CEPS COMMENTARY
Thinking ahead for Europe

Restructuring the Greek banking sector with an empty purse

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Greek banks are close to collapse, even if a new bail-out programme is agreed soon. The deterioration of the economy means that their fragile capital position is deteriorating further. Any new programme needs to include recapitalisation, comprising possibly a bail-in and restructuring to get the banking system working again. With only a small part of the assets unencumbered and a government with empty pockets, the depositors might have to take a large part of the burden. As private investors are unlikely to participate in a recapitalisation, foreign official funds will be needed. A direct equity investment by the EIB or the EBRD could be used to transfer control rights and special ESM bonds could be used to provide additional capital without entailing additional risk to the creditors.

Since the escalation of the country's debt problems in 2010, the Greek banking sector[1] has been suffering. At the beginning of the crisis, Greek banks appeared to be the innocent victim of the government's default. Their large holdings of government debt had to be written down when the PSI (private sector involvement) operation of March 2012 forced them to accept a haircut of over 50%. After 2012, the economy continued to deteriorate for a while, leading to a massive increase in non-performing loans (NPL) and losses. However, these losses were compensated by a recapitalisation with EFSF/ESM funds, leaving the government (via its Hellenic Bank rescue fund) with a dominant ownership in the remaining four large banks, which account for 90% of the sector. In 2014, when the economy seemed to have stabilised, private investors were so confident that they poured €8.3 billion into the sector, somewhat diluting the government's stakes, but allowing the banks to pass the ECB/EBA stress test.

The private investment in 2014 was based on the expectation that the Greek economy was stabilising, thus stemming further losses and that the robust recovery foreseen for this year would soon allow the banks to become profitable again soon. However, given the political uncertainty created by the elections of January this year and the continuing threat of a default and potentially a Grexit, the economy has tanked and deposit flight has set in. The banks are thus confronted simultaneously with a liquidity problem and mounting losses.

[1] Greek banks still hold substantial investments in banking operations abroad. These investments have been little affected by the Greek crisis. But the value of these foreign investments has fallen along with the generalised decline in the sector since 2008.

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The bank run should abate if there is a new programme. But the closure of the banks, and the capital controls, have already done irreparable damage to the economy. This implies that non-performing loans are bound to increase considerably, eating up the small capital buffers. The banks are thus likely to be insolvent very soon even if a new programme materialises. This leads to a tangle of legal and political problems given the unfinished state of the Banking Union.

Since the end of last year, the SSM (an arm of the ECB) is the supervisor for the four large Greek banks and it thus the responsibility of the SSM to declare that these banks are "failing or in danger of failing". The Single Resolution Mechanism (SRM) would then supervise any restructuring. But any restructuring plan would have to be implemented and financed by the Greek authorities.

The key immediate problem is that any finding of the SSM that the Greek banks are failing (or in danger of failing soon) would require the eurosystem (i.e. technically the Bank of Greece) to immediately call back all ELA. But this would mean a shutdown of the entire banking system.

What is needed is thus a recapitalisation/restructuring plan, executed ideally over a weekend, under which the banks would recognise the losses resulting from the deteriorating economic situation and either find sufficient additional capital, which today can be estimated at about €15 billion, or bail in enough creditors to be able to reopen immediately with a viable capital position. This would then allow ELA (emergency lending assistance) to continue, and would open the way to a slow return of confidence and deposits under a new programme.

However, it is impossible to restructure banks with an empty purse.

Under EU rules, deposits are guaranteed up to €100,000. Given that all large deposits have already fled, this implies that the Greek banks have few liabilities left that could be bailed in. Moreover, the government clearly does not have the means to guarantee the remaining deposits (of around €150 billion).

This means that the banks will need to receive an infusion of capital from either the Greek government or the ESM. An infusion of Greek government bonds is unlikely to restore the confidence of depositors, which leaves a recapitalisation by the ESM as the main alternative.

However, the creditors are understandably reluctant to provide additional capital for a banking system that is draining funds and whose assets (loans to Greek companies and households) could be rendered worthless by government action (the government could – indeed has – announced a moratorium on collateral seizures, or any change in bankruptcy legislation). One solution to this 'time-inconsistency' problem would be to provide Greek banks with special, non-tradable ESM bonds as new capital. These bonds would have a special provision: they would not be payable in case the Greek government decides to exit the euro area or undertakes any measures that materially affect the solvency of the banks.

An infusion of these special ESM bonds could thus take care, partially, of the credibility and time-inconsistency problem. What remains is the governance problem: given the political situation in Greece, the Hellenic Bank fund (HFSF) will be under enormous pressures and objective conflicts of interest. It might thus be best to transfer the formal ownership of the banks to either the EBRD or an investment arm of the EIB. This could be done via an infusion of a (small) quantity of real equity capital from these institutions. An equity stake by these two European institutions should also increase the confidence of Greek savers, accelerating the return of deposits.