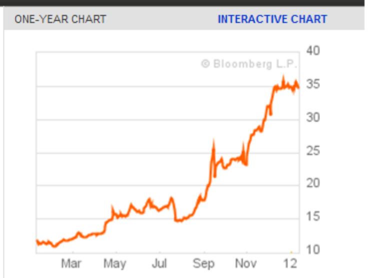
Greece negotiations: Behind the scenes

The media bombards us with a fanfare of European sovereign debt crisis headlines. But what is happening behind the scenes in the negotiations between responsible parties tasked with finding a solution? Is the situation as dire as the media purports?

It’s common knowledge that the Greek government has issued more debt than it can possibly repay. This explains why one can currently buy its government bonds at cents on the US dollar. At market opening on 12 January 2012, secondary markets were pricing Greek 10-year security issues at prices that give buyers a jaw-dropping 35% yearly return.

Snapshot

SUMMARY	
Value	34.88
Change	(%)
Open	35.10
High	35.65
Low	34.45



Source: Bloomberg

Comparable US Treasury securities issued by the US government, which are not expected to default, are yielding less than 2%. Germany recently issued bonds at rates even lower.

The discounts have the certainty of default priced into them, and indeed, the Bloomberg news organisation reports that the Greek government has been quietly asking its creditors to accept a 60% reduction in interest payments - which would still keep rates around the 14% level. Meanwhile, the German and French governments have persuaded European banks to exchange their Greek bonds for new securities with longer maturities and lower coupon rates.

The effort to put the Greek debt crisis safely behind us has recently hit a snag.

According to the New York Times, a small group of hedge funds have been aggressively buying up Greek debt at cents on the US dollar, and now are refusing to negotiate any kind of a so-called haircut.

The hedge funds are betting that the European governments will eventually have to pay them the full face value of the bonds they bought at huge discounts - giving them big windfall profits at a time when everybody else is accepting losses for the sake of long-term Euro stability.

It may work.

If Greece is forced to break off negotiations, formally default and unilaterally impose the 60% so-called haircut - that default legally becomes what can be described as a "credit event."

A credit event is how former European Central Bank President Jean-Claude Trichet and other European officials describe a circumstance where traders increase their bets against other indebted European nations such as Italy, Portugal and Spain. It is expected a credit event would worsen the debt crisis.

A credit event would trigger the payment provisions of untold numbers of derivative contracts, which are basically private insurance policies called credit default swaps. The issuers of those contracts, chiefly those same European banks, would suddenly have to pay face value for the Greek bonds that everybody else is buying at a discount.

But only if there is a credit event.

Nobody outside the European Central Bank knows exactly how many of these derivatives are held by European lending institutions, but it is clear from the nature of the negotiations that all parties are carefully avoiding this trigger event. The hedge funds, by demanding either full payment or a credit event, seem to have figured out a way to hold the entire European banking system hostage to their demands for outsized profits.

The story offers a rare view inside the negotiating rooms where the European sovereign debt crisis is being managed, and suggests that responsible parties are, behind the scenes, working to resolve the European Sovereign debt crisis without a lot of the fanfare you see in breathless headlines.

As the bank negotiations move forward, the "crisis" might not be as dire as the headlines make it out to be. As agreement is purported to be “close to finalisation” for banks and creditors to take a 50% haircut on the money they are owed, the problem still exists that Greece has outrightly refused to accept a proposal that the EU hold power over its budget.

There is even a chance that the hedge funds' greedy stand could backfire. The European Central Bank is now inserting what are called "collective actions clauses" in their agreements with banks, which would let the lenders impose the concessions they had to make on all bondholders if a majority of holders agree to it. The hedge funds would either have to acquire a majority of Greek debt or lose their leverage, and most of their hoped-for windfall.

As your Financial Planner, we concentrate on what is best for you as an investor without trying to take advantage of ways markets may be mistakenly relying on media noise. We take advantage of what markets offer and ways that markets compensate investors.

We believe that understanding and managing risk, and using properly diversified portfolios, reduces uncertainty. Our integrated approach and efficient administration structure ensure you receive appropriate and consistent fund management in investment markets, no matter the dominating theme in world markets.

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