



Fixed Income & Currency Strategy

Greek Referendum FAQ

Summary: Greek PM Papandreou surprised everyone – even his own government – by announcing plans for a potential referendum on the second bailout package agreed at last week’s Euro Summit. The implications are significant – and not just a ‘domestic issue’ for Greece. Short-term uncertainty and risks have increased, early elections could take place, and a possible hard default on Greek debt is back on the table less than a week after it had been ruled out. This move calls into question the entire European response to the crisis and is likely to place additional pressure on other peripheral countries, especially Italy.

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November 1, 2011

Priced as of prior trading day's market close, ET (unless otherwise stated).

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FAQ1: What was announced and what are the next steps?

Greece will hold a confidence vote on Friday (with the Parliamentary debate beginning on Wednesday). If the confidence vote succeeds, PM Papandreou would move towards holding a referendum on the second bailout in January. The situation is constantly evolving though and as we go to press, the Greek PM is holding a cabinet meeting with his own party official saying the referendum is “dead”. Markets have reacted positively to that headline but this is not over.

FAQ2: What are the different scenarios?

There are a number of different scenarios which arise out of this development. Most of them lead to early elections (the current electoral cycle ends in 2013) and, in all cases, valuable time is lost. The result of early elections would likely be either a win for the opposition New Democracy (which so far has stuck to a policy of renegotiating the existing bailout) or no clear majority. If Friday's vote passes, the threat of a referendum will hang until it is held (in January 2012) or something else quashes it. For example, Papandreou could succumb to pressure – from his own party or from the international community – or the referendum could be deemed unconstitutional.

There is also a chance that Greece runs out of money before a referendum is held (see FAQ3-6), meaning that a hard default in the near-term cannot be ruled out.

Exhibit 1: Possible referendum scenarios and outcomes

Scenario	Outcome
Confidence vote fails	Early elections
Confidence vote succeeds; referendum not held	Major volte-face by government; increased political and social unrest which could put pressure for early elections
Confidence vote succeeds; referendum invalid due to low turnout	Hard to assess, but likely could lead to early elections
Confidence vote succeeds; referendum struck down	Early elections
Confidence vote succeeds; referendum succeeds	Stronger mandate for Papandreou government and second Greek bailout; 2-3 months of lost time

Source: RBC Capital Markets.

FAQ3: What does this mean for troika funding under the current Greek programme?

This announcement throws into question continued troika support under the current Greek bailout programme. The sixth tranche of funding (originally scheduled for September and approved by the Eurogroup during the first of its two recent summits) is worth €8bn and would be disbursed in early November pending sign-off by the IMF Board. In theory, the decision should be based purely on Greek performance against its bailout targets and not on domestic political developments. But in practice, the decision to hold a referendum will colour the IMF Board's decision – especially given its timing less than a week after the conclusion of the Euro Summit and with no advance warning to other European governments. In addition, Greece will reportedly run out of money by mid-month without additional support. Local talk suggests it may already be tapping funds earmarked in a separate account (the HFSF) for bank recapitalisation – this could be up to €5bn and would be part of the reason why the Euro Summit statement explicitly said that “the governance of the Hellenic Financial Stability Fund will be strengthened”.

This places the IMF in a difficult position – failure to approve the tranche will push Greece into an immediate default. The government would not be able to pay its bills this month and faces redemptions in December (see FAQ4).

