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WHAT SHOULD BE DONE WITH GREEK BANKS TO HELP THE COUNTRY RETURN TO A PATH OF GROWTH?

EMILIOS AVGOULEAS and DIMITRI B. PAPADIMITRIOU

The battered Greek banks will soon face another round of recapitalization, yet the prospects for a return to their precrisis role as liquidity providers to the economy are unlikely. In this context, it is imperative to remind the country's creditors and the officials at the European Central Bank's Single Supervisory Mechanism, which assumed oversight of Greek banks at the beginning of the year, of the pitfalls of previous recapitalizations. Greek banks began receiving direct aid from the state as far back as 2008. The aid, however, especially in terms of cash injections, was miniscule compared to the levels that capital infusion and extension of guarantees reached in the brief period before and after the private sector involvement (PSI) debt restructuring in late 2011. Greek banks had rather imprudently become significant holders of Greek bonds in the post–2008 period and suffered serious losses due to the PSI haircut. Despite direct cash infusions to Greek banks that have so far exceeded €45 billion, with corresponding guarantees of around €130 billion, credit expansion in Greece has failed to pick up.

EMILIOS AVGOULEAS is a research associate at the Levy Economics Institute of Bard College and professor and chair of international banking law and finance at the University of Edinburgh School of Law. DIMITRI B. PAPADIMITRIOU is president of the Levy Economics Institute.

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There are two obvious reasons for this failure: first, the massive (€130 billion) exodus of deposits from 2010 to August 2015, more than €40 billion of which was withdrawn this year after currency uncertainty resurfaced (with some of it used to meet tax obligations); and second, the continuous recession—mainly the product of strongly deflationary policies dictated by international lenders' Memoranda of Understanding (MOUs), which successive Greek governments agreed to implement.

However, blaming the liquidity crunch facing Greek corporations solely on this string of unfortunate events is misleading, as it masks another unpleasant story. The recapitalization of Greek banks—which have suffered from all sorts of governance failures (both before and after 2008), including allegations of self-dealing and crony banking (evident from lending scandals that culminated in a number of prosecutions of senior bankers and businessmen)—did not conform to the accepted international practice adopted under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the European Union's Bank Recovery and Resolution Directive, and the standard bank restructuring practice followed by the US Federal Deposit Insurance Corporation before 2008.

The infusion of colossal amounts of borrowed public money into the banking sector was not followed by wiping out the value of the old controlling shareholders, firing the incumbent management (regardless of culpability), or the radical restructuring of bank loan portfolios. The recapitalization in 2012–13 involved the injection, in two installments, of borrowed cash in the vicinity of €40 billion. The decision by creditors to allow the old, now minority, shareholders and incumbent management to retain effective control of Greek banks is highly questionable. This rather unusual governance approach in a post-rescue period meant that the Greek banking system did not benefit from any cleanup efforts, especially in light of the interlocking and privileged relationships some bankers enjoy with Greek political, media, and economic interests.

Even more important, bank governance was riddled with perverse incentives. Sitting on the ticking bomb of ever-expanding nonperforming loans (NPLs), Greek banks failed to adopt the measures necessary to restructure their loan portfolios. The extraordinary level of NPLs is the manifestation of the continuous deflation of asset values and the evaporation of household income and corporate profits caused by the ongoing and deepening recession and ensuing unemployment, together with the increased tax burden on the private sector. Greek banks refrained from recognizing the severity of their NPLs for fear of recording massive losses on balance sheets that were already very stressed. In addition, they behaved in the classic tradition of a typical banker who, while sitting on top of a mountain of hidden NPLs, stops lending. According to Bank of Greece statistics, in the first eight months of 2015, household lending, mortgage lending, and corporate lending were all lower than the year before, while the country's economy continued to shrink.

The obvious way to rehabilitate Greek banking following the new round of recapitalization scheduled for November/December of this year is the establishment of a "bad bank" that can assume responsibility for the NPL workouts, manage them, and in some cases retain them to maturity and turn them around. This would allow Greek banks to make new and carefully underwritten loans, resulting in a much-needed expansion of the credit supply.

This method is not ex post theorizing, since it has sound empirical foundations. It has worked well both in Sweden, where it brought to speedy resolution the early 1990s Scandinavian banking crisis, and in the United States post 2008, with the Troubled Asset Relief Program making a small profit for the public purse while winding down.

In light of the robust evidence provided by other countries' experiences, the approach so far adopted in concert with the requirements of the previous MOUs—which, on the one hand, allow bank management and minority shareholders to continue business as usual and, on the other, acquiesce to creditors' insistence that all NPLs are identical and have to be written off in one fell swoop—is flawed. In view of the forthcoming recapitalization, Greek bank NPLs should be transferred to and managed by a bad bank–type fund that enjoys government guarantees, which ought to be withdrawn from the recapitalized banks. Under this scheme, Greek borrowers would be offered an effective way to restructure their borderline loans while banks could avoid writing off all NPLs, with significant consequences for their balance sheets, and instead have the loans objectively valued and transferred to the bad bank. In addition, creditors would not have to face an unduly inflated Greek bank rescue bill, and the investment that Greek taxpayers have made and will make in the banking sector would not be entirely wiped out.

Sound bank recapitalization with concurrent avoidance of any creditor bail-in—which under the current circumstances would prove catastrophic—and implementation of robust and

sensible corporate governance changes could help the Greek banking sector return to financial health. It would also be an effective first step in returning the country to the path of growth and would eliminate any remaining doubts about Greece's euro membership. Each of those developments would translate into fewer NPLs in the future and a gradual return of the dozens of billions of euros that have left Greek banks since 2010 and are now in safe deposit boxes and proverbial "under the mattress" storage.

The recapitalization of Greek banks—perhaps the most critical problem for the Greek state today—has entered its most critical stage. Instead of repeating the mistakes of the past, recapitalization should create an environment of hope amidst renewed efforts to repair the Greek economy. Any failure of the Greek government, the European supervisors, and, above all, the creditors to do so will have grave consequences for Greek savers, Greek businesses, and the country's euro membership.