KIM: Lenders also need to suffer from Greek debt tragedy

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We've heard *ad nauseam* about Greece's ***third*** trip to the brink of default in the past ***five years***. Greece's lenders have demanded Greece be held accountable and pay for its spendthrift ways by suffering the consequences of a draconian "austerity program."

Greece shoulders most of the blame for this "crime," but it takes two to tango and Greece had a *most* willing accomplice; the lenders themselves.

Governments and corporations borrow by issuing bonds, which are a contract between the borrower and lender spelling out the timing and amount of interest is to be paid (i.e. the "coupon") and when the principal amount borrowed is to be repaid (i.e. the "maturity"). Because the amount and timing of the cash flows are contractually set, bonds are referred to as "fixed income" investments.

Although the cash flows are fixed by contract, the price of a bond will fluctuate between the date of issuance and maturity based on ***interest rate risk*** (bond prices fall as interest rates rise) and ***credit risk*** (the risk the issuer defaults).

Unlike with stocks, there is ***no upside*** beyond receiving the contracted payments. The essence of credit analysis is determining if you're being paid enough to compensate you for the risk the issuer defaults. The higher the credit risk, the higher the interest rate you should demand. For U.S. corporate bonds, this compensation is expressed as the interest rate "spread" vs. the comparable maturity U.S. Treasury bond (considered "risk-free"). If XYZ Corp. issues a 5% bond maturing 8/15/2025 when the 10-year U.S. Treasury yields 2.2%, then the spread is 2.8% (which may or may not be adequate compensation).

Let's go way back to April 2014 (i.e. 16 months ago). Greece had been in exile from the world financial markets since March 2010, when it issued bonds just weeks before the markets lost confidence in Greece, forcing its first bailout by the European Union and IMF. However, investors tend to 1) have short memories and 2) over-reach for yield, particularly in this era of ultra-low interest rates. So, Greece decided to test the waters by marketing a 2.5 billion Euro ($3.5 billion) bond issue maturing in 5-years with a mid-5% interest rate.

Hindsight is 20:20, but the results were astounding. More than 550 institutional investors placed orders for more than *20 billion* Euros of bonds ***(eight times more than Greece wanted to sell)***. This enabled The Hellenic Republic to both *upsize* the deal to 3 billion Euros and *reduce* the coupon interest rate to 4.75% a skinny 3% more than Uncle Sam's rate.

Alas, the honeymoon proved short-lived. By the end of 2014 the bonds were trading below 80 cents on the dollar and bottomed at 40 cents in early July 2015. The bonds have rallied to around 76 cents (yield of 13%) on hopes this most recent crisis will be averted with a third bailout.

"Moral hazard" occurs when one person takes more risks because someone else bears the burden of those risks. If investors didn't believe Greece would be bailed-out (if necessary), Greece wouldn't have been able to sell as many bonds and would have had to pay a much higher rate.

If investors aren't made to feel the pain of reckless bets, they will continue making reckless bets.

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