans of roughly €85.5 billion just to cover the remaining amortisation payments on medium-and long-term debt between July 2011 and June 2014, if they want to avoid burden-sharing with the private sector (key numbers taken from Table 13 in the Third Review of the IMF Programme²).

9. If all private creditors were to participate in the swap proposed by French banks, the required refinancing of market debt would drop significantly in the next three years. For every €100 in bonds coming due the Greek government would only have to pay private creditors €30 in cash, and it would have to spend €23 to purchase zero-coupon bonds as collateral. These cash outlets would have to be funded by new loans of €53 from official lenders. The Greek government would also be assuming new market debt with a face value of €70 in the process.

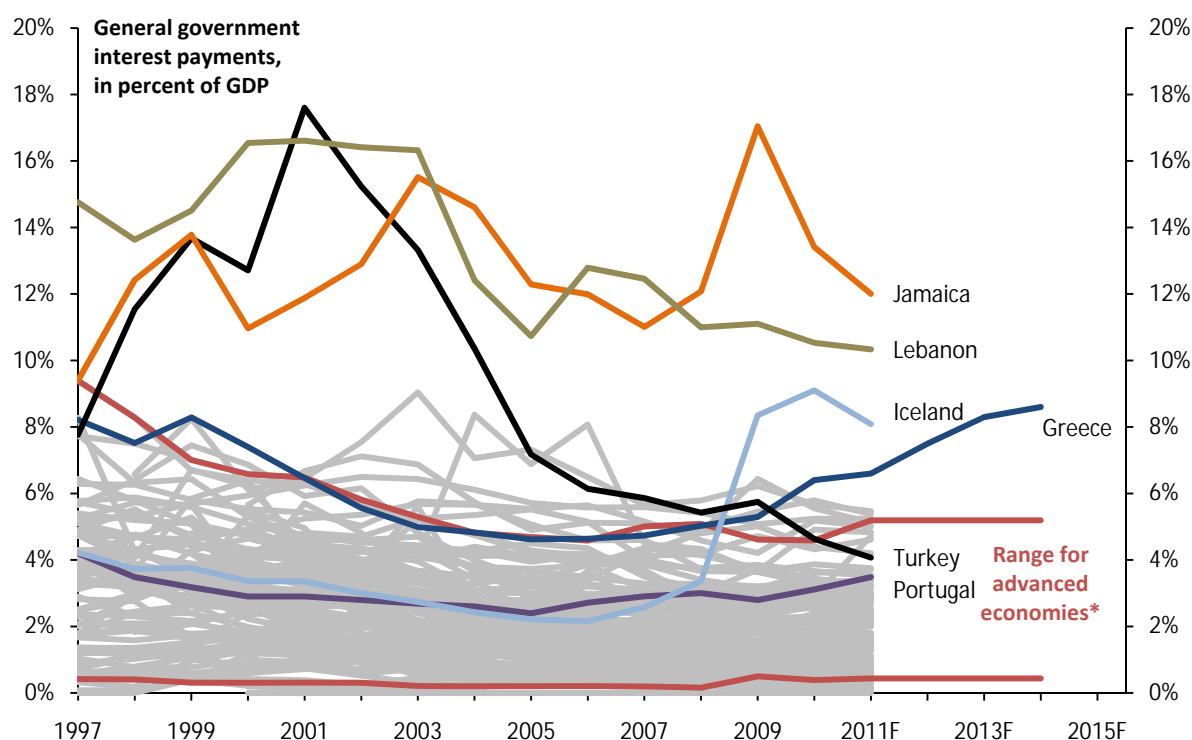
10. Full endorsement of the French proposal by private creditors would thus reduce multilateral lending to Greece by around €40 billion for the period of July 2011 to June 2014 (from €85.5 billion to €45.3 billion). Assuming no participation by the ECB and a purely voluntary participation by private creditors would likely reduce this cash flow relief to €20 billion or so.

² International Monetary Fund, "Greece: Third Review Under the Stand-By Arrangement", IMF Country Report No. 11/68, March 2011 (<http://www.imf.org/external/pubs/ft/scr/2011/cr1168.pdf>).

Evaluation from the perspective of the Hellenic Republic

11. Under IMF staff projections, Greece's interest payments on public debt will amount to 8.6% of GDP in 2014. This assumes that new debt is contracted at Bunds + 300 basis points (see Table 8 in the Third Programme Review). The costs of this magnitude are outside the range of the debt servicing expenditures that advanced economies have sustained over the past 15 years. As the figure below shows, there are only four out of 110 countries rated by Moody's that have faced public debt service in excess of 8.5% of GDP in the recent past. These countries have been able to alleviate their public debt service through debt restructurings (Jamaica and Lebanon) or through

devaluation, inflation and rapid growth (Turkey and Iceland). In all four countries, most of the government debt has been held by domestic agents, sometimes even by state-owned banks. In the case of Greece, devaluation and inflation are impossible under the current monetary regime, rapid growth is quite unlikely given sky-high interest rates for the private sector, and financial repression is not an option either as most of the government debt is held by foreign investors. Because of this, private investors believe that Greece will have to resort to debt restructuring in order to bring down its public debt service costs to an affordable level. This raises the question whether the French proposal would contribute to meaningful debt service relief for the country.



