GREECE’S CREDIT CYCLE – IMPLICATIONS FOR REGULATION AND POLICY

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Outline

- Greece’s credit boom (2000-2008) and crunch (2009-present).
  - Review of key facts.
  - The credit cycle in an institutionally weak economy.
  - A grim credit outlook.
  - Policies for the short/medium run.

- Greece’s financial development.
  - Performance of Greek financial markets and institutions.
  - Policies for the long run.
Credit Boom

Banks’ private-sector loans (households and non-financial corporations) to GDP:

- Greece:
  - Lowest starting point in EZ.
  - Fastest growth in EZ after Ireland and Spain.
  - Similar to EZ average in 2008.

Source: ECB
Credit Boom and the Economy

Drivers of the economic boom after Euro entry:

- Private credit overtook government spending and EU transfers as main driver of the boom.

Composition of Credit Boom

Breakdown of banks’ private-sector loans to GDP by category (households vs. non-fin. corp.) and growth of each category:

- Greece: Breakdown in 2008 same as EZ average.
- Fastest growth in EZ in loans to households (consumption loans and home mortgages).

Source: ECB
Banks’ Risk Exposures

- Private-sector loans:
  - Fast growth in loans to households and SMEs.
  - New borrowers with limited credit histories.
  (IMF, FSSA for Greece, 2006)

- Government bonds:
  - Only Greek bonds – lack of diversification across the EZ.
  - Holdings increased in the run-up to the crisis.
Lack of Diversification

Domestic government bonds held by banks as % of EZ government bond holdings:

Greece: Least diversification in EZ.

Credit to Government

Greek banks’ holdings of Greek government bonds and loans to the Greek government:

- Credit to government increased from 35bn in 01/2008 to 58bn in 04/2010.
- Credit to governments increased for the other GIIPS as well.

Source: BoG.
For the aggregate of Greek banks:
- Core tier 1 capital as of 12/2011 was 22bn.
- PSI losses were 38bn.
- PSI rendered Greek banks insolvent.

If Greek banks had been holding a well-diversified government bond portfolio:
- Insolvency could have been avoided.
- Less severe credit cycle.

Effects of State Control

- Ratio of credit to government to core tier 1 capital:
  - 3.03 for aggregate of state-controlled banks. (NBG, ATEbank, Postbank)
  - 1.71 for aggregate of privately-controlled banks. (Eurobank, Alpha, Piraeus, Emporiki, Millenium, Geniki, Attica, Probank, Proton, FBB, Panellinia)


- (Based on this measure) State control:
  - Did not result in more stable banks.
  - Made credit cycle more severe.
Credit Crunch

- How severe is the credit crunch?
  - % of non-performing loans (NPLs).

- How quickly is deleveraging taking place? Are NPLs being resolved quickly, through restructuring or liquidation?
  - Incentives of banks to “extend and pretend”.
  - Bankruptcy code.
NPLs

NPLs, expressed as % of banks’ private-sector loans in 12/2008:

□ Ireland is highest. Greece is next highest and the fastest growing.

Sources: ECB and PwC, European NPL Outlook, 10/2013.
Deleveraging

Banks’ private-sector loans (households and non-financial corporations) to GDP:

- Large reductions in Ireland and Spain, partly because of creation of public “bad bank” (NAMA, 40% of GDP; SAREB, 10% of GDP).
- Small increases in Greece, Italy and Portugal.

Source: ECB and BoG
Advantages of Public Bad Bank

- Better incentives to resolve NPLs.
  - Banks are forced to recognize their losses since NPLs are transferred to bad bank at (or close to) market value.
  - If NPLs remain with the banks, with no forced write-downs, then banks have an incentive to “extend and pretend”, i.e., not restructure or liquidate the NPLs.
    - NPL resolution hurts banks’ regulatory capital and can force them to issue more shares, diluting their shareholders.
    - Bad bank does not have such an incentive: its only mandate is to resolve the NPLs.
- Banks can make new loans.
  - Selling the NPLs to bad bank frees up regulatory capital for new loans.
- Overall:
  - Reduction of debt overhang.
  - Better allocation of credit.
Public Bad Bank in Greece

A public bad bank has not been created in Greece because:

- Market for distressed loans is illiquid.
  - Ireland, Spain: Many homogeneous real-estate loans.
  - Greece: Heterogeneous loans to households and SMEs.

- There was not enough money (from the 50bn aid package to banks) to create bad bank.

