

27 April 2010

# Fixed Income Strategy

## Focus on Greece

### Table of contents

1	Market Context.....	2
2	Scenario 1: The EU/IMF support package.....	4
3	Scenario 2: The voluntary debt restructuring .....	6
4	Scenario 3: The default .....	8
5	Conclusion.....	9

## 1 Market Context

### 1.1 Recent Evolution

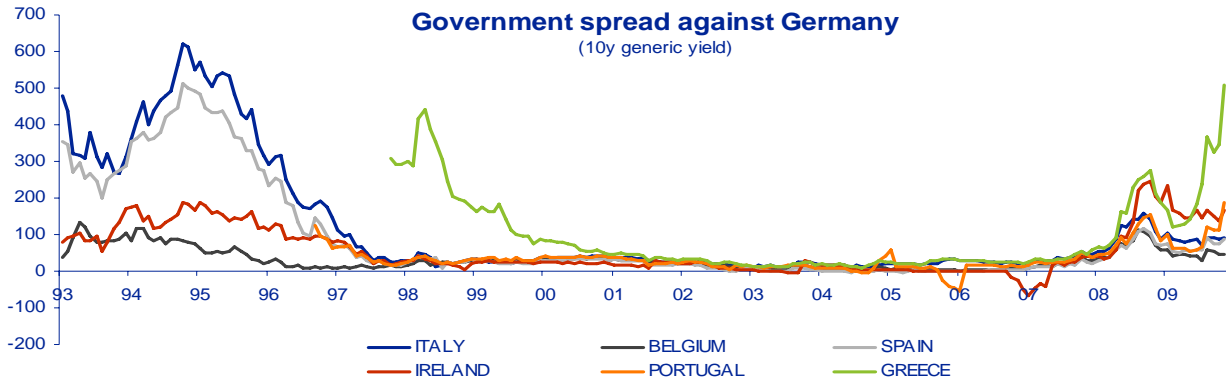
Although help for Greece is under way, Greek bonds suffered massively during last days with an important widening across the curve and in particular the 2 year and 5 year maturities. The steady sell-off in peripheral sovereign spreads creates a dangerous dynamic and the outlook for Greece becomes more and more binary (between a successful bailout and an unavoidable default/restructuring).



Source: Bloomberg, Dexia AM, data as of 27 April 2010

Recent news flows have exacerbated the sell-off:

