The Parthenon freeze

Did Greece's state pension funds lose their marbles over structured bonds? *Life & Pensions* tells the exclusive story of the backlash over an investment that went wrong

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ON 14 NOVEMBER 2006, the Greek public supplementary pension fund, Teapoka, received a letter proposing an unusual investment. The offer, also made to three other Greek pension funds, set off a chain of events culminating in a criminal investigation, as well as a storm of firings and recriminations at the highest reaches of the Greek government and London-based financial institutions.

Teapoka is typical of what the Paris-based Organisation for Economic Co-operation and Development (OECD) has criticised in a recent report as a 'highly fragmented' Greek pension system. Unlike most other EU countries, the first pillar state pension in Greece is not administered by a centralised government body, but an archipelago of some 200 odd individual funds, associated with different areas of the economy. Although ranging in size from the Social Insurance Institute (IKA) with two million members to Teapoka with 47,000 members, all these funds share a similar governance structure. As the common sponsor for the funds, the Greek government appoints a majority of board members with the balance made up by trade union members representing employees.

With a total of €32 billion in assets, the 200 Greek pension funds may superficially resemble industry-wide occupational schemes found in northern Europe. However, the funds' unique role as first pillar state pension providers makes them far more intertwined with the government than they might initially appear.

Although some Greek public schemes like Teapoka file income and expense statements, their managers typically are unfamiliar with the concept of a pension fund balance sheet, and are uninterested in the services of advisers who could tell them the size of their defined benefit liabilities, or how they might be funded. According to George Kotzamanoglou, one of Teapoka's union-appointed board members, "Teapoka does not employ external advisers".

Indeed, the Greek government itself has little idea of its pension liabilities as the OECD has pointed out. In essence, the 200 schemes operate as an administration network for Greece's pay-as-you-go (PAYG) system, managing the day-to-day cash flows for millions of members and negotiating benefits. The weak controls on liabilities at the funds may have created a 'fiscal time bomb' according to the Paris think tank.

This warning would have gone quietly unnoticed were it not for the scandal that erupted due to the built in governance flaws on the asset side of Greek state pension balance sheets. While encouraged to build up 'reserve funds' to meet obligations, the state schemes received scant guidance on how to link the investments in these funds to their liabilities, but instead were constrained by crude investment limits.

Until the recent scandal, Greek pension schemes were permitted to invest up to 23% of their reserve funds in Greek stocks, mutual funds and property. In Teapoka's case, only 18% of the fund's €658 million assets were invested in this way, with the remainder in government bonds and deposits. With the subsequent problems that emerged with Teapoka's and other pension fund investments, the supervisory process has come under the spotlight.

According to the Bank of Greece, a special committee chaired by the Ministry of Labour and Social Affairs has oversight over equity, fund and real estate investments made by the state pension funds, but the oversight ended there. "The law specifically exempted government and bank bonds from its field of competence," says the Bank. "Pension

funds were fully responsible for their investment decisions. They could freely invest in Greek government bonds without limits." This would prove to be a dangerous loophole in the law.

While undoubtedly safe as investments, the pedestrian returns normally offered by such assets prompted the creation of more unusual investments labelled as government bonds, designed to attract the attention of state pension schemes like Teapoka. "It is important for investments to have stable profit and bigger return than the rate of investment of the Bank of Greece," comments Kotzamanoglou.

And it was one such investment that was offered to Teapoka in November 2006. The letter proposing the investment came from Acropolis, an obscure Athens-based brokerage with a network of business interests across Greece, Cyprus and the Balkans. According to Kotzamanoglou, the letter was signed by Theodoros Priniotakis, the son of the Acropolis chief executive, Soflokis Priniotakis.

Within the constraints described above, the investment seemed compelling and quickly won the approval of Teapoka's board. It would be a twelve-year structured bond, backed by the Greek government. Instead of a yield hovering around the 4.5% mark paid by normal Greek government bonds, it would pay a far more exciting 6.25% for two years – the kind of rate normally associated with risky high-yield bonds. For the remaining ten years of its life, the bond offered the possibility of continued, abnormally high returns of 1.5% higher than the three month floating rates offered by the Bank of Greece on its deposits. But if the difference between two-year and 10-year Greek government bond yields fell below 1%, the return would be four times this difference.

It was not the first time that Teapoka had invested in structured bonds. "Teapoka invested for the first time in structured bonds in June 2005," Kotzamanoglou comments. "The second time was in November 2006. The reason for the investment is complete faith in the Greek state and the profits made up to then." Although he adds that, "Teapoka always consults many banks before investing," the fund was so reassured by the fact that the Greek government was issuing the bond that it did not ask any other financial institution for advice on the Acropolis proposal.

