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# Heralding a new Greek PSI?

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**The discussions about reopening the current Greek PSI have intensified recently. We group the main potential factors behind this into three categories: 1) market factors; 2) funding & solvency; and 3) political & logistical factors. In this report, we discuss each in detail. We also outline two different forms that the new PSI might take and examine the potential differences between them in a Q&A format.**

Over the past week or so, headlines suggesting that the Greek PSI will be reopened have increased. Indeed, Reuters reported on Thursday that the Greek Finance Minister Venizelos had suggested that the PSI would now be implemented by mid December, although the reports were later denied by the Finance Minister. The original implementation deadline for the PSI was as soon as the 21 July decisions for the EFSF were ratified. However, there has subsequently been the notable delay caused by the six-tranche release for Greece from the first bilateral loan package, which naturally set back the PSI as well. This is mainly due to the fact that the PSI is integrated into the second Greek package and the 'troika' (EU, ECB and IMF) would simply not be content to adopt the second package unless they are happy with the developments on the first package.

We believe that there might be a variety of reasons behind the discussions on reopening the Greek PSI. We group them under the market factors, funding & solvency, and political & logistical factors.

### *Market factors*

According to a Reuters report on Tuesday, Austrian Finance Minister, Maria Fekter, stated in a news conference that in the current PSI, private investors are orienting towards Option 1. She was also reported as saying that is by far the most expensive option. Of the options available, we have previously pointed to Option 1 as potentially the most favourable given our risk analysis (for more details on this and the analysis of different options and instruments under the current PSI, see *Greece: Love me tender*, 7 Sep 11). The initial assumption of the IIF was that investor participation would be split equally between each option (ie, €33.75bn: €135bn divided by 4). On this basis, given that the 3rd and 4th options are 20% discount bonds, Greece was hoping to reduce debt by €13.5bn. However, if the information-gathering exercise on the PSI implies that most of the investors are leaning towards the conservative Option 1, then this debt reduction is not likely to materialise. Aside from this factor, it is important to note that long-end AAA zero yields (we use the average of French and German 30y zero principal yields) have rallied notably (by about 70bp) since July. Therefore, if the officials still price the new instruments at 79 using a 9% exit yield for the Greek risk, the contribution of the present value (PV) of the 30y AAA principal guarantee to the 79 price level is proportionally much higher now (from a PV of c.33 in July to about c.40 now). In other words, private investors would receive even more protected new 30y bonds, requiring more cash for collateral for the same amount of new 30y instruments (eg, €135bn notional new exchange bonds would require €44bn and €54bn in cash to buy the AAA zero collateral bonds with 33 and 40 prices for the AAA zero bonds, respectively). Therefore, the official sector is unlikely to be happy with these increased costs.

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### *Funding and Solvency factors*

Economic projections used to calculate the size of the second Greek package have changed since 21 July, which has been the main source of the divide between the troika and Greece lately. Greece has now fallen behind on fiscal as well as structural measures, with new deficit targets by Greece in 2011 and 2012 standing at 8.5% and 6.8%, respectively, up from 7.6% and 6.5%. While Greece has announced certain measures to help fill these funding gaps, the troika might not necessarily agree with them. More importantly, the €109bn second package also assumed €28bn of privatisation plans within the programme period (until mid 2014), a further measure on which Greece has fallen behind. These, in turn, mean that the second Greek programme might need additional financing requirements, which the official sector may not be willing to fill.

In order for the IMF to release further funds to any programme country, it requires no funding gap for the following year as well as no solvency gap. Even if we assume that the funding gap is filled by Greece in an optimistic scenario by additional measures, the deterioration in other economic inputs such as GDP since July would very likely have resulted in much worse results in the debt sustainability analysis of the troika, raising serious questions about solvency.

### *Political and logistical factors*

The market's perception of Greece since the July deal announcement has worsened notably. Market prices for Greek bonds imply that even if the PSI goes ahead in its current form, Greece is likely to face another restructuring to achieve sustainable debt in the next year. The deterioration in this perception has worsened particularly following the recent fiscal and structural slippages, which led to the troika/Greece divisions during the 6th tranche release assessments.

