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"Bad Bank" Strategy in Greek Banking Sector and Receivables from Banks under Liquidation

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Abstract

Purpose - The purpose of this paper is to present the "bad bank" strategy followed in Greek banking system to safeguard the stability during the current financial crisis.

Design/methodology/approach - Swedish model designed in a more stable macroeconomic and financial global setting than today. Swedish crisis of the early 1900s was a local problem to a small open economy with a pegged exchange rate. Establishing a "bad bank" was the solution of choice for Ireland and Spain in the aftermath of the recent global financial crisis. Bad bank solution in Greece is most of all a funding problem. The Hellenic or Greek Financial Stability Fund was founded in Greece, in July 2010 (under Law 3864/2010) as a private legal entity and does not belong to the public sector, became liable to pay until 31/12/2014 the amount that the Hellenic Deposits and Investments Guarantee Fund would have covered, in the context of the resolution of the financial institutions.

Findings - In Greece from October 2011 to March 2014, twelve banks resolved through the legal and regulatory framework under either a transfer order (order to transfer assets and liabilities to a transferee credit institution) or establishment of a bridge bank. The solvent or "good assets" of these failed banks were transferred either to another bank (in the case of purchase and assumption) or to a bridge bank, leaving the remaining assets ("bad assets") and liabilities in entities under liquidation, under the responsibility of liquidator. Also, Bank of Greece appointed "PQH Single Special Liquidation S.A." as Special Liquidator for all the banks under liquidation, to manage total assets under special liquidation, amounting to about €9 billion, consisting almost in their entirety in non-performing loans. Up to 30/09/2016 the total amount provided by the HFSF to cover funding gap reached the amount of € 13,489m, out of which € 516m were recovered and €11,036m were assessed as non-recoverable.

Originality/value – This is the first paper to present the "bad bank" strategy followed in Greece and receivables from banks under Liquidation.

Keywords: Bad banks, Greek banks, banking crisis
JEL Classification: G01, G10, G21
Type: Discussion paper

1. Introduction

"Bad Bank" is a term for a financial institution or an asset management company created to hold nonperforming assets owned by a state guaranteed bank. Bad banks are created to address challenges arising during an economic credit crunch where private banks are allowed to take troubled assets off

their books. "Toxic" or "bad" assets are assets for which there are no buyers, and as a result, no clear value.

Bad bank institutions have been created to address challenges arising during an economic credit crunch wherein private banks are allowed to take problem assets off their books. Securum, a Swedish bank founded to take on bad assets during the Swedish banking rescue of 1991 and 1992, is an example of such a bank.

If a bank becomes overloaded with toxic assets, it may be unable to respond to changes in the market, or to serve its customers. This can create concerns among customers of the bank, who may panic in response to the bank's instability and make the bank more unstable in the process. In these cases, the bank's best move is to try and get rid of the toxic assets, but it may have a difficult time doing so, because of the inability to find buyers.

These assets had a value at some point in time, and many people believe that they still have a value, even if no one will buy them. The issue is that when a bank acquires large numbers of toxic assets, these assets inflate the value of the bank's books, but contribute nothing real to the bank's financial position. In other words, the bank has a lot of money on paper, but it can't actually sell its toxic assets, and as a result it has minimal liquidity.

Some investors may volunteer to take on toxic assets at a fraction of their face value, bargaining on the fact that the assets will become saleable again at some point in the future, but banks are often reluctant to accept such deals.

By segregating assets, the bank tries to keep away the bad assets from contaminating the good. The effects of bad bank on the banks' liquidity, balance sheets, and profits can be difficult to predict specially in the current credit crisis.

Greek banking now is facing difficulties because of Greek public debt crisis and Non-Performing Loans (NPLs) that are still increasing, causing profitability and capital adequacy problems.

2. Implementing "Bad Bank" Solution in Sweden

Contagion risk of a bank failure is many times high and is a term used to describe the spillover of the effects of shocks from one or more firms to others, within or outside the industry. Runs and contagion resulting from failure or near-failure of firms are widely feared more in banking than in other industries because of their perceived greater speed and wider adverse impact within the industry, greater number of resulting failures, greater losses to creditors and depositors and the potential spreading of their effects beyond banking to other financial sectors and the macro economy (Kaufman, 1994).

An economic reason for the implementation of a good/bad bank strategy derives from investors' reaction to the segregation of assets. Monitoring is better when assets are separated and buyers are better informed because sellers have superior knowledge of assets' quality. As Akerlof (1970) described, sellers of bad quality goods ("lemons") can act dishonest and extending Gresham's Law, the bad assets tends to drive out good assets due to quality heterogeneity and asymmetric information.