While it is not completely clear what happened next, there is no doubt that in November 2006, Acropolis did actually not have a bond to sell Teapoka. Indeed, the bond that Teapoka would eventually buy did not yet exist. As a broker licensed by the Hellenic Capital Markets Commission (HCMC), the Greek securities regulator, Acropolis lacked the banking license that would have allowed it to take custody of bonds in order to offer them for sale. Moreover, the brokerage apparently lacked access to the circle of primary dealer banks that were permitted to issue such bonds for the Greek government. But armed with expressions of interest from Teapoka and three other state pension funds, Acropolis had little trouble in enlisting support from major international financial institutions to ensure that four months after it first approached the pension funds, the Greek government issued the required bond.

The reason was simple – the four pension funds that responded to Priniotakis' letters were collectively prepared to pay €280 million for their investment. However, the 'CMS steepener' features that made the bond more attractive to the pension funds than a standard 12-year Greek government bond actually reduced its value to around €260 million. Unbeknownst to the pension funds, the €20 million difference could be split among those involved in issuing the bond.

Petros Doukas

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The first port of call for Acropolis was a London-based hedge fund, North Asset Management, which has $1 billion under management. The managing partner of North is a former Morgan Stanley banker called George Papamakakis. From Acropolis' perspective, the fund appears to have been an effective bridge between the provincial world of Athens broking and the international capital markets desks of London.

Sources familiar with the situation say that North received a 'reverse enquiry' from Acropolis, which amounts to a statement that investors in a bond with specific features are ready to buy, if the bond can be obtained at a suitable price. But Acropolis took care not to reveal the identity of Teapoka and the three other pension funds to North Asset Management. As a broker, it would normally have had to disclose the accounts at the Bank of Greece in the name of the four pension funds to which the bonds would need to be transferred once a sale had been agreed. To avoid doing that, Acropolis enlisted the Athens subsidiary of Munich-based Hypovereinsbank (HVB) to set up an intermediate custody account for the bonds. HVB says that its role as custodian meant that it was not

Savvas Tsitouridis

Agapios Simeoforidis

aware of the circumstances of the bond sale, and that its fees were small.

Having received the reverse enquiry involving Acropolis and HVB, North approached JP Morgan, with whom it had a relationship, and which it knew was one of the 22 international banks approved by the Greek government to issue its bonds. There has been some disagreement about what North told JP Morgan it intended to do with the structured bond that was the subject of the reverse enquiry, and how this information was passed between JP Morgan staff. But two things remain unambiguous. Firstly, since North had no idea that pension funds were the ultimate buyers of the bond, there can be no suggestion that JP Morgan knew this either. Secondly, as sophisticated international market participants, both institutions would have immediately noticed an opportunity implicit within the terms of the reverse enquiry.

After a month of stormy sessions in the Greek parliament, the employment and social security minister, Savvas Tsitouridis, was forced to quit.

The payment features that attracted Teapoka – the initial high fixed coupons followed by floating rates calculated according to a special formula – could be easily replicated and priced using interest rate derivatives contracts. And the apparent free lunch of high coupons on the bond was more than paid for by the more likely prospect of very low returns if the yield curve refused to steepen over time.

As a result, this embedded derivative had a negative value of €20 million. By accepting the proposal from Acropolis, Teapoka and the other three pension funds were in effect agreeing that the market intermediaries could enjoy a €20 million free lunch at their expense. Seeing this free lunch on the table, JP Morgan could now play its role and forge the final link in the chain, persuading the Greek government to issue the required bond in return for offering the country's debt managers a share in the free lunch.

With a high level of outstanding debt to service – and until recently one of the highest debt-to-GDP ratios in the EU – the public debt management agency (PDMA) set up by the government's ministry of Economy and Finance was focused on one task above all else: to make Greece's debt costs as cheap as possible. Because the PDMA had a parallel function in maintaining liquidity in Greek government debt, this normally involved scouring the markets for opportunities to issue standard Greek government bonds at the cheapest possible rates.

However, there was another way for Greece to reduce its debt costs using structured bonds. Sophisticated investors – for example, private wealth managers – will perform extensive research to determine if the market prices of structures such as the CMS steepener pitched to Teapoka are distorted in some way, perhaps due to temporary supply and demand factors. Such informed investors might be prepared to bet on taking a short-term hit with the confidence that price distortions will soon be corrected, yielding healthy returns for a small level of risk.

The existence of these sophisticated investors allows bond issuers to cheapen their funding costs. With the help of an arranging bank, issuers package a structured bond that includes a derivative allowing the investors to take their chosen bet. But the issuer does not take the other side of the derivative contract. Instead, this is hedged out by the arranging bank, and the short-term hit accepted by the informed investors is passed on to the issuer which pays a below-market interest rate on its borrowings, while the bank earns a fee as well as a spread on the derivatives trade.