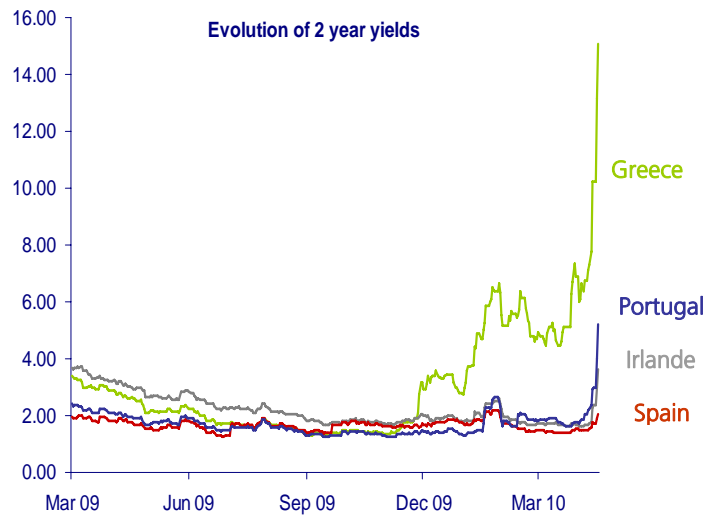
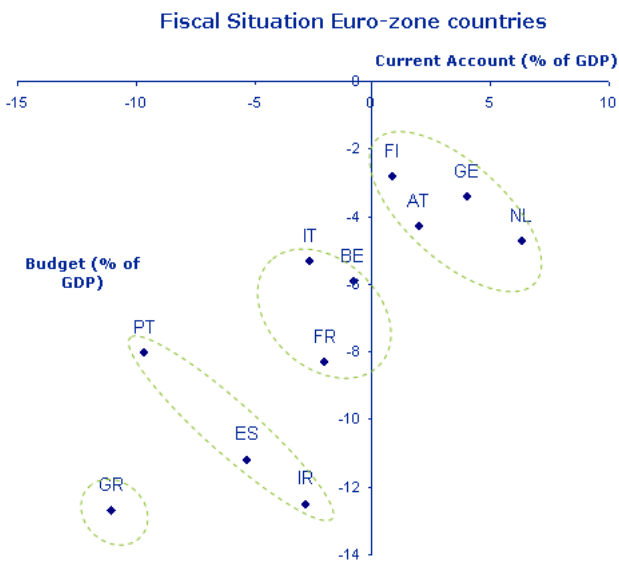
- Contradictory declarations about the European Union support package have illustrated the lack of credibility of the European authorities. The support package has to get through national parliaments and market worries that politicians preparing for upcoming elections won't be keen on passing an unpopular act.
- Eurostat revised in 2009 Greek deficit to 13.6% from a previous estimate of 12.9% due to the poor quality of data reported by Greece. The credibility about official figures remains problematic. Moody's responded by giving the latest of many downgrades (from A2 to A3) by agencies to Greek bonds.
- The market expectations of a debt restructuring have considerably increased due to the lack of credibility on the EU support package.
- Investors are worried about the inability of Greece to deliver tough spending cuts and tax rises to adjust its public finance according to the plan pre-announced and also the ability of the population to accept those additional measures.
- Markets are also concerned about the contagion risk spreading to other intra-EMU countries.
- Downgrade of Greek debt to BB+ from BBB by S&P on the 27<sup>th</sup> of April, would induce a forced selling in the coming days.



Source: Bloomberg, Dexia AM

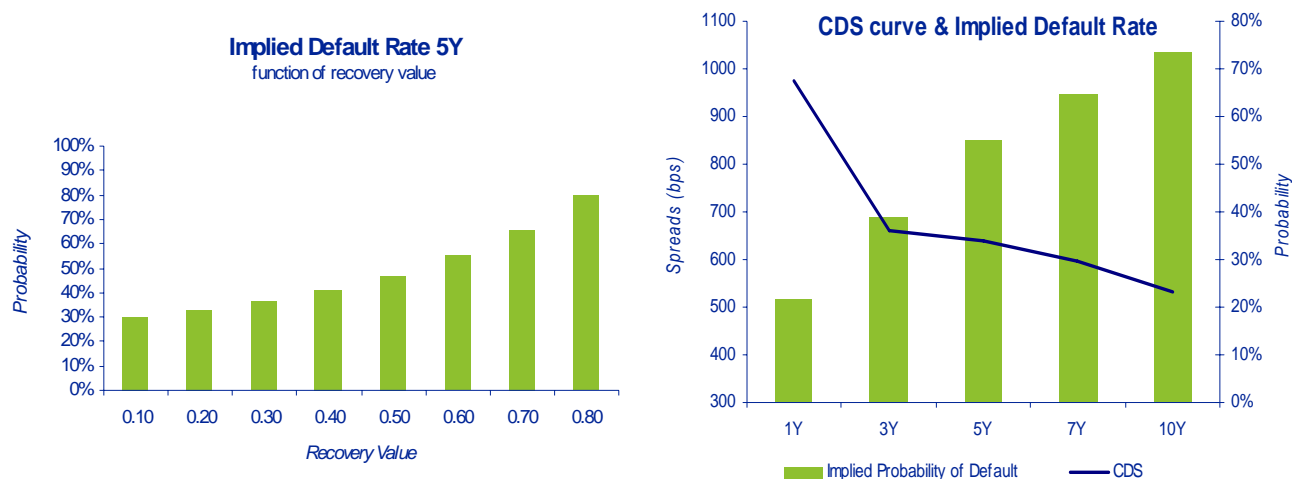
## 1.2 Market Expectation

The market is taking into account the risk of a Greek debt restructuring in spite of the proposed support package, as evident from the sharp inversion of the GGB yield curve, which reflects a higher default risk. Also the following countries are already influenced by speculation: Portugal, Ireland and Spain.



