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Euro Area

Euro Area Summit: New Tools, But Not More Ammunition*

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- The Euro area Heads of State and Government agreed on a statement which is mainly in line with the draft version published by news agencies earlier. According to EU Commission President Jose Manuel Barroso, technical details of the decisions will be presented, Friday, July 23 at 12:00pm London Time.

- **Comment:**

- The agreed measures are quite a significant step forward in the flexibility of the EFSF and in the ability of the EFSF to provide liquidity assistance to non-programme sovereigns and banks on more reasonable terms. But, the unwillingness of the Heads of State and Government to increase the size of the EFSF is very disappointing. Hence, unless the ECB signals that it is willing to use its Securities Markets Programme for bond purchases, the market will question quickly how long the EFSF is able to use the new toolkit. Furthermore, it remains unclear what the date is from which the EFSF will be able to use the new framework. This suggests that the EFSF currently has little power to support the Italian and Spanish sovereign bond markets.

- Regarding the PSI, the latest IIF proposal includes a larger contribution from the private sector than the previous versions. While this is more favorable for Greece it raises doubts regarding the targeted 90% participation.

**Correction: This amends an incorrect calculation in the second paragraph of page four of the original document.*

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Euro Area Summit: New Tools, But Not More Ammunition

Here are the key points of the Summit agreement:

Greece:

•There will be a new bailout programme funded by the EFSF and the IMF (Managing Director Christine Lagarde said that IMF will participate once requested) with a total amount of €109bn for funding up to mid-2014.

•Private Sector Involvement (PSI) limited to Greece in voluntary approach, the net contribution of the PSI is estimates at €37bn in the period 2011-mid 2014.

•Additional contribution to reduce Greek debt through buyback programme for Greek bonds estimated at €12.6bn.

•EFSF will provide "credit enhancement" to guarantee Greek sovereign debt offered as collateral by Greek banks to the ECB/Eurosystem.

•Provision of "adequate resources" to recapitalize Greek Banks by EFSF.

•Member states and EIB will contribute to European "Marshall" Plan for Greece.

•Member states and Commission will provide technical assistance to implement reforms in Greece.

EFSF Loan Terms:

•Extension of maturities for new loans from currently 7.5 years to a minimum of 15 years and up to 30 years, with a grace period of 10 years; the existing loans to Greece (paid out at the first Greek package) will be also extended.

•The interest rate for all loans, old and new, to Greece, Ireland and Portugal, will be around 3.5% (from current 4.5% for Greece and Portugal and around 5.5% for Ireland), with a lower bound of the funding costs of the EFSF.

EFSF and future ESM gets more flexibility:

•The ability to act on the basis of a precautionary programme (presumably by extending a contingent credit line even to countries not under a programme).

•The ability to finance recapitalization of financial institutions through loans to governments including in non-programme countries.

•The ability to intervene in the secondary market, on the basis of an ECB analysis recognizing the existence of exceptional financial market circumstances and risks to financial stability and on the basis of a decision by mutual agreement of the EFSF/ESM Member States, to avoid contagion.

The statement does NOT mention a change in the size of the lending capacity of the EFSF and, according to Eurogroup President Jean-Claude Juncker, the targeted lending capacity of €440bn of the EFSF would be sufficient. The targeted increase to an effective lending capacity for the EFSF to €440bn is not available until the full national approval (probably September). Until then, the EFSF only has €255bn at its disposal minus what's already been committed to Portugal (€26bn) and Ireland (€17.5bn).

ECB President Jean Claude Trichet welcomed the increased flexibility of EFSF and highlights that PSI in Greece is voluntarily. He was pleased that Eurogroup pledged to provide “credit enhancement” in case of a “selective default” assessment of Greek collateral. Mr. Trichet therefore accepts (selective) rating default and even credit event, as long as the collateral offered by Greek banks to the Eurosystem is guaranteed.