The Greek finance ministry has made it clear that it believed the Acropolis reverse enquiry, communicated via JP Morgan, to have been of

this type. According to a statement released by Greece's deputy finance minister, Petros Doukas, "As in many developed countries, the Greek state, in order to reduce the borrowing cost, very often receives proposals by the primary dealers to issue special bonds. Structured bonds are an attractive investment product, internationally established and not some product one wants to get rid of."

The proposal passed on to Doukas' team by JP Morgan was especially attractive, according to Doukas. "The borrowing cost was lower by 17 basis points than the borrowing cost of the Greek State for the respective period, saving interest expenses amounting to €5 million for the loan's repayment." The proposal would be handled not by the PDMA, but by an obscure unit called D23 based in the Greek government accounting office, which was allowed to borrow independently for military procurement purposes.

Four months had passed since Priniotakis' letter first landed on Teapoka's doorstep, and the proposal was now being implemented as a bond issue by D23, only a mile or so from Teapoka's offices. But the distance might as well have been to Mars as far as the gap in sophistication between Teapoka and the Greek government funding agencies, and their advisers, was concerned. As Doukas concedes, "The bond without the swap had a lower value" – €20 million lower, a far bigger discount to face value than would be accepted by an informed speculative investor.

On 6 February 2007, the bond issue finally took place, with the €280 million cash proceeds passing to the Greek government, and the newly-minted securities passing in the opposite direction through the intermediaries' accounts in a matter of hours. Of the €20 million difference between the bond's face value and market value buried within the associated swap that JP Morgan put in place, €5 million was used to reduce the Greek state's borrowing costs. The remaining €15 million was apparently split between JP Morgan, North Asset Management and Acropolis, although neither of these institutions will comment on this.

With the structured bond in their accounts, Teapoka and the three other pension funds were happy. Despite the government-imposed investment restrictions on risky assets, they had the above-market returns they wanted – in Teapoka's case, over 27% of its assets were invested in structured bonds in May 2007. And they had documentation that they believed to be proof that the bond was worth the full €280 million they had paid for it. According to Kotzamanoglou, "Teapoka never discovered that the bond was mispriced. The Bank of Greece, up to March 2007, valued the bond at 100%."

This statement – which could be interpreted as a suggestion that the Bank had a duty of care to inform Teapoka of the correct price – draws a strong response from the Bank. "Regarding the possible mis-pricing of certain bonds, we would like to state unequivocally that the Bank of Greece is not responsible for pricing any bonds. This is particularly true in the case of the bonds referred to by Teapoka.

We learned about the existence of this structured bond only because the Bank of Greece was chosen by Teapoka as its local custodian. In this capacity and only for the purpose of Teapoka's portfolio revaluation, we transmitted related information received from the global custodian (Clearstream) because of the absence of an organised market where this bond could be traded."

This information appears to have included the face value of the bond, which Teapoka apparently thought was a statement of market price. What is clear is that by late March, the true value of the structured bonds bought by Teapoka and the other pension funds was somehow disclosed to the market.

The question of the commission received by Acropolis was widely discussed in Athens, and the HCMC investigated the broker. On 18 April, the regulator revoked Acropolis' license for what it described as, "Serious breaches of capital markets legislation," adding that it could not discuss the case further because, "The details are currently being reviewed by a prosecuting judge."

This decision effectively put the Greek unit of Acropolis into liquidation, but attention had already shifted elsewhere. On 20 March, Agapios Simeoforedis, the chairman of Teady, one of the four pension funds involved, resigned. On 28 April, after a month of stormy sessions in the Greek parliament, the employment and social security minister with overall responsibility for state pensions, Savvas Tsitouridis, was forced to quit.

JP Morgan, meanwhile, had sought to ringfence itself from the taint of mis-pricing. On 28 March it made a statement to the finance ministry stating that it was ignorant of the Acropolis reverse enquiry, and that it believed North Asset Management would be a 'buy-and-hold investor' of the bond. On 20 April, the US bank offered to buy the bonds back at their market value of around €260 million, and to unwind the associated swap.

"Given the questions about what happened with this bond after North Asset Management purchased it, our offer to repurchase the bond and terminate the swap will facilitate the best outcome for all concerned," JP Morgan said in a statement. Arguably, this offer was hardly likely to be viewed as the 'best outcome' among the four pension funds that were being asked to lock in a loss of €20 million for their members.