Several governments have used bad banks to address credit crises before they get worse. In order for this technique to be effective, many economists agree that it must satisfy several criteria. In the first place, the bank is run by the government, or by a government agency which insures bank deposits, and it is usually set up as a self-liquidating trust, which means that after the mission of the bank is accomplished, it is dissolved. The bad bank is a nationalized bank, run by and for the people, a concept which some nations have difficulty with.

Bad banks are only one of many potential solutions to an economic crisis, and they must be weighed carefully, along with other options. The tendency to panic when faced with financial crises on the part of government officials can contribute to some very bad decisions which may have long-lasting repercussions, making it important to avoid rushing into any particular plan of action, from a bad bank to a stimulus plan.

The objective is to maximize taxpayer return from bailout. It is a zero sum game because if taxpayer doesn't insist on the best possible deal, some other party to the bailout will reap benefits at the taxpayer's expense. Calomiris (1998) showed that the practice of bailing our banks has encouraged financial structures that keep profits private while losses are borne by the public. Also indicated that from 1983-1998, ninety episodes of banking collapse have occurred and twenty of them have produced bailout costs for governments in excess of 10% of their country's GDP.

Scandinavian financial crisis of the early 1990s followed a period of financial liberalization in the 1980s. Liberalization caused a rapid expansion in the volume of bank loans for speculative investment and banks became more sensitive to creditor default rates. After a big drop in the world oil price in 1986, Norway, an oil-exporting country, experienced a shift in its current account of balance of payment from a surplus to a deficit and a devaluation of the Norwegian krone in 1986. A recession began in 1988 and followed a financial crisis among country's savings banks and real estate market.

Also faced currency problems. The value of Krona was fixed to a basket of currencies and it was both significantly and increasingly overvalued relative this basket. The government sought to protect its value by maintaining high interest rates. Commercial and retail borrowers sought foreign currency denominated credits at lower rates. Swedish banks facilitated borrowing and lending in foreign currencies. With the exchange rate fixed, the foreign exchange risk was not managed. In 1992, the rapid deflation of the real estate bubble led to fall of stocks. Loss on non-performing loans and declining collateral values had to be recognized which adversely impacted bank capital. Banks was neither safe nor sound. Loan losses were accumulating in banking system, the Krona was devalued and unemployment was increasing.

The first to be affected were finance companies that had provided loans against the upper range of the value of assets pledged as collateral. Banks provided part of the financing of the financial companies. By lending through financial companies, banks could circumvent exposure limits. The crisis mainly developed of credit risk and concentration risk, but it became acute due to the manifestation of liquidity risk (Bank for International Settlements, 2004).

The government funded the failed banks through its new Government Bank Insurance Fund (GBIF) in January 1991. The GBIF was an independent legal entity with the aim to provide liquidity to two private guarantee funds. Also imposed conditions such as hiring and firing key personnel, board composition and investment decisions.

Large losses were reported by three banks with about half of the total assets in the banking sector. The GBIF poured liquidity into insolvent banks and began to purchase securities (preferred securities) floated by relatively healthy banks that was convertible into common stocks. Norwegian parliament allowed government, by law, to write down a bank's common stock to zero against its losses, preventing equity holders from holding up to bail out the banking system. Norway economy started to recover in 1993 and banking crisis was over and by the end of the 1990s the government sold most of its banking stocks to private investors.

The crisis in Sweden started with heavy losses reported by the country's largest saving bank, Forsta Sparbanken, in 1991. Then, commercial bank, Nordbanken, owned 71% of common stocks by Swedish government, also reported big losses. The government purchased a new stock issue and bought out the private stockholders at the equity issue price, in contrast to Norway where private equity was written down to zero before government intervention. Government took full control of Nordbanken and split the bank's assets into two parts: the "good" assets were still within the bank while the "bad" assets were spun off into a separate legal entity, an asset holding company, called Securum, created in 1992 (Eckbo, 2009). Securum financed the purchase with a loan from Nordbanken and a government equity infusion.

A second "bad bank" was also created for Gota Bank when it failed in early 1992 and bad assets were transferred to the asset management company, called Retriva. The remaining "good" assets of Gota Bank were auctioned off and purchased by Nordbanken in 1993 with no payment to Gota

Bank's stockholders. Securum's basic aim was to liquidate the troubled or "bad" assets maximizing recovery. Assets were successfully liquidated.

Sweden also issued a blanket guarantee of all bank loans in the banking system, until July 1996 and benefited existing bank stockholders. Also Swedish Central Bank provided liquidity by depositing large foreign currency reserves in troubled banks and by borrowing freely at no risk the Swedish currency. Government's cash infusion limited to these two banks.