Since the July package, we have highlighted in a number of publications that even if the PSI was implemented successfully, in a best-case scenario it would lead to Greek debt stabilising at a very high level (155% ratio), leaving it vulnerable to a return to an explosive path on any fiscal or economic slippage. It is most likely that (as we have argued in the funding and solvency factors section above) the troika is now recognising this as well. In other words, if the troika goes ahead with the PSI as it is, the market's concerns on Greek insolvency are likely to remain. And more importantly if both legs of the PSI (exchange and buyback) are completed in their current form, the remaining stock of Greek debt will be much smaller. Indeed, the buyback operation will take out of the market up to €35bn Greek debt, and the debt exchange will result in €135bn (assuming 90% participation) of new 30y bonds with AAA principal guarantees and coupons under English law. Therefore, following the exchange and buyback operations if we exclude IMF loans as well, the remaining Greek debt will almost all be ECB holdings of GGBs under SMP and EU bilateral loans. This, in turn, means that if Greece were to restructure again a few months after the current PSI, the official sector might easily end up taking notable losses/haircuts on their Greek exposure.

Being aware of this and that the solvency picture has worsened since July discussions, the appetite of policy makers to go ahead with more significant restructuring with higher haircuts on the private sector might have increased. It is most likely that one of the main reasons why some policy makers are still trying to avoid this scenario is they know that the eurozone does not have the right backstop facilities available to deal with the contagion consequences of a more substantial restructuring of the Greek debt now. However, policy makers appear increasingly aware of the need for urgency in making bold actions, and they are expected to deliver plans for the recapitalisation of the European banks as well as leveraging of the EFSF soon. This could make them feel more comfortable with a more substantial restructuring in Greece.

## What kind of reopening of the PSI deal are we talking about?

Given the recent developments, the reopening of the PSI deal seems likely in our view. What remains unclear is the nature of the new deal. We think it is likely to take one of the two forms. "Option A": a new voluntary PSI with very similar exchange instruments but somewhat different parameters such as coupons or even possibly longer maturities than 30y. Figure 1 below shows a reduction of coupon from 3.8% to 2% or a new 40y or 50y combined with 3% and 3.5% coupons can result in delivering around 40% haircuts instead of 21% in headline terms. "Option B" would involve a new PSI with more aggressive haircuts and potentially being coercive in nature, which ensures debt sustainability in Greece.

**Figure 1: New exchange instruments with different average coupons and maturities ***

| Coupons | New 30y par price | New 40y par price | New 50y par price |
|---|---|---|---|
| 3.85% | 79.4 | 70.3 | 63.4 |
| 3.50% | 75.4 | 66.6 | 59.6 |
| 3.00% | 70.3 | 61.2 | 54.1 |
| 2.50% | 65.1 | 55.8 | 48.6 |
| 2.00% | 60.0 | 50.4 | 43.1 |
| 1.50% | 54.8 | 45.1 | 37.7 |
| 1.00% | 49.7 | 39.7 | 32.2 |

* In pricing the new exchange instruments, we used discount rate of 3.15% (average of ultra long end AAA zero principals from France and Germany) and for the Greek risk we used in all cases 9% exit yield as suggested by IIF in the current PSI. Source: Barclays Capital

Q1) Which one of these options will the officials select?

This will mostly depend on where we stand in terms of the backstop facilities in place in Europe before the launch of the PSI and market's trust in these facilities' long-term resilience.

Q2) How quickly can these options be launched?

We believe that "Option B" for the new PSI would require more time than "Option A". The earliest the latter can be launched is probably December, while the earliest the former one can be launched is more likely November.

Q3) Why does it matter whether "Option A" or "Option B" is chosen?

Option A has the potential to leave suspicions about debt sustainability in investors' mind as it cannot be too aggressive, while the latter option has much more room to completely remove the solvency question marks hanging over Greek debt. However, the contagion impact of the latter option will be much larger in the absence of the correct backstop facilities. Moreover, the participation appetite in these new PSI options is likely to be low compared with the current PSI, given that it will be much less attractive. Therefore, achieving a high participation rate might require some level of coercion that may exist in "Option B".

Q4) Which backstop facilities are we talking about exactly?

Under "Option B", PSI will likely require a leveraged version of EFSF, which has full operational capacity, flexibility and full market confidence. Also, before the launch of "Option B", banks should have already been recapitalised appropriately. And it will take time to find out whether we have these conditions in place or not, which explains the longer time delay for the launch of the new PSI if "Option B" is decided by the policy makers. However, if either the European banks are not capitalised properly or the leveraged EFSF fails to build confidence in the market, we believe the policy makers would mostly likely go with "Option A".

Q5) Would these options make any difference from a CDS trigger perspective?

"Option A", which is essentially a modified version of the current PSI but still voluntary, is not likely to trigger the CDS. In fact, this week, ISDA lawyers were quoted on Reuters as saying "If it's the same as the IIF deal just with different numbers then the legal analysis is going to be the same: if it's voluntary exchange then typically it's not going to be a credit event". However, "Option B", which could include a certain level of coercion, might trigger the CDS. This is why policy makers need full back stop facilities in place if they are to consider "Option B".

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