But meanwhile, JP Morgan had to contend with an infuriated North Asset Management, which on 18 May issued its own press release refuting the account given by JP Morgan to the finance ministry, stating that the, "Intended sales [of the bond to Acropolis] were communi-

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cated by North to JP Morgan at a senior level.” The hedge fund added that it was willing to participate in the buyback of the bonds by JP Morgan and would, “Forgo the profits it made on the sale of the bonds.”

By 24 May, JP Morgan had retracted its earlier characterisation of the hedge fund as a ‘buy-and-hold investor’, and dismissed a junior salesman, Mike Savvides, for not sharing knowledge about the transaction with his superiors. The bank also accepted that its earlier buyback offer was unrealistic. JP Morgan now joined forces with North and the two institutions collectively proposed to buy back the bonds from the four pension funds at 100% of their face value. With Acropolis now shut down by its regulator and immersed in a criminal investigation, it was in no position to participate in this offer.

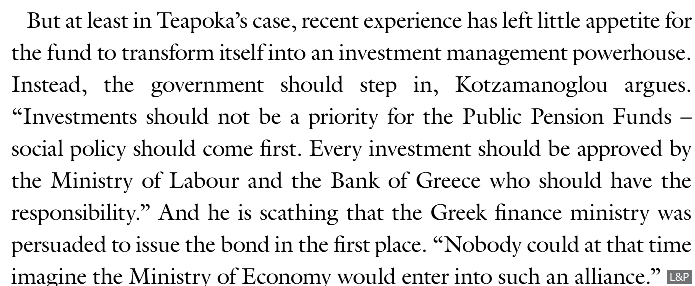
Such a voluntary restitution of profit in the absence of a lawsuit is unusual in the caveat emptor world of the wholesale capital markets. But this was a far from typical case. The continuing furore in Greece – readily exploited by the country’s socialist opposition – was causing real embarrassment to JP Morgan and North, even though they had not directly sold the bonds to the pension funds. Both institutions had good commercial reasons to present a positive image to pension funds generally, but instead were being forced to dispatch their senior officials to defend their actions to a Greek parliamentary inquiry.

Addressing the inquiry on 12 June, JP Morgan’s European chief operating officer Jakob Stott explained, “We regard this as an extremely generous proposal on the part of JP Morgan – it was not something we were legally required to do rather we felt that it was the right thing to do.” But if JP Morgan and North expected the four pension funds to be grateful for the 100% buyback offer, they were wrong. Teapoka still refuses to accept any valuation for the structured bonds apart from the face value description given by its custodian. It wanted to know why JP Morgan was not paying its share of the accrued 6.25% interest promised in the bond’s documentation.

In the words of Teapoka’s Kotzamanoglou: “Teapoka received an offer from JP Morgan for only 100% of the amount paid, less the interests of the first trimester (€1.25 million). At first Teapoka asked for 100% of the amount paid, plus the interest of the first trimester. Then it asked for 100% of the amount paid, plus the interest that the Bank of Greece would have paid for the first trimester if the amount was deposited in the Bank of Greece. In both occasions JP Morgan refused, although the interest was already credited by the Greek State.”

JP Morgan responded angrily to this stonewalling. “The pension funds’ management has shown complete disregard with respect to the interests of their stakeholders, not only in their original investment processes but also in their repeated decisions to reject a generous proposal,” the US bank said in a statement. The Bank of Greece says that from 3 May 2007 it ended its practice of providing Clearstream prices to customers for non-traded bonds, requiring pension funds, “To rely on their financial advisers for the estimation of the prices.”

On 8 June, the Greek finance ministry stepped in and offered to bridge the gap between JP Morgan and the pension funds, and pay the interest. This offer was accepted by all four funds. According to Kotzamanoglou, “Our response could not be other than acceptance regardless of our personal views. One reason for that is that our money is drawn from the Greek State budget”. Meanwhile, other banks involved in the sale of structured bonds to Greek pension funds have also made buyback offers. Stung by the scandal, the Greek government has now proposed reforms to the country’s pension system, although the measures still fall short of what the OECD has suggested. In the near term, the old asset limits and governance loopholes will be abolished, and in future, structured bonds will be limited to 2% of assets, and pension funds will be allowed to invest in non-Greek assets for the first time.



But at least in Teapoka’s case, recent experience has left little appetite for the fund to transform itself into an investment management powerhouse. Instead, the government should step in, Kotzamanoglou argues. “Investments should not be a priority for the Public Pension Funds – social policy should come first. Every investment should be approved by the Ministry of Labour and the Bank of Greece who should have the responsibility.” And he is scathing that the Greek finance ministry was persuaded to issue the bond in the first place. “Nobody could at that time imagine the Ministry of Economy would enter into such an alliance.” L&P