Europe in Crisis

Current Situation

"Time is running out. The set of policy choices that are both economically viable and politically feasible is shrinking as the crisis shifts into a new, more political phase."
~ IMF Global Financial Stability Report

Given the fluid nature of the unfolding European financial crisis, it is nearly impossible to predict with any certainty what is likely to happen next week, let alone next quarter. That said, given the importance of these issues to the global financial markets, we felt it necessary to explain what is going on in Europe and how we are responding to these unprecedented events.

We begin our discussion with an overview of the current debt situation, providing some context where needed. We then discuss what issues need to be addressed, as well as the different options available to address those issues, including some of the impediments to those proposed solutions. We conclude our discussion with an examination of what we believe to be the most likely outcome and what that means for your portfolio.

One caveat before we proceed – the data and conclusions presented below are reflective of the information available to us at the time of the writing of this letter (early October). By drowning out the media-amplified noise and focusing on a few key issues, we aim to provide some insight and, in the process, communicate our strategic thinking as it relates to the crisis and, more importantly, to your portfolio.

While Greece is at the heart of the current crisis, the fear is that these debt issues will quickly spiral out of control, spreading to other high debt/weak economy countries in Europe, notably Portugal and Ireland. There is also a risk, if left unchecked, that this "contagion" could spread to larger, more stable countries, like Italy and Spain. The financial markets are justifiably skeptical of European politicians, who up to this point have done just enough to stave off catastrophe without dealing with the underlying problem – too much debt and not enough economic growth to deal with the debt burden.

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The most pressing concern is Greece, a country mired in recession and grappling with severe (structural) budget deficit issues. These issues are in turn complicating Greek efforts to receive much needed bail out funds from the "troika," a group of European and international institutions[1] that earlier this year agreed to provide Greece with €109 billion to help it meet its short-term debt obligations. However, the disbursement of those funds is tied to Greece meeting certain budget deficit targets, none of which have been met.[2] The greater fear is that the €109 billion is insufficient to handle Greece's increasingly perilous fiscal dilemma and that the political impediments to providing additional bail out funds are such that Greece will ultimately be forced to default on its obligations.

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Depending on how it is handled, a Greek default can be potentially dangerous for several reasons. First, it could spur additional sovereign debt defaults, most likely in Portugal and Ireland (two countries already receiving bail out funds), but also in Italy and Spain, particularly if interest rates spike up in those countries on fears of default, making them effectively insolvent (i.e., fear of default becoming a self-fulfilling prophecy). Second, a default could lead to a banking crisis as many European banks would have to write down the value of their Greek debt to levels that would make the banks themselves insolvent (highlighted in Exhibit 1 next page). While much attention has been focused on Dexia, it is clear that sovereign debt exposure is fairly widespread throughout the European banking system.

What is particularly troublesome is that Europe's interlocking sovereign debt and banking crises are starting to feed into one another, in what market analysts refer to as a "negative feedback

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Exhibit 1: European Bank Exposure to Troubled Debt (€ million)

Bank	Sovereign Periphery Exposure (SPIE)	Periphery Loan Exposure (PLE)	Periphery Total (PT)	TNAV*	SPIE/TNAV	PT/TNAV	Domicile
Credit Agricole	3,261	31,825	35,086	28,612	11%	123%	France
Dexia	6,713	3,894	10,607	8,905	75%	119%	Belgium
RBS	3,533	73,857	77,390	68,752	5%	113%	UK
Danske Bank	89	11,086	11,175	12,103	1%	92%	Denmark
Santander	5,173	33,342	38,515	51,530	10%	75%	Spain
Lloyds BG	169	31,451	31,620	52,223	0%	61%	UK
Barclays	1,838	20,728	22,566	53,781	3%	42%	UK
Intesa SPI	794	9,362	10,156	29,866	3%	34%	Italy
Societe General	5,093	4,830	9,923	34,149	15%	29%	France
BNP Paribas	8,090	3,500	11,590	59,675	14%	19%	France

**Tangible Net Asset Value 2011 (TNAV): seen as the true "loss absorbing" part of the capital base; strips out goodwill.*

Source: CEBS Morgan Stanley Research

loop." Worries that the Greek government will default on its debts is triggering concern that the region's other weak economies may also default. This in turn increases the risk that the region's banks, many of which hold these sovereign bonds, will need to be rescued/recapitalized by their governments, many of which are already struggling with heavy debt burdens themselves.