Source: Dexia AM

With the explosion of government spread, the implied probabilities of default have increased significantly. We calculate a cumulative implied default rate with a recovery value of 60%. For the 5 years horizon, the implied probability of default is close to 55%.



Source: Dexia AM

## 2 Scenario 1: The EU/IMF support package

Greece has officially asked for the activation of the EU/IMF package on 23rd of April 2010. The country will have to find over €8,1 bn to finance GGB redemptions before the May 19<sup>th</sup>.

### 2.1 Description of the package

The package set forward by the European Union and the IMF will cover a three years period. A total size of around **€ 45 bn** (including €30 bn by EU & €15 bn by IMF) in the form of loans will cover the first year. The financial support for the following years is not yet defined and will be decided upon agreement of the joint programme according to the EU statement.

The funding will be split among Eurozone countries in respect to their quotas in the ECB's capital:

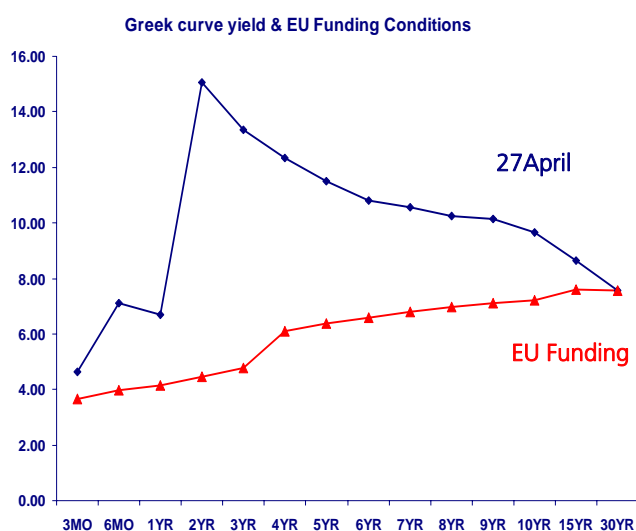
<u>Euro-zone Countries</u>	<u>% Contribution</u>	<u>Amount</u>
Germany	28%	8.4bn
France	21%	6.3bn
Italy	18%	5.5bn
Spain	12%	3.6bn
Holland	6%	1.8bn
Others	15%	4.5bn
<b>Total</b>		<b>30</b>

## 2.2 Modalities of the package

Fixed rate loans will be based on the Euribor swap rates for the relevant maturities + **300 basis points (+100 basis points** for the amount to be given for more than 3 years) + max 50 bp to cover operational cost and to be paid up front.

The package came with no extra budgetary conditions for Greece, although the later should respect the set of recommendations proposed by Ecofin council in last February and bring its deficit down to less than 3% by 2012.

In order to activate the package, Greece has asked for financial help and declared that it cannot access financial markets. Then the European Commission and the ECB will assess the situation and evaluate if Greece is on a good track in implementing the fiscal consolidation measures. Finally, the Euro- zone countries have to decide unanimously on the bilateral loans.



Source: Bloomberg, Dexia AM

### Detailed Cash Flow Calendar Greece

Date	Type	Amount
Quarter 1	Coupon payments	-2.3
13/04/2010	Redemption Bills 52 W	-1.00
16/04/2010	Redemption Bills 52 W	-1.30
20/04/2010	Redemption GGB 3.1% 20/04/10	-8.20
20/04/2010	Coupon Payment	-0.30
23/04/2010	Redemption Bills 13 W	-1.60
18/05/2010	Coupons	-0.80
<b>19/05/2010</b>	<b>Redemption GGB 6% 19/05/10</b>	<b>-8.10</b>
19/05/2010	Coupons	-0.50
20/05/2010	Coupons	-0.90
31/05/2010	Redemption GGB 6% 31/05/10	-0.40
16/07/2010	Redemption Bills 52 W	-0.90
16/07/2010	Redemption Bills 26 W	-1.00
19/07/2010	Coupons	-0.90
20/07/2010	Coupons	-1.40
23/07/2010	Redemption Bills 13 W	-1.60
12/08/2010	Q2 GDP	
20/08/2010	Coupons	-1.60
20/09/2010	Coupons	-1.60
29/09/2010	Redemptions GGB 6% 29/09/10	-0.20
15/10/2010	Redemption Bills 52 W	-1.30
22/10/2010	Coupons	-1.00
23/10/2010	Redemption Bills 13 W	-1.60
<b>Total</b>		

