

The recapitalization of Greek banks

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Abstract

Because of the impending haircut on Greek government bonds, and of the large fraction of non-performing loans, Greek banks are likely to be insolvent on aggregate. Calls for increased state ownership of the banking system as a long-run solution to the problem should be resisted: state control distorts lending decisions of banks and hinders their effective regulation. Data on Greek banks' holdings of Greek government bonds confirm the costs of state influence. Recapitalization should proceed promptly as follows. Solvent banks should be required to meet their Basel capital ratios, and in a way that involves not only asset sales but also injections of fresh capital. Banks that are insolvent but not deeply so should continue operations, existing equity should be set to zero, and capital ratios should be restored through injections of capital. In either case, existing equity holders should be given the chance to provide the necessary capital before public funds are injected. The process should be monitored carefully by the troika to ensure good corporate governance in the banks that receive public funds. Banks that are deeply insolvent should be liquidated through a good bank/bad bank scheme.

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Introduction

One of the main reasons why the recession in Greece is so deep is the difficulty that firms have to borrow from banks. Greek banks are extremely constrained in their lending because of the losses that they have realized or are expecting to realize in their asset portfolios. The losses stem from banks' holdings of Greek government bonds, as well as from banks' non-performing loans (NPLs) to the private sector.²

According to the Bank of Greece, the aggregate capital of Greek banks was 47 billion Euros in September 2011. Moreover, Greek banks held 58 billion of claims (bonds and other loans) on the Greek government, and their loans to the Greek non-government sector were 251 billion. Assuming a haircut of 50% of government debt, the losses on claims to the Greek government would be 29 billion Euros. Provisions for NPLs were 18 billion in September. Assuming that actual NPL losses turn out to be equal to NPL provisions, Greek banks have exactly zero capital on aggregate, based on these numbers ($47-29-18=0$). Moreover, these numbers are likely to understate the extent of the losses. Indeed, the haircut on government debt is likely to exceed 50%, and NPL losses are likely to exceed the provisions. Assuming a haircut of 60%, for example, and NPL losses of 25 billion, Greek banks are insolvent on aggregate by 13 billion.

Restoring the Greek banking system back to financial health is crucial for the good functioning of the Greek economy and for exiting the current crisis. But how should this be done?

The Perils of State Control

Some politicians and commentators argue that an essential element of the solution is greater state control of banks, e.g., in the form of state ownership of some key banks. A few go even further and argue for a nationalization of the entire banking system. Moves in this direction would be disastrous and set the Greek economy many years back. Indeed, state control of banks is harmful because it opens the door to political influence and corruption. For example, state-controlled banks can be coerced to channel credit to politically connected firms and to the government, even when such loans have little economic merit. Moreover, managers of state-controlled banks can be chosen based on their political connections rather than their banking skills, and politicians can prevent bank regulators from monitoring effectively state-controlled banks. For all those reasons, state control of banks is harmful, and this has been confirmed by a number of academic studies. For example, La Porta et al. (2002) find that greater state ownership of banks predicts low growth of GDP and of productivity across a cross section of countries.

Of course, the state has an important role to play in safeguarding the good functioning of the banking system: banks must be supervised so that they do not take excessive risks with depositors' money. This role, however, should be performed by an independent regulatory authority, which in the case of Greece is that Bank of Greece. Regulatory authorities should be well staffed, accountable, and independent from politicians and banks. The effective supervision of banks cannot be accomplished by state ownership of banks. State ownership has, in fact, the exact opposite

² Non-performing loans are loans for which the borrower has missed some payments.

effect: it hinders effective supervision because political pressures prevent regulators from monitoring vigorously state-controlled banks.

The control of banks by the state has been declining in Greece. Yet, the state's influence is still present, and its costs are visible. Consider, for example, banks' holdings of Greek government bonds (GGB). Table 1 shows the five largest Greek banks in terms of 2010 assets: National Bank of Greece (NBG), EFG Eurobank, Alpha Bank, Piraeus Bank, and Agricultural Bank of Greece (ABG). State influence is largest for ABG and NBG. (NBG has been privatized, but the state retains control through minority holdings of state pension funds, as can be seen, for example, by the fact that top management changed after each of the 2004 and 2009 national elections.) One would, therefore, expect that ABG and NBG can be pressured more easily by the government to buy GGB, and hold larger amounts of GGB in their portfolios. This is confirmed in Table 1: ABG ranks first in terms of GGB holdings as a percentage of assets, while NBG ranks third and only slightly below Piraeus Bank. Large holdings of GGB harmed the banks because they precluded their effective diversification across the Eurozone, and left them overexposed to the risk of default by the Greek government.

Table 1: Assets and holdings of Greek government bonds (GGB) of the five largest Greek banks. (Numbers are in billions of Euros. Assets are from annual reports. Holdings of GGBs are calculated from annual reports and interim statements.)

