CEPS COMMENTARY
CEPS
Thinking ahead for Europe

Addressing the immediate needs of the Greek banks

Willem Pieter De Groen and Daniel Gros

31 July 2015

Based on a detailed calculation of the recapitalisation requirements of the Greek banks, we find that the sector needs an infusion of capital, but that the level largely depends on the stringency of the capital requirements applied. An expedient quick fix to comply with the minimum capital requirements could be achieved by a bail-in of existing creditors under the EU Bank Recovery and Resolution Directive of around €5 billion, leaving only €6 billion needed for re-capitalisation. If the 'Cypriot' standard is applied, however, the required re-capitalisation would be €15 billion. A 'generous' approach, which takes into account the phasing in of the new more-stringent capital requirements until 2018, would imply a re-capitalisation of €29 billion (or more bailing-in of creditors). The re-capitalisation should be undertaken preferably by the EIB, the EBRD or the new Greek investment fund, rather than via loans from the ESM to the Greek government.

The political uncertainty and the concomitant deterioration of the real economy have put into reverse the recovery of Greece's banking system, which started in 2014 when the sector attracted €8 billion in private funds. But the mix of weakening economic performance, uncertainty about the sustainability of Greek government debt and its future in the euro area led to renewed deposit flight since late last year. These developments and the strengthening of the collateral requirements by the ECB forced Greek banks to re-apply for Emergency Liquidity Assistance (ELA). Since the beginning of the year, the ELA provided by the Bank of Greece with approval of the European Central Bank (ECB) surged to around €87 billion in June, or over one-fifth of the total balance sheet. With the announcement of the referendum, the ECB decided to limit the amount of ELA the Greek banks could use and the Greek government was forced to introduce capital controls and limits on bank withdrawals.

The controls can only be lifted if the Single Supervisory Mechanism (SSM) can certify to the ECB that the Greek banks are solvent. But this might be a problem, given the rapid deterioration of their capital position. The 2014 stress test already showed that the Greek banks were vulnerable, barely passing the threshold after recapitalisation and assuming future deleveraging. However, the economy is now doing worse than even the most pessimistic adverse scenario envisaged last year. It is thus likely that the capital ratios are falling below the regulatory minima.

Willem Pieter De Groen is Research Fellow in the Economy and Finance research area at CEPS. Daniel Gros is Director of CEPS.

CEPS Commentaries offer concise, policy-oriented insights into topical issues in European affairs. The views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

Available for free downloading from the CEPS website (www.ceps.eu) • © CEPS 2015

The latest figures publically available on the regulatory capital position of the individual Greek banks are from end-2014. In order to assess their capital needs today, we must therefore use estimations to assess the magnitude and impact of the economic deterioration. The estimations shown in Table 1 are based on the Greek credit institutions' monthly aggregated balance sheet for June 2015, the 2014 annual reports of the four large banks and the 2014 stress test results.

Table 1. Estimated capital shortfall of Greek banks (€ bn)

Indicators	Amounts
Capital and reserves	69
Provisions for bad loans (June 2015)	(41)
Total equity	**28**
Regulatory capital adjustment (Basel 2.5)	(3)
Regulatory capital adjustment (Basel 3 – 2014)	(3)
Minimum total regulatory capital (assuming 8% of RWA)	(18)
Capital buffer/(shortfall) based on end of 2014 capital definition	**4**
Estimated increase in bad loans (+15%)	(15)
Capital buffer/(shortfall) as of July/August	**(11)**
Additional capital required o increase capital ratio to 12% (of RWA)	(9)
Capital buffer/(shortfall) based on 2014 capital definition (12% of RWA)	**(20)**
Regulatory capital adjustment (CRR/CRD IV – needed fully only in 2018)	(14)
Capital buffer/(shortfall) based on fully loaded capital definition (12% of RWA)	**(34)**

Sources: Authors' estimations based on data from the 2014 annual reports of four largest banks, Bank of Greece and European Banking Authority.

Until recently, Greek banks still had capital in excess of the minimum required: €69 billion in capital and reserves were partially offset by €41 billion of provisions for bad loans, leaving around €28 billion in equity. But about €6 billion needs to subtracted from this figure for items that are not eligible as regulatory capital.[1] Thus, based on the capital definition as of the end of 2014, the Greek banks had as recently as June approximately €4 billion in excess of the €18 billion aggregate total minimum capital requirement of 8% of 'risk -weighted assets'.[2]

'Quick-fix'-recapitalisation

These calculations explain why until recently the SSM could consider the Greek banks solvent. But the deterioration of the economy is worsening the capital position. Non-performing loans will surely increase, leading experts to foresee an increase of around 10 to 15 percentage points on top of the current 40%.[3] A quick back-of-the-envelope calculation shows that this would

[1] The capital items and assets that need to be deducted from the regulatory capital have been expanded under the new capital requirements legislation (CRDIV/CRR), which is gradually being phased-in (one-fifth every year).

