Greek banking sector recapitalization and restructuring
Program modalities, progress already made and next steps

Safeguarding domestic financial stability is one of the three main pillars of both the first and the second Greek adjustment programmes agreed with official lenders (the other two being the restoration of fiscal sustainability and the creation of a solid base for a return to sustainable economic growth via the implementation of ambitious structural reforms). In these lines, the completion of a sizeable recapitalization plan for the domestic banking system constitutes an important structural benchmark under the country’s new adjustment programme and it is considered to be a key precondition for a gradual restoration of domestic financial conditions. Note that the new IMF baseline scenario (Dec 2012) expects bank credit and deposits to resume positive growth as early as in 2014, contingent on a vigorous implementation of the agreed programme targets. In this report we take a closer look at the progress already made as well as the next required steps towards the successful completion of the recapitalization of Greek banks.

Bank of Greece assessment of domestic bank recapitalization and restructuring needs
In a detailed study (hereon, BoG exercise) that was completed in March 2012 and became publicly available in late December, Bank of Greece (BoG) confirmed that the amount of €50bn earmarked, under the new EU/IMF-adjustment programme, for the recapitalization of the domestic banking system is deemed adequate. According to the methodology applied in the BoG exercise, the following two elements were taken into account:

1. The capital needs for all Greek banks on a consolidated basis, estimated at €40.5bn

Out of this amount, €27.5bn corresponds to the four biggest domestic lenders, with the following allocation: National Bank of Greece: €9,756mn; Eurobank: €5,839mn; Alfa Bank: €4,571mn; and Piraeus Bank: €7,335mn. As per the BoG’s strategic assessment of the domestic banking system, these four banks were identified as “core”, based on certain regulatory criteria (regulatory ratios, asset quality and governance) and an assessment of their business fundamentals (commercial strength, profitability and risk management). These four banks account for approximately 75% of domestic banking sector assets.

As a starting point for the calculation of the domestic banking system’s capital needs over the period 2012-2014, BoG used the Core Tier 1 ratio of each bank as it was presented in the respective 3-year business plans submitted in December 2011. Note that these ratios incorporated neither the impact of the PSI nor the €18bn bridge recapitalization loan provided to the four core banks by the Hellenic Financial Stability Fund (HFSF) in April 2012, so as to bring their capital adequacy ratio to 8%. The BoG estimated thereafter the projected evolution of the banks’ Core Tier 1 capital
adequacy ratio over the period 2012-2014.

The capital need for each bank was finally calculated as the difference between i) the target level for the bank’s Core Tier 1 capital ratio in 2014 (see analysis below); and ii) the estimated level of the corresponding Core Tier 1 capital ratio at the end of each year until 2014. The BoG’s assessment of the domestic banking system’s capital needs was performed under both a baseline and an adverse scenario for each bank. The baseline scenario assumed a certain future path for a range of key macro indicators (e.g. real GDP growth, unemployment rate, inflation and residential & commercial real estate prices) along with a Core Tier 1 ratio target of 9% for 2012 and 10% for both 2013 and 2014. The adverse Scenario utilized more downbeat macro assumptions relative to the baseline along with a Core Tier 1 ratio target of 7% for the whole period 2012-2014. The scenario that resulted in the highest capital need was considered binding for each commercial bank.

The BoG’s methodology for calculating the projected path of banks’ Core Tier 1 capital ratios in 2012-2014 incorporating the following:

(a) Total losses incurred as a result of the Greek debt restructuring (PSI) as well as selected state-related loans. These amounted to an estimated €37.7bn, including €5.8bn of provisions booked by banks ahead of the PSI.
(b) Credit Loss Projections (CLPs) of Greek banks’ total loan portfolio over the period June 2011-December 2014. These losses were estimated at €46.8bn, including €24.7bn of accumulated loan loss reserves as of December 2011. More specifically, CLPs carried the following types of risks: (i) Greek risk as assessed by an independent diagnostic study conducted by BlackRock Solutions on the domestic loan portfolios of Greek commercial banks over a three-year period and a loan-lifetime horizon; (ii) foreign risk for Greek banks’ subsidies abroad (based on a methodology similar to that of the EU-wide stress testing exercise conducted by EBA in June 2011); and (iii) state-related risk, for loans that remained outside the PSI perimeter (based on BlackRock and BoG estimates).
(c) Banks’ expected internal capital generation, estimated at €11.4bn. The latter figure was estimated based on the banks’ business plans for 2012-2014 that were submitted to the BoG in December 2011 as well as their capital actions as of the time of the completion of the BoG exercise (March 2012).