PSI Proposal

Probably in order to dilute the flavor of coercion, the Euro area Heads of State and Government statement does not include details regarding the PSI. The PSI will be probably based on a financing offer by the IIF (Institute of International Finance, the global financial institutions association) which has been signed by 30 financial institutions, including 5 Greek banks.

This financing offer includes four different forms of swaps (or roll-over) of existing bonds into bonds with a longer-term maturities. According to the IIF, the options will be priced to produce a 21% NPV loss based on an assumed discount rate of 9%. Therefore, the rating agencies most likely will assess this as a default (possibly selective). The IIF assumes that the use of the four instruments will be evenly distributed (25% each):

1) A Par Bond Exchange into a 30-year instrument, principal collateralized by 30-year zero-coupon AAA bond, coupon: 4% for years 1-5, 4.5% for years 6-10, 5% for years 11-30.

2) A Par Bond offer involving rolling over maturing Greek government bonds into 30-year instruments, principal collateralized by 30-year zero-coupon AAA bond, coupon: 4% for years 1-5, 4.5% for years 6-10, 5% for years 11-30.

3) A Discount Bond Exchange into a 30-year instrument, offered at 80% of the par of the existing bond, principal collateralized by 30 year zero-coupon AAA bond, coupon: 6% for years 1-5, 6.5% for years 6-10, 6.8% for years 11-30.

4) A Discount Bond Exchange into a 15-year instrument, offered at 80% of the par of the existing bond, only partially collateralized, coupon 5.9%.

According to the IIF plan the funding of the 30-year zero-coupon AAA bond should come from the EFSF and Greece should pay the interest for that. This means that the Greek debt position will deteriorate through the funding of the guarantee. The IIF assumes that there is a 90% participation rate in the programme. The bonds involved in the exchange would amount to €135bn, out of €150bn maturing bonds up to 2020 assumed to be held by the private sector at present. The measure should provide a liquidity contribution of €54bn for the period mid-2011 to mid-2014. The average debt maturity would increase to 11 years from a current average of 6 years.

The target of the 2 discounted exchange options is a debt reduction for Greece of €13.5bn. The IIF also expressed the willingness of the member banks to participate in a buyback of Greek bonds.

Comment:

The agreed measures are quite a significant step forward in the flexibility of the EFSF and in its ability to provide liquidity assistance to non-programme sovereigns and banks on more reasonable terms. While assessment from the ECB regarding the need for using the secondary market facility is reasonable, the required “mutual agreement of the EFSF/ESM Member States” shows that the hurdle to actually use the facility is high, although not as high as suggested in the draft agreement.

The unwillingness of the Heads of State and Government to increase the size of the EFSF is very disappointing. Hence, unless the ECB signals that it is willing to use its Securities Markets Programme for bond purchases, the market will question quickly how long the EFSF is able to use the new toolkit. With the already running programmes in Portugal and Ireland, the new Greek package (€73bn) and the Greek buyback package (€32bn, assuming an average bond price of 60) there will be €293bn left in the EFSF (assuming the extension to €440bn gets through). Out of this, the outstanding funds of the first Greek package (€33bn) will probably also have to be covered.

On top of that, Greece needs funding for 30-year zero-coupon AAA bonds, this might be as large as €24bn (20% of €121bn). Hence, there will probably only €236bn left in the EFSF (without the planned increase to €440bn only around €51bn is left in the EFSF). This is a small number to support the European banking sector and the Spanish and Italian sovereign bond markets. Hence, the pressure on the Italian and Spanish Bond markets is likely to stay high, suggesting adverse consequences for banks throughout the EU.

Furthermore, it remains unclear from what date the EFSF will be able to use the new framework (and the €440bn envelope). In our view, the changes have to be ratified by the parliaments in the member states. Hence, without extraordinary parliament sessions during the summer holidays, the measures are unlikely to be operational and effective until September 2011.

Regarding the PSI, the latest IIF proposal includes a larger contribution from the private sector than the previous versions. While this is more favorable for Greece it raises doubts regarding the targeted 90% participation.

Appendix A-1

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