How the SYRIZA-led government privatized Greek banks

JANUARY 3, 2016
MIRANDA XAFA

In this photo taken in January 2015, leader of SYRIZA left-wing party Alexis Tsipras speaks to his supporters after his election victory outside Athens University Headquarters. (AP Photo/Petros Giannakouris)

After lengthy negotiations that lasted through the summer, Greece's radical left SYRIZA government and its creditors reached an agreement last August to secure €86 billion in bailout funds. Within this total, €50 billion were set aside to recapitalize the Greek banks, which had suffered massive deposit withdrawals prior to the imposition of capital controls in late June, funding pressures, and a sharp rise in non-performing loans (NPLs) as the payment culture deteriorated in response to Grexit fears. Greece and the troika of program monitors —the European Commission, European Central Bank (ECB) and International Monetary Fund (IMF) — went out of their way to speed up the bank recapitalization part of the agreement in order to avoid triggering new "burden sharing" rules on Greek depositors that went into effect on January 1, 2016.

The rush to avoid hitting the new Bank Resolution and Recovery Directive reflects the Single Supervisory Mechanism's (SSM) reluctance to impose a haircut on uninsured deposits in excess of €100,000 that belong to Greek corporations and would negatively affect economic activity. This aggressive timeline to recapitalize Greek banks risked imposing losses on taxpayers in order to protect Greece's depositors. The Greek taxpayers' existing stake in the four systemic banks, valued at €25.5 billion in May 2013, faced certain dilution, as did €8.3 billion in fresh capital injected by private investors in the spring of 2014, ahead of the ECB's Comprehensive Assessment of all Euro area bank balance sheets. Asking all four

systemic banks to raise funds at the same time in in a risk-off market environment ahead of the Fed's tightening cycle, and before the Greek government had shown a clear commitment to the program by concluding the first review, including bank-related reforms, appeared to be a hard sell.

This was the third Greek bank recapitalization in as many years, each agreed as part of rescue packages funded by official creditors. The first one, finalized in May 2013, followed the debt exchange of 2012, which recognized the losses incurred by Greek banks in the government bond portfolio. The Greek state, through the Hellenic Financial Stability Fund (HFSF), acquired majority stakes in each systemic bank through direct capital injections of €25.5 billion, funded by the ESM. A second bank recapitalization took place in April 2014, ahead of the SSM's Comprehensive Assessment of all Euro area banks. It was entirely funded by private investors, who acquired a 27 percent stake in Greek banks by injecting an €8.3 billion of equity.

Value destruction

The third recapitalization process begun in the fall of 2015, with the SSM's Comprehensive Assessment of Greek bank balance sheets, including an asset quality review (AQR) and stress tests to assess the capital shortfall, which was estimated at €14.4 billion, including €4.4 billion under the baseline scenario and €10 billion under the adverse scenario. "Covering the shortfalls by raising capital would then result in the creation of prudential buffers in the four Greek banks, which will facilitate their capacity to address potential adverse macroeconomic shocks," the ECB said in a statement, adding that a minimum of €4.4 billion, corresponding to the AQR and baseline shortfall, was expected to be covered by private investors. Indeed, a total of €9.1 billion was raised from private investors, including €3.4 billion raised by bailing-in junior and senior bondholders.

Two banks, Alpha and Eurobank, were able to raise almost all their capital needs from private sources, while the other two relied more heavily on state support. Reaching deeper into the prudential tool kit, for recapitalizing Greek banks by bailing-in bondholders, may have discouraged equity investors from participating at the offering, for fear that bondholders would immediately sell their newly-acquired shares, thus depressing their price and creating an opportunity for equity investors to buy shares in the secondary market after the offering.

The remaining €5.3 billion — largely representing the adverse stress test scenarios for two of the four banks — were provided by the Greek state (via the HFSF) using a portion of the €86 billion bailout funds. The bulk of the capital requirements contributed by the HFSF were met through contingent capital instruments (CoCos) rather than direct capital injections. Contingent capital, a form of hybrid capital recognized as loss-absorbing by the Basel Committee, requires no bailout funds from the ESM unless specific economic conditions are

triggered. In theory, this form of capital helps preserve taxpayers's existing stake in the banks by limiting new share issuance. In practice, the shareholders' existing stake already had all but evaporated.