II. The so-called Financial Envelope, estimated at €9.5bn

This is the level of public resources required as a backstop facility for the banking sector’s recapitalization needs and restructuring costs over the period 2012-2014. The breakdown of the corresponding amount (€9.5bn) is as follows:

(a) A net impact of €1.4bn from completing certain commercial bank resolutions and recapitalizations as of the time the BoG exercise was concluded. In particular, the latter estimate incorporates: (i) the cost of the activation of resolution procedures for three commercial banks (ATEbank, Proton Bank, and T-bank) as well as three cooperative banks; and (ii) the reduction in the estimated capital needs as a result of the recapitalization of two foreign subsidiaries operating in Greece;
(b) A €3.1bn for potential future restructuring(s), if required; and
(c) A €5bn capital buffer, to cover potential contingencies.


Greek government announces bank recapitalization terms

With a ministerial cabinet act on 12 November 2012, the Greek government unveiled the terms of the bank recapitalization program. In what follows, we present some of key program modalities:

Minimum capital requirement ratio

— Greek banks should meet a Core Tier 1 capital ratio of at least 6% through the exclusive issue of common shares, without taking
into account: (i) existing preferred shares (that were issued by banks to the Greek State under the 3723/2008 law); and (ii) any contingent convertible bonds. Note that, based on the Q3 2012 results of all four systemic banks (announced last December) their net capital position was in negative territory.

— Private shareholders will be required to cover at least 10% of new common equity capital so as to keep credit institutions privately run. Should this be the case, the remaining 90% will be covered through the issue of common shares to the Hellenic Financial Stability Fund (HFSF) with restrictive voting rights. Yet, should the Fund’s participation exceeds 90% of the common equity capital increase, the HFSF shares will carry full voting rights, implying an effective nationalization of credit institutions.

— Subscription price for the HFSF and private shareholders
  o HFSF subscription price to the common equity capital increase will be equal or lower than the minimum of the following two values: (i) a 50% discount to a bank’s weighed average stock price over the 50 trading sessions prior to fixing the subscription price; and (ii) the closing stock price in the trading session prior to fixing the subscription price.
  o Subscription price to the common equity capital increase for the private sector can not be lower than that of the HFSF.

Eventual capital adequacy ratio target

— The remaining capital requirement - i.e., above the 6% Core Tier 1 ratio - that is necessary to meet the BoG’s core Tier 1 target (estimated at 9%) will be covered through the issue of contingent convertible bonds by the credit institutions, such as CoCos, taken up by the HFSF, upon approval of the general meeting of shareholders of each credit institution (see Table A1).

— Should private investors cover at least 10% of the common equity capital increase, they will be granted warrants as an incentive, enabling them to purchase the remaining 90% common shares from the HFSF at a future time (see Table A2).
Table A1 - Contingent convertibles to be used as part of Greek banks’ capital increase (terms & modalities)

a) **Duration/Ownership**
Contingent convertibles have duration of 5-years, unless they are converted into common shares (under certain conditions presented below) or are bought back by the credit institution prior to expiration of this period. Moreover, they are non tradable; they are instead exclusively under the ownership of either the HFSF or the credit institutions which have bought them.

As long as contingent convertibles are outstanding, credit institutions are not allowed to distribute ordinary dividends. Any amount that would normally be used for the distribution of ordinary dividends will now be channeled proportionally to meet coupon payments on contingent convertibles as well as securing funds to buy them back at a future time. The issue of contingent convertibles may precede or follow the common equity capital increase.

Upon a written approval by the BoG, credit institutions can buy-back contingent convertibles, in whole or partially under the following conditions:

(i) they substitute them with equal or better-quality capital; and
(ii) they have provided, at the BoG discretion, satisfactory evidence that, post buy-back, their Core Tier 1 ratio will exceed the minimum required threshold. Contingent convertibles will cease to be in force after they are bought back by credit institutions.

b) **Interest payment**
Contingent convertibles will bear an annual coupon of 7% plus a 50bps step-up per year. The said interest has to be paid in cash on an annual basis, provided that capital adequacy requirements are fulfilled. Yet, interest payment could be paid via the issue of common shares in case that a cash payment would result in a fall of the Core Tier 1 ratio below the minimum acceptable threshold. Common shares would then be issued at a price equal to the 50% of the bank stock weighed average price over the 50 trading days preceding the interest payment date.

c) **Automatic conversion**
Contingent convertibles are mandatorily converted into common shares in case that one or more of the following events occur:

(i) an *extraordinary* event, defined as (a) Common Equity Tier 1 ratio falls below 5.125%; and/or (b) EBA Core Tier 1 (including preferred shares) falls below 7%; and/or (c) contingent convertibles are not bought-back by credit institutions within 5 years post their issue date; and/or (iv) private investors fail to cover at least 10% of the common equity capital increase;
(ii) a *viability* event, defined as a contingency under which some kind of State support is deemed necessary by the BoG so as to keep the credit institution afloat;
(iii) the credit institution decides not to pay the annual coupon on contingent convertibles.

d) **Conversion price**
Provided that conditions (i) & (ii) of part c) above apply and contingent convertibles are issued after the capital increase, then the conversion price will be determined by applying a 50% discount on the HFSF’s subscription price in the capital raising process. If a capital increase does not take place, the conversion price will be equal to 25% of the weighed average price of common shares over the 50 trading days preceding the issue date. Under (iii of part c), the conversion price will be equal to the 65% of the weighed average price of common shares over the 50 trading days preceding the coupon payment date.

