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Update on Greece

In this note, we use a Q&A format to address the many complicated and interacting issues related to Greece.

I. What's the current cash situation of Greece?

1) Outflows

Greece has very limited cash flexibility. The major deadlines are: April 27th (pension and wages 1.7bn€), May 2nd (IMF 202m€), May 8th (1.4bn€ T-bill), May 12th (IMF, 770m€), May 15th (1.4bn€ T-Bill). The final deadline for cash management is probably the very large repayment on ECB-held GGBs in July.

2) Inflows

Possible inflows are:

- **General Budget**. Greece's primary surplus has transformed into a primary deficit. Q1 cash-flows numbers (1.75bn€ primary balance surplus) were distorted by one-offs (HFSF, etc.). On an "operational basis", we believe the budget has negative cash-flows now.
- **Exceptional tax receipts**. The government expect proceeds from the tax arrears scheme (100-installements). Numbers are hard to estimate but a few hundreds millions per month are already an optimistic assumption.
- **T-Bill rolling**. Greek banks are allowed by the SSM to keep their global T-Bill exposure unchanged. The Greek government, within the MoU with the Troika, is allowed to issue only up to 15bn€ of T-Bills. So T-Bills can be rolled but not increased. The only liquidity shortfall on T-bills comes from the small amounts sold to foreign investors if they do not roll. Reportedly, Chinese investors have purchased a few hundred million at the last auction.
- **Privatizations and asset sales.** There is not much to be expected in the short term except maybe some advanced payment on the sale of Piraeus port to Chinese investors.
- **Pension funds' reserves**. Pension funds have lent money to the government on a "voluntary" basis. It is hard to say how much money is left. On April 22, Mr Mardas (Deputy MoF) declared that the government was short of 400M€ to pay wages and subsequently announced that the sums had been found. We understand that the 400M€ came from pension funds, but they are running out of cash.
- **Cash transfers from government "agencies"**. This source of funds has largely been exhausted already.
- **Cash from local authorities**. According to some sources, the total amount available is approximately 5bn€ to 5.5bn€. The government passed a legislative decree to force local

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authorities to lend half of their cash to the government on a two-month basis. However, the Greek constitution provides for a very strict independence of local authorities and some of them have refused to give the cash (including Athens.) The government could try to seize the cash but it is often deposited in commercial banks. This action will require court orders to accept such a freezing of assets. Moreover, some local authorities have announced their intention to challenge the decree with an emergency procedure at the Supreme Court. We believe it will be very difficult for the government to access this cash quickly and it will come with a very high political cost.

- **Other sovereign lending**. Reportedly, Greece has asked Russia and China for cash. The former is not really in a position to help and the money of the latter usually comes with strict conditions. Potential advance payments (up to 5bn€) on a pipeline deal with Gazprom have been mentioned by Greek sources but denied by Russian officials.

So far, Greece has managed to dig up some extra cash whenever needed. However, it appears this has a limit and Greece is now very close to that limit. The next major hurdle will be paying the salaries and pensions at the end of May, if not paying the IMF on May 12th.

II. What's the status of the discussions between Greece and its creditors?

Setting aside the ridiculous rhetoric issues (Troika vs institutions, MoU vs growth agreement, *etc.*), we believe there are five main areas of strong discussions between the Eurozone and Greece: labor market reform, pension reform, VAT hikes, privatization and structural surplus.

- **On the positive side:** On labor market reform, Greece has already agreed to a vague "OECD best practices" convergence. There is probably some leeway to find an agreement there. Similarly, VAT hikes are probably manageable in some sectors and we believe it will be possible to find a compromise that protects "basic needs" (food, healthcare, etc.) from VAT hikes and still impose higher VAT on the Greek islands.

- **On the negative side**. Pension reform is a big no-go for Syriza's left wing. It will be very hard to sell an agreement on pension reform to the current parliament.

- **On the not-so-clear side**. Large privatizations are also a big no-go for Syriza's left wing. However, this is one area where agreements and reality can depart a lot. All previous Greek governments had agreed to massive privatizations and this was enough for the Eurogroup to sign off on the bailouts. Obviously, none of these asset sales ever materialized. Structural surplus is also a grey area and a possible ground for consensus. The initial surplus target for 2015 is now impossible to achieve, and so is probably the surplus target for 2016. Syriza could save face with reduced targets for 2015 and 2016 and the Eurogroup could be satisfied with unchanged long term objectives.