Bank share prices, which had fallen massively during the year, sunk to new lows ahead of the November offering. Private investors, who had already lost money in the 2014 recapitalization, were not inclined to participate in the new offering unless they acquired control of the banks at fire-sale prices. The chosen book-building process, with no effective minimum price set, succeeded in minimizing new taxpayer funding at the cost of complete dilution of the Greek taxpayers' existing stake in the four systemic banks. But this was only the final stroke in a lengthy process of value destruction. The €25.5 billion invested in banks in May 2013 had already largely evaporated ahead of the offering due to Grexit fears that triggered deposit withdrawals of €43 billion since September 2014 (a drop of 26 percent) and a steep rise in NPLs to €107 billion (55 percent of GDP) according to the ECB. Valued at the share prices of the 2014 recapitalization, the HFSF's stake in the four banks was worth €18.5 billion in the spring of 2014. By the end of the year, after SYRIZA triggered early elections by voting against the country's Presidential candidate, the HFSF's stake was worth €11.6 billion. Following protracted and fruitless negotiations with creditors after SYRIZA won the January 2015 elections, the share value dropped to €7.5 billion at the end of June 2015, when capital controls were imposed. Valued at the price of the November 2015 recapitalization, the shares acquired in 2013 were worth €747 million, leaving the state holding a minority stake in each bank. The state's stake in Alpha Bank fell from 83.7 percent in 2013 to 11 percent, and in Eurobank from 95.2 percent to just 2.4 percent. Recapitalizing Greek banks using contingent capital instruments for the entire €10 billion capital requirements under the adverse scenario would have limited the dilution of existing shareholders — and the loss for Greek taxpayers — but it is not clear whether this option was explored.

As the Chairman of the ECB's Supervisory Board Daniele Nouy has stated, the need for recapitalization had nothing to do with the Greek banks themselves. They were found to have sufficient capital in the Comprehensive Assessment that was conducted before the ECB took over the supervision of Euro area banks in November 2014. Deposit outflows started in October 2014, when early elections appeared likely and radical left SYRIZA campaigned on a defiant platform that rejected austerity and promised demand stimulus instead. Grexit fears intensified ahead of early elections in January 2015, which SYRIZA comfortably won, and during the protracted negotiations with Greece's official creditors that lasted through the summer. During this period NPLs rose sharply.

Looking forward

Looking forward, recent economic data shows that the 2015 recession was more shallow than feared. GDP growth in the first half year surprised to the upside as

private and public consumption rose. Even though growth in the second half has been negatively impacted by fiscal tightening and capital controls, consensus estimates suggest that growth for the year as a whole will be around -0.5 percent rather than the -2.3 percent underlying the program (revised to -1.4 percent in the European Commission's Autumn Forecasts). The economy is projected to remain in recession in 2016, with an upturn expected in late 2016 provided the program is fully implemented. Assuming confidence is rebuilt, capital controls could be lifted later this year giving a boost to the economy.

Nevertheless, important challenges lie ahead. First, politically difficult reforms need to be implemented as prior actions for the first review, including comprehensive pension reform and an increase in the taxation of farmers. Second, successful conclusion of the first review is a precondition for discussions on official debt relief, which should help smooth out a hump in Greece's debt service payments starting in 2023. Yet debt sustainability and market re-access would also require further fiscal consolidation and growth-oriented reforms that the government has not so far embraced. Lastly, recent legislation permitting home foreclosures even for the primary residence of borrowers who are not in financial distress is only a first step toward cleaning up bank balance sheets. Further steps are needed to improve loan recoveries and accelerate bankruptcy procedures. The World Bank's Doing Business report ranks Greece fairly low in the areas of enforcing contracts and resolving insolvency. Bankruptcy procedures in Greece succeed in collecting 34.9 cents per euro on average, compared with 90.1 in Finland, 83.7 in Germany and 73.4 in Finland. Commercial disputes take longer to get resolved than almost any other country on the planet – 1,580 days on average. Hopefully the 2015 recapitalization of Greek banks will be the last that will be needed in the foreseeable future, but this positive outcome is contingent on difficult policy decisions ahead.