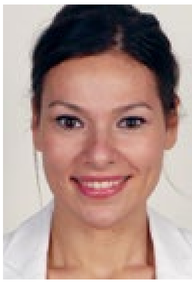
A CRUCIAL STEP TO ENSURE REAL ESTATE MARKET **GROWTH**

COMPREHENSIVE PRIVATE DEBT RESTRUCTURING



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Since 2008, Greece has been involved in a three-fold overall crisis:
i) a €240bn sovereign debt crisis with sovereign debt/GDP and yields on government bonds rising to unsustainable levels,
ii) an economic growth crisis more protracted and deep than any other European country, resulting in a 25% drop in GDP and a rise in official unemployment to 28%, and
iii) a banking sector crisis caused by the sector's significant exposure to Greek sovereign debt, a €100bn deposit flight from the system as well as high levels of private debt, rendering many banks unable to cope stand-alone due to the simultaneous occurrence of all these.
The sovereign debt crisis, after a first inconclusive €110bln bail-out in 2010, was finally dealt with by a second, more decisive €130bln bail-out in combination with a €100bln one-off sovereign debt write-down in Q1 2012 and the strict implementation of structural reforms that followed and which was designed to ensure the future affordability of the remaining and new debt obligations.

{Together with the buyback of €30bn in nominal face value bonds for an amount of €10bn in November 2012, these actions have resulted in a successful return of the Hellenic Republic to international capital markets in April 2014, only 2 years after the write-down, and a drop in Greek government bond yields from over 45% in Q1 2012 to a near-term low of less than 6%in September 2014.}

The core elements of this approach were modelled on lessons learned from other sovereign debt restructurings across the world, including breaking the vicious cycle between a sovereign crisis and a bank crisis.
The structural reforms implemented within the framework of the 2 international bail-outs also used templates of previous economic shock-therapies applied in other crisis-stricken regions from Asia to Russia to South America. These measures, as well as the great sacrifices made by the Greek people, have after six years also mitigated the economic crisis resulting in 1.9% cumulative growth in GDP since the end of 2013, a 1.9% drop in unemployment to 25.9% since August 2013 and a twin surplus for the primary and current balance in both 2013 and 2014, all elements coming in ahead of even the most optimistic estimates.

The banking crisis in Greece has encompassed various elements:
i) a liquidity crunch by the loss of €100bln in deposits,
ii) a solvability challenge due to the banks' participation in the PSI as part of the €100bn sovereign debt write-down in Q1 2012 resulting in severe losses,
iii) a fragmented banking sector and the retreat of foreign bank ownership, and iv) a steep rise in non-performing loans ("NPLs") from 5% at the end of 2008 to 33% at the end of 2013 due to the severe drop in disposable income and the 25% contraction of the local economy.
ECB emergency liquidity assistance was offered and €50bn was earmarked for bank recapitalisation through HFSF. During 2013 and 2014 HFSF disbursed €39bn of funds and instigated a sector consolidation and resolution whereby >20 banks were folded into 4 main systemic banks and several bad banks were created and put in resolution. In addition, the 4 main banking groups raised €9bn in equity and €2bn in debt in various capital markets transactions in 2014.
All of the above leaves one final step uncompleted: a comprehensive solution for the bank NPLs.

HOW BIG IS THE ISSUE?

According to the Bank of Greece diagnostic assessment published in March 2014, the Greek banking system had €216bn in relevant exposures to corporates and households in Greece. Of this amount, €70bn was related to mortgages, €26bn to consumer loans and €121bn to business loans. With currently around 35% of all loans categorised as NPLs, this translates to €80bn of problematic loans and there is not yet an end in sight.

A significant part of business loans are secured by real estate collaterals; more than €100bn of Greek bank loan exposures have a real estate angle. Taking a conservative NPL rate of 30% across all real estate collaterals (considerably lower than the 40%+ NPL rate of consumer loans) translates to a minimum of €33bn of real estate assets that are currently under threat of repossession or another form of resolution.

The overhang of this NPL-related real estate has contributed significantly to a severe dislocation of the real estate market and exacerbated the drop in property values of over 40% from peak with the number of transactions and new loan originations at minimal levels. Therefore NPLs need a comprehensive solution before the Greek real estate market can recover.

WHAT MIGHT A SOLUTION LOOK LIKE?

A wealth of experience in private debt resolution and restructuring techniques has been gained and different models have been used from country to country whereby depending on the severity of the situation either centralised, government-run asset management companies (AMCs) or separate entities per bank were set up.

To start with, Greece is not unique in having faced a severe banking crisis, as from 1970-2011, 147 different banking crises have been recorded, with some countries experiencing up to 4 crises during that period (see figure on the bottom).

Furthermore, it has not been alone in having to deal with an exceptionally high level of NPLs (ideally NPL percentages should not exceed mid-single-digit numbers), however at the current stage NPL levels in Greece (35%) are higher than they were in the Scandinavian countries in 1991 (12-15%), Turkey in 2000 (27%) and even the Asian countries in 1997 (32%).

