



McLean Budden Perspective

Why European banks with significant exposure to Portugal, Ireland, Greece and Spain, remain largely un-investible

June 2011

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The Euro is failing in so far as it was designed. The situation in Greece was never expected to happen because deficits were not supposed to be above 3% of GDP and debt to GDP was not supposed to surpass 60%. European authorities had not counted on “misleading” Greek government figures, which “fudged” the numbers. If the problem were limited to Greece, it would be manageable, but it is not. The source of Ireland’s troubles are its outsized and now bankrupt banking sector. In aggregate, the banks’ total assets represented an astonishing 10 times that country’s GDP. The fact the Irish Government took on those banking assets and liabilities during the crisis means the country’s debt has exploded, landing it with a sovereign debt crisis like Greece. Portugal is the most recent case and, when added to fears that Spain might need a bailout, shifts the dynamics from small to big countries where concerns of “too big to bail” start to worry investors, as government liabilities are ultimately taxpayer liabilities.

The original Greek bailout of 110 billion Euros has not worked as planned. The aid package from the International Monetary Fund (IMF) and the European Union (EU) was supposed to settle the markets so that Greece could once again borrow internationally. Such a capability might have allowed Greece to borrow enough to avoid another bailout from the EU. There are numerous reasons why private markets balked at conforming to plan, not the least of which was the EU’s desire to have Greek bonds bought by the European Central Bank (ECB) and European Stability Fund, considered of a higher grade than those purchased by the private market, after 2013. The rationale was to avoid the EU from becoming a transfer union, as feared by the German electorate.

A transfer union is the term used to permanently assist a weaker member, not unlike the way the federal government in Canada transferred money to Newfoundland. Politically it is more acceptable to be doing this within a nation than one nation to another, which is what many Germans fear.

Germany is the creditor nation with the resources to bail out the “Periphery” [formerly referred to as the PIGS (Portugal, Ireland, Greece, Spain) before that term was softened]. Thus all potential losses had to be mitigated to avoid the political fall-out. This display of financial illiteracy quickly led to Greek bond spreads rising for maturities after 2013. Why would an investor not demand a higher yield if they knew their bonds would be inferior to those held by the ECB? The shorter (maturity) end of the market did somewhat better but, in the absence of a virtuous circle, which the longer maturities might have provided, the situation deteriorated as it became obvious Greece would not be able to roll over 75% of its medium to long term debt after March 2012, which the original bailout had envisioned.

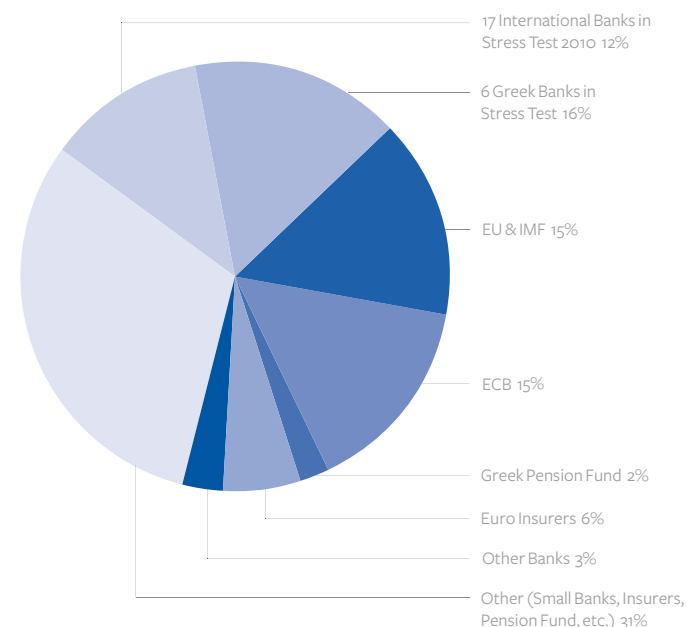
The financial illiteracy was again on display when the EU recently insisted on Greece privatizing its state assets at an accelerated pace to reduce its fiscal deficit. Selling state assets certainly makes sense over time, but selling now, when risks have increased and investors justifiably question the viability of Greece’s participation in the Euro, ensures buyers will demand large discounts. Imagine private equity having to sell assets during the financial crisis after the Lehman Brothers collapse compared to what they are obtaining today, almost three years later.