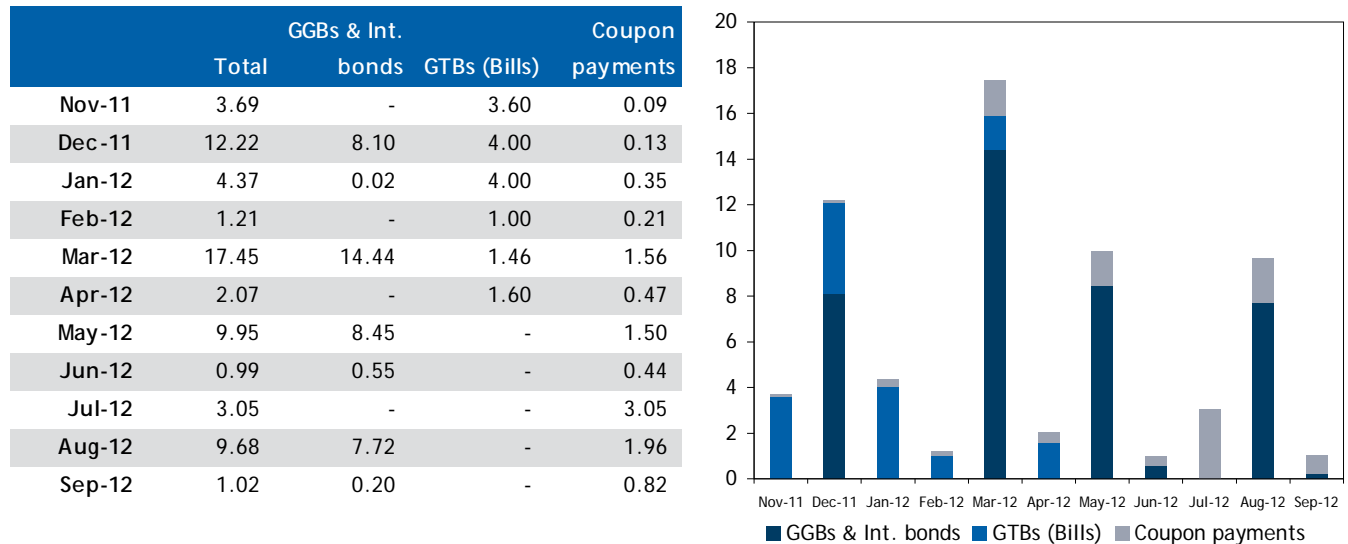
Furthermore, even if the troika makes this disbursement, the seventh tranche (€5bn, originally planned for December) is called into question. A new troika mission is due to visit Greece in late November/early December to consider that review, but the same question marks will surround that payment.

FAQ4: When are Greece's next big redemptions due?

The disbursement of aid tranches for Greece (see FAQ3) by the EU/IMF will be crucial with redemptions and coupon payments looming. Even though the Greek Finance Minister outlined in early October that sufficient funds were available until mid-November to keep Greece afloat, GGB redemptions of more than €8bn due in December (€1.72bn on 19-Dec, €0.98bn on 22-Dec, €0.23bn on 29-Dec and €0.71bn on 30-Dec) are a hurdle that cannot be overcome without EU/IMF support (Exhibit 2).

In addition, monthly bill redemptions of €3.6-4.0bn will have to be rolled over in the next three months (Exhibit 2). This has not been an issue in the past as Greece was able to auction up to €4bn (including non-comps) via two GTB auctions per month. However, on the back of the recent developments this could become an obstacle as even a three-month exposure to Greece could be scrutinised. The Greek Debt Management Agency (PDMA) already indicated another four GTB auctions until year-end (8-Nov, 15-Nov, 13-Dec and 20-Dec) to roll over its outstanding bill stock. However, the official auction announcement had usually been communicated by the PDMA on the Friday before the auction. From this perspective the upcoming Friday will be in focus where next Tuesday's (8-Nov) GTB auction should be announced.

Exhibit 2: Greek Debt Repayment Profile over the next months (in €bn)



Sources: Bloomberg, RBC Capital Markets.

FAQ5: What does this mean for the 2nd Greek bailout agreed in last week's Euro Summit?

The precise details of the PSI, in which a 50% haircut is being targeted, are yet to be decided, and it is hard to see private bondholders signing up to this if a referendum looms in early 2012. The amount that is forthcoming from the haircut will be a direct input into the second Greek bailout as any shortcomings would have to be financed via the official sector. The EU/IMF will continue to negotiate the terms of the second bailout in the interim – it has set a precedent for being pragmatic when faced with adverse domestic political scenarios in both the Irish and the Portuguese bailouts.

FAQ6: Does this increase the risk of a disorderly Greek default?

In a nutshell, yes. Last week's Euro Summit had (in theory) removed a disorderly outcome for Greece from the table, with a clear political red line being the need for private sector involvement to be voluntary and for CDS contracts not be triggered. However, the decision to go to a referendum throws the timetable into question, as it is not clear to what extent the troika will continue to support Greece (see FAQ3) in the context of its upcoming bond and bill redemptions (see FAQ4). Thus, the risk of a hard default by Christmas has increased.

FAQ7: Implications for CDS contracts?