[2] The Greek banks' risk-weighted assets were equal to 58% of total assets at the end of 2014.

[3] Calculated as the ratio of non-performing to total loans already in the books.

imply losses of €15 billion.[4] Total regulatory capital would then fall €11 billion below the minimum requirement.

'Standard'-recapitalisation

The Cypriot banks that faced similar problems in 2012-13 were required to reach capital ratios of at least 12% of risk-weighted assets. To reach this 4 percentage points higher level, the Greek banks would need €9 billion additional capital, bringing the shortfall to €20 billion.

'Generous' recapitalisation

But the supervisor might ask the banks to anticipate the phasing-in of the new capital requirements, which are fully applicable only from 2018 onward. Although the capital is not required yet, the three-year duration of the new ESM programme and uncertainty about the profitability in the upcoming years might prompt the Supervisor to ask the banks to comply already with the fully-loaded capital ratios now. Taking into account the additional €14 billion that is needed to comply with the CRDIV/CRR, the total shortfall would thus be around €34 billion.

At the present time, the Greek government barely has any funds available, which suggests that the Greek banks might have to be re-capitalised directly by the European Stability Mechanism (ESM). The statement issued by the Euro Summit of 12 July 2015 already mentioned that the new ESM programme will include €10-25 billion to cover the recapitalisation and resolution costs of the Greek banking sector. Our calculations show a similar range.

Table 2. Mandatory bail-in of Greek banks (€ bn)

Indicators	Amounts
Total liabilities and own funds	339
Bail-in amount (8%)	27
Own funds	22
Bail-in of other creditors	**5**
'*Pari-passu*' creditors	
Debt securities issued	2
Other liabilities (incl. employee or trade credits that are exempted)	15
Other non-eligible deposits	22
Total '*pari-passu*' creditors	39
Estimated haircut	**13%**

Source: Authors' estimations based on data from the Bank of Greece.

The ESM prescribes that the creditors of the banks should first be bailed-in *before* the fund can put in capital. The fast-tracking of the transposition of the EU Bank Recovery and Resolution Directive (BRRD) into national law,[5] which is one of the conditions before the negotiations on a new ESM programme can start, should contribute to an orderly bail-in. The bail-in should be 8% of total liabilities plus own funds – or about €27 billion for the Greek banks.

[4] Loans to non-financial corporations accounted for around €220 billion in June 2015. Assuming a 15 percentage point increase, the non-performing loans would increase up to €33 billion. Applying the 45% average expected loss rate from the 2014 stress test, the Greek banks are likely to face €15 billion in additional loan losses.

[5] The BRRD was transposed into Greek legislation on 22 July 2015.

However, and this is critical, there are own funds (including shares and subordinated bonds) equal to about €22 billion. These could be written off entirely. But since these instruments were already part of the own funds, writing them down does not generate the new own funds necessary to cover the shortfall.

New own funds could be obtained if the creditors with a *pari-passu* claim are bailed-in. Table 2 shows that there are about €39 billion of 'bail-inable' other liabilities.[6] Even if not all of these creditors can be bailed-in, it should be possible to obtain €5 billion in bail-in, or somewhat more than 13% of the total of this class of creditors.

If this is done, Greek banks would still need to generate between €6 and €29 billion in capital, depending on whether the supervisor demands a quick-fix [€6 billion], standard-recapitalisation [€15 billion] or generous recapitalisation [€29 billion]. It is envisaged that the ESM will be endowed with between €10 and €25 billion for re-capitalisation of banks under a new programme, which is sufficient to allow banks to comply with the fully-loaded capital requirements, given that the funds need to be accompanied by a contribution of the domestic government. The 10% to 20% of the total public contribution that the government needs to contribute in case of an ESM direct recapitalisation might be generated from the privatisation process. But it might be preferable to find the capital entirely within institutions whose purpose is to invest in and manage risky assets. Possible candidates might be the European Investment (EIB), the European Bank for Reconstruction and Development (EBRD) or through the €50 billion Greek privatisation fund that is currently under development, as we argued in an earlier paper.[7]

[6] Secured liabilities are protected against the bail-in through collateral, while other liabilities are exempted or have received a preferential ranking in BRRD. The covered deposits and liabilities for payment and settlement are, for example, protected and the deposits of natural persons and small- and medium-sized enterprises have received a preferential status. The remaining creditors consist primarily of holders of debt securities, remaining liabilities and the deposits that are not eligible for the deposit guarantee scheme (DGS).

[7] See "Restructuring the Greek banking sector with an empty purse", 13 July 2015 (www.ceps.eu/publications/restructuring-greek-banking-sector-empty-purse).