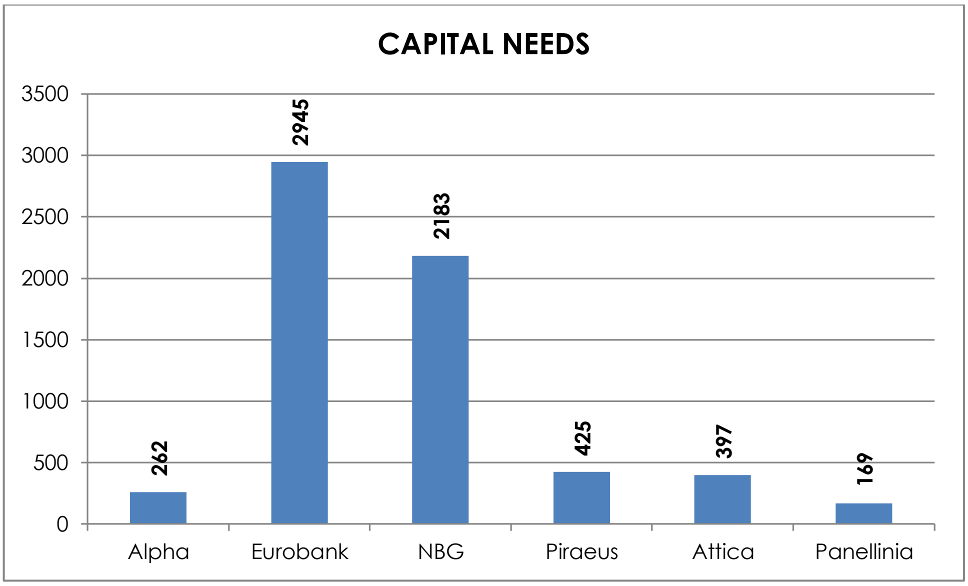
STRESS TESTS BANK RECAPITALISATION: THE ROAD AHEAD

In the second quarter of 2013, the four systemic banks, namely Alpha Bank, Eurobank, National Bank of Greece (NBG) and Piraeus Bank completed their recapitalisation on the basis of the 2012 capital needs assessment (following the initial Blackrock stress tests) and along the recapitalisation framework prescribed in Law 3864/2010 and Cabinet Act 38/2012. However, troika has asked for more tests to be carried out in 2013 and as a result Bank of Greece conducted *"a follow-up stress test on the basis of end-June 2013 data to update banks' capital needs."*



Source: Bank of Greece, March 2014

Non-performing loans held by Greek banks rose to about 31 percent of their total loan book at the end of the third quarter last year from 29.3 percent at the end of the first half. Companies in several key economic sectors, including aquaculture, construction and hotels, all face difficulty in servicing their loans but banks have so far been willing to make concessions on repayments. The BoG report said that in the period from 2014 to 2016, local banks will suffer losses of 50.24 billion euros from nonperforming loans in Greece, plus another 10 billion euros from bad loans issued abroad.

From this latest exercise, total capital needs for the banking system were estimated at 6381 million euro and should be covered for the stress-test horizon (June 2013 – December 2016) by private sector participation, internal generation of capital through the sale of assets and HFSF funding. The Bank of Greece has also asked banks to submit their new business plans to strengthen their capital bases by April 15.

In a recent (14/3/2014) letter to the Greek government the EU Commissioner Mr. Almunia provided guidelines for banks recapitalisation and sets four conditions. The contents of the letter were leaked to the press on Monday evening and were published at the Kathimerini site on the 25th of March. In particular the specific conditions set in the letter are:

- Banks should adopt measures to strengthen their capital and base and raise capital from the market.
- The state aid from the Financial Stability Fund (FSF) should be minimal.
- The participation of the FSF will be limited only to the extent that offers from private investors do not meet the fair value of the bank.
- Any participation by the FSF will be preceded by a "haircut" of subordinated bonds.

According to the letter, Mr. Alnunia would **<u>not</u>** oppose a limited involvement of the FSF in the capital increase if the price at which private investors are willing to engage is below a reasonable estimate of the fair value of the bank.

On Thursday (27/3) the government is expected to submit to Parliament legislation about banks' recapitalisation which will also include specific guidelines for the privatization of Eurobank. It will give the Fund greater flexibility and more possibilities to achieve the fastest return of banks to the private sector. Among other things, the FSF may submit a tender offer to the holders of warrants, in order to acquire shares of banks and then sell them quickly to private investors. The values set for capital increases and the redemption of warrants should be based on estimates by two independent consultants. **<u>We expect legislation to be in line with EU recommendations as the draft legislation has been previously submitted to the EC Competition for approval.</u>**

The market expects FSF to participate with 1 billion euro in the forthcoming **Eurobank** recapitalisation while the private investors will cover the rest, estimated at about 2 billion euro. The FSF has already provided 5.8 billion euro in the first round of Eurobank capitalisation. Failure to participate in this second round will lead to a marginalisation of its shareholding and accusations of losing money on its investments (financed through tax payers money), which in turn may cause a legal challenge by prosecutors against the board. **<u>It remains to be seen whether the proposed legislation provides adequate legal cover for the FSF board.</u>**

Although, Eurobank has been the focus of attention by EU authorities and investors, **NBG** has also become a major concern. The failure to disinvest from Finanzbank before the Turkish crisis is now creating difficulties in the implementation of the agreed business plan. NBG is reportedly seeking a delay for the disinvestment process until June 2015. European authorities are reportedly pushing NBG to conclude all necessary steps as soon as possible and no later than the announcement of the results of EU-wide stress test to be carried out by the ECB, which is expected to take place until next November.

If not successful NBG might be forced to sell more than 49% of its shareholding in Finanzbank in order to cover the agreed level of capital funding from internal sources.

Following Mr. Almunia's letter the risks of a new referral to the EU competition authorities is limited provided that the government follows the guidelines. Competition authorities at EU level follow general guidelines irrespective of the specific conditions in a member state. As far as Greece is concerned they take a more stringent approach as the previous recapitalisation proved inadequate in the space of 12 months. Furthermore, European authorities are concerned about possible future requirements for additional capital injections. Bank restructuring should be in line with the EU Banking Communication guidelines on state aid, with banks covering their needs through the sale of assets and private sector participation and may also involve some actions regarded as "bail in" which are invariably politically sensitive. Hence, EU authorities are pressing for more private participation at this stage to safeguard the HFSF reserve that might be needed in the future avoiding as a result the implementation of damaging bail in measures further down the road. Mr. Almunia repeatedly mentions in his letter the issue of "mandatory conversion or write-down of subordinated creditors" in the context of burden sharing requirements of the Banking Communication document.

Although the return by Greek banks to capital markets after a five-year gap underscores growing international interest for investing in Europe's periphery as it emerges from recession, the continuing weakness of the business sector may generate more non- performing loans and undermine banking recovery. It remains to be seen whether the BoG estimates will be challenged later this year when the ECB, which is due to take on a fresh banking oversight role beginning in 2015, runs its own independent stress tests of Europe's banks.

S. Travlos 27-3-2014