Issues to be Addressed

Over the short term, the risk of contagion will ultimately depend on the ability of European leaders to "ring-fence" Greece. In order for any "grand bargain" response to be perceived as effective, it must address all of the following issues in some form:

1. Restructuring of Greek Debt. On July 21, an agreement was struck among European leaders for a "private sector involvement" (PSI) scheme in which bondholders would exchange their short-term (3-year) bonds for long-dated bonds (10-year), effectively taking a 21% loss on the value of their bonds. With Greek bonds trading at 40 cents on the dollar on the open market, a more realistic PSI "haircut" would be 50%, given the deteriorating Greek fiscal situation. While this would help ameliorate the Greek funding crisis, it would mean instant insolvency for certain European banks.

2. Recapitalization of Euro Banks. Euro leaders need to make available substantial amounts of capital with which to bolster bank equity to reassure markets that a Greek or Portuguese default would not precipitate a systemic financial crisis. Any recapitalization plan should go much further than the €2.5 billion required by regulators after the Euro bank stress tests in July. JP Morgan estimates that banks will need €75 to €100 billion, while the IMF estimates banks will need €200 billion, with a further €100 billion at risk from interbank exposures. In response to increased pressure on Euro banks, the European Central Bank (ECB) is expected to increase the emergency credit available to banks in need of financing.[3]

3. Enlargement of EFSF. At that same meeting in July, Euro leaders agreed to increase the capacity of the European Financial Stability Facility (EFSF) to €440 billion, €140 billion of which has already been committed to the bailouts of Portugal, Ireland and Greece. In addition, the facility was granted rescue fund powers to recapitalize banks, as well as the ability to buy sovereign debt. Given the new functions/ responsibilities being levied on this facility, its fund would need to be enlarged to €1 to €2 trillion to be able to adequately handle any contagion spreading from the periphery countries to Italy and Spain. Building an effective firewall around these two countries is vital to containing the contagion within Europe.

European leaders aim to have a plan in place by the next G20 summit in Cannes in early November, though it is unclear whether Greece can hold out until then. Longer term, European leaders will need a credible plan to deal with the massive debt overhang and restore growth to the region, if the Euro is to survive. That will most likely include tighter economic, fiscal and political integration among Euro countries, which is dubious at this juncture.

Possible Solutions

- **Leverage the EFSF.** The only way to increase the capacity of the facility to the required €2 trillion level to cover Italy and Spain without having to get approval from 17 different national parliaments is to either turn the EFSF into a bank or link it to the ECB.

  – Turn EFSF into a Credit Institution. Turning the facility into a bank opens it up to outside sources of capital through

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the issuance of bonds or through direct loans with outside credit institutions.

– EFSF/ECB Combination. Link the EFSF to the ECB by allowing the EFSF to borrow money from the ECB's unlimited lending operations, which it could use to inject money into troubled government bonds or banks. Under the "Geithner" version[4] of this plan, the facility would assume an "equity" stake of 20% in holdings of Euro debt (i.e., take the first 20% of losses), supported by loans of 80% from the ECB.

Impediment: The ECB is fighting against pressure to use the bank to supercharge the EFSF. Klaus Regling, chief executive of the EFSF, recently said, "there are serious concerns" that such a scheme wouldn't be allowed under the EU Treaty, which forbids the ECB from financing governments directly. In fact, the ECB's controversial bond-buying program has already caused German conservatives to decry its actions as undermining German independence by straying into fiscal policy.

- **Move up Euro Stabilization Mechanism.** One plan is to move up the start date for the ESM to 2012 from 2013 as a permanent replacement for the EFSF. The ESM will ensure that countries with difficulties borrowing in the markets will have rapid access to loans in conjunction with adjustment programs until they are able to roll over their debts.

Impediment: Euro leaders are still hammering out the details of the ESM and any acceleration in implementation would likely require approval by all 17 national parliaments. The funding of the ESM would most likely mirror the contributions to the EFSF, which are already problematic.

- **Issuance of Euro Bonds.** The issuance of a Euro Bond, backed by all of the Euro nations, has been hailed as a possible solution to the funding crisis. Another version of this plan calls for the separation of insolvent banks from solvent institutions in order to prevent the zombie banks from infecting the financial system, similar to what the U.S. was able to accomplish with its Resolution Trust Corporation to deal with the losses from the S&L crisis in the 80s.

Impediment: Higher contributions would strain the public finances for several European countries. As highlighted in Exhibit 4 below, any future contributions would be made pro-rata, which given the inability of Greece, Portugal, Ireland, and perhaps Italy and Spain to contribute, would mean an increased load for Germany and France, which is in danger of losing its AAA rating if forced to commit additional funds, according to Standard and Poor's.

