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Banks resilience and economic downturns : Lessons from Greece and Cyprus

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Banks resilience and downturns

- Enhancing the resilience of the banking sector, and particularly the ability of banks to absorb losses, is absolutely necessary for protecting the financial stability and consequently the real economy.
- CRD IV and CRR which introduced Basel III requirements into the European Union regulatory framework were important steps taken after the financial crisis of 2007-2008.
- BRRD which introduced a harmonized and comprehensive crisis management framework for credit institutions, was another important milestone for enhancing the resilience of the European banking sector.
- The Eurozone crisis which erupted in Ireland, Greece, Cyprus and Portugal, brought into light the weaknesses of the framework within Eurozone and led to the much needed initiatives of SSM and SRM.
- The current presentation will focus on the banking crisis in Greece and Cyprus and the measures taken to enhance the resilience of the respective banks.

A. The Greek case

The sovereign issue : main indicators in 2009

	GDP growth %	Public Debt as % of GDP	Fiscal Deficit as % of GDP	Current Account deficit as % of GDP	Inflation	Unemployment
2008	-0.34%	109.4%	-9.4%	-14.9%	4.2%	7.8%
2009	-4.3%	126.7%	-15.4%	-10.9%	1.3%	9.6%

- The debt crisis which hit Greece in late 2009 was an accident waiting to happen.
- Greece had the worst rank among euro area members regarding : Public Debt , Fiscal and Current Account Deficits.
- During 2001-2009, Greece's competiveness loss against its trading partners was about 30%.
- Facing an unprecedented sovereign crisis, in mid 2010 the Greek government agreed on a support program with EC, ECB and IMF.
- In the absence of fiscal integration and flexible labor and product markets, this program called for :
  - Fiscal discipline and
  - Structural adjustment.

Greek banks were sound prior to 2009

	Assets in €bn	Assets as % of GDP	CAR	NPL ratio	LTD	Household Debt / GDP	ROA
2008	425	176%	9.59%	5%	114.2%	50.3%	1.6%

- Main financial and regulatory ratios of Greek banks were sound prior to 2009.
- Greek banks did not have a significant capital impact from the financial crisis of 2007-08 as they had only minor exposure to the US subprime market and other complex structured products.
- Contrary to other countries' experience it was the sovereign's weakness that caused problems to the Greek banks.

After the eruption of the sovereign crisis the Greek banks were about to face liquidity problems and capital problems.

The liquidity problem: main issues

- Reliance of Greek banks to Eurosystem funding was negligible prior to the international financial crisis of 2008 :
  - Eurosystem funding at 2006 : €4.8 bn
  - Eurosystem funding at 2007 : €8.8 bn
  - Eurosystem funding at 2008 : €40.5 bn.
- During 2008 due to the global liquidity crisis, Greek banks as other banks increased substantially their central bank funding.
- From 2009 when the Greek sovereign crisis erupted, the Greek banks faced increasing liquidity pressures due to :
  - Downgrading which led initially to a limited access and later to a complete shut down of wholesale market funding
  - Uncertainty which led to an outflow of deposits . From 2009-2015 deposits were reduced by close to 45% (- €100 bn).
- Collateral for participating in the Eurosystem's monetary policy operations took a hit both in value as well as in eligibility status.
- In June 2015 the uncertainty over the participation in the Eurozone led to a government's decision of imposing capital controls.

The liquidity problem: measures

- The liquidity problem during the 2007-2008 crisis was addressed by :
  - Eurosystem funding (monetary policy operations)
  - State support : Law 3723/08 to enhance the collateral of the Greek banks :
    - ✓ Issuance of bank bond guarantees worth €15 bn.
    - ✓ Greek Government bonds worth €8 bn.

- The pressures after 2009 were addressed again by Eurosystem funding and the liquidity measures of Law 3723/08. To this end the government increased the amount of guarantees to bank bonds to €85 bn.

- From August 2011 Greek banks, as they run out of eligible collateral, started to use the ELA facility.

- During 2011 – 2015 most of the wholesale funding for the Greek banks came from the Eurosystem either as monetary policy operations or as ELA.

The capital problem : main issues

- The structural & fiscal reforms introduced by the program had major repercussions on Greek banks' capital.
- As debtors were hit by an increase in unemployment and taxes while suffering salary and pension reductions, the NPLs increased dramatically. To address the issue the banks had to increase provisions. Moreover their profitability was hit, due to the high cost of funding and the subsequent reduction in net interest margins.
- In 2012 and in an effort to address the accumulated sovereign debt a decision for a Private Sector Involvement (PSI) for a debt exchange was taken. The Greek banks participated in the PSI and faced big losses.
- As a consequence of all the above developments, Greek banks suffered a major negative impact on their capital.