Overall, substantial differences remain, but none of them appear absolutely impossible to overcome.

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III. What's the position of the IMF?

Selling the Greek bailout and projected debt trajectory to the IMF board has been extremely difficult since the beginning of the EZ crisis. Many IMF members are poorer than Greece, whatever the reasonable metric used. We believe the IMF now has only one goal left: get rid of its Greek exposure. It is almost sure that its board will not approve any further payment. It is even more certain that the board will not approve any grace period or standby facility to Greece. Anything short of timely repayment will be considered extremely serious. Grace period for developed countries is unchartered territory for the IMF.

IV. What's the position of the ECB?

The ECB is in a very difficult situation with Greece, both politically and financially.

Firstly, the ECB does not want to take a decision that could be seen as a political one – e.g. blackmail to impose reforms on Greece – especially since the ECJ's advocate general expressed the clear view that the ECB should not be part of any program definition. On the other hand, the ECB's financial exposure is huge and, as a central bank, it cannot fund insolvent banks at any cost. In practice, this means that the ECB will not continue to extend the ELA facility forever, but any dramatic decision will only be taken when the board believes that some political consensus has been reached on the future of Greece. The ECB has the most powerful tools to put pressure on Greece (ELA, Target 2, etc. see below) but it will most likely not act on its own.

Financially, the ECB is also in a challenging situation. Its overall exposure to Greece is around 110bn€. This includes the MRO facility (normal bank refinancing) and the ELA facility (emergency refinancing.) The theory is that (i) MRO losses are shared between central banks whereas ELA losses are only taken by the relevant central bank and (ii) legally, the ECB's exposure is on the Greek central bank only. However, the size of the ELA exposure is way above the Greek's central bank capacity to absorb losses. This is why even in a scenario in which Greek banks default and Greece stays in the Euro, we believe the losses would be shared among Eurozone members. Needless to say, if Greece exited the Eurozone, the Greek central bank would default on € liabilities. In practice, the ECB is on the hook for 110bn€.

V. What's happening with Greek banks?

Greek banks have massively restructured and recapitalized themselves since 2011. They all passed the stress tests. They are now operating in a concentrated and highly profitable market and should trade above book value in a normalized environment. This being said, they suffer from four structural issues that make them hostages of the current political environment:

a) On the asset side:

   i) They have huge amounts of NPLs which are at the mercy of any law protecting homeowners from foreclosure (so-called humanitarian relief). In a very vocal opinion, the

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ECB (acting as SSM) has expressed its concern against a draft law that would protect homes with values as high as 300k€.

ii) They have very large amounts of exposure to Greek sovereign debt: T-Bills and exchanged bonds from the 2012 PSI.

b) On the liabilities side:

i) They have had no capital market access for several years so the bulk of their funding comes from deposits – which are sensitive to market fears about bail-in, sovereign defaults, capital controls, etc. They are currently able to refinance these deposits at the ECB but for this they rely on (i) the willingness of the ECB's board to continue ELA (2/3 majority required to stop ELA) and (ii) the definition of eligible collateral and haircuts on this collateral. Reports that haircuts have been increased have been subsequently denied but this would clearly be a way for the ECB to gently put some pressure on Greece without using the nuclear option (stop ELA). It should be stressed that Greek banks have the capacity to create eligible ELA collateral (but not MRO collateral) by issuing sovereign guaranteed debts to themselves but the ECB is likely to strongly limit these tricks (so-called Pillar 2 bonds.) Currently, banks operate with a ≅3bn€ ELA buffer to be able to withstand a short term bank run.

ii) A large part of their capital base comes from deferred tax assets which have sometimes been booked too aggressively. (e.g. corresponding to 40 years of future profits whereas most EZ banks limit DTA to 5-7 years of future profits.) This means that in its SSM-capacity, and as part of its supervisory review process (SRP) the ECB could require further capital from the banks to compensate for the large DTAs.

This is why Greek banks are currently trading at highly distressed levels.

