

# Thesis Reaction

27 October 2011

## EU Debt Crisis Summit - Deal or no deal?

Clearly there was immense pressure to achieve a result which would tackle the immediate problems of heading off a Greek default, restore confidence in the European banking sector and create a credible process for greater monitoring and control of individual sovereign balance sheets.

No one realistically expected 100% consensus or a dramatic final solution to all the issues, but some important progress has been made. However the fact that there are also many unanswered questions in the announcement highlights how desperate the Heads of State were to send out a positive consensual message of intent. This note therefore takes each of the key points in turn together with our initial assessment of their effectiveness and impact.

### Greek debt

**The announcement:** A proposed 50% haircut on private sector holdings of Greek debt is in line with the most recent market expectations (and slightly better than the 60% being rumoured in some quarters). However, to avoid an official default this must be voluntarily accepted by creditors.

#### Our view:

The level of the haircut and take up are crucial to the bank recapitalisation plan and EFSF leveraging (see next two sections). The problem is (i) the unknown level of participation (although banks will effectively be blackmailed into agreeing, ie. a "stick and carrot" approach) and (ii) avoiding the risk of triggering Greek credit default swaps (CDS) with the wider financial repercussions this would have. Intense negotiations are on-going and our view is that a deal will be cobbled together. However this would still leave Greece's debt to GDP ratio - according to the announcement - at a chronic 120% by 2020, and with no improvement in their level of competitiveness. We therefore still believe Greece will eventually default and exit the Eurozone.

### Banking recapitalisation

**The announcement:** Banks must reach a 9% core capital reserves ratio (post the haircuts). An estimated 106bn euros will be needed (this is equivalent to roughly half private sector holdings of Greek debt) by June next year. Failure to comply would place constraints on paying dividends and bonuses. Banks finding it difficult to raise capital would have to tap first their national governments, with the EFSF lender of last resort.

#### Our view:

No real surprises here, in terms of the 106bn figure, tying in with media and market expectations. However it is, for example, less than half the forecast figure by some economists. There is very little detail, but we would expect the ECB to cover crucial shorter term funding requirements, with the EIB providing an important guarantee enabling banks to repo debt with the ECB in exchange for liquidity. Overall a positive development, particularly in addressing the problem of weaker banks in accessing medium to longer term funding. We can now expect more restructuring by banks, such as subordinated bank debt being exchanged for equity.

### More firepower for the EFSF "rescue fund"

**The announcement:** The European Financial Stability Facility (EFSF) is to be increased to 1 trillion euros, possibly accessing funding from the IMF and Sovereign Wealth Funds (notably Chinese). Details are patchy as further consultations are unlikely to be concluded until, at the earliest, the G20 summit on 3-4 November.

#### Our view:

If agreement can be reached with all potential partners then, subject to the conditions imposed, this could be positive for markets. Best outcome (of the two reported as previously being considered) would be the setting up of a Special Purpose Vehicle (SPV) which could act in the secondary sovereign bond markets, this combined with the EFSF providing first loss insurance (at 20%-25%) to buyers of new debt issued by sovereigns such as Italy and Spain.

Markets have reacted favourably today, more a relief rally than any fundamental change of heart, but some reality check is inevitable given the on-going uncertainties. One of the key issues is that, in committing to a maximum limit of support, the likes of Germany and France face the prospect of downgrades of their own sovereign debt if the figures prove to be insufficient. Then the whole question of how the defaulting states are dealt with will be reviewed more aggressively.

This update is for information only and is not an invitation to engage in investment activity.

Thesis Asset Management plc and Thesis Unit Trust Management Limited are authorised and regulated by the Financial Services Authority and Thesis Asset Management plc is an authorised ISA plan manager. Investors should be aware that the value of their investments and the income from them can fall as well as rise and investors may not receive back the full amount they invest. Past performance is not necessarily a guide to future performance. Investments denominated in foreign currencies are subject to fluctuations in exchange rates which can be favourable or unfavourable.



This Reaction written by:

**Michael Lally**  
Investment Manager

Email Michael  
with any feedback:  
michael.lally@thesis-plc.com