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Harsher terms leave a ‘bitter taste in mouth’ for bondholders

By Patrick Jenkins and Richard Milne in London and Peter Spiegel in Brussels

After months of negotiations, the public and private sector finally came together in the early hours of Tuesday morning to announce a comprehensive refinancing package for Greece.

But the private sector element of the deal – involving a voluntary writedown of 53.5 per cent of the €206bn of Greek sovereign bonds held by banks and other financial institutions, and a slashing of future interest rates payable on replacement bonds – is still far from secure.

The terms are tougher than the earlier blueprint drawn up in October, which involved a 50 per cent “haircut” and a less severe reduction of interest rates. The new deal, which would see the creation of €96bn of new bonds, cuts coupons to 2 per cent up to 2015, 3 per cent up to 2021, and 4.3 per cent thereafter. Overall, the restructuring represents a 75 per cent decrease in the “net present value” of Greek sovereign bond holdings. The question now is whether bondholders will volunteer to take part.

The deal has the support of the Institute of International Finance, which has fronted negotiations. But the banks and other financial services groups that the IIF represents have shrunk in number substantially over the months that the talks have dragged on. “The banking community has probably sold down its holdings by 30 or 40 per cent,” said one senior banker.

In their stead, hedge funds and other investors that were not represented in negotiations, have increased their holdings sharply, and many observers doubt their willingness to participate in any voluntary debt exchange. “There is a lot of uncertainty and execution risk over PSI,” said Andrew Balls, head of European portfolio management at Pimco, one of the world’s largest bond investors.

There is no certainty that even the banks and other entities represented by the IIF will subscribe, though Charles Dallara, who led the negotiations, said he was confident of support. “From my point of view, this is a solid deal for investors, a fair deal for all parties, and one that holds considerable benefits for Greece,” he said. “The losses are going to be substantial, but they are contained.”

Mr Dallara said that overnight talks had quickly demonstrated that “additional efforts would be needed by all parties,” he said. “As those extra efforts began to emerge ... we felt that on our side extra efforts were warranted as well.”

Large bondholders say the take-up should be high if only because the alternative of a full-blown Greek default is so bad. "This deal is clearly at the absolute limit of what can be called voluntary. The harsher terms do leave somewhat of a bitter taste in the mouth. But ultimately we didn't have very good cards in our hand. None of us wanted a disorderly default," said one large European bondholder.

Another said: "The participation rate is always going to be a bit of guess work. This is a fantastically complicated deal with lots of moving parts. You just have to hope everybody realises their responsibilities."

But even those involved in the talks concede that the estimated 25-30 per cent of Greek bonds now in the hands of hedge funds will complicate the deal. With many of those investors reckoned to be pursuing investment strategies that would benefit from a formal default of the bonds, and a pay-out of CDS bond insurance, few are likely to volunteer for haircuts.

Recognising many investors' likely reluctance, the deal struck in Brussels involves an element of arm-twisting. The Greek government is expected to pass a legal reform in the coming days applying retroactive so-called collective action clauses, which would allow them to force a restructuring on recalcitrant bondholders, assuming 66 per cent of them are in favour of a deal.

Almost regardless of how many investors support the deal voluntarily, bondholders say the collective action clauses can be used to guarantee 100 per cent participation.

But an imposed deal would likely invalidate any sense of voluntary participation, triggering CDS pay-outs – something that the whole PSI deal had been designed to avoid and an eventuality that the European Central Bank, several big European banks and other authorities have been desperate to avoid, to minimise the knock-on impact to those that have underwritten the insurance.

The bond exchange deal will take place over the coming weeks and must be wrapped up by March 20, when Greece's next debt repayment is due. An end is in sight, but the wrangling is far from over.

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