Established guidelines for banks receiving government support such as a government member in board composition's management, balance sheet restructuring targets and risk management. The final results were a relatively speedy recovery, a return to robust economic growth and banking crises were relatively short-lived.

Jonung (2009), presented that the Swedish approach for resolving the banking crisis of 1991-1993 was successful for seven reasons: (1) the importance of political unity behind the resolution policy, (2) a government blanket guarantee of the financial obligations of the banking system, (3) swift policy action where acting early was more important than acting in exactly the right manner, (4) an adequate legal and institutional framework for resolution procedures including open-ended public funding, (5) full disclosure of information by the parties involved, (6) a differentiated resolution policy minimizing moral hazard, (7) proper design of macroeconomic policies to simultaneously end the crisis in both the real economy and financial sector.

3. Recent examples of "Bad Banks" in Ireland and Spain

Establishing a bad bank was the solution of choice of several European countries in the aftermath of the recent global financial crisis, in order to deal effectively with the system stability threatening risk connected with the increase in Non-Performing Loans (NPLs) which followed the Lehman debacle.

The extent of the NPLs phenomenon differed significantly among countries, with the so-called peripheral countries, Portugal, Ireland, Greece and Spain being the ones where the most significant increase took place. Among these countries, Ireland and Spain were the ones where the greatest amount of bad assets was disposed of.

In 2009 the National Asset Management Agency (NAMA), controlled by the National Treasury Management Agency, was established in Ireland in order to deal with the burst of the Irish property bubble. NAMA was set up as a bad bank and its purpose was to acquire illiquid property development loans (with an initial book value of €74 billions) from five Irish financial institutions through a Special Purpose Vehicle in return for government bonds.

While the initially planned haircut on the book value was to be about 30 %, NAMA ended up acquiring the loans for €32 billion, at a 57 % discount. NAMA's situation was then compromised after 2010: the financial markets deemed the government support for banks excessive and this caused the yields on Irish bonds to rise. There were two main consequences.

First, as the value of the assets in the "good banks" dropped, they were forced to raise more capital. Second, the European Central Bank and the International Monetary Fund were forced to bail out the Irish government itself with a €67 billions loan. Despite these facts, NAMA managed to perform well thanks to the major improvement in conditions in Irish commercial property market.

The bad bank set up in Spain was under many aspects similar to the one adopted in Ireland. In 2012 the Spanish government created an asset management company, referred to as SAREB, which started gathering troubled assets from financial institutions in order to allow them to manage the remaining "good bank" separately. The purchase was funded by government guaranteed bonds (which were zero risk weighted in order to reduce the capital burden) issued by SAREB. The assets purchased were mainly real estate backed loans: a portfolio of loans by 9 banks of €74 billions was at the end transferred to SAREB for €50 billion, with a 50 % average discount. As in the case of NAMA, both private investors (Spanish "healthy" banks) and the government (via its bank resolution vehicle, the FROB) provided the initial equity capital. SAREB is currently still fighting in order to become

profitable, but overall it has contributed in handling a major part of the NPLs and in providing some relief to the Spain's troubled banking system, helping out and accelerating the consolidation of the sector and its restructuring and turn around.

4. "Bad Bank" Strategy in Greek Banking Sector: "Bridge Bank" and Transfer of Assets

The Hellenic or Greek Financial Stability Fund (HFSF) was founded on 21/07/2010 under Law 3864/2010 as a private legal entity and does not belong to the public sector, neither to the broader public sector. It has administrative and financial autonomy, operates exclusively under the rules of the private economy and is governed by the provisions of the founding law as in force. On a supplementary basis, the provisions of company codified Law 2190/1920 are applied as in force, provided they are not contrary to the provisions and the objectives of the founding law of the HFSF. The purely private nature of the HFSF is neither affected by the fact that its entire capital is subscribed solely by the Greek State, nor by the issuance of the required decisions by the Minister of Finance. According to Law 4389/2016, HFSF is a direct subsidiary of the Hellenic Company of Assets and Participations, however the administrative autonomy and independence of the HFSF is not affected according to the provisions of the Law 4389/2016. The HFSF shall comply with the obligations arising from the Master Financial Facility Agreement signed on 15/03/2012. According to Law 4340/2015, the HFSF's tenor has been extended up to 30/06/2020. By decisions of the Minister of Finance, the duration of the HFSF may be extended further, if deemed necessary for the fulfillment of its scope.