VI. What are the consequences of a default?

If it ever comes, Grexit will almost certainly come after a sovereign default. This is why it is absolutely key to understand the consequences of a Greek sovereign default.

The first question one needs to answer is "on what would Greece default?" because the consequences would be very different from one instrument to the other. We describe the various options in increasing order of default likelihood (in our view):

a) **Default on wages / pensions** (suppliers are already not paid.) Mr Tsipras has repeatedly said that pensions and wages would be prioritized over any debt repayment. This makes sense since he has been elected with promises to end austerity, i.e. to increase (or at least not reduce) wages and pensions for the public sector, certainly not to default on them. Leaving these unpaid would trigger a very quick fall in his ratings and probably snap elections (see below.) An alternative has been mentioned occasionally in the press: Greece could issue IOU to pay its civil servants. This has even been presented as a "parallel currency". Despite the fancy wording, this would be nothing else than another layer of public debt and certainly not a new currency. However it is likely that Grentham's law would apply: all citizens would do their best to get rid of their IOUs as quickly as possible in exchange for Euros and most true Euros would leave Greece through international trade. Expressed in IOU terms the country would probably face very sharp inflation and it is hard to imagine that the government could resist the public outcry.

b) **Default on IMF loans**. This would establish Greece as a pariah in the world community and would be extremely embarrassing for the Eurozone. Considering the relatively small amounts at stake we think it is likely that the ESM would directly repay the IMF rather than letting Greece default. Should Greece actually default, it takes usually one month for the IMF board to declare such a default. This is not technically a grace period but rather an administrative procedure. It is generally considered that the IMF is a super-senior creditor although this has no true legal basis. Consequently, an IMF default does not necessarily force or trigger a default on other debts. In the case of Greece, the question of cross default arises for the two largest debt stocks: GGBs and ESM/EFSF loans. The terms of the GGB have no cross defaults with the IMF facility: bonds cannot be accelerated because of an IMF default. However, they do have a cross-default with the EFSF loans and the EFSF loans have a cross default with IMF loans. In a nutshell, it means that any cross default trigger on IMF is up to the EFSF board. Considering the long term repayment schedule of EFSF loans we see absolutely no incentive for the EFSF to accelerate its loans – except to increase the pressure on the Greek government.

c) **Default on EFSF/ESM**. It is almost impossible for Greece to default on EFSF/ESM apart from a cross default trigger (or various other events of default such as fraud, *etc.*) as the EFSF / ESM are not owed any money before a very long time.

d) **Default on GGBs or T-Bills**. This is clearly the most likely default scenario. However, it should be stressed that ESM/EFSF funding is *pari passu* with the new "post PSI" GGBs under UK law so this default would have huge political and financial ramifications for the Eurozone. The bond market is already trading GGBs at a price that would make Greek debt sustainable (assuming ESM/EFSF funding traded at the same price) so the price impact on GGB would not necessarily be massive. This is why we believe the main contagion would be through Greek banks, in three steps :

    i) Impairment on Greek bonds and T-Bills (the loss rate could be as high as 75% considering that long term bonds are already trading in the 50s) and possibly impairment of DTA.

    ii) Bank run with probably capital controls established immediately.

    iii) Recapitalization of Greek banks (imposed by the SSM) through bail-in. This would be necessary to protect ELA funding. The key issue here is that banks have very small "bail-in-able" liabilities: subordinated debt is minimal and so is wholesale senior unsecured debt. Covered bonds cannot be bailed-in and are effectively *pari passu* to ELA so would be protected; except in a full Grexit scenario. This means that the SSM would have to bail-in deposits, unguaranteed ones first and then guaranteed ones. We understand there were roughly 25bn€ of non-guaranteed deposits so this could be enough with a 100% haircut (!!) but this number is likely to have gone down recently. Guaranteed deposits should not be considered very safe either as the guarantor would ultimately be the bankrupt Greek state. In any case, this would be a major political blow to the government and we struggle to see how the fragile coalition in Parliament could resist. We believe the most likely scenario would be accelerated talks to resolve the default during the grace period and avoid this political nightmare.

VII. Does a default necessarily imply Grexit?

The short answer is no.