* Advanced economies exclude Hong Kong, Singapore and Greece.

Sources: IMF, Moody's, author's calculations (110 countries, 15 years of data).

12. It turns out that the French proposal would not allow for any debt service relief – to the contrary, it would significantly increase the interest burden of the Hellenic Republic. In order to demonstrate this outcome, we focus only on the stock of €85.5 billion in government bonds coming due between July 2010 and June 2014 which is subject to the proposal.

- The weighted-average coupon rate on this stock of debt is close to 4.3%. At present, the annual debt service amounts to:
 Medium-term market debt: €85.5 billion
 Annual debt service cost: €85.5 billion
 4.3% = € 3.7 billion
- In the absence of burden sharing with the private sector, the Greek government would

slowly replace this stock of market debt with new loans from official lenders that currently carry an interest rate of 5.5%. In June 2014, the picture would look as follows:

New market debt:	€0 billion
New multilateral debt:	€85.5 billion
Annual debt service cost:	€ 85.5 billion · 5.5% = €4.7 billion

- As explained in paragraph (9) above, full participation in the French proposal until June 2014 would alter Greece's debt profile in the following way:

New bonds with principal guarantee:	€ 85.5 billion · 70% = € 59.9 billion
New loans from official creditors:	€ 85.5 billion · 53% = € 45.3 billion
Annual debt service cost:	€ 105.2 billion · 5.5% = € 5.8 billion

The form of 'burden sharing' proposed by the *Fédération Bancaire Française* would thus increase Greece's *gross* public sector debt and the sovereign's annual net interest payments by 23% compared to a solution with no private sector involvement at all. Greece would have to target a significantly higher primary surplus in order to sustain this additional debt in the future.

13. It can be argued that the French proposal would actually not alter Greece's stock of *net* public sector debt, as the government would acquire financial assets in the form of zero-coupon bonds in the process. However, what counts for a distressed sovereign is not the theoretical concept of net debt but the actual interest payments that have to be financed through tax revenues, and these interest payments are a function of gross government debt. The cash outlets of the Greek government will not be offset by cash revenues from a 30-year zero-coupon bond, because zero-coupon bonds pay no coupons. Furthermore, taking on additional debt at an interest rate of 5.5% in order to purchase a zero-coupon bond with an internal rate of return of 3.8% would leave Greece worse off. Compared to the baseline scenario of rolling all maturing government bonds into new multilateral loans with an interest rate of 5.5%, implementation of the French proposal would increase the net present value of Greece's public debt.

Conclusion

14. We have shown that implementation of the French initiative under the proposed parameters would significantly worsen the solvency of the Hellenic Republic. It would result in a marked increase in gross government debt and in net debt service over the coming years. From Greece's perspective, it is difficult not to regard the initiative in its current form as an insult.

15. The French proposal mimics the form of the Brady plan, without accepting its economic substance, namely to provide debt relief to countries with a clear sovereign debt overhang. In the 17 sovereign debt restructuring exercises undertaken under the terms of the Brady plan between 1990 and 1997, private sector holders of government bonds accepted to exchange their original claims into new instruments with the same notional but a lower coupon rate (Par bonds) or into new instruments with a lower notional but the same coupon rate (Discount bonds). Under the French proposal for Greece, on the other hand, commercial banks are offering a partial exchange of their original claims into new bonds with the same notional and a higher coupon rate. On top of this, commercial banks are demanding a cash repayment of 30% of their original claim, a principal guarantee on the new bonds, and a GDP-linked surcharge on future coupon payments. Banks would be well-advised to remember that the recovery value on claims against Russia and Argentina were 46% and 25% of original face value, respectively.³ These two countries defaulted on their obligations when interest payments on government debt approached 4% of GDP. In the case of Greece, interest payments on government debt are expected to reach 8.6% of GDP under the most optimistic assumptions, which arguable presents a greater challenge to sovereign creditworthiness. Asking too much from a distressed sovereign may well result in getting too little.