### Table A2 - Warrants

**a) Number of warrants private investors are entitled to receive**
The exact number of warrants private investors participating in the common equity capital increase are entitled to receive is calculated as the ratio between the total number of common shares taken-up by the HFSF and the total number of shares taken-up by private shareholders. Under the assumption that private investors cover the remaining 10% of the common equity capital increase and the HFSF covers the remaining 90% (so as to keep credit institutions privately run), 9 warrants will be issued for each common share.

**b) Exercise price of warrants**
The exercise price of each warrant will be determined as the price paid by the HFSF to acquire 1 share of common stock (on which an annual interest rate of 3% and a certain *premium* will be applied) times the total number of common shares the owner of the warrant is entitled to receive. The said premium is 100bps for the first year and increases by 100bps in each of the following four years.

**c) Exercise period**
Warrants may be exercised every six months; the exercise period commences six months post their issue date and is expanded for the subsequent 54 months. If warrants are not exercised until the end of this period, they will automatically lapse.

**d) General terms**
The HFSF is not allowed to transfer common shares to third parties for a period up to 36 months as of their issue date. Upon expiration of that time horizon and for as long as the warrant exercise period is in force, the HFSF is allowed to transfer its common shares provided that: (i) it has notified the owners of warrants of its intention and it has made known the exact number of common shares it intends to transfer; and (ii) it has invited the owners of warrants - via a 30-day prior notice - to acquire common bank shares held by the HFSF. If a number of shares is finally transferred to third parties, the number of outstanding warrants is adjusted accordingly.

Bank recapitalization timeline

As per the conditionality laid out in the revised MoU (December 2012), the legal framework for bank recapitalization comprises the following steps:

I. Core banks

a) **Transfer of bridge capital to four core banks by the HFSF**, so as to boost their Core Tier 1 ratio up to the regulatory minimum threshold of 9% under Pillar 1 (completed already). Moreover, the HFSF would have to issue a commitment letter to subscribe to 100% of the remaining capital needs.

b) **Issuance of contingent convertible bonds (CoCos)** by end-January 2013. The HFSF will subscribe to 100% of any convertible instruments the banks will decide to issue.

c) **Completion of share capital increases** by end-April 2013, which will be fully underwritten by the HFSF (MoU structural benchmark).

In November 2012, soon after the issuance of the ministerial act on the terms of the bank recapitalization programme, BoG officially informed banks of their individual capital needs and requested them to finalize their capital raising process by end-April 2013. As per the conditionality laid out in the revised MoU, following the completion of the recapitalization programme, all banks (core & non-core) should update their restructuring plans by end-June 2013 and submit them for validation. Banks that have acquired other institutions through Purchase and Assumption (P&A) transactions sponsored by the HFSF, are allowed to update their restructuring plans by end-July 2013. On its part, BoG will complete a follow-up stress test for all banks by end-FY 2013.

II. Non-core banks

As spelled out explicitly in the December 2012 revised MoU, due to limited business opportunities and higher funding costs, non-core banks are expected to be fully recapitalized with private resources by end-April 2013. Alternately, their capitalization programme can be completed by end June-2013 through P&A transactions with well capitalized banks or, as a second best, through the establishment of a bridge bank. Against this background, ATE, the largest publicly-owned bank, was resolved in July 2012 through a P&A transaction by Piraeus Bank with €7.2bn upfront costs for the HFSF. In another step towards restructuring the domestic banking system, the Hellenic Post Bank announced earlier this week its breakdown into two parts; the healthy side which will initially be running on its own before being finally absorbed by another lender (with upfront costs estimated at ca €4.5bn) and the so-called “bad side” (i.e., its bad loans portfolio) which will be cleared out by BoG. Moreover, Proton’s restructuring is expected to have been completed by mid-May 2013 in an open bid process under the sponsorship of the HFSF, with upfront costs estimated at ca €0.5bn.

In the interim, BoG will place all undercapitalized non-core banks under enhanced supervision in order to prevent potential market distortions and unsound banking activities.