Positive Aspects	Challenges
<ul style="list-style-type: none"> <li>□ The size of the package (€ 45 bn) is significant and should completely cover Greece's remaining financial needs for the next 12 months. The critical April-May financing hurdle should thereby be passed.</li> <li>□ The support package reduces the funding cost of Greece. We can estimate that Greece will save up to € 0.6 bn. (versus Friday 9 April market levels) on a one year basis if the country would lend € 30 bn. via 3 years bilateral loans. This corresponds to 5.5% of total 2009 Greek interest rate charges.</li> </ul>	<ul style="list-style-type: none"> <li>□ The loan from euro area member states require approval from all the euro group members and in some cases the bilateral disbursement might require approval from the respective parliaments (Germany...)</li> <li>□ The support package doesn't specify the redemption problems of 2011 &amp; 2012</li> <li>□ It's not clear that the IMF support would be contingent on the EU loan.</li> <li>□ the market assumes that IMF loans would be senior to bonded debt</li> </ul>

The EU package could reduce the risks of near-term default, especially for the short term maturities. If the plan is effectively adopted by EU, the short papers could rally significantly steepening the yield curve. A contrario, if national parliaments disapprove the plan, a debt-restructuring would become unavoidable increasing the contagion risk in the rest of Europe.

### 3 Scenario 2: The voluntary debt restructuring

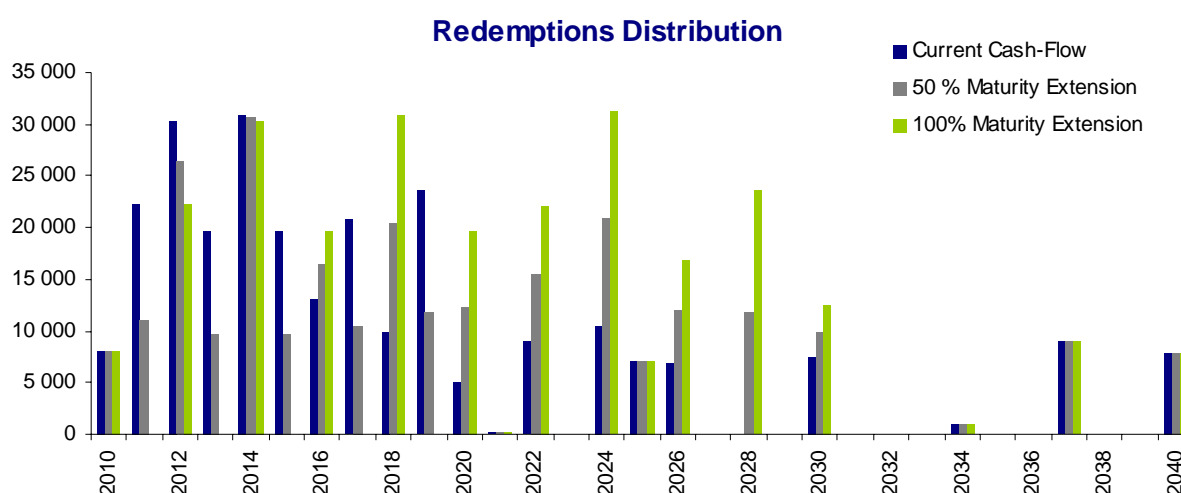
Both Greece and IMF denied the scenario of a debt restructuring.

