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In Greece, Some See a New Lehman

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LONDON — Bond traders and officials at the European Central Bank have been unified in their warnings that a restructuring of Greece’s debt would set off an investor panic similar to the one that followed the bankruptcy of Lehman Brothers.

Others, however, have argued that Greece’s debt of 330 billion euros, or $473 billion, while too large for the country to bear, is small enough to allow banks and other institutions to take a loss without bringing the world financial system to its knees.

But the comparisons between Greece and Lehman grew more frequent last week as global markets reeled, spurred in part by the view that Germany’s insistence that private investors participate in a second rescue package for Athens would overcome the objections of the European Central Bank.

“It is a valid concern,” said David Riley, head of sovereign ratings at Fitch. “The Rubicon would be crossed — we would have a sovereign default event and that can be quite a shock, not just for the peripheral countries but for Spain and beyond.”

The thinking goes like this: though banks and other investors have done much to pare their Greek holdings in the last year, if they are forced to take a loss, and the ratings agencies declare Greece in default, investors would start selling in a panic. And they would not sell just the bonds of countries struggling with debt — Portugal, Ireland, Spain and Italy. In a hasty retreat into cash, traders would unload more liquid assets as well, everything from high-grade corporate bonds to American and emerging market equities — as occurred in 2008 after Lehman failed.

To be sure, much has to be wrong for the European debt crisis to approximate what happened after Lehman failed in 2008. Not only did banks, hedge funds and insurance companies immediately seize up, but the effect on the broader global economy was also striking as trade flows nearly ground to a halt.

Analysts point out that the global financial system has survived sovereign defaults in the past, including Russia’s in 1998 and Argentina’s in 2001.

Also, since the prospect of a Greek default has been foreshadowed for so long, financial institutions have had sufficient opportunity to reduce their holdings of Greek debt. But in doing that, the private sector has passed much of the exposure to Greece and other troubled economies in Europe to public sector entities like the European Central Bank and the International Monetary Fund. That means that if a restructuring comes, the taxpayer — more than the private investor — will pay.

Lending weight to the fears of another Lehman crisis, regulators are warning that in such a situation, even super-safe money market funds may not provide the risk-free refuge they proclaim to offer.

According to a recent report by Fitch, as of February, 44.3 percent of prime money market funds in the United States were invested in the short-term debt of European banks. Some of those institutions, like Deutsche Bank and Barclays, do not have dangerous Greek exposure. But some of those funds also hold shares of French banks like Société Générale, Crédit Agricole and BNP Paribas, which do have significant Greek bond holdings — about 8.5 billion euros, or, in the case of BNP and Société Générale, about 10 percent of their Tier 1 capital.

This month, the president of the Federal Reserve Bank of Boston, Eric S. Rosengren, warned that the large share of European banks in American money market fund portfolios posed a Lehman-like risk if, in the wake of a default in Europe, panicky investors took their money out all at once.

"Money market mutual funds have the potential to be impacted should there be unexpected international financial problems emanating from Europe," he said in a speech at Stanford.

The idea that European banks, not those in the United States, would take a hit if Greece defaulted, has sustained a view that such a crisis might be containable. But according to a recent analysis by The Street Light financial blog, this misses the point. It will be American banks and insurance companies that will have to make the lion's share of default insurance payments to European institutions if Greece fails.

Citing recent data from the Bank for International Settlements, the blog points out that in the event of a Greek default, direct creditors would be on the hook for 70 percent of the losses, with credit default insurance picking up the rest. Thus, if one includes credit default exposure, American exposure to Greece increases from $7.3 billion to $41.4 billion.

Again, a pinch of salt: such numbers in no way approach the wild bet that the American International Group made on the United States housing market, a wager that led to the company's collapse. But they are a reminder that, as was the case with Lehman Brothers, the links that directly or indirectly bind investors to Greece extend far beyond Europe.

It is still unclear what type of loss private sector banks would suffer if the Germans overcame the central bank's objections and got acceptance for their proposal for "reprofiling," which would have investors exchange their shorter-term Greek debt for longer-term paper.

The ratings agencies have already determined that if there is any indication that banks are being forced to participate in such a reprofiling, that would constitute a "distressed debt exchange" and violate the terms of the original contract between Greece and its creditors.

But for many investors, such contractual niceties are largely irrelevant. In their view, it is only a question of when, not if, Greece defaults. They are already preparing for the Lehman-style panic that they believe will follow.

"This is not just about Greece," said Steffen Gruschka of SG Alpha, a hedge fund focused on emerging markets in Europe. "It is about the effect that a default will have on credit default swaps in Spain and Italy. You could see a situation where there is a domino effect."

Mr. Gruschka said he had been broadly reducing his equity positions and he now has 70 percent of his portfolio in cash.

The stock market sell-off Friday, in which the Dow Jones industrial average fell below 12,000 for the first time in three months, suggested that Mr. Gruschka was not alone in adopting a "risk-off approach," as investors now term a bias against higher-returning but riskier assets like stocks, commodities and richer-yielding bonds.

Indeed, the data has been suggesting just such a dynamic for a while now.

According to EPFR, a provider of fund flow data, American and emerging market equity funds experienced continued outflows in the first week of June, with investors redeeming $7.74 billion from equity funds and putting $5.98 billion into less-risky bond funds — a 47-week high.

To some, such a material shift suggests that the real worry should be the question of how larger indebted countries outside the euro zone — like Britain, Japan and even the United States — face the challenge of reducing deficits as their economies stagnate.

"We are too fixated on Greece," said Stephen Jen, a widely followed currency expert who is now in the process of setting up his own hedge fund. "You can bail out Greece, but how much is it going to cost to bail out the United States and Japan?"