The HFSF began its operation on 30/09/2010 with the appointment of the members of the Board of Directors according to the decision 44560/B. 2018 on 30/09/2010 of the Ministry of Finance. On 30/01/2013, the Board of Directors was substituted by the Executive Board and the General Council. The purpose of the HFSF is to contribute to the maintenance of the stability of the Greek banking system, through the strengthening of the capital adequacy of credit institutions, including subsidiaries of foreign credit institutions, provided they legally operate in Greece under the authorization of the Bank of Greece. HFSF exercises its shareholding rights deriving from its participation in the credit institutions to which capital support are provided by the HFSF, in compliance with the rules of prudent management of the assets of the Fund and in line with the rules of the European Union with respect to State aid and competition.

The HFSF according to Law 4051/2012, as amended by Law 4224/2013, was liable to pay until 31/12/2014 the amount that the Hellenic Deposits and Investments Guarantee Fund (HDIGF) would have paid for the process of the resolution of the credit institutions in accordance to Law 4261/2014, acquiring the right and the privilege of the HDIGF in accordance to paragraph 4 of Article 13A of the Law 3746/2009. According to Law 4340/2015 and Law 4346/2015, the HFSF may grant a resolution loan to the HDIGF for the purposes of funding bank resolution costs, subject to the provisions of the facility agreement and in line with the European Union's State aid rules.

In Greece from October 2011 to March 2014, twelve banks resolved through the legal and regulatory framework under either a transfer order (order to transfer assets and liabilities to a transferee credit institution) or establishment of a bridge bank (table 1). All policies succeeded to safeguard Greek financial stability and restore losses that caused to banks from Greek public debt "haircut".

To deal with the prospect of potential banks failure, Greek authorities, in cooperation with national and international authorities, established a legal and regulatory framework for bank resolution in 2011, which introduced two main schemes: temporary credit institutions ("bridge bank") and purchase and assumption ("P & A" also known as "transfer of assets"). This framework was first activated in October 2011, with the successive resolution of twelve banks under either the purchase and assumption or the bridge bank schemes by March 2014.

The solvent or "good assets" of these failed banks were transferred either to another bank (in the case of purchase and assumption) or to a bridge bank, leaving the remaining assets ("bad assets") and liabilities in entities under liquidation, under the responsibility of liquidator.

Table 1: Overview of banks resolved in Greece from October 2011 to March 2014

Bank resolved	Type of bank	Resolution method	Resolution date
Proton Bank	Commercial	Bridge bank	9/10/2011
T-Bank	Commercial	P & A with Hellenic Postbank	17/12/2011
Achaia	Cooperative	P & A with National Bank of Greece	19/3/2012
Lamia	Cooperative	P & A with National Bank of Greece	19/3/2012
Lesvos-Limnos	Cooperative	P & A with National Bank of Greece	19/3/2012
ATE	Commercial	P & A with Piraeus Bank	27/7/2012
Hellenic Postbank	Commercial	Bridge bank	18/1/2013
FBB – First Business Bank	Commercial	P & A with National Bank of Greece	10/5/2013
Probank	Commercial	P & A with National Bank of Greece	26/7/2013
Evia	Cooperative	P & A with Alpha Bank	8/12/2013
Western Macedonia	Cooperative	P & A with Alpha Bank	8/12/2013
Dodecanese	Cooperative	P & A with Alpha Bank	8/12/2013

Source: Bank of Greece, various press release

5. Receivables from Banks under Liquidation

According to paragraph 15 of article 9 of Law 4051/2012, as amended by Law 4224/2013, the HFSF became liable to pay until 31/12/2014 the amount that the HDIGF would have covered, in the context of the resolution of the financial institutions, as foreseen by paragraph 13 of article 141 and paragraph 7 of article 142 of Law 4261/2014. In this case, the HFSF took over the rights of HDIGF as per paragraph 4 of article 13A of Law 3746/2009. In this context, HFSF's receivables are a combination of its contribution of EFSF FRNs and cash, instead of the HDIGF, in order to cover the funding gap of financial institutions, which were resolved.

The liquidators of credit institutions under liquidation are nominated by the Bank of Greece and are subject to its monitor and control. On 04/04/2016, Bank of Greece appointed "PQH Single Special Liquidation S.A." as Special Liquidator for all the banks under liquidation, aiming to ensure a more efficient management of their assets and a higher performance against the operational targets.

PQH Single Special Liquidation S.A., jointly owned by PwC Business Solutions S.A., Qualco S.A. and Hoist Kredit Aktiebolag, replaces the existing liquidators and takes up the management of all the institutions under special liquidation. The Special Liquidator will henceforth manage the total assets under special liquidation, amounting to about €9 billion, consisting almost in their entirety in non-performing loans. This ensures the operational unification of the institutions under special liquidation, while at the same time each of these institutions remains a legally independent liquidation entity and the legal status of its creditors is not affected.