#### 3.1 Recent declarations (25<sup>th</sup> April 2010)

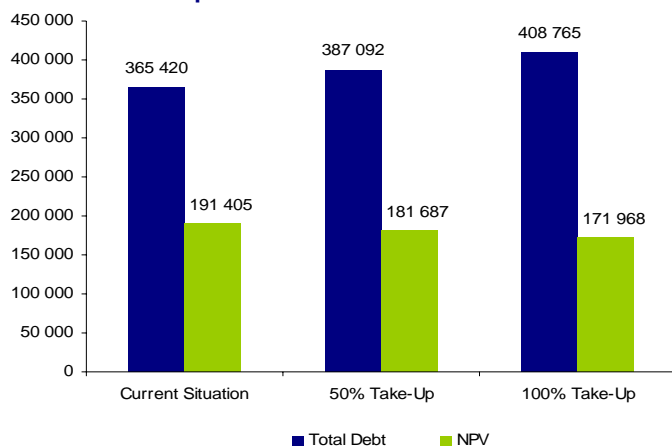
Greece	IMF
Mr. Papaconstantinou said <b>"I want to categorically state that any restructuring is off the table."</b> adding that Greece "is a member of the euro zone will always remain a member of the euro zone, will always remain a member of the European Union."	"That is not something we are working on," Strauss-Kahn said at a press conference ahead of the IMF's spring meeting this weekend. There has been growing fear among investors that Greek debt holders could be forced to accept losses. <b>Strauss-Kahn said there was no "silver bullet" to solve Greece's debt woes</b>

#### 3.2 Modalities of debt restructuring

50% of the Greek debt will mature in the next five years. This front loaded profile could raise an issue for the Greek government and could justify a debt restructuring by a maturity extension. A solution will be to offer an exchange to investors which would receive a next extended maturity bond with double the maturity up to 2020. We assume different scenarios in function of percentage of exchange. We calculate the impact in terms of total debt, present value and price.

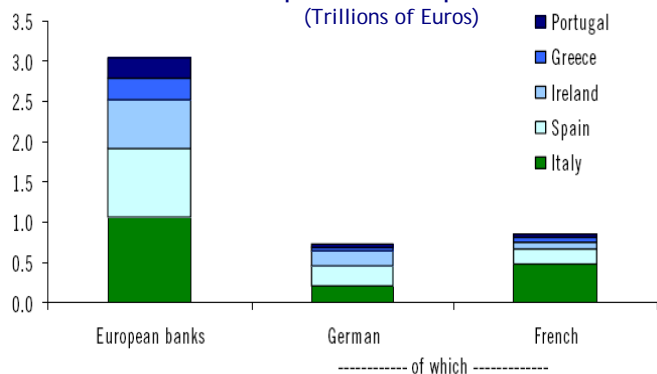


**Impact on Future Cash Flows**

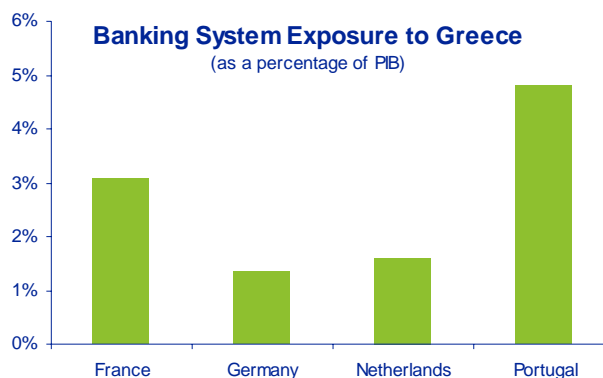


In case of debt restructuring with maturity extension, two alternatives can be considered: the one in which 50% of investors accept the maturity extension of their debts and the second alternative, all the debt payments are extended. The present value decreases in both alternatives while the total cash flow to be paid increases. The percentage change is more important in the second case than in the first one. But Greece will have more time to implement its austerity measures. European Banks are heavily exposed to Greek debt (as a percentage of GDP), in particular Portugal

