

Euro Summit – Taking A Closer Look At The “Comprehensive Plan”

After marathon talks into the early hours of 27 October 2011 (Thursday), leaders of the Eurozone finally came up with a “comprehensive” package to dispel the crisis. The result was better than some had hoped, consisting of three main parts.

The first is an agreement among private holders of Greek debt, that they will voluntarily give up 50% of face value, thus helping to reduce Greece’s debt burden to 120% of GDP by 2020.

To enable banks to cope with that, the second part of the package involves the recapitalization of banks, where about EUR106bln (based on end-September sovereign prices) will be given to 70 banks in order to bring their core tier 1 ratio up to 9%. According to estimates released by the European Banking Authority (EBA), these major banks come from 13 countries, and order to reach that 9% mark, will need to raise additional capital, including EUR30bln in Greece, EUR26.2bln in Spain, EUR14.8bln in Italy, EUR8.8bln in France, and EUR5.2bln in Germany. This quantitative capital target is to be attained by 30 June 2012, with the eight-month deadline being one of the few concrete resolutions to be agreed at the summit. It is envisaged that if a bank does not meet these criteria, it must try to raise capital in the private markets first, then turn to national governments, who in turn may seek assistance from the EFSF as a last resort.

The third is an agreement, in principle, to leverage the firepower of the European Financial Stability Facility (EFSF), with explicit mention of a “leverage effect which could be up to 4 or 5”. This would be consistent with a final firepower of EUR1tln after taking some EUR250-275bln into account. This EUR250-275bln amount is likely the original EUR440bln in commitments to the EFSF, less those funds which have already been earmarked for the existing Greece, Portugal and Ireland bailouts. Leaders have agreed to use two methods simultaneously: (i) through the establishment of one or more special purpose vehicles (SPV); and (ii) by providing credit enhancements to enable member states to issue new sovereign bonds.

A Deal For Now...

In our opinion, the package should be seen as a progress forward. Indeed, the enhancement of the EFSF by creating a EUR1tln firewall is aimed at preventing the spread of panic to vulnerable, bigger but still-solvent states; whilst the plan of recapitalizing the banks is aimed at restoring confidence and protecting European banks’ balance sheets to ensure that they can get on with the business of lending. Hence, it would be true to say that whilst the latest measures may have only helped to temper some of the symptoms (and have certainly not cured Europe’s illness on a whole), they are more enduring this time and have certainly bought European leaders some more time.

We recall, also, that a week prior to the summit, things were looking bleak when German Chancellor Merkel had rejected a push by French President Sarkozy to boost the EFSF by allowing it to borrow money from the European Central Bank (ECB). Leaders were unable to call off the summit planned for 23 October. Instead, they decided to call for a second leg three days later. It’s no wonder why some have mentioned that this is probably the toughest kick that the can has been dealt with so far.

For financial markets, a relief rally has been evident, and market’s reaction so far suggests that expectations have more or less been met (for now). EUR/USD has held up very well, trading above 1.4100. And overall, risk-appetite has taken a come-back, with higher yielding and risk-correlated assets moving higher since.

...But Still Plenty Of Questions Unanswered

Nonetheless, we do note that the “Comprehensive Plan” unveiled is still lacking a lot in details, and in this piece, we highlight the areas we remain concerned about.

Private Sector Involvement (PSI)

- This deal was negotiated by the Institute of International Finance (IIF), a membership organization which represents banks but cannot commit them to anything. Ultimately, it comes down to these banks making their own decisions on whether they are going to tender their bond holdings of Greek debt into a new exchange, and if so, how much of their debt will they tender. Hence, in principle, there is still a need to reach an acceptable level of participation, and at this point of time, the technical details of PSI are still missing.
- Additionally, it has been reported that even if banks will write down their Greek debt holdings by 50%, that does not mean Greece itself will see the value of its private sector liabilities shrinking by anything close to half.
- Furthermore, European leaders have insisted that the Greek write-down be voluntary. Assuming that everyone agrees that the haircuts are sufficiently voluntary not to trigger a credit event, what does these all mean for sovereign credit-default swaps (CDS)? So while the EFSF is designed to offer insurance to bondholders, this large “voluntary” write-down will lead investors in other European sovereign bonds to doubt whether CDS offer much protection in the first place, and this will only make Eurozone debt harder to insure.

Bank Recapitalization

- Banks may not be able to raise sufficient money on their own, and the burden would fall on national governments which may prove reluctant and that means having to fall back on the increasingly stretched resources of the EFSF. This will also drag in terms of time with the possibility of being unable to meet the deadline.
- Besides, moving towards higher bank capital standards is not an easy task, least to say, without seeing any impediment to credit growth. Banks may have to shrink their balance sheets further to bolster their capital ratios.
- The recapitalization will be reckoned according to bond prices on 30 September 2011. Since then, yields have moved higher in some countries and we find no convincing arguments to suggest that sovereign bond yields in the Eurozone will come down meaningfully.