In order to finalise the required decisive response to the Greek NPL challenge, a look at the most meaningful comparisons to the Greek situation is needed.

In selecting which cases to highlight, one needs to filter the distinctive features of the Greek crisis:

- > Occurrence of sovereign debt/ banking crisis, combined with severe economic contraction in a developed and open economy
- > No ability to devaluate its currency due to the use of a common currency
- > Loans related to real estate and land development are a large contributor to private debt
- > No deep market for securitised products, bank debt is the main source of lending
- > Existence of interconnected, deregulated and globalised capital markets

By applying the above criteria, the examples of particularly Ireland and Spain (2008) seem very suitable as they are recent and broadly encompass most elements outlined above. The example of Sweden (1991) will also be examined. Even though it did have the ability to devalue its currency and was mostly a banking crisis, it was the first country in a European context that implemented the so-called "good bank, bad bank" model on a national scale, a crisis mitigation tool that has been widely used in subsequent systemic bank crises in Europe since.

As noted in Herring and Wachter (1999), although banking crises can occur without real estate cycles and vice-versa, there is a high incidence of both being strongly correlated and they also note that the evolution of a property-related crisis depends on the scale of the inter-linkages between the financial system and the real economy. In Ireland, Spain and Greece, these inter-linkages are quite acute given the prevalence of bank debt as a key source of financing for the resident private sector.

Example 1: **Ireland**

Since 2008, Ireland experienced a severe financial crisis characterised by a systemic banking crisis and a significant economic adjustment. Ireland had a protracted property and

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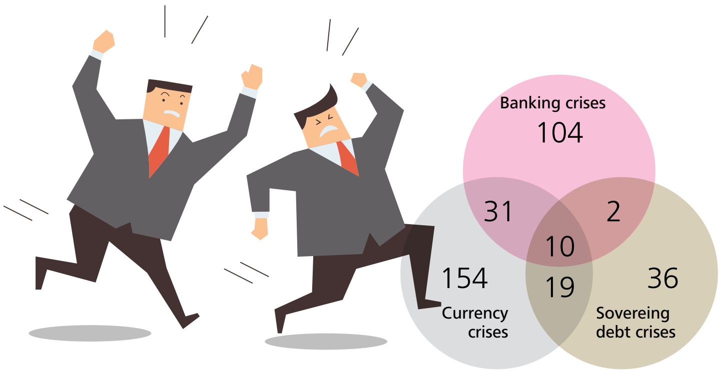
SEVERE **CRISES**



Source: Laeven and Valencia (2012)

NPLs/GDP

LUXEMBERG	1
SWITZERLAND	1.2
AUSTRIA	2.5
BELGIUM	2.5
NETHERLANDS	2.7
GERMANY	2.9
GREAT BRITAIN	3
FRANCE	3.3
DENMARK	3.5
BELARUS	4
SPAIN	4.5
ESTHONIA	5
CHECH REPUBLIC	5
SLOVAKIA	5.5
PORTUGAL	6
CYPRUS	7
MALTA	8
POLAND	9
FYROM	10
RUSIA	10
ITALY	11
SLOVENIA	12
BOSNIA	12.2
CROATIA	12.5
HUNGURY	13
ROMANIA	14
IRLAND	15
GREECE	15
BULGARIA	15
UKRANE	15.2
MOLDOVA	16.5
ALBANIA	19.5
SERBIA	19.5
LATVIA	19.5
LITHUANIA	20
MONTENEGRO	21
ICELAND	4.8
FINLAND 1991	14
SWEEDEN 1991	14
NORWAY 1991	16
TURKEY 2000	28
ASIA 1997	31.5

credit boom which contributed to unsustainable domestic imbalances prior to the crisis. Furthermore, the economic adjustment coincided with, and was exacerbated by, the global financial crisis, which began in2007. The Irish government's intervention was quick and significant, guaranteeing all customer deposits in Irish banks. This created significant actual and contingent fiscal liabilities (over €60bn) and transformed banking risk into sovereign risk. Against the background of heightening tensions in European sovereign debt markets, these risks intensified from the summer of 2010, resulting in Ireland applying for external EU/IMF assistance in November 2010.

Ireland decided in late 2009 to institute a nation-wide "bad bank" (National Asset Management Agency or NAMA) to absorb the non-performing loans from the 6 major banking groups to avoid their otherwise likely insolvency.

NAMA
acquired a nominal value of €74bn in non-performing loans from the main banks at a 57% discount

At its inception, NAMA acquired a nominal value of €74bn in non-performing loans from the main banks at a 57% discount, paying €32bn in 2009, funded 95% by senior debt (guaranteed by the Irish state) and 5% by subordinated debt. NAMA is tasked with winding down this balance sheet to 0 and ensure that at least the acquisition price is recovered. To date, NAMA has generated €23bn in cash receipts of which €18bn from asset sales and has already redeemed more than 60% of its senior debt, 2 years ahead of schedule. The value of the underlying collateral of NAMA's loan portfolio by now has become worth more than its acquisition price of the loans in 2009.