There are no simple solutions to the sovereign debt crisis because they are all politically challenging to say the least.

To appreciate the scale of the problem, one has to review the European banks’ exposure to Greek debt and the implications of a debt restructuring -- which appear inevitable. Greece has 340 billion Euros of outstanding debt, or 142% of its GDP. Economists are unanimous in saying that only debt relief will allow Greece a chance to get out of this hole.

About 1/3rd of the Greek debt is outside the known banking system, pension funds, insurers and EU, ECB and IMF

Greek Government Debt Exposures as of 31/3/2011 (100% = €340bn)



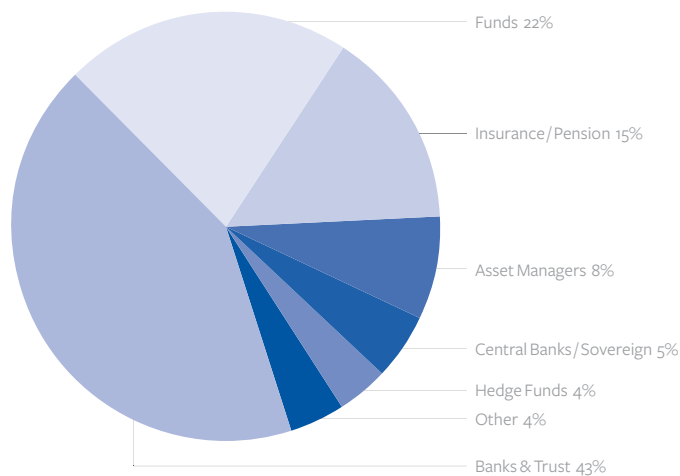
Source: Stress Test results, ECB, EU, press articles, Bernstein analysis and estimates

Note: While the stress test data is fairly robust, the assessment of ECB, Pension funds and insurers are estimates

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... and banks make up only 43% of the initial allocation vs. 49% held by insurers, asset managers and funds.

Initial Allocation of Greek Government Debt '05 - '10 by Type



Source: Hellenic Republic, Ministry of Finance

Using the Maastricht criteria target of 60% debt to GDP, would result in a 196.3 billion Euro reduction in debt, less the 50 billion which is expected to be raised through the sale of state assets. We argue, as noted above, that it will probably be less than this figure.

According to Bernstein Research, Greek banks could not sustain the impact of a debt restructuring costing between 90 and 150 billion Euros, whereas the rest of the listed European banks could.

The problem, however, is also one of politics as the ECB and the EU/IMF each hold 15% of the debt. They would invariably have to be recapitalized. This would also put stress on the viability of the European Financial Stability Facility (EFSF), the vehicle through which the loans are provided to Greece and that are only backed by IOU's. A restructuring would likely result in actual losses being taken, something which is not currently politically acceptable.

A restructuring would set off a "credit event" triggering the exercise of credit default swaps which would likely heighten fears over counterparty risk and pressure the banking sector.

Finally, Greece cannot be viewed in isolation. It has to be addressed with the other Periphery countries (Ireland, Portugal and Spain). The risk of contagion is very large, very real and very unpredictable.

So what are the solutions:

A no nonsense Anglo Saxon approach would see European authorities designing a generous bailout package to negotiate the exit of Greece, Ireland and Portugal from the Euro. There are no legal measures to kick a member out of the Euro but a member can leave. A bailout package would be essential because any departure would lead to a national banking collapse as citizens would surely make a run on their banks before converting back to their old currency, in the accurate assumption that it would quickly be devalued. This would also cause major stress in the European banking sector, with unpredictable consequences.

There is little to no chance of this happening. There is simply not the political will, vision or desire to execute such a strategy, which would be an admission of failure and a step backwards in the founding fathers' attempt to integrate Europe in the quest of keeping the continent sustainably at peace.

A more draconian version of the above, and one many Euro-sceptics have espoused since the introduction of the Euro, is simply to allow its collapse as either Germany refuses any more bailouts or a nation decides to exit the Euro spontaneously. The impact of such an event would be nothing short of another Lehman Brothers, but many times over. The consequences would be so dramatic that this will not be allowed to happen.