- **Bank Recapitalization Funds.** Germany has proposed a system of backstops, requiring bank shareholders to put up more equity first, then national governments and, finally, the EFSF rescue fund as a last-ditch lender if national governments do not have the means. In Germany, there is talk of reopening the Soffin bank rescue fund, founded in 2008 with a total of €480 billion in federal guarantees and cash available for bank recapitalization.

Impediment: Few countries would be able to backstop their banks alone, without help from the EFSF. Germany would shoulder most of the liability here and it is not clear German voters are willing to bail out non-German banks.

- **Delay Default.** Postponing a default gives the French and German financial institutions time to build up their capital, reduce their exposure to Greek banks by not renewing credit when loans come due, and sell Greek bonds to the Europea Central Bank.

Impediment: Buying time requires additional bail out funds, since Greece is highly dependent on these funds. Not politically feasible in Germany.

Most Likely Outcome

Perhaps what is most striking when examining the possible short-term solutions is that the largest impediments are oftentimes not economic, but social. As the quote below attests, this is the first true stress test of the Euro experiment.

> **"In the end, Germans are Germans and Greeks are Greeks. Germany and Greece are different countries in different places with different value systems and interests. The idea of sacrificing for the European Union is a meaningless concept. The EU has no moral claim on Europe beyond promising prosperity and offering a path to avoid conflict. When prosperity stops, a large part of the justification evaporates and the aversion to conflict begins to dissolve."**
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> **~ George Friedman, Stratfor, "The Crisis Europe and European Nationalism," September 13, 2011.**

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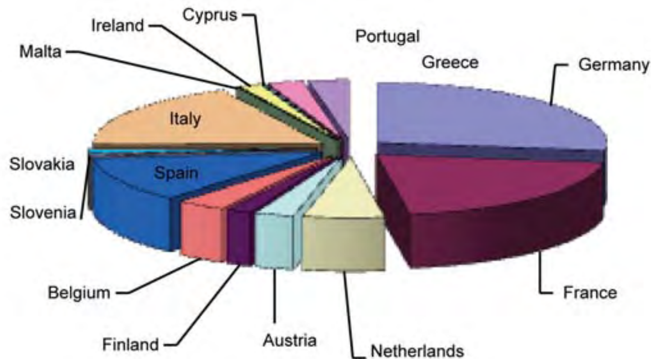
Exhibit 2: EFSF Contributions



Source: EFSF, Thomson Reuters Datastream

Trying to predict which plans are politically feasible is easier said than done because decisions will be based on social and political factors in addition to economic and fiscal factors. That said, as we have seen in recent economic history, crisis affords politicians the opportunity to enact policies that may not be politically expedient in non-crisis times. This crisis may well give politicians the cover to move toward a unified Europe that is more economically, politically and fiscally integrated. Whether Greece, Portugal and Ireland will be part of that stronger union remains to be seen, but it is clear neither the Germans nor the French have any incentive to kick these countries out of the Euro, at least while their banks are exposed to Greek and Portuguese debt.

The timing, duration and ultimate secondary effects of a Greek default are difficult to quantify given all of the considerations listed above. In our opinion, the most likely outcome is that Greece defaults and some combination of the EFSF/ECB steps in to provide temporary relief to Euro area banks to contain the damage. Given the U.S. bank exposure to European banks, it would not be surprising to see the U.S. Treasury or Fed play a role in building a firewall around Italy and Greece, similar to the coordinated central bank moves after the Lehman collapse in 2008. Whether this coordinated action is successful will determine both the severity and duration of any resulting crisis.

Our Response

We have responded to the unfolding crisis by decreasing our exposure to the economically sensitive sectors in the portfolio. This not only takes some risk off the table, but increases our cash levels (more than 25% cash in the global core portfolio), giving the remaining portfolio a decidedly defensive posture. In addition, we don't currently own any stocks in the affected countries, nor do we own any European banks in the portfolio. The portfolio is geared to outperform in the current, volatile market environment by protecting to the downside and participating on the upside when those swings occur. We have plenty of cash and, as in 2009, will follow a disciplined approach to redeploying that capital into quality companies once we feel the macroeconomic issues have been adequately addressed in Europe as well as in the U.S. ▪

[1] Includes the European Commission (EC), the European Central Bank (ECB), and the International Monetary Fund (IMF).
[2] At the time of this writing, the troika is currently withholding a much-needed €8 billion disbursement, which Greece needs to make it through the end of the year.
[3] The last time it was forced to do so was in 2008 in the aftermath of the Lehman collapse.
[4] Proposed by U.S. Treasury Secretary Timothy Geithner at the last G20 meeting to his European counterparts; plan based loosely on the U.S.'s TALF program in 2008.