Coordination Problems, Perverse Incentives and the Key to Greek Recovery: The Greek Banking System[1]

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28 October 2010

Abstract

Greek banks, like their international peers, have not simply faced the unfortunate consequences of an externally imposed crisis. Coordination problems and perverse incentives in the banking sector, often exacerbated by short-termism in government policies and objectives, led to perpetuation of macroeconomic imbalances and higher overall risk in the economy. Greece is currently in an inefficient, self-reinforcing cycle of tightening credit conditions and economy-wide recession. Policy initiatives to improve credit conditions and increase the lending capacity of the Greek banking system should complement government efforts to restore its fiscal position. Catalyzing new lending in the economy would require policy initiatives along three dimensions:

1. Maintaining support to the banking system, but with an explicit mechanism for sharing the benefits of such support with the real economy.

2. Promoting more efficient risk-sharing between the public and the banking sector, in the spirit of public-private partnerships (PPPs) and revolving financing facilities.

3. Sponsoring the creation of a market mechanism to enhance the credit quality and ratings of bank-issued paper, such as asset backed securities (ABS). That would facilitate banks accessing market funding and gradually weaning off the ECB window.

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[1] This article is available at www.greekeconomistsforreform.com.

A retrospective view

In the run up to the Greek fiscal crisis, lack of effective governance in the Euro area created a "double moral hazard" problem among Member States, which exacerbated external imbalances and threatened the stability of the Euro: On the one hand, some countries delayed regulatory reforms to improve their competitiveness and fiscal position; on the other hand, countries with stronger competitive advantages and fiscal discipline kept on focusing on their narrow commercial interests, exploiting, rather than serving, the benefits from the Euro.

For more than a decade, perpetuation of imbalances among Member States appeared as a "win-win" game not only for governments, but also for the financial sector. Financial intermediation funded, and profited from, a consumption/construction-propelled growth and unsustainable current account deficits. Cheap funding induced a moral hazard problem with governments postponing the time of reckoning and avoiding the political cost of much needed structural reforms.

During the period 2002-2007, low risk premia in capital markets subsidized macroeconomic imbalances and low growth activities (consumption) at the expense of high growth ones (capital investments). When the tide of global liquidity went out, as a result of the global financial crisis, structural weaknesses of the Greek and other economies surfaced, showing who is been swimming without bathing suit.

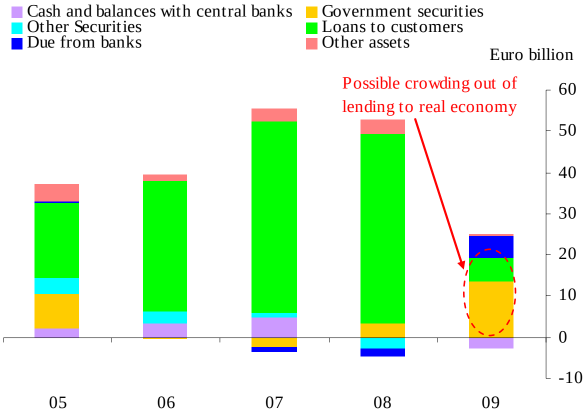
In order to mitigate the shock-waves from the Lehman collapse in 2008, the Greek government extended Euro 28bn state-support facilities to the banking sector. That was Euro 5bn capital injections and Euro 23bn liquidity provisions (i.e. state guarantees and asset swaps). In 2010, the Greek government has further increased the amount of state guarantees to the banking sector by Euro 25bn bringing the, up to date, total sector liquidity support to an aggregate Euro 48bn.

But in the hindsight, support to the banking sector could have been designed and executed in a way that safeguards *quid pro quo* benefits for the real economy. Under Greece's scheme, support to the banking sector has been effectively unconditional, without an explicit mechanism for sharing the benefits commensurate to such support with the real economy. In the absence of such conditionality, the banking sector had been facing the risk of diverting valuable financial resources to non-productive investments.

In the run up to the Greek debt crisis, Greek banks met a significant part of the government's borrowing needs. As a result, in 2009 the amount of government securities held on major