Let's keep kicking the can down the road:

The most likely scenario, and the one that regularly plays out when Europe faces a crisis, is to "kick the can down the road". The political will is not there to make the hard and visionary decisions, but there is enough historical baggage dating back to the founding fathers to prevent the dismantling of the European experiment.

In the short-term Germany is proposing a supplemental package for Greece, but is insisting that the private sector participate by extending all Greek sovereign bond maturities by 7-years. Rating agencies have declared such a move be deemed a credit event. The ECB is fiercely opposed to this proposal. It appears that the president of the ECB, Jean-Claude Trichet, fears that a credit event, no matter how much authorities would say it is contained, might be the thin edge of the wedge, in the same way sub-prime U.S. mortgages proved not to be containable in spite of all of the markets key players claiming it would be. A possible solution appears to be a voluntary extension of maturities, but it's difficult to see who would be willing to extend their Greek bond maturities.

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Germany is still likely to extend a further bailout, with more fiscal austerity in return. This process will be repeated because in the absence of debt relief, Greek debt levels will continue to rise while GDP will continue to decline on account of the increased austerity. Greece will still not be able to access the private bond market and will be reliant on the ECB and the EU for funding.

What about the European banks?

Markets dislike uncertainty and the likely process we've outlined suggests there will be no permanent solution to the crisis. Could European banks be coerced into voluntarily rolling over their Greek bonds? That possibility cannot be dismissed. There will be periods when sovereign pressures will dissipate, allowing European banks to rally from arguably very depressed levels.

At some point, the situation will reach a breaking point where a restructuring of the Greek debt, and that of all who comprise the Periphery, will be addressed in a holistic approach. Europe will continue to muddle through, kicking the can down the road and hoping tomorrow will be better than today.

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Contact Information

Toronto

145 King Street West
25th Floor
Toronto, ON
M5H 1J8
Tel 416 862 9800
Fax 416 862 0167

Roger Beauchemin,
President & CEO

Ralph Daghfal
Alan Daxner
Sue Eagleson
Ted Harris
Brad Hicks
Catherine Jackman
David Kilburn
Soami Kohly
Ed Kwan
Bob Livingston
Robert Spector

Montréal

1250 René-Lévesque
Blvd. W.
Suite 3010
Montréal, QC H3B 4W8
Tel 514 933 0033
Fax 514 933 8163

Patrick Fournell
Bill Healy
Alexandre Legault
Benoit Paradis

Vancouver

595 Burrard Street
Three Bentall Centre
Suite 3043
P.O. Box 49105
Vancouver, BC, V7X 1G4
Tel 604 623 3430
Fax 604 623 3436

Doug Andrews
David Davies
Dave Mason
Colin Sinclair

Chicago

4026 N. Bell Avenue
Chicago, IL
60618
Tel 773 866 9210
Fax 773 866 9211

Bruce MacNabb

United Kingdom

Netherwood,
Furze Field Chase
Dormans Park,
East Grinstead
West Sussex, UK, RH19 2LY
Tel 1342 329833
Fax 1342 770579

Stephen Watson

Institutional contacts:

Ontario/Atlantic
Québec
Western Canada
U.S.A.
Global

Alan Daxner
Benoit Paradis
Doug Andrews
Bruce MacNabb
Stephen Watson

Foundations/Endowments contacts:

Ontario/Atlantic

Québec

Western Canada

Global

Ted Harris
Brad Hicks
Patrick Fournell
Bill Healy
Alexandre Legault
Dave Mason
Colin Sinclair
Stephen Watson

Private Client contacts:

Ontario/Atlantic

Québec

Western Canada

Catherine Jackman
David Kilburn
Ed Kwan
Bob Livingston
Bill Healy
Alexandre Legault
David Davies
Dave Mason

Managed Asset Program contacts:

Ralph Daghfal
Sue Eagleson
1 877 8 BUDDEN (283336)

McLean Budden Mutual Funds for Canadian Investors:

Michael Bissonnette
1 800 884 0436

Finance & Administration

Barb Lockhart