	National Bank of Greece	EFG Eurobank	Alpha Bank	Piraeus Bank	Agricultural Bank of Greece
Assets	121	87	70	58	31
Holdings of GGB	13.5	7.5	3.0	6.9	5.7
Holdings of GGB as % of assets	11.2	8.6	4.3	11.9	18.4

While state control of banks is harmful in general, some state involvement in the Greek banking system is unavoidable in the current crisis. Indeed, Greek banks must raise new capital. Perhaps some banks will be able to raise private capital, but many will not, and this capital will have to come from the Greek state as a loan from the troika. The Greek state will hence need to have a say on the management of the banks, in exchange of providing the funds. The process, however, must be structured carefully to avoid the perils of political interference.

Efficient Recapitalization

An efficient recapitalization program should have different prescriptions for different banks, depending on their solvency. Assessing solvency requires measuring assets and liabilities, a process which is difficult, especially in the case of assets. It is essential to have a relatively precise assessment (currently performed by Blackrock), and to act upon it promptly. We distinguish three cases.

1. **Solvent banks:** Banks for which assets exceed liabilities should be required to meet their Basel capital ratios, i.e., their equity capital should be at least 8.5% of assets. Moreover, this target should be met mainly by raising fresh capital and not by asset sales.

Asset sales by one bank create a negative externality for other banks and firms: they reduce asset values, and hence reduce banks' ability to lend, deepening the recession. Policy makers should take the externality into account and mandate a minimum level of capital that banks should raise---in absolute terms and not as percentage of assets.

If banks fail to meet their Basel capital ratios and to raise the minimum level of equity capital from private sources, then two options should be considered. One is a debt/equity swap, where the bondholders of a bank convert their debt into equity. A second is that the Greek state acquires equity in the bank. The two options are closely related: since much of the debt of Greek banks carries guarantees by the Greek state, the Greek state would be bearing the losses and hence should be acquiring the equity.

The provision of capital from private and public sources should be negotiated in a coordinated manner for each bank, and all capital providers should receive equal treatment. For example, if private capital is 60% of the new capital and public capital the remaining 40%, then 60% of the new shares should be given to the providers of private capital. The new shares should be issued at a discount relative to the price at which the bank's stock is traded, hence diluting existing equity holders. Dilution is necessary because of the debt overhang problem: the providers of new capital must be compensated for the fact that some of their capital is likely to go to bondholders.

A recapitalization plan in which the Greek state acquires equity will succeed only if political interference is minimal. The state's record in that respect is poor. The state's participation is currently through the Hellenic Financial Stability Fund (HFSF). The HFSF should be well staffed and be given appropriate powers, independence and accountability. It is important, however, that the process is monitored carefully by the troika, both through its appointees at the HFSF and through board members that the troika should appoint at the banks where public funds will be injected. This will help ensure good corporate governance during the transition stage until a bank is sold again to the private sector. *It is essential that the financial assistance that Greece is receiving is used to improve corporate governance, and not as a vehicle to return to bad practices of the past.*

2. **Banks that are insolvent but not deeply so:** Banks for which assets are lower than liabilities but not by much should typically be allowed to continue their operations. The existing equity should be set to zero, and Basel capital ratios should be restored through injections of fresh capital and possibly debt-equity swaps. As in the case of solvent banks, existing equity holders should be given the chance to provide the necessary capital, and if not enough private capital becomes available, public funds should make for the rest.

A recapitalization plan along these lines was performed successfully in the UK in the context of the 2008 crisis. The UK state acquired equity stakes in Royal Bank of Scotland and Lloyd's,

and changed the top management in those banks. It has already sold some of its equity stake.

As in the case of solvent banks, the troika should exercise careful monitoring through its appointees at the HFSF and at banks' boards. The top management of a bank should be changed in a number of cases. The bank should be restored to health and the state should sell its equity stake to private investors in a few years. It would be desirable that some of the equity is purchased by long-term strategic investors, including other Eurozone banks. Indeed, as Calomiris et al. (2004) point out, entry by foreign banks carries many advantages: (a) new capital is injected in the banking system, (b) competitive pressure on domestic banks is increased, and (c) bank regulation is improved and enforced more strictly.

3. **Deeply insolvent banks:** Banks for which their assets are much lower than liabilities should be closed down. The state should compensate the depositors and sell or settle the loans to recover some of the compensation proceeds. The existing equity should be set to zero. The rationale of liquidating deeply insolvent banks is that the insolvency is likely to reflect the poor quality of the banks' management and to also signal poor future investment opportunities.

The liquidation can be done through a good bank/bad bank scheme, as was done in Sweden in the 1990s (Calomiris et al. 2004). The good bank keeps the deposits, which are covered by a government guarantee, and possibly some good loans. The bad bank keeps the remaining assets, and converts them gradually into cash. The Greek state has followed this route recently in the case of Proton Bank.

The good bank/bad bank solution was successful in Sweden in that the bad bank's assets were liquidated promptly and efficiently. But as Calomiris et al. (2004) point out, efficient liquidation requires an efficient justice system and a strong regulator that can withstand political pressures. In comparable situations in Mexico and Indonesia, the liquidation of assets was slow and inefficient. Given the institutional weaknesses in Greece, the good bank/bad bank solution is likely to be problematic especially if used at a large scale. At the very least, the bad bank should be well staffed and be given appropriate powers, independence and accountability.

References

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