Sovereign bonds: no longer risk-free?

One of the basic assumptions of modern finance is that bonds issued by sovereigns in the domestic currency have no credit risk. (Such bonds carry zero risk weight under the Basle norms.) Bonds of other issuers are priced at a higher yield, to reflect their credit risks. The rationale for the assumption is that the sovereign would print currency notes and honour its obligations; the resultant inflation would, in any case, diminish the real value of the outstanding bonds.

The first major blow to the assumption was struck by Russia in 1998 when it defaulted on domestic currency bonds. The Greek bond swap completed last week is not comparable to the Russian situation; Greece has no control over money supply given that it uses a supra-national currency, namely the euro. The bond swap is part of the conditions for getting a second tranche of assistance from the IMF/EU, which Greece badly needs: it may be recalled that Greece was the first country whose sovereign debt crisis attracted headlines to the problems in the euro zone.

But this apart, the last week's swap, which wiped out € 100 bn of Greece's sovereign debt (a third of the total), had several interesting features for students of financial markets:

⇒ The exchange of existing bonds for new ones with lower face value, coupon, and longer maturity was, at least on paper, "voluntary" (Its "voluntary" nature reminded me of the famous line uttered by Marlon Brando in *Godfather*: "Make him an offer he can't refuse", by pointing a gun at his head!)

⇒ The European Central Bank and other preferred holders were outside the scope of the swap with most of the burden falling on commercial banks.

⇒ Those who braved Greek – and euro zone – wrath by not volunteering, were also forced to accept the swap under a new "collective action clause" introduced with retrospective effect! (CACs mean that if a large majority of bond holders accept a re-structuring, voluntary or otherwise, the rest are obliged to follow suit.) This could be done only in respect of bonds issued under Greek Law; a small percentage is issued under English/Swiss Law.

⇒ The International Swaps and Derivatives Association (ISDA) has ruled that, inasmuch as the swap was voluntary, it was not a “credit event” and therefore the credit default swaps would not be triggered!

Will the drop in Greek debt solve its debt crisis? The market reaction to the price of the new bonds suggests otherwise: they are being quoted at a hefty discount in the secondary market and yield something like 18% p.a. The IMF/EU are insisting upon further austerity measures including sacking of government servants, faster sale of government assets, etc. Greece faces years of swallowing the bitter medicine prescribed by the IMF-EU, if it does not wish to exit the euro. Elections are looming next month and their results could still upset the rescue deal. To be sure, Greece needs to take radical measures in order to improve its competitiveness within the euro zone. It is not just a question of bringing the sovereign debt down to 120% of GDP by 2020: equally important is the need to bring down the national central bank’s outstanding dues to the European Central Bank (ECB). The way the intra-euro zone interbank clearing system operates, intra-zone imbalances on current and capital accounts are reflected in the national central banks’ balances with the ECB. For example, the Deutsche Bundesbank has a credit balance of € 500 bn with the ECB; the deficit countries are corresponding debtors! No wonder, the Bundesbank has publicly expressed concerns about the poor quality of ECB’s assets.

There is another interesting feature to the ECB’s pumping money into the European banking system. It has made available 3-year refinance facilities aggregating € 1 trn, at 1% p.a., that too with lower quality collateral. Commercial banks have snapped up the funds. The objective was to increase bank lending to households and businesses to increase economic activity: in point of fact, bank lending to these segments has fallen after the re-finance facilities. Banks seem to be using the money to make some easy profits by buying higher yielding bonds. Many of the banks have a huge hole in their balance sheets particularly after the Greek bond swap – and the easy profits coming from the refinance window, are helping to plug the gap between the actual and needed capital.

One big question is whether other countries with unserviceable debts would be tempted to follow suit. (Apparently, Jamaica in the West Indies has done so.) Within the euro zone, Ireland is holding a referendum on the terms on which it has borrowed money from the EU/IMF, and Portugal could as well be tempted. What about Spain and Italy? One thing is clear: the euro zone crisis is hardly over after the Greek bond swap.

Meanwhile, the euro is still trading above $1.30, once again evidencing the lack of strong correlation between changes in fundamentals, and price reactions (the currency had fallen below $1.20 a couple of years back, when Greece first made headlines).

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