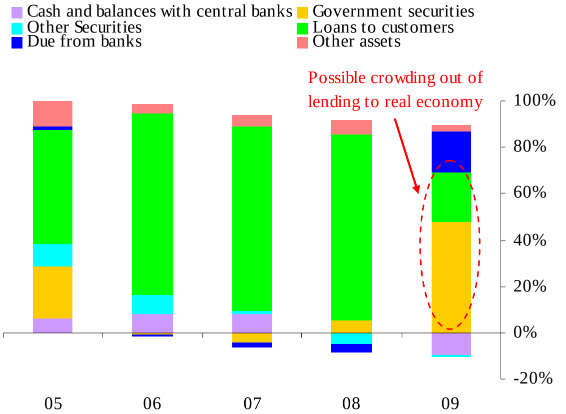
Greek banks' balances sheets increased year-on-year by approximately Euro 13.5bn (or 46%), compared with Euro 3bn (or 12%) increase in 2008 (Chart 1).[2] Such an increase in government securities accounted for almost 62% of the total increase in major Greek banks' assets in 2009, from 7% in 2008 and -5% in 2007 (Chart 2). But in contrast to the increase in government securities holdings by major Greek banks, in 2009, loans to customers increased by only Euro 6bn (or less than 3%), compared with an increase of Euro 46bn (or 24%) in 2008 (Chart 1).[3] In 2009, the increase in loans to customers accounted for only 27% of the y-o-y increase in major Greek banks' assets, from in 96% in 2008 and 90% in 2007 (Chart 2).

Chart 1: Changes in major Greek banks' assets 2005-2009(a)



Sources: Published accounts and own calculations.
(a) Major Greek banks ranked by total assets in 2009: National Bank of Greece, EFG Eurobank Ergasias, Alpha Bank, Piraeus Bank, Agricultural Bank o Greece.

Chart 2: Changes in major Greek banks' assets 2005-2009(a)



Sources: Published accounts and own calculations.
(a) Major Greek banks ranked by total assets in 2009: National Bank of Greece, EFG Eurobank Ergasias, Alpha Bank, Piraeus Bank, Agricultural Bank o Greece.

Although it is difficult to disentangle loan-supply from loan-demand effects, increased borrowing needs by the government in 2009 and concerns of limited market access led to a significant increase of government securities holdings by major Greek banks that possibly *crowded out* productive investments. Excluding from the total Euro 13.5bn increase in government securities the Euro 3.3bn Greek government bonds that were transferred to major Greek banks under the state-support facilities in 2009,[4] the estimated crowding out of lending to the economy in 2009 could be around Euro 10bn (13.5bn-3.3bn).

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[2] Major Greek banks are ranked in terms of total assets in 2009 and include here the National Bank of Greece, EFG Eurobank Ergasias, Alpha Bank, Piraeus Bank, Agricultural Bank o Greece.

[3] Loans to customers are reported here net of impairments.

[4] According to the requirements of Law 3723/2008 "*Enhancement of the Greek economy's liquidity in response to the impact of international financial crisis*", in 2009, Greek government bonds were transferred to major Greek banks in order to cover equal amount issuance of banks' preference shares to the Greek State. The preference shares issued were Euro 350mn by the National Bank of Greece, Euro 950mn by EFG Eurobank Ergasias, Euro 940mn by Alpha Bank, Euro 370mn by Piraeus Bank and Euro 675mn by the Agricultural Bank of Greece.

In the presence of heightened macroeconomic uncertainly, banks operating under the objective to maximize shareholder returns could find it optimal to increase their holdings of government securities at the expense of customer lending. Holding ECB-eligible securities, such as government bonds, would meet two objectives at the same time: first, to hoard liquidity in anticipation of adverse macroeconomic shocks and deterioration in asset quality; second, to borrow at low rates from the ECB and lend at higher rates to the government. The latter (known as the ECB carry) would allow banks to offset the opportunity cost of hoarding liquidity and preserve their main source of income, namely net interest revenue. In 2009, net interest revenue of major Greek banks increased by approximately 4%.[5]

But rational banks operating under self-interested motives in times of crisis could adopt suboptimal credit policies that feed into a vicious cycle of higher overall risk in the economy. Aggressive tightening of lending standards by one bank could trigger a similar behaviour in others due to correlated balance-sheet exposures and incentives to front-run further deterioration in asset quality. The result could be a vicious cycle of deleveraging in the banking system, with higher overall risk in the economy feeding into further deleveraging.

Greece is currently in an inefficient, self-reinforcing cycle of tightening credit conditions and economy-wide recession. Current efforts to spur economic growth are racing against procyclical government policies to restore its fiscal position and unilateral decisions by banks to curtail new lending in order to maintain their key capital and liquidity ratios. *De facto* coordination of banks with the public sector before the crisis contributed to perpetuation of imbalances. A similar coordination is currently taking place, but in reverse.

As a result of such coordination, the fortunes of the public and banking sectors are now tied together. Spreads of Greek government bonds remain high, which is partly due to concerns about the banking sector, while funding conditions of Greek banks remain challenging due to sovereign ceiling and macroeconomic considerations. Capital market access for Greece would require progress being made both in resolving macroeconomic imbalances and in mitigating liquidity tensions in the banking system.

