THE EUROPEAN DEBT CRISIS: IN OR OUT OF THE MONEY? - ABBC

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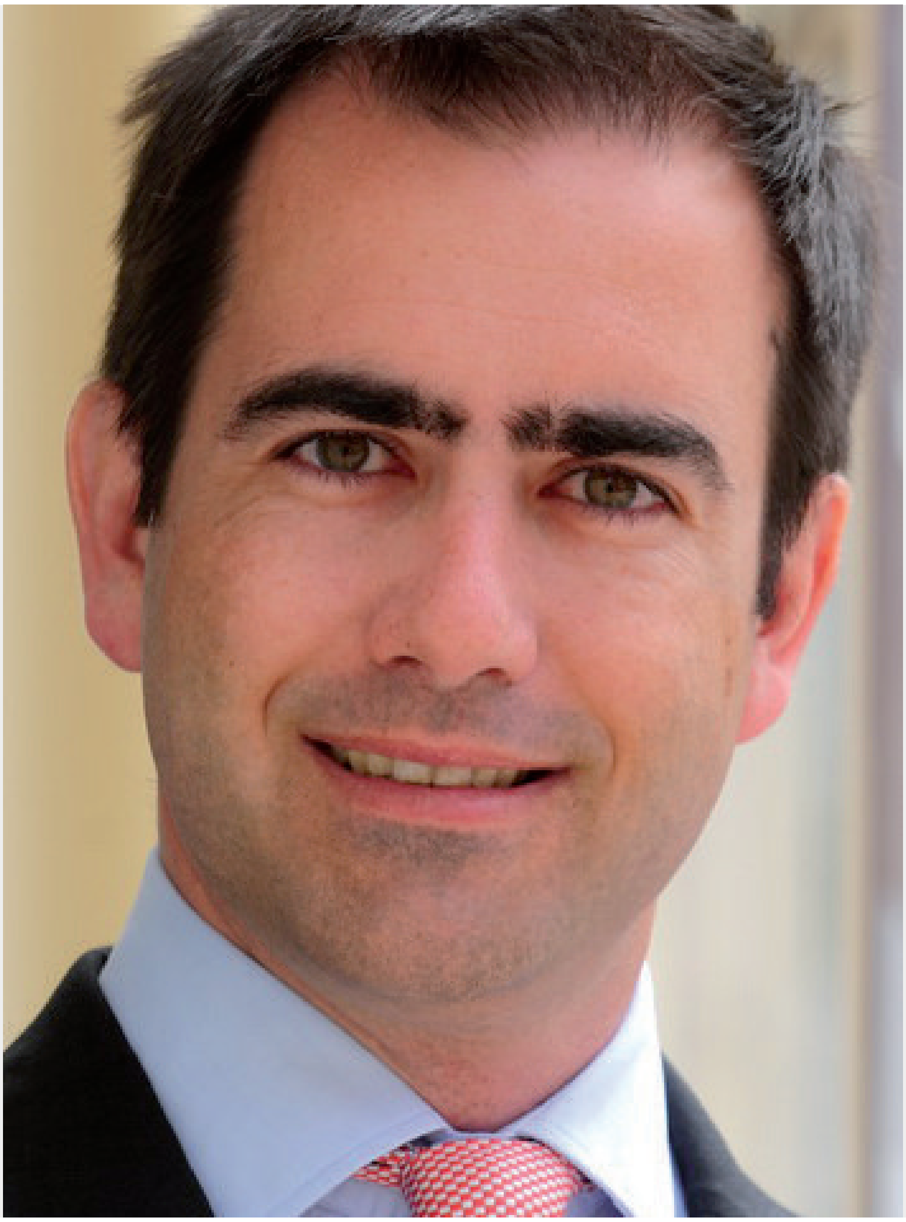

Category: Corporate

As happens with any crisis, the European sovereign debt crisis brings both perils and opportunities. From the investors' point of view, the question is: are you on the right side of the fence?
For those investors with liquidity, in particular investors in distressed debt, there are many interesting opportunities under a careful cherry-picking strategy. The acquisition of distressed debt, which is now available as banks are forced to clean their balance-sheets in order to survive, may grant a

high-rated investment with manageable risks and very appealing possible turnover - for those who are capable of spotting valuable underlying assets.
A selective investment policy driven by the acquisition of assets held by banks and indebted companies with problematic balance-sheets, with harsh credit ratings, short term liquidity problems and associated risk of default, may yet prove very rewarding for some.