16. In spite of its shortcomings, the French proposal is a good starting point in the design of a solution for Greece, as it acknowledges the need

³ Federico Sturzenegger and Jeromin Zettelmeyer, "Haircuts: Estimating Investor Losses in Sovereign Debt Restructurings, 1998–2005", IMF Working Paper 05/137, July 2005 (<http://www.imf.org/external/pubs/ft/wp/2005/wp05137.pdf>)

for private sector involvement in dealing with the country's sovereign debt overhang. In order to be successful, the parameters of a sovereign debt restructuring must alleviate Greece's public debt service costs, and bring interest expenditures on public debt relative to GDP into the range of what advanced economies have been paying over past decades. Reducing the cash component of the planned bond exchange and lowering the

coupon rate of the new long-term Greek government bonds with principal guarantee to a level of 1%, plus a GDP-linked surcharge would turn this into a sensible proposal. Private creditors should also be offered an option to exchange their holdings into new long-term Greek government at a somewhat higher coupon rate if they are willing to forego the accounting advantages of the proposed principal guarantee.

Annex

June 24, 2011

Fédération Bancaire Française

To: Ministère de l'Economie, des Finances et de l'Industrie

Subject: Long-term investor initiative for Greece

1) Context

French regulated investors have committed since April 2010 to maintain their holdings in existing Greek government bonds (the "Existing GGBs")⁴. This constant support has prevented a possible systemic shock on the Greek debt market and by extension of the European government bond market.

Further to our earlier discussions, we understand that it is now critical (i) to structure a voluntary mechanism allowing Greece to reach €30bn of government financing from private investors by July 1, 2014, and (ii) to prevent credit event on Greece CDS.

2) Proposal

During the review of holders of Existing GGBs, it has become apparent that a large portion of holders are regulated investors. These investors often have different needs based on accounting, regulatory, tax and investment considerations. Flexibility in any proposed initiative is essential to maximize investor participation. For this reason, it is preferable to offer multiple options to bondholders who have varying needs and constraints.

Assumptions:

Having no specific information on the holders of the Existing GGBs (private vs. public, institutional vs. retail, amounts per individual bond per holder, etc.), we have assumed the following:

- The total Existing GGBs maturing by mid 2014 amounts to €85.5bn;
- The European Central Bank and Euro Area Central Banks hold €25bn out of the €85.5bn;
- A significant percentage – up to 80% – of the holders (the "Participants") of the remaining €60.5bn would be willing to contribute to the proposed mechanism (i.e. up to €50bn); and
- From July 2011 to July 2014, an estimated €30bn of net financing would be provided to Greece by the Participants.

Objectives:

One of the primary success factors underpinning the European Union and the International Monetary Fund program (the "Program") revolves around the ability of Greece to access international capital markets for debt financing. The medium-term sustainability of the Greek government debt profile and risk of future debt restructuring is of paramount concern for many investors. Further clarity, additional transparency and sharing of information between the European Union, the International Monetary Fund and investors is essential to restoring investor confidence in Greece.

The long-term investor initiative for Greece (the "Proposal") aspires, through the provision of long-term financing, to reduce short-term stresses on the Greek debt profile and to allow Greece to focus on longer-term investments needed to generate economic growth and foster a durable recovery. The performance-

⁴ This amount and the proposed mechanism exclude any Greek sovereign bonds held on trading books.

based remuneration linked to Greek GDP growth further supports the spirit of cooperation between private sector investors and Greece to make economic recovery objectives a reality as soon as possible.

Description of the Proposal

The European Union and the International Monetary Fund would continue to provide new debt financing to Greece, in coordination with the commitment provided by the Participants, to support the medium-term sustainability of the Greek fiscal situation.

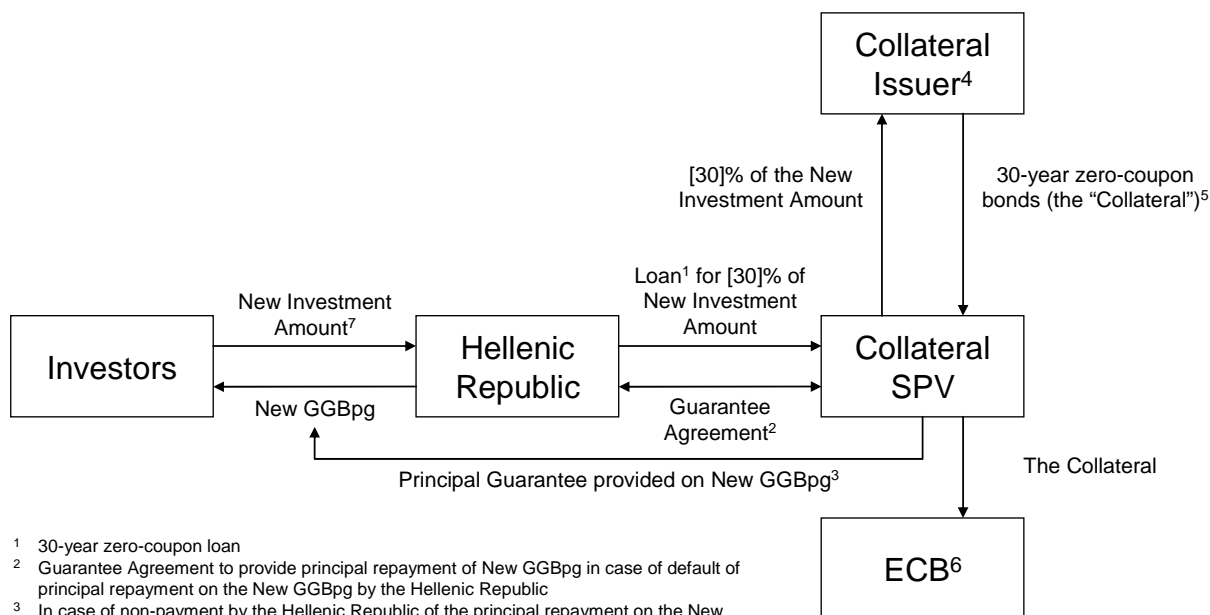
During the period from July 2011 until June 2014 (the “Period”), following each redemption of Existing GGBs, each Participant undertakes to participate in one of the following options.

