AXIS BANK

EU DEBT CRISIS UPDATE– COMBATING LEVERAGE WITH MORE LEVERAGE

The information contained here is based on or derived from information generally available to the public from sources believed to be reliable. No representation or warranty is made or implied that it is accurate or complete. This has been prepared solely for information purposes and for private circulation and does not constitute any solicitation to buy or sell any instrument, or to engage in any trading strategy. Markets can be volatile and opinions may change without notice. The opinion expressed here is solely that of the author and does not purport to represent the views of Axis Bank.

AXIS BANK

EU Debt crisis update

Levering the EFSF/Insurance model: The differences between France and Germany

Germany's version- EFSF will issue fresh bonds to raise money to recapitalize needy Banks and fiscally challenged sovereigns. The cost of debt- Bund + 200 bps at the very least, if not more in normal market scenarios. However , given that the bulk of the money will be required to fill in the hole in insolvent Bank balance sheets at times of stress, bond issuance at stressful times is estimated to average Bund + 300 bps and upwards. The EFSF will be used only to help banks and sovereigns in extreme situations. Normal requirement will continue to be fulfilled out of normal borrowing/auction in the open market.

French version – EFSF will issue bonds to ECB, which will subscribe to these bonds at German bunds + 125 bps- 150 bps. The EFSF will now invest in Tier 1 capital of banks out of its entire corpus. France wants the EFSF to invest in French banks so that it itself does not lose its AAA rating in trying to fund banks out of its budget.

The CDS trigger explained- 21% haircut agreed to on all Greek debt in July this year arranged in such a manner so that a formal Greek default is not to be looked upon as a formal CDS default event as per agreement with ISDA.

Now Germany wants 50% haircut for all private bond holders including banks. Without an all party agreement – a fresh agreement that supercedes the July agreement which would purport to say that 50% haircut will not trigger a default event(with ISDA signing off on this) is needed to prevent the 1-1.5 Trillion Notional CDS contracts riding on Greece, the sovereign state. Banks are unwilling to either take a 50% haircut, or make ISDA comply with the fresh request. The G7 cannot dare risk trigger Greek CDS, for it may increase the capital shortfall at banks and FI's even further.

The background needs to be explained. When an investor invests in a bond of an entity he/she does so with the full understanding of the risks associated with the bond- credit/market/legal/collateral risk etc. The entity could be a sovereign and if it defaults, entails the investor to accept the loss on the bond; much as he/she would have pocketed profits, if any.

With this background, let us understand the behaviour of various banks and Financial institutions including Accounting agencies that are responsible for certifying the accuracy of the balance sheets reported every quarter by all banks and FI's. When the going was good, all banks and FI's invested in sovereign bonds at a pricing that seemed to suggest that Greek paper risk was almost at par with German bunds. This was their cardinal sin- lack of due diligence. The argument that goes now is that why should tax payers today foot the bill today for the mistakes that banks made over the last

The information contained here is based on or derived from information generally available to the public from sources believed to be reliable. No representation or warranty is made or implied that it is accurate or complete. This has been prepared solely for information purposes and for private circulation and does not constitute any solicitation to buy or sell any instrument, or to engage in any trading strategy. Markets can be volatile and opinions may change without notice. The opinion expressed here is solely that of the author and does not purport to represent the views of Axis Bank.

decade? The counter to this is that if banks are not bailed out today, there could be a depression era like bank-run in Europe and kill growth for the next decade. So bail out the banks, but punish the shareholders and the managers who were responsible for irresponsible credit allocation, the original sin, for over the last decade. This is the counter-counter argument.

Now here is where the moneyed powers-that-be propagandize it into a class war. They scream "class war". It is not. It is capitalism. But what the money bags want is crony capitalism. And they have the politicians with them. This is the battleground today. The tax payer wants the wrong doers to pay. However the accused pleads "class war". The accused are powerful people and history has it that it is very difficult to hold powerful people accountable after more than 2 decades of wrong doing.

Banks do not want to mark to market sovereign bonds unless the state recapitalizes them at their terms – read: at the cost of tax payers. Cronyism at its best.

The Western world ice-caked it's prosperity with lots of leverage. Now the time has come to repay the lender – and there is no money.

Merkel and her ilk are in the thick of this conflict. To act decisively against all pulls and pressures and to deliver a result that does not hamper growth in the EU is the challenge today.

Whatever be the final form of the EFSF, it will require approval from each and every member state legislature within the EU.

Market positioning

Combating leverage with even more leverage-will eventually lead to higher volatility in the longer end even as it quells volatility in the short term.

To summarize- Since leverage leads to asset price volatility, then we have two scenarios:

1. **An acceptable EFSF leverage is found – leads to a steepening of the vol curve**
2. **No acceptable EFSF leverage – shorter end vols blow out- ECB has to step in with fiat currency to stabilize markets- stabilizes market- buy Butterflies in the short tenor.**

Strategist
Anupam K Mitra, AVP
Axis Bank
Treasury, Global Markets Group
Contact details – 66043222, 42026622. anupam.mitra@axisbank.com

The information contained here is based on or derived from information generally available to the public from sources believed to be reliable. No representation or warranty is made or implied that it is accurate or complete. This has been prepared solely for information purposes and for private circulation and does not constitute any solicitation to buy or sell any instrument, or to engage in any trading strategy. Markets can be volatile and opinions may change without notice. The opinion expressed here is solely that of the author and does not purport to represent the views of Axis Bank.