Greek banks' capital problem : some data

Developments of major macroeconomic indicators :

Cumulative Development	GDP	GDP %	Unemployment	Housing prices
2008-2015	- €66 bn	-27.3%	7.8% **->** 24.9%	-35%

NPLs : 2008 -> 5.0%
2015 -> 35.8%
NPEs : 2015 -> 44.2%

Losses from PSI : €37.7 bn (when capital at end 2010 was €34 bn)

Huge increase in capital needs

The capital problem : measures

- Capital issues were addressed through :
  - Law 3723/08 during 2009/10 : state acquiring up to €5 bn of preference shares in banks
  - Capitalization by public funds (program money), only for viable banks. In the support programs a total of €75 bn were earmarked for the banking sector either for recapitalization of viable banks or for resolution of non viable banks.

- Specific capital needs of the banks were assessed through stress testing
  - During 2011 – 2015 Greek banks underwent the scrutiny of 5 stress tests.

- A comprehensive viability test was conducted by the supervisor in cooperation with banks in 2012 to identify the viable banks. The four systemic banks were found viable, and thus they were eligible for state funds.

- The Hellenic Financial Stability Fund (HFSF) was created with an objective not only to inject funds through program money, but also to enhance the governance of the Greek banks.

Bank Resolution - Consolidation

- Undercapitalized banks which were deemed non viable and failed to attract private investors to cover their capital needs were resolved.
- In the course of 2011- 2015 : 14 banks (7 commercial banks and 7 cooperative banks) were put into resolution.
- The total assets of the resolved banks ranged from €17 bn to €100 m.
- The Sale of Business Tool was used in 12 cases, while the Bridge Bank Tool was used in 2 cases (the two bridge banks have already been sold).
- Total resolution cost (funding gap) amounted to 15.2 €bn : €1.7 bn was financed by the national resolution fund, while the remaining €13.5 bn from program money (through the HFSF).

Main target of resolution strategy was the protection of financial stability and particularly the protection of ALL deposits.

Evolution of key figures 2008-2015 for Greek banks

	Loans *	NPLs	Deposits *	Eurosystem funding *	NII *	NIM	Total Assets*	CAR
31/12/2008	249	5.0%	227	50	11.1	2.2%	425	9.59%
31/12/2015	204	35.8 %	123	109	7	2.1%	348	16.53%
* in €bn								

- **During the period 2008 – 2015 the consolidation of the Greek banking system was impressive :**

	2008	2015
- Number of commercial banks	20	8
- Number of cooperative banks	16	9
- Foreign branches	29	17
- **TOTAL**	**65**	**34**

- **Market capitalization of Greek banks was substantially reduced (despite the three recapitalization rounds) from €33 bn in Dec 2008 to €12 bn in Dec 2015.**

Conclusions for Greek banks

- The main repercussions of the sovereign crisis for Greek banks were:
  - Capital and liquidity problems
  - Consolidation of the Greek banking system.

- Due to state aid Greek banks had to agree on restructuring plans with the EC.

- The support programs addressed also areas such as improving the corporate governance of banks.

- **Even if CRD IV, CRR and BRRD were fully implemented when the Greek sovereign crisis erupted, it is difficult to believe that they could address the liquidity and capital challenges the Greek banks faced. The extraordinary amount of state money used for recapitalization and the liquidity funding from the Eurosystem, were pivotal in enhancing the resilience of the Greek banks.**

Challenges for Greek banks

Greek banks are still facing important challenges :

- To manage and reduce the high level of NPLs/NPEs.
- To reduce reliance on Eurosystem funding (around €78 bn today).
- To fulfill the commitments undertaken in the restructuring plans.

To address the NPL issue the Greek authorities :

- ***Strengthened the supervisory framework for the management of non-performing exposures*.** BoG issued guidelines regarding the management of NPEs by banks covering areas such as corporate governance, portfolio segmentation, restructuring toolkit, IT systems and granular reporting.
- ***Issued a Code of Conduct for the handling of NPEs*** to ensure appropriate and effective interaction between the banks and the borrowers. The Code of Conduct introduced the notion of "cooperative borrower" and provided a framework for the interaction with certain type of borrowers (e.g. backed by residential real estate, SMEs, common borrowers etc.)
- ***Agreed, in cooperation with the ECB Banking Supervision, NPE operational targets for banks***. NPE targets cover the period up to end-2019 and will be monitored on a quarterly basis. The banks committed to reduce their NPEs by approximately 40% in the next 3.5 years.

B. The Cypriot case

The Cypriot case – Main economic indicators

	GDP in €bn	GDP growth %	Public Debt as % of GDP	Unemployment	Current Account as % of GDP
2010	19.1	1.36%	56.3%	6.1%	-10.7%
2011	19.6	0.4%	65.8%	9.6%	-4.0%
2012	19.5	-2.45%	79.3%	13.8%	-5.6%

- Although Cyprus did not have the alarming Debt and CA ratios of Greece, the crisis in the euro area and particularly the Greek sovereign crisis led to a deterioration of the short term economic prospects.