As it happens with any crisis, the European Sovereign Debt Crisis brings along perils and opportunities. From the investors' point of view, the question is: are you on the right side of the fence?

We all sure remember when, after September 2008, some people tried to explain what had just happened, and that three main expressions were amongst such explanations: Subprime; Collateralized Debt Obligations ("CDO") and Credit Default Swaps ("CDS"). Then began the hysteria, the world's attention was drawn to financial innovation, and a strong and vehement reaction against over the counter derivative markets rose. Briefly described CDS, a commonly finger pointed as one of the villains, work as a credit "insurance", whereby the buyer will be entitled to receive a payout in case of default of a reference entity. The main difference between an insurance and CDS is that the second ones do not imply that the buyer holds any debt instrument. Thus the buyer of a CDS may not be subject to any kind of credit risk and still be benefiting from protection against such risk. This feature allows the investors, not just to hedge credit risk, but also to trade on cash bonds without actually having to "buy" them.

Several countries reacted more vehemently against CDS and short-selling. The UK and other countries banned short-selling of equities of financial institutions as a reaction to Lehman's knock-out; when European Debt Crisis blew up, Germany responded by banning short-selling of equity of several financial entities, euro-zone sovereign debt and 'naked' CDS positions in that debt. New terms of regulation were inevitable, and two big changes have already taken place: Basel III, which will consume trillions of Euros all around the world, and a new regulatory framework in the European Union, through which it was created the European Securities and Markets Authority ("ESMA"), European Banking Authority ("EBA") and European Insurance and Occupational Pensions Authority ("EIOPA").

In respect of over the counter ("OTC") derivatives, the two main steps are still in the brink of being taken. The European Commission has been working in two regulations whereby short-selling, 'naked' credit default swaps and OTC derivatives in general will be subject to a new legal framework: "Regulation on Short Selling and certain aspects of Credit Default Swaps" and "Regulation on OTC derivatives, central counterparties and trade repositories".

However, despite this strong reaction there are several evidences that the concentration in using CDS has actually exceeded the scenario before the crisis. Concentration risk and lack of liquidity are now the main concerns in the European financial sector, and along comes the opportunity: There is no doubt that European Debt Crisis has no near end at sight, and that the recent bail-outs have given a last push on Greek, Irish and Portuguese credit ratings to red-line levels. As a consequence, these downgrades automatically implies a downgrade in several banks with reflect on overexposed companies with liquidity issues, for whom the sun seems to have stopped shinning. This occurs mainly because national banks that already had public debt in their portfolios were called to buy additional public debt, which is the typical collateral offered by the same when resorting to ECB financing. As so, banks’ exposure is as risky as ever, their financing costs increase and their access to credit becomes more difficult and expensive due to lack of collateral (which may be challenged on the basis of its depreciation) and the banks requested to increase the guarantees offered.

As often happens, it is always possible to seek the bright side of every crisis, and this one is not an exception. For those investors with liquidity, in particular investors in distressed debt, there are many interesting opportunities under a careful cherry-picking strategy. The acquisition of distressed debt, that the banks are now being forced to clean from their balance-sheets in their struggle to survive, may grant a high rated investment with manageable risks and very appealing possible turnovers - for those who are capable of spotting valuable underlying assets. A selective investment policy driven for the acquisition of assets held by banks and indebted companies with problematic balance-sheets, with harsh credit ratings, short term liquidity problems and associated risk of default, may be very rewarding.

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