Option 1: 30-year financing to Greece principal-guaranteed by SPV

Participants will invest a minimum of 70% of the principal amount of proceeds received (the “Received Amounts”) in new Greek government bonds, resulting in a net debt financing of at least 50% of the Received Amounts for Greece, as described below (the “New GGBpg”):

- Government bonds issued by the Hellenic Republic with a maturity at issue of 30 years;
- With a full principal guarantee by an SPV collateralised by zero-coupon bonds purchased from one or more AAA-rated sovereigns, supranational institutions or European agencies (the “Collateral”);
- Bearing interest at a rate of 5.5%⁵ plus the yearly Greek GDP growth capped at 2.5% and floored at 0% per annum⁶; and
- Listed on an EU regulated market, but with restricted trading in the New GGBpg until 1st January 2022⁷.

Description of the Collateral SPV Structure



¹ 30-year zero-coupon loan

² Guarantee Agreement to provide principal repayment of New GGBpg in case of default of principal repayment on the New GGBpg by the Hellenic Republic

³ In case of non-payment by the Hellenic Republic of the principal repayment on the New GGBpg, Collateral SPV will make immediate payment to the paying agent of cash funds received from the principal redemption of the Collateral

⁴ AAA rated supranational institution and/or European agency

⁵ The cash price of the 30-year zero-coupon bonds is expected to be around 30% of par

⁶ The Collateral is placed with the ECB as trustee for safe-keeping

⁷ The New Investment Amount is equal to a minimum of 70% of the Received Amount

⁵ Similar to the current interest rate paid by Greece for its borrowings under the European Union financing package

⁶ To compensate for the significantly longer maturity lending compared to the 7.5-year financing provided by the European Union financing package

⁷ Trading and transferability restrictions do not apply to ECB financing transactions

The above structure is the favored option by investors due to accounting, regulatory and investment-eligibility constraints. Additional structures are being studied, such as structured credit options⁸, but raise specific issues for the majority of regulated investors.

Option 2: 5-year Greek government bonds

Participants will invest a minimum of 90% (and preferably 100%) of the Received Amounts in new GGBs as described below (the “New GGB”):

- Government bonds issued by the Hellenic Republic with a maturity at issue of 5 years;
- Bearing interest at a rate of 5.5%⁹; and
- Listed on an EU-regulated market, but with restricted trading¹⁰.

Benefits of the Proposal

- Collective and voluntary effort from bondholders to provide 30-year credit enhanced financing or 5-year vanilla financing for Greece at fair conditions, to complement existing support from the European Union and the International Monetary Fund, without support from European taxpayers; and
- The private-sector commitment should provide Greece with the necessary financial support to focus on the objectives provided for under the Program.

Conditions precedent and ongoing conditionality

- Informal clearance from rating agencies that the Proposal will not trigger a downgrade to default or similar status on the Hellenic Republic, Existing GGB, New GGB or New GGBpg;
- ECB’s willingness not to sell its Existing GGBs during the Period;
- A significant majority of bondholders participate as Participants;
- Greece respects its commitments under the Program; and
- The European Union and the International Monetary Fund respect their current commitments, disburse funding as provided under the Program and continue to provide assistance to promote the medium-term sustainability of the Greek fiscal situation.

⁸ In the event of an eventual structured credit option, prior confirmation that i) securities issued will be eligible for Eurosystem refinancing purposes and ii) will qualify as “HQLA” will be needed by regulated investors.

⁹ Similar to current interest rate paid by Greece for its borrowings under the European Union financing package.

¹⁰ Trading and transferability restrictions do not apply to ECB financing transactions.