Cyprus : the banking system

- In the period 2005-2011, the assets of the banking system increased from 69.1 bn euros to 141.2 bn euros, representing close to 720% of GDP.

- The combined assets of the two largest banks (Bank of Cyprus and Laiki Bank) were about four times the size of GDP.

- The Cypriot banks faced big challenges from the Greek crisis through:

    - their exposure to Greek Government Bonds : Bank of Cyprus and Laiki Bank had invested an amount equivalent to almost their entire capital.

    - their exposure in loans in Greece (their branch network's exposure in Greece was nearly 140% of Cyprus' GDP).

When the Greek sovereign crisis erupted in 2010, it had the usual two major repercussions for Cypriot banks : Liquidity and capital problems.

Cypriot banks : liquidity issues

- Following a series of downgradings by the credit rating agencies Cyprus as well as its banks were shut out of international markets.
- The increased difficulties and rumors regarding the solvency of Cypriot banks led to outflow of deposits
- The liquidity needs were dealt through Eurosystem funding and mainly with ELA.

Cypriot banks : The capital problem

- The Greek PSI resulted in huge losses for the Bank of Cyprus and Laiki bank (around 80% of their GGB portfolio).

- NPLs of Cypriot banks experienced the same substantial increase due to the deterioration of the Greek economy and austerity measures taken in Cyprus.

- In 2011 the stress test conducted by EBA identified capital needs for the two major banks. Both banks did not manage to address the capital needs by private funds and requested state aid.

Facing increasing fiscal imbalances and a need to bail out the banking sector, in June 2012 Cyprus requested financial assistance by the euro area support mechanism and the IMF :

- **Negotiations were be difficult and prolonged. For months there was no agreement, while the situation in Cyprus deteriorated.**
- **On 18 March 2013 the Cypriot Government took a decision for a temporary closure of banks and the imposition of capital controls to stop deposit outflows.**

The capital problem : measures

After dramatic negotiations, following the imposition of capital controls and under the threat of ECB seizing ELA funding, on 25 March 2013 a decision was taken by the Eurogroup regarding the resolution of Laiki Bank and Bank of Cyprus, while on 2 April 2013 a 3 year Economic Adjustment Program was agreed. Measures taken (among others) were :

- The liquidation of Laiki Bank while its "good assets" were transferred to the Bank of Cyprus. The "good assets" did not include uninsured depositors.
- The recapitalization of the Bank of Cyprus mainly through bailing in the uninsured depositors : 47.5% of the value of uninsured deposits were converted into equity, so that Core Tier 1 of the bank reached 12.0%.
- The sale of the three Cypriot branches operating in Greece to a Greek bank, in order to reduce contagion which could further destabilize the Greek banking sector.
- The restructuring and recapitalization with program money of the cooperative banking sector.
- The enhancement of corporate governance and particularly improving the banks' loan origination and management practices.

Outcome of the support program

The economic adjustment program for Cyprus was completed at the end of March 2016 and achieved :

- The strengthening of public finance sustainability by adopting structural reforms : Debt to GDP ratio is expected to decline below 100% by 2017. After 3 years of recession and a cumulative shrinkage of the economy by 11%, the Cyprus economy returned to 1.6% growth in 2015.

- The restoration of financial sector stability
  - Reduction of the size of the banking system relative to GDP : from over 700% in 2012 to around 400% by the end of 2015.
  - Consolidation and restructuring of the cooperative sector : in 2013 Cyprus had 80 local cooperatives which merged into 18 regional cooperatives under the umbrella of the Central Cooperative Bank.
  - Strengthening of the corporate governance in all banks.

Cypriot banks : Challenges ahead

Regardless of the success of the program, Cypriot banks still face challenges, particularly arising from the very high level of NPLs.

➡ **NPE's level in 2015 : 46%**

To this end the Cypriot authorities :

- ✓ **approved an enhanced foreclosure framework,**
- ✓ **reformed corporate and personal insolvency laws and**
- ✓ **adopted new legislations on the transfer and the sale of loans.**

Conclusions – lessons learned

- Although the enhanced EU regulatory framework (CRD IV, CRR and BRRD, SSMR and SMRR) is adequate in addressing idiosyncrantic bank failures, it is hard to believe that it is adequate to deal with systemic banking crises as large as the ones that hit Greece and Cyprus.

- In systemic crises extraordinary measures are needed to protect financial stability and thus the real economy by addressing the two major problems :
  - <u>Liquidity</u> => it has to be addressed with central bank funding
  - <u>Capital</u> => it is very hard to envisage a situation where the use of public money can be totally avoided in a systemic crisis.

- We still need to find strategies and policy measures to prevent/address effectively systemic crises while at the same time implement all the envisaged provisions of the current regulatory framework.

- The timely preparatory work for supervisory and resolution authorities as well as their close cooperation, is a necessary condition for the efficient management of any bank crisis.

Thank you for your attention!