
FINANCIAL NEWS



Make way for Trichet bonds

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Difficulty in resolving the debt problems of its weaker states is edging the eurozone ever closer to the brink. Even after the announcement last May of an EU/IMF €750bn sovereign loan support programme, together with appropriate budget-tightening efforts, Greek bonds still trade at around record levels over German bunds of 895 basis points, with Ireland (565) and Portugal (425).



Jean-Claude Trichet

One reason may be that too many investors see the EU as just papering over the problems, while the difficulties with the Germans may be greater than meet the eye.

Upset over the apparent violation of the no-bailout provisions of the Maastricht Treaty, and under strong political pressure, Germany might declare the sovereign support plan to be unconstitutional, forcing it out of the deal and sending everything over the cliff.

Germany does not want to spoil everything, of course, so chancellor Angela Merkel has sought to persuade European leaders to create a new permanent debt resolution treaty to handle eurozone countries with too much debt. We know how hard this is to do from the recent American experience in trying to create an “orderly resolution” process for troubled banks. The task of writing a workable

new treaty that 27 sovereign countries would sign is far more difficult; perhaps impossible.

What is needed instead is a market-based solution to reduce the amount of sovereign debt among the weaker eurozone countries and to ease investor concerns. Such a solution necessarily involves restructuring existing debt through an exchange of old debt for new, lower-cost, longer-maturity bonds.

A brilliant precedent

In March 1988, in an effort to resolve a debilitating international debt crisis, the Mexican government offered to exchange new, 30-year US dollar bonds for outstanding dollar-denominated bank loans at a discount to their face value of about 30%, their approximate market value.

The banks holding the Mexican loans would receive new, tradable bonds, the principal amount of which was collateralised by a 30-year zero-coupon bond issued by and directly acquired from the US Treasury. The banks were offered a menu of variable or fixed-rate payment options for the new bonds which were priced to trade at par.

Mexico had already agreed to programmes of economic reform under the guidance of the IMF in order to improve its ability to service debt in the future. Bank regulators in the US let it be known that they strongly preferred American banks, the largest holders of the loans, to accept the exchange offer.

The debt-for-debt exchange was a big success and was followed a year later by an announcement by US Treasury secretary Nicholas Brady that the collateralised debt restructuring programme would also be available to other “third world” countries similarly struggling with severe credit problems.

Thus the “Brady Bonds” were launched. In time, 17 countries participated in the programme that involved \$130bn of exchange offers. This programme, more than anything else, was responsible for the development of viable access to international capital markets for emerging market debt securities that has been in use ever since.

Time for Trichet Bonds?

Surely the market is waiting for an effort to restructure distressed Greek bank loans as a demonstration case. These loans could be exchanged for new tradable 30-year “Trichet Bonds” backed by a zero-coupon bond issued by the ECB (with the sovereign support fund as its back-up) to guarantee the principal and named after [Jean-Claude Trichet](#), president of the European Central Bank.

The bonds would be issued at a market interest rate, perhaps around 10% (uncollateralised 10-year Greek debt is now trading to yield 11.7%), but they would be exchanged for old ones at their market value (now about 70% of face value).

Lowering the principal amount outstanding by 30% and extending debt service over 30 years should help Greece to service debt over time, but the most important benefit of the exchange would be removing the overhang in maturing Greek paper and the fear of a run on it.

The ECB may have to figure out ways to help the Greeks finance the purchase of the collateral, as was done for some countries with Brady Bonds. The Greeks also would have to agree to accept IMF or some comparable EU-based economic reforms and supervision, but, as in the case of the Brady Bonds, the politics of a nationally arranged voluntary exchange offer are preferable to “cram down” solutions imposed on the debtors by outsiders.

Make banks take the hit

Those accepting the exchange offer would have to book a loss of up to 30% on surrendering old debt. It has been reported that the bulk of the Greek foreign debt is held by German, Swiss and French banks that were among 91 banks that successfully passed the recent European bank “stress test”, though the test was criticised for letting some participating banks fudge their foreign debt holdings.

Regulators, presumably, know the truth and will have encouraged banks to make appropriate write-offs and capital additions, or work with them to do so. The offer will clear market uncertainty about the banks, and the sooner this happens the better.

Failure to find a market-based solution will mean Europe will have to face the prospect of expelling its weaker members from the eurozone or bailing them out – both bad choices to make. Trichet Bonds would not be bailouts (investors take their “haircuts”) and would relieve the immediate pressure on forthcoming rollovers of maturing debt. Make them widely available and the over-indebted countries would have some breathing room to work out of their problems.

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