Credit markets have a message for European officials wrangling with investors to cut Greece’s debt: You will get a deal, but it may not be the one you want.

Trading in Greek bonds and credit-default swaps suggests that while investors are betting an agreement will be reached, some bondholders are unlikely to enter into it voluntarily. That could lead to a technical default under the arcane rules of the credit markets, an outcome that European officials have been working hard to prevent.

European officials have aimed for voluntary agreement in part because it allows Greece to avoid the stigma of officially defaulting on its debt. Such an agreement also would mean bondholders had no right to make any claims under credit-default swaps, which offer insurance-like protection for bondholders in the event of a default. Trading in these swaps, known as CDS, has been vilified by European officials who see them as the domain of unscrupulous hedge funds seeking to profit from the region’s troubles.

Expectations that a default still is in the cards can be seen in rising prices on Greek CDS. The cost of insuring $10 million Greek bonds for five years has risen to $7 million from $6 million over the past six weeks, according to pricing service Markit.

Traders say the higher costs of insuring against a Greek default reflects a growing belief that some bondholders, mainly hedge funds, won’t voluntary agree to the deal. Some hedge funds have been purchasing short-term Greek debt, angling to profit from delaying a restructuring agreement and triggering CDS payments.

Should the hedge funds not sign on to a restructuring, Greece may need to force holdouts into a deal. That turn of events would likely be considered a default under the rules of CDS contracts and trigger a payout of the swaps.

Regardless of the possibility of hedge-fund holdouts, Greece is focusing its efforts on banks and asset managers, which own the majority of the bonds.

Those talks are entering their final stages, but key areas remain unresolved, people involved in the discussions said on Thursday. Pressure is rising to reach an agreement in time to be implemented before Greece has to pay holders of €14.5 billion ($18.6 billion) of bonds maturing in March.

"We are quite concerned about the lack of a clear process," said Charles Dallara, managing director of the Institute of International Finance, which is negotiating on behalf of...
more than 400 banks. "All parties really do need to come together here...and it has to be done in the next few
days."

A senior Greek finance ministry official said the talks are "on track" and that a final outline may be reached by the
end of next week.

Officials are pondering whether to add sweeteners to help convince investors to agree to the deal, under which
many would have to take big losses. Under the current proposal, bondholders would accept an exchange of old
bonds for new ones with maturities ranging between 20 and 30 years and a coupon of 4% to 5%. The exchange
would slice roughly €100 billion off Greece's total public debt—50% of what it owes private creditors.

Potential carrots Greece might use to entice bondholders include higher interest rates on the new bonds or
warrant-like instruments that would make additional payments if Greece hits economic growth targets, according
to people involved in the negotiations. The two sides have agreed on one sweetener: Bondholders who participate
in the restructuring would receive 15% of face value in a cash payment, the people said.

Panos Giannopoulos, a European interest-rate strategist at Credit Suisse AG, expects Greece will have to use some
form of "coercive mechanism" to drag hedge funds into any agreement. Greece could pass new laws to impose the
restructuring on all bondholders—which would trigger CDS payments—or levy other penalties.

Meantime, Greek bonds are trading as if a deal, at least with the banks, will get done. Most bonds are trading
between 21% and 24% of face value, according to Markit.

That is about what bondholders could expect to recover. They will lose about 50% of face value when the bonds
are swapped, but the new bonds also will be worth less to bondholders because their maturities are much longer.
The expected recovery is anywhere between 30% and 35% of face value, according to bondholders.

Bondholders also are factoring in the risk that no deal gets done and Greece defaults in a disorderly fashion, in
which case they may face even deeper losses. And they also are worried that even if a deal gets done, Greece's
economic woes will force a second restructuring in the future.

"The market is pricing in some probability of [a voluntary restructuring], but...further down the road you have
more restructuring risk," said Zoeb Sachee, head of European government-bond trading at Citigroup in London.
At the same time, the market "is also allowing for some sort of forced restructuring or even a hard default."

The positioning by hedge funds in Greek debt is thought by market participants to account for a relatively small
percentage of the country's bonds held in private hands, perhaps totaling around 10%.

One trader described recent hedge-fund activity in Greek bonds as coming in "dribs and drabs." Investors say that
the market for Greek debt remains extremely illiquid with little trading.

Some hedge funds have been snapping up debt that comes due in March, betting that if they hold out of the bigger
restructuring, Greece may end up repaying them in full. Those bonds are trading at 40% of face value.

"In theory you would stall the process to the point that Europe has no choice but to pay the bond on March 20 or
face default at the same time," said Sohail Malik, a portfolio manager at European Credit Management in
London, who currently doesn't have bets involving Greece.

Some hedge funds are also buying debt issued by Greece under international law. They differ from the other
bonds because the terms would allow investors to sue Greece in U.K. courts to demand a full payout. They also
trade at about 40% of face value.

While there may be profits to be had, there is a significant public relations risk for hedge funds that hold up the
Greece restructuring.

If there's enough public outcry, "Politicians could want to make an example out of this," said Mr. Malik.

—Stephen Fidler contributed to this article.

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