From a legal point of view, the current EU treaties do not allow for Euro exit but they allow for EU exit. This being said, a principle of international law ("*Lex Monetae*") allows any sovereign country to choose its own currency and we believe Greece could choose to use a new currency – or to exit EU altogether. That second option is quite unlikely, however, as EU membership comes with very large structural funds! Other EU members have absolutely no legal way to expel an EU member or a Eurozone member.

From a practical point of view, the capacity of Greece as a defaulted state to remain in the Eurozone is highly unclear, to say the least. Exiting the Eurozone would not necessarily help Greece to repay its debt as it is unclear whether the currency of the outstanding Euro bonds could be changed to drachmas. Moreover, as long as Greek banks are solvent, and ELA not defaulted, the ECB would have no reason to cut its funding to Greek banks and prevent Euros from flowing in the country.

VIII. Can the current government pass an agreement in Parliament?

The current government has no real incentive to go all the way to default. After showing strong resistance to the Eurogroup's demands, we believe an honorable defeat could be sold to the public opinion.

The Parliament is another story.

Syriza currently has 149MPs and is two MPs short of a full majority, but the group is not homogenous. Of these 149 MPs, we believe roughly 100 could be sold an agreement broadly consistent with the Eurogroup's requirements, if only to keep their jobs a few more months. The remaining 50 MP are the "far-left" fraction of Syriza and it will be hard to convince them to vote for a new MoU. The missing votes will not be replaced by votes from the Communist party or Golden Dawn. New Democracy and PASOK will also probably refuse to vote unless there is a change in government. Potami is the only party likely to vote for the agreement, but it could be insufficient (17MPs) in case of strong resistance from a large fraction of Syriza MPs.

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Even if the Greek government and the Eurogroup reach an agreement in May, the Greek parliament will be a substantial hurdle.

IX. Will there be new elections?

A Greek default "by accident" could also happen if an agreement is reached but the Parliament refuses to vote it and new elections take too much time to organize. This is why the likelihood of new elections has to be assessed.

A constitutional technicality could be key to the process: because the last elections were snap elections in order to elect a President, if the government lost its majority in Parliament, we understand the President would have to ask New Democracy to form a government before calling for new elections. At that point the country would be facing huge risks and a coalition could emerge with ND, PASOK, POTAMI and a substantial part of Syriza's MPs. The stability of that coalition remains to be seen but it could be enough to vote for the new MoU.

If ND was unable to form a new government, the President would have to call snap elections.

X. Will the Eurogroup blink?

Of course we have no final answer to that question but our best guess is no, for a combination of reasons.

a) The impact of Greek default will be terrible for Greece and not so good for the rest of the Eurozone, but the Eurozone has largely isolated itself from Greece. As in all chicken games, the weak hand is usually the one giving in.
b) A Greek default does not mean Grexit and Grexit is the only outcome that the Eurozone wants to avoid at all (reasonable) costs.
c) The Eurozone's exposure on Greece has a very long grace period and it can safely be expected that any failure to pay on an ESM/EFSF loan will be discussed with another Greek government. In the meantime, the EU could withhold the large structural funds paid to Greece to compensate for any default on ECB-held GGBs.
d) Moral hazard considerations should not be underestimated, especially with general elections coming soon in Spain, nor should the Greek fatigue of some EZ members, some of them poorer than Greece.
e) The ECB will act largely along the lines of the Eurogroup's decisions and the central bank is holding the most potent weapon (ELA.)

XI. What are the most likely outcomes?

In decreasing order of likelihood we believe the scenarios are:

1) Last minute agreement (probably in May before the payment deadline on wages and pensions, but possibly as late as July before redemptions on ECB-held GGBs) and parliamentary signoff.

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2) Last minute agreement, resistance from some Syriza MPs, new government formed with "grand coalition" and parliamentary sign-off.

3) Last minute agreement, resistance from some Syriza MPs, snap elections called, default on ECB-held GGBs and any decision of SSM regarding Greek banks postponed until outcome of elections, ND wins elections and agrees to new MoU.

4) No agreement before default, default on GGBs, bail-in imposed by SSM on deposits, fall of government, snap elections, ND wins elections and agrees to new MoU.

5) No agreement before default, default on GGBs, bail-in imposed by SSM on deposits, government holds or wins snap elections, Greece stays in default - possible Grexit.

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