During the entire planning phase of the Greek PSI (Private Sector Involvement) deal, the case was rather clear-cut that CDS contracts would not be triggered. This was because ISDA's 'Credit Event' definition calls for a restructuring to happen in a fashion 'that binds all holders' of the obligation that is due to be restructured. As the PSI deal was deemed voluntary and would only have applied to a fraction of the Greek debt, it would have been likely that the CDS contracts would not have been triggered.¹ Most recently this notion put significant downward pressure on Greek (and other EMU sovereign) CDS. Yet, with the current events unfolding the likelihood of CDS triggers has increased. Apart from 'restructuring', the ISDA definitions explain other events of default. With the next aid tranche jeopardised (see FAQ3) and with bill and bond redemptions due before any referendum would likely be held (see FAQ4), there is a risk that Greece would simply fail to make a payment. If such a failure after an 'applicable grace period' persists, a Credit Event would have to be declared.

¹ We argued this case in more detail in a note labelled 'Trigger (un)happy' from 24 Mar 2011.

Secondly, even if this was avoided until a referendum was held there is a risk that the referendum would lead to a euro exit and thus indeed lead to a redenomination of the outstanding Greek debt. In that case, a restructuring event would very likely have to be declared (even if the Greek government would aim at honouring the face value – which would be unlikely). The ‘Credit Definitions’ declares a ‘restructuring’ if ‘any change in currency or composition of any payment of interest or principal to any currency which is not a Permitted Currency’ occur. The latter are defined as G7 currencies or other AAA rated OECD countries’ currencies of which Greece clearly is neither.

This leaves the question about implications of such an event. Exhibit 3 shows the current gross and net amounts of Western economies’ sovereign CDS contracts according to DTCC. As can be seen, the net amount of Greece is a rather small EUR2.6bn. Yet, it seems likely to assume that in case of a CDS trigger on Greece the other CDS spreads of European nations would widen drastically adding to market pressure. More importantly, there is the distinct risk that some counterparties involved in the CDS market might be unable to fulfil their obligations to pay. If that was the case, the actual ‘net amount’ as a whole and for single entities might be much larger than shown in the exhibit as some of the netting out might not be applicable anymore. In other words, some holders of CDS contracts might find themselves in a net long or short position they did not anticipate to have as some of their counterparts might be unable to honour their contracts. The sheer risk that this might happen should inject another source of risk in the market.

Exhibit 3: Gross and Net amounts outstanding of Western sovereign CDS contracts

	Gross		change vs. May*	Net		change vs. May*	no of contracts
	in bn US\$	in bn EUR		in bn US\$	in bn EUR		
Italy	309.5	221.0	22.9	22.0	15.7	-2.9	9,337
France	132.4	94.5	24.1	24.0	17.1	2.9	6,835
Spain	167.8	119.8	8.2	18.0	12.8	-0.4	7,438
Germany	116.1	83.0	16.0	19.6	14.0	2.1	4,327
Belgium	59.3	42.3	7.6	6.6	4.7	-0.4	3,243
Portugal	68.1	48.6	-1.7	5.6	4.0	-0.8	3,781
Austria	54.5	38.9	2.2	6.4	4.5	0.1	2,421
Greece	74.8	53.4	-1.8	3.7	2.6	-1.2	4,321
Ireland	42.7	30.5	-1.0	4.1	2.9	0.0	2,818
Netherland	25.8	18.4	3.5	3.0	2.1	0.1	1,379
Finland	16.4	11.7	-0.7	2.4	1.7	0.1	709
Slovakia	10.4	7.4	0.2	1.0	0.7	0.1	817
Slovenia	5.4	3.9	0.5	1.1	0.8	0.2	467
UK	129.6	92.6	48.5	8.8	6.3	-2.1	10,323
USA	72.5	51.8	35.7	12.7	9.1	6.3	4,981
Japan	63.8	45.6	12.8	9.2	6.5	0.7	6,298

Sources: Bloomberg, DTCC, RBC Capital Markets. * changes are calculated on figures published in our last note on sovereign CDS markets labelled ‘Trigger (un)happy’ dated 24 May 2011.

FAQ8: What are the implications for markets?

The market reaction can only be described as historic. Not only did the Bund future have its largest day-to-day swing with a nearly 3 big figure gain measured on official closings since the euro’s introduction (see exhibit 4a). In addition, euro area spreads reached historic highs as exhibit 4b indicates. Within the euro area complex, Italian bonds exhibited the largest moves and extended their underperformance against Spain, which had been on display since last Friday. As a result, the need for a firewall for Italy (and Spain) has greatly increased, given the increased risk of a hard Greek default.

It should be noted that Italian debt is still very resilient to interest rate shocks, given that it is relatively long-term (average maturity of around 7 years) and less than 12% is at variable rates. Back in July, the IMF estimated that a 100bp increase in 10y yields only increase the stock of debt by about 0.2% of GDP. The ECB has remained active in its bond-buying programme and, if

questions about the ability of Italy to finance itself continued, the enhanced (but not yet leveraged) EFSF could also play a role. Another avenue that would be available for Italy would be to request a precautionary lending line from the IMF.