Undoubtedly, some degree of deleveraging is warranted for the economy to find a new trajectory towards sustainable growth. But systemic risks arise from individually rational, yet economically inefficient, credit policies by banks require policy response. And an integral

[5] That increase was mainly due to a 10% y-o-y increase in net interest revenue of the National Bank of Greece.

part of government efforts to restore economic stability should be policy initiatives to mitigate systemic risks from excessive tightening in credit conditions.

A policy proposal

Policy initiatives to improve credit conditions and increase the lending capacity of the Greek banking sector should complement government policies to restore its fiscal position and efforts by banks to raise new equity in capital markets. Catalyzing new lending in the Greek economy would require policy initiatives along three main dimensions:

1. **Extending support facilities to the banking system with explicit conditionality on new lending to key sectors of the economy.** That could be in the spirit of France's plan to restore confidence in the banking sector, which was designed to ensure the financing needs of households and businesses. Under the French plan, a refinancing facility was established to guarantee debt for banks, provided that they were able to furnish collateral in the form of loans to the economy. Similar facilities where designed by the European Investment Fund, under the CIP and Securitisation Program, where credit enhancement of loan securitisations is made conditional on a minimum extension of new lending to the SME sector.

2. **Designing and implementing mechanisms for efficient sharing of financial risks between the government and banks.** That could catalyse productive investments and create economic value-added. Public-private partnerships (PPP) and initiatives in the spirit of revolving financing, such as the EU-sponsored Jeremi and Jessica initiatives, are but a few examples of public funds put to work in an ingenious way. But even these financial innovations require leverage from a banking system with sufficient access to long-term liquidity, which brings us to point 3.

3. **Sponsoring the creation of a market mechanism to enhance the credit quality and ratings of bank-issued paper, such as asset backed securities.** That would facilitate banks accessing market-based liquidity and gradually weaning off the ECB window.

Regarding the latter point (3), policy initiatives are already in place to help maintaining financial stability. Under the Economic and Financial Policies Programme agreed with the EU, ECB and IMF to support the conditionality requirements of the financial support to Greece, a Euro 10bn Financial Stability Fund was established to offer contingent capital injections to Greek banks in case they would have no other option left to strengthen their capital base. That is through the purchase of preference shares that could be converted into ordinary equity. Moreover, the ECB has suspended the application of the minimum credit rating threshold in collateral requirements for the purposes of the Euro system’s credit operations for debt instruments issued or guaranteed by the Greek government. In addition, the ECB has accommodated asset backed securities (ABS) transactions down to A- levels.

But actions by rating agencies have exacerbated bank liquidity constrains. Over the past year there has been a barrage of sovereign and bank downgrades. Also, ratings of many asset backed securities (ABS) have been downgraded to the cusp of ECB eligibility. This is despite the ECB lowering rating requirements and making concessions. As a result, the ECB is currently the main provider of bank liquidity, acting as lender of last resort. In July 2010, Greek banks borrowed a record high Euro 96.2bn from the ECB, having pledged collateral worth Euro 135.8bn, approximately 30% of their assets. And creating eligible ECB collateral may have required an even larger pool of bank assets to be pledged.

There is a risk that the ECB would find it difficult to make any further adjustments to eligibility criteria should the rating agencies make any further downward rating actions. In addition, any recovery that is based on massive monetary stimuli would be a recovery on shaky foundations that cannot sustain for long. Although ECB concessions offer a strong pillar of systemic support, extraordinary liquidity measures sooner or later may start conflicting with its statutory responsibility to maintain price stability in the Euro area. And banks will eventually have to wean themselves off the ECB window.

A Greece-led initiative for facilitating bank access to market liquidity could be to establish a credit-enhancement mechanism that achieves higher ratings for bank-issued paper. There is no doubt that such an exercise would require superior structuring skills and cooperation at an international level in order to achieve risk-sharing in such a way that releases economic value for all parties involved. But such a risk-sharing could be attained through appropriate equity buffers, diversification of underlying exposures, subcontracting of certain operations and some degree of subordination of key international counterparties, subject to fair pricing.

Sponsoring such a mechanism would not be straightforward, both from a technical and a signaling perspective. Designing and getting it off the ground would involve significant technical challenges. But the technology to tackle those challenges exists and could aspire to offer a test-case, a benchmark for best practice in dealing with bank-liquidity problems also in other EU countries, also affected by sovereign and bank rating downgrades. Following strict policy guidelines agreed at an international level, such a mechanism could potentially offer a pillar of *bank liquidity* support next to the ECB window, for as long as it remains available, complementing contingent *bank capital* backing by the Financial Stability Fund.

Euro-area Member States should keep on focusing on innovative solutions to deal with the complicated institutional and financial challenges the Greek debt crisis has reveled. Significant risks remain in the Euro area, such as limited access by banks to market liquidity. If such risks crystallize, no Member State will be able to avoid violent adjustments. And as the Greek debt crisis demonstrated, there are no more music chairs to sit in such a game.