Further to that, HFSF's law, as amended by Law 4254/2014, explicitly states that the monitoring and supervision of the actions and decisions of the bodies of the special liquidation of the credit institutions do not fall within the functions of the HFSF and therefore, the HFSF has no involvement or control over the liquidation process and the recovery of any amounts, nevertheless the HFSF maintains its own independent valuation estimates over amounts to be recovered.

Up to 30/09/2016 the total amount provided by the HFSF to cover funding gap reached the amount of € 13,489m, out of which € 516m were recovered and €11,036m were assessed as non-recoverable (table 2).

Table 2: Funding gap, impairment and collections per bank under liquidation, until 30/9/2016 (amounts in Euros)

Bank under Liquidation	Funding Gap	Cumulative Impairment	Cumulative Collections	Estimated Recoverable Amount
Achaiki Cooperative Bank	209,473,992	(107,300,654)	(48,000,000)	54,173,338
ATEbank	7,470,717,000	(5,705,136,184)	(345,000,000)	1,420,580,816
Dodecanese Cooperative Bank	258,547,648	(148,159,788)	(49,000,000)	61,387,860
Evia Cooperative Bank	105,178,136	(85,464,522)	(2,000,000)	17,713,614
First Business Bank	456,970,455	(414,178,813)	(7,500,000)	35,291,642
Hellenic Post Bank	3,732,554,000	(3,451,624,425)	(15,000,000)	265,929,575
Lamia Cooperative Bank	55,493,756	(30,221,547)	(10,000,000)	15,272,209
Lesvos-Limnos Cooperative Bank	55,516,733	(38,664,778)	(12,000,000)	4,851,955
Probank	562,733,502	(519,769,011)	(5,500,000)	37,464,491
Proton Bank	259,621,860	(244,760,837)	(5,018,676)	9,842,347
T-Bank	226,956,514	(224,944,714)	(2,011,800)	0
Western Macedonia Cooperative Bank	95,244,475	(65,549,884)	(15,000,000)	14,694,591
Total	**13,489,008,071**	(11,035,775,157)	**(516,030,476)**	**1,937,202,438**

Source: Hellenic Financial Stability Fund, Interim Financial Statements for the nine month period ended September 30th, 2016.

Greece has a very low competiveness and cannot depreciate its currency which is Euro. Also today crisis is global and there is a more globalized, less transparent and more sophisticated financial system than that at early 1990s.

Bad bank solution in Greece is most of all a funding problem. Bad bank solution and no other solutions are the best solution because the Greek economy and Greek banking sector are in a weak fiscal position. Even the issuance of Greek government guaranteed bonds in exchange of preferred stocks were not enough to stabilize Greek banking sector and offer funding in Greek economy.

In order to prevent possible future liquidity crisis, there is need to improve liquidity buffer (safe assets) of Greek banking sector which means higher capital adequacy standards to limit liquidity risk and better risk management. The introduction of the leverage ratio and the short-term liquidity coverage ratio of "Basel III" draft proposals will help Greek banks to improve their strength. But regulatory reform although is necessary, is not a sufficient condition for a safer financial system.

In a future Greek banking sector crisis a combination of mergers and acquisitions would be the first best solution. Then and as a last resort solution a combination of non-performing asset guarantees and a mild form of nationalization would be extremely difficult to be implemented.

6. Conclusions

The purpose of this paper is to present the "bad bank" strategy followed in Greek banking system to safeguard the stability during the current financial crisis.

Swedish model designed in a more stable macroeconomic and financial global setting than today. Swedish crisis of the early 1900s was a local problem to a small open economy with a pegged exchange rate. Establishing a "bad bank" was the solution of choice for Ireland and Spain in the aftermath of the recent global financial crisis.

Bad bank solution in Greece is most of all a funding problem. The Hellenic or Greek Financial Stability Fund was founded in Greece, in July 2010 (under Law 3864/2010) as a private legal entity

and does not belong to the public sector, became liable to pay until 31/12/2014 the amount that the Hellenic Deposits and Investments Guarantee Fund would have covered, in the context of the resolution of the financial institutions.

In Greece from October 2011 to March 2014, twelve banks resolved through the legal and regulatory framework under either a transfer order (order to transfer assets and liabilities to a transferee credit institution) or establishment of a bridge bank.

The solvent or "good assets" of these failed banks were transferred either to another bank (in the case of purchase and assumption) or to a bridge bank, leaving the remaining assets ("bad assets") and liabilities in entities under liquidation, under the responsibility of liquidator.

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