Papandreou's referendum bombshell led to a large drop in EUR/USD (reaching a low just shy of 1.36) and the knock-on effect has been a sharp decline in risk appetite and a flight to safety, reflected across asset classes. As noted above the situation is still evolving with ruling party officials casting doubts on the referendum (and EUR/USD rallying 90pts on the headline that the referendum is "dead". But this is not over yet. There are many variables that will determine the longer-term implications of the planned referendum, but the huge dose of uncertainty injected, only days after some certainty seemed to be returning, is likely to keep EUR under pressure as an "uncertainty premium" is built in.

Exhibit 4a: Daily changes of Bund future since 1999 in ascending order

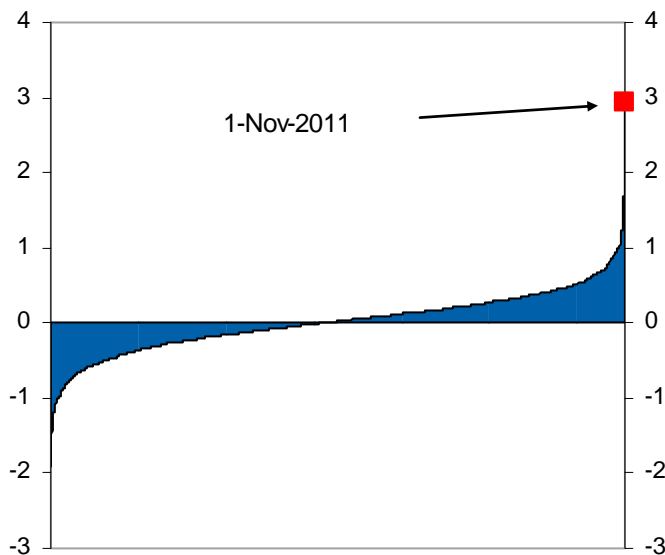
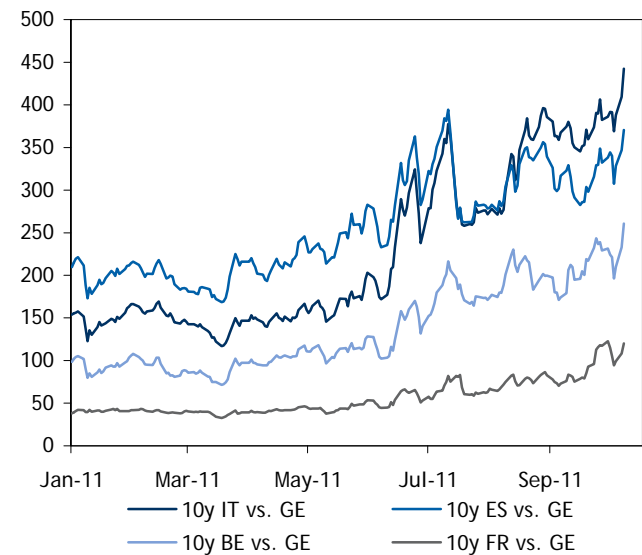


Exhibit 4b: Substantial spread impact in tier-2 (yield spreads in bp)



Sourcess: Bloomberg, RBC Capital Markets.

Timeline of key events

- Nov 2:** Parliamentary debate on confidence motion begins
- Nov 3-4:** G-20 Summit in Cannes
- Nov 4:** Parliamentary vote of confidence on government
- Nov 7-8:** Eurogroup/ECOFIN meetings of finance ministers
- Nov 8:** planned bill auction
- By Nov 11:** planned disbursement of troika tranche (€8bn)
- Nov 15:** planned bill auction
- By mid-November:** Greece runs out of cash (according to widely accepted forecasts)
- Nov 29-30:** Eurogroup/ECOFIN meetings of finance ministers
- December:** scheduled disbursement of troika tranche (€5bn)
- Dec 9:** Euro Summit
- Dec 13:** planned bill auction
- Dec 19:** €1.72bn bond redemption
- Dec 20:** planned bill auction
- Dec 22:** €0.98bn bond redemption
- Dec 29:** €5.23bn bond redemption
- Dec 30:** €0.71bn bond redemption
- By end-year:** details of 50% haircut and 2nd Greek bailout finalised
- January:** possible referendum

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