(IMF, Greece Selected Issues, 06/2013)
Incentives to “Extend and Pretend”

- Banks’ incentives to “extend and pretend” must be addressed.
  - Force write-downs through creation of public bad bank or otherwise.
  - Do this in a uniform and transparent manner across banks. Spain offers a good model (e.g., royal decree of 05/2012).

- This is likely to require extra capital and further dilution of shareholders.

- But the alternative is many years with a non-functioning banking system and no growth.
Bankruptcy Code

- Does bankruptcy code support efficient resolution of NPLs?

- Households: Katseli law (3869/2010).
  - Collateralized loans (home mortgages): Loan amount is reduced to 85% of collateral value.
  - Uncollateralized loans: Borrower’s assets, except first home, are used for debt repayment. Borrower is discharged of any remaining debt.
Household Bankruptcy Code: Pros

- Better to reduce principal, than leave it unchanged and reduce interest payments (as per recent laws).
  - Restores positive equity of borrowers, and improves incentives to repay the loan and maintain the collateral.

- Better to discharge borrower of any debt that remains after assets are liquidated, than keep him/her liable until full debt is repaid (as in Spain).
  - Improves incentives to generate future income (e.g., find a new job or start a firm).
Household Bankruptcy Code: Cons

- Long delays to take cases to court. (Court dates currently set to 2023!)
  - No payments due until case goes to court.
  - Strong incentives for strategic default.
  - Weak incentives to maintain the collateral and to invest. (Debt overhang)

- Evaluated by low-level courts, staffed by judges with insufficient training.
  - Huge variation in decisions, especially given that law leaves large discretion to judges.

- Foreclosures of collateral are currently prohibited.
  - Negates basic principle of collateralized lending.
  - Direct cost to the taxpayers since banks are taxpayer-financed.

- Delays and judge training are also key problems with corporate bankruptcies.
Credit-market problems are exacerbated by recent increases in real-estate taxes.

Collateral values decrease:
- More loans become distressed, with negative borrower equity.
- Borrowers will lack collateral to obtain new loans.

Some of the proceeds of the tax will eventually go to cover the losses that banks will incur because of the reduced collateral values.
Credit Outlook

- Large and growing pile of NPLs in Greek banking system.

- Hard to see how this pile will be cleared:
  - Banks prefer (and are pressured) to avoid write-downs.
  - Bankruptcy involves long delays.
  - Home foreclosures are prohibited.
  - Collateral values are being reduced sharply by real-estate taxes.

- Grim outlook for credit (and hence for economic growth), unless above problems are addressed.
Financial Development

- Financial development measures the quality of a country’s financial markets and institutions.
  - Laws protecting investors.
  - Financial regulatory agencies.
  - Financial literacy.
  - ...

- Large academic literature documents strong link between financial development and economic growth. (See, e.g., survey by R. Levine in the Handbook of Economic Growth 2005.)

- Brief overview of some financial development measures for Greece.
Investor Protection and Corporate Governance

  - Extent of disclosure.
  - Extent of director liability.
  - Ease of shareholder suits.

- Corporate governance quality index (De Nicolo et al., IMF WP 2006).
  - Disclosure of accounting information.
  - Earnings opacity.
  - Stock price synchronicity.

- Greece scores low (tied bottom with Netherlands on IP, bottom on CGQ).
  - But significant recent rise in IP score (from 3.3 in 2012 to 4.7 in 2013).

- Effects: High cost of capital for firms and high barriers to entry.
Household Portfolios

Relative to their EZ counterparts, Greek households:

- Invest the least in financial assets as % of total assets.
- Invest the most in real assets (mainly real estate).
- Have the smallest holdings of liquid assets relative to income.

Household Portfolios (cont’d)

Composition of households’ financial asset portfolio:

- Greece has:
  - Largest share of deposits.
  - Smallest share of mutual funds and stocks (⇒ Least trust in financial markets?)
  - Smallest share of voluntary pensions (e.g., individual retirement accounts).

Summary

- **Main objective for the short/medium run:**
  - Efficient resolution of NPLs.
  - Well-capitalized banking system.

- **But should not lose sight of the longer-run issues:**
  - Efficient design and enforcement of investor-protection laws.
  - Strengthen financial regulation (transparency, accountability, conflicts of interest, resourcing, etc).
    - Current plans to centralize regulation at EZ level should help.
  - Cut links between politicians and banks.