**Exposure to Peripherals**  
(Trillions of Euros)



**Banking System Exposure to Greece**  
(as a percentage of PIB)



Positive Aspects	Challenges
<ul style="list-style-type: none"> <li>□ A voluntary debt restructuring is not a default and not trigger a CDS credit event.</li> <li>□ A debt restructuring could reduce the risk of liquidity in the near term (decreasing the present value)</li> <li>□ A debt restructuring doesn't need political agreement avoiding the German veto</li> </ul>	<ul style="list-style-type: none"> <li>□ The maturity extensions could lead to a multi-downgrade by different rating agencies. Greece would become non-investment grade. ECB will have to change its collateral rule in a case of severe downgrades</li> <li>□ A debt restructuring would create jurisprudence in the Euro area and exacerbate the contagion risk to other peripherals.</li> <li>□ Risks on the European banking system</li> </ul>

	<ul style="list-style-type: none"> <li>□ The debt restructuring in EU could impact the Eastern Europe and the principle of convergence.</li> <li>□ The debt restructuring doesn't solve the problem of the primary deficit and the solvency issue in the long term (increasing total cash outflows)</li> <li>□ The future funding ability will be problematic. Historically market access was close 4-7 years in some instances</li> </ul>
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A Greek debt restructuring is not an absurd hypothesis. In a case of non European bailout, the restructuring would be a solution to solve the near-term liquidity issue for Greece. However this solution would be a Greek solution and not a European solution. In this case, all European countries could be threatened by a contagion risk and this jurisprudence could be catastrophic for the long term outlook of Europe.

## 4 Scenario 3: The default

### 4.1 Recent declarations (25<sup>th</sup> of April 2010)

German Finance minister Schaeuble	CSU	SPD
<p>"We cannot allow the bankruptcy of a euro member state like Greece to turn into a second Lehman Brothers. Because Greece is a member of the European monetary union. Greece's debts are all denominated in euros, but it isn't clear who holds how much of those debts. For that reason, <b>the consequences of a national bankruptcy would be incalculable.</b> Greece is just as systemically important as a major bank."</p>	<p>CSU head Friedrich said a debt restructuring should be considered and <b>a Greek exit of EMU should also be "no taboo"</b>." Greece "I am extremely sceptical as to whether the aid package conforms with European Union law and the German constitution," he said. <b>"The real alternative would be for Greece to leave the currency union and become competitive again via hard structural reforms."</b></p>	<p>Frank-WalteSteinmeier, the floor leader for the center-left Social Democratic Party (SPD), made it clear that <b>"decisions on possible financial assistance for Greece are of fundamental importance for the future of the European Union."</b> That's why, he wrote, "they have to be thoroughly discussed in the parliament and why responsible decisions are needed."</p>

### 4.2 Modalities of the default

The regional default raises a **vacuum**. Indeed European treaties have not anticipated the case of a default of a country. Due to a lack of jurisprudence, there exists a high level of uncertainty for other European debt. Moreover the default will not solve the primary deficit of Greece and will profoundly undermine the credibility of the government. The contamination effect would be disastrous, as the market would test other countries like Spain, Ireland and Portugal.

Greece could leave European Union and create a new currency. But debt would remain denominated in euro, increasing the ratio debt/GDP... According to a recent ECB legal working paper, it would be "legally inconceivable" for a country leaving the Euro to still remain a member of the wider EU. This is a very high hurdle to pass. **Leaving the Euro-area would mean a major loss of political influence, while the cost of leaving would likely be much higher** than the fiscal efforts necessary to end their massive deficit. We think it's newly created currency would immediately face a currency crisis. Issuance of Greek debt would also come out at punitive

rates. Moreover a voluntary withdrawal or a possible expulsion will raise a **political issue** which could put into question the existence of the European Union.