EFSF

- While the plan involves giving the EFSF more firepower without having to increase the size of the fund upfront, details of how the EFSF will be leveraged are only expected to be decided by the end of November.
- Virtually no information was given on the SPV option, but with the hope that the EFSF could potentially attract other money from outside the Eurozone (for instance, China), the enhancement will be ultimately dependent on the capacity to attract private investors and non European sovereign funds, which means that no precise indication can be given on its final size. The credibility of the insurance is of a big question; and even then, this could prove risky as it would mean that the plan will succeed or fail depending on the strength of the sovereigns backing it.
- EUR1tn of insurance, would possibly enable the EFSF to guarantee all of the new issuance of Italian and Spanish government debt for the next three years, but we would never know if that amount is large enough, especially if circumstances arise where a large sovereign is struggling to meet its commitment (economically or politically).
- Moreover, following the 21 July 2011 summit, the remaining capacity of the EFSF (given its existing commitments to Ireland, Portugal and Greece and taking into account additional help expected from the IMF) was reckoned to be about EUR280bln. However the Troika alongside the European Commission and the ECB had concluded that on more realistic assumptions, Greece would need additional official financing not of EUR109bln, but of EUR252bln. Greece will need EUR164bln rather than EUR109bln envisaged in July from now till 2014. And instead of being able to fend for itself in the second half of this decade, the country will need EUR89bln of bailout money. Taking all

of that into account, that would leave only about EUR100bln available to the EFSF, and if that is taken as a starting point, then even with the leverage, the effective firepower would be only EUR500bln, far less than the EUR1tn.

- Inevitably, the role of the ECB in the new rescue mechanism has also been the focus. One thing's for sure – the money is not coming from the ECB. In fact, contrary to most central banks (which would act as a buyer of last resort), the ECB seems unwilling to pick up any slack, and has thus been lurking behind the fund, more than standing directly behind it.

Apart from the implementation risks mentioned, the package as a whole also depends on the various countries carrying out the reforms that they have announced. Not forgetting that we still have quarterly reviews in Greece, and with increasing expectations that the country is a lost cause that is unable to credibly regain solvency, the IMF might just call it a day on providing extra support. As it stands, Greece is caught in a debt spiral, whereby austerity measures required to bring its debt and deficit ratios down to required levels impose an intolerable social and financial burden on its population. Moreover, GDP is likely to fall more rapidly than debt levels. The country's debt-to-GDP was around 147% and appears that it could hit more than 170% this year.

Elsewhere, Italy and Spain are at risk from a mild recession in 2012, which should be no surprise given IMF estimates that 1% off the budget deficit translates into approximately 0.6% lower GDP growth. This could be the next catalyst for a reassessment of Italian or Spanish debt sustainability, and by then, it will be inevitable when markets take them on again. The French economy is also appearing to be cooling off more rapidly than Germany and with the country's banks having been battered in the recent months, France's AAA rating still remains under severe threat. Given that its rating underpins the EFSF's triple-A rating, it would be crucial that France maintains its triple-A status.

Last but not least, political risk remains, as shown by the higher risks of an early election in Greece and Italy. With deteriorating fiscal trends, only the ECB has sufficient firepower to backstop the system. Perhaps until a pledge by the central bank of unlimited backing for solvent governments, we think that major headwinds still lie ahead as European leaders sort out the legal and financial details. We continue to remain watchful on developments out of the region.

This perhaps explains why we have not seen Italy and Spanish yields lower, despite the aggressive measures. Some said Italy and Spanish bonds have already been downgraded. Clearly, the market is waiting for the details. But this is a plan much needed, as it would determine if the world will go through another Lehman. And, we have bought time again.

Date	Event
31 October	Jean Claude Trichet leaves ECB, to be replaced by Mario Draghi.
3 November	ECB interest rate decision and press conference.
	G20 Heads of State Summit in Cannes, France.
	French and Spanish auctions.
4 November	Portugal parliament to vote on 2012 budget.
7 November	French and Spanish auction.
8 November	ECOFIN Council meeting.
10 November	EU semi-annual economic forecasts published.
14 November	Italian auction.
15 November	Italy – Deadline to review uses and goals of structural funds in conjunction with the European Commission.
Mid-November	Disbursement of 6th bailout tranche to Greece (original deadline of mid-October).
	Portugal – Troika review begins.
17 November	French and Spanish auctions.
20 November	Spain – General election.
25 November	Italian auction.
29 November	Italian auction.
29 November	Eurogroup Meeting.
30 November	ECOFIN Council Meeting.
	Italy – Deadline for detailed privatization plan to raise EUR5bln per year for the next 3 years.
Late-November	Greek PSI – exchange expected to take place.
1 December	French and Spanish auctions.
8 December	ECB interest rate decision.
	ECB Council Meeting and press conference.
9 December	European Council Meeting.
15 December	Spanish auction.
Mid-December	Greece – Troika begins its sixth review.
20 December	EC Quarterly report on Euro-Area.
29 December	Italian auction.
31 December	Italy – Deadline for university reforms, labour market reforms, pension and fiscal retrenchment.
	Greece – 7th tranche may be due.
<i>Source: Reuters, UOB Economic-Treasury Research</i>	

Disclaimer: This analysis is based on information available to the public. Although the information contained herein is believed to be reliable, UOB Group makes no representation as to the accuracy or completeness. Also, opinions and predictions contained herein reflect our opinion as of date of the analysis and are subject to change without notice. UOB Group may have positions in, and may effect transactions in, currencies and financial products mentioned herein. Prior to entering into any proposed transaction, without reliance upon UOB Group or its affiliates, the reader should determine, the economic risks and merits, as well as the legal, tax and accounting characterizations and consequences, of the transaction and that the reader is able to assume these risks. This document and its contents are proprietary information and products of UOB Group and may not be reproduced or otherwise.