Practical Guide to Leave European Unions (EU)	
<b>A voluntary withdrawal</b>	
<i>How before Lisbon?</i>	A state could not, pre-Lisbon Treaty, withdraw unilaterally from the EU An <b>agreement</b> would require the unanimous consent of its partners
<i>How after Lisbon?</i>	The exit clause recognises a <b>unilateral right</b> to negotiate its exit from the EU To inform the european council - guidelines & negotiation Qualified majority of the council and approbation by thee Parliament
<b>A collective right of expulsion</b>	
<i>How after Lisbon?</i>	Expulsion from the EU is not an option under the treaties Persuading a Member stat to withdraw by making use of the proposed exit clause Using the the errant Member State's partners of the "enhanced co-operation procedure"
<b>Consequences ?</b>	Creating a new currency Refunding the departing national central bank Reimbursing its foreign reserve assets transferred to the EuroSystem Transferring full monetary sovereign back to the new central bank

Positive Aspects	Challenges
<ul style="list-style-type: none"> <li><input type="checkbox"/> The solvency issue will be improved</li> <li><input type="checkbox"/> There is no moral hazard</li> </ul>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Contagion risk spreading to other countries would be disastrous: default would open a Pandora's box by putting other peripheral European countries under huge strain. Spain, Ireland, Portugal could be the next target of the financial markets.</li> <li><input type="checkbox"/> Financial sector risk: European banks would also have to take massive write-downs.</li> <li><input type="checkbox"/> Euro zone collapse</li> <li><input type="checkbox"/> No access to capital market</li> </ul>

The hypothesis of a default remains low. No involved party has an interest to provoke a Greek default which means most likely a breakup of the euro area.

## 5 Conclusion

We esteem the realisation of the joint EMU/IMF support plan as the most likely scenario. Greece will need to detail a credible 3-year plan to return to fiscal stability to get the IMF support. Afterwards, we expect the EU would join the program. In fact, there is a high upcoming solvency risk on Greek debt on the 19<sup>th</sup> of May of €8bn. That said, we believe that this risk will be avoided by the support of the IMF/EMU (or one of both institutions if the deal is not yet completely settled by one of its participants). Ultimately, the 3 years support plan should enter into force once the agreement between EC/ECB/IMF and Greece will be reached. However, we do not exclude extra conditions by the IMF.

Once activated, the execution of the Greek commitments will be closely monitored by the IMF/EC/ECB. In the event that Greece doesn't correctly implement the plan, a debt restructuring or outright default cannot be excluded. The activation of the support plan should reduce the spreads on the Greek government bonds, especially on the short end of the yield curve.

## Addendum:

### Statement on the support to Greece by Euro area Members States

Following the statement by the Heads of State and Government of the Euro area on 25 March, Euro area Members States have agreed upon the terms of the financial support that will be given to Greece, when needed, to safeguard financial stability in the Euro area as a whole. Euro area Members States are ready to provide financing via bilateral loans centrally pooled by the European Commission as part of a package including International Monetary Fund financing. The Commission, in liaison with the ECB, will start working on Monday April 12th, with the International Monetary Fund and the Greek authorities on a joint programme (including amounts and conditionality, building on the recommendations adopted by the Ecofin Council in February). In parallel, Euro area Members States will engage the necessary steps, at national level, in order to be able to deliver a swift assistance to Greece. Euro area Member States will decide the activation of the support when needed and disbursements will be decided by participating Member States. The programme will cover a three-year period. The euro area Member States are ready to contribute for their part up to € 30 billion in the first year to cover financing needs in a joint programme to be designed with and cofinanced by the IMF. Financial support for the following years will be decided upon the agreement of the joint programme. In order to set incentives for Greece to return to market financing, Euro area Members States loans will be granted on non-concessional interest rates. The pricing formula used by the IMF is an appropriate benchmark for setting Euro area Members States bilateral loan conditions, albeit with some adjustments. Variable-rate loans will be based on 3-month Euribor. Fixed-rate loans will be based upon the rates corresponding to Euribor swap rates for the relevant maturities. A charge of 300 basis points will be applied. A further 100 basis points are charged for amounts outstanding for more than 3 years. In conformity with IMF charges, a one-off service fee of maximum 50 basis points will be charged to cover operational costs. For instance, as of April 9th, for a three year fixed-rate loan granted to Greece, the rate would be around 5%. The Eurogroup is confident that the determined efforts of the Greek authorities and of its European Partners will allow to overcome the fiscal and structural challenges of the Greek economy. In this context, the Eurogroup welcomes the budget execution in the first months of the year, which shows that the measures taken so far are bearing fruit.

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