Example 2: **Spain**

The main drivers of the 2009 financial crisis in Spain has been the weakness, lending practices and failures of the cajas (savings banks), with particularly large exposures to construction and real estate development companies and assets. The weaknesses were exacerbated by the 2008 credit crunch and sovereign debt crisis.

Shying away from incorporating a government-backed "bad bank", in June 2009 the Spanish government initiated the Fund for Orderly Bank Restructuring (FROB), a banking bailout and reconstruction program which would preside over the mergers and acquisitions of Spain's failing cajas. FROB would use its €9bn funds (later increased to €15bn in equity and €11bn in bonds) to incentivize the large cajas to participate in «virtual» mergers in an effort to stave off systematic financial instability. Troubled national banks in the meantime had incorporated their own "bad banks".

In 2009 and 2010, FROB granted financial support through convertible preference shares to 7 integration processes amounting wwto €10bn and resolved a further 5 institutions. After this phase of sector restructuring, 45 cajas were folded into 10 banks and only 2 cajas remained.

In 2011, FROB injected €6bn into 4 large banking groups to improve their solvency to at least 8% of risk-weighted assets, subscribing to common shares in those institutions and receiving stakes ranging from 90-100%.

Largely as a result of the request for a €19bn bail-out of Bankia, it became clear that FROB would not be a sufficient mechanism to deal with Spain's banking crisis and that a separate entity needed to be set up. The creation of such a separate asset resolution entity was an idea proposed by foreign specialists. Their proposals were initially contested by the Spanish government, yet eventually in late 2012, as a condition by international lenders for a €100bn recapitalisation of the total Spanish banking sector through the ESM, a bad bank was set up called SAREB, leaving FROB to become the resolution authority.

SAREB is responsible for managing assets transferred by the four nationalized (Group 1) Spanish financial institutions and later on several Group 2 financial institutions. Its shareholders are private financial institutions (55%) and FROB (45%). The total equity capital contributed was €2.6bn from private investors and €2.2bn from FROB, and SAREB manages the ESM contributions deployed through FROB.

SAREB acquires property development loans from Spanish banks in return for government bonds, primarily with a view to improving the availability of credit in the economy. Over the 15 years of its life, SAREB has to dispose of all of its assets and its main objective is to maximise its profitability with a target Return on Equity of 14-15%. Currently SAREB manages €55bn of mostly real estate assets, acquired at a discount of around 60% in 2012 and 2013. Its assets cannot exceed €90bln.

Example 3: **Sweden**

The banking crisis in Sweden followed a housing bubble that deflated during 1991 and 1992, and resulted in a severe credit crunch and widespread bank insolvency, with the causes broadly similar to those of the subprime mortgage crisis of 2007.

The Swedish government responded quickly by taking the following actions:

Focused on early recognition of losses, whereby true valuations and transparency were preconditions for receiving government support – banks were forced to write down losses according to their true valuations and markets received accurate information

Guaranteed all bank deposits and creditors of all 114 banks

Made government assistance available not only to Swedish banks but also foreign-owned subsidiaries in the country and other specific credit institutions, with the structure and amounts tailored to the necessities of particular banks or institutions

Bank assets were divided in good and bad debts: good quality assets were left in the respective institutions, which continued business as usual, while troubled assets were transferred to special asset management funds (AMFs), which were deliberately overcapitalized so that they had the capacity to absorb losses

The bad debts were assumed in exchange for a write down by the banks and an equity interest for the government – existing shareholders at the systemic banks were diluted further by private bank recapitalizations yet bondholders at all banks were protected. Nordbanken and Götabanken were nationalised and their bad debts were transferred to AMFs which sold off the mainly real-estate related assets that the banks held as collateral

Proceeds from later asset sales flowed to the Swedish state, and in addition there remained the ability to recoup more money later by selling shares in the nationalized banks

The Bank Support Authority was formed in 1993 to supervise institutions needing recapitalization, to assess the magnitude of troubled loans as well as each bank's earning potential in the long run

The bailout initially cost about 4% of GDP, which was later lowered to below 2% of GDP due to the value of the bank equity later sold when the nationalized banks were privatized. The last liquidations by AMFs took place as early as 1997, 5 years after the start of the process.

{The Swedish resolution mechanism is widely known to be a model for how to effectively solve a banking crisis at minimal cost to taxpayers. First, it shows the importance of accurate information and true valuations in times of crisis. Second, it underscores benefits of an efficient management of troubled assets. Finally, the Swedish experience reflects the importance of balance between support for the banking sector and the soundness of public finances.}

CONCLUSION

Left unresolved, high levels of private debt are likely to impede a recovery, helping neither debtors nor creditors. Therefore, private debt restructuring should be modelled along the following key principles:

1. Aim should be to maximize recovery rates and minimise time and cost involved
2. Government role should ideally be restricted to providing the coordination and leadership necessary to create a sound enabling economic and legal framework, including a functioning and effective insolvency regime
3. Speed of implementation and execution is of the essence
4. Actual resolution of a bank's assets is best in the hands of specialised institutions, with an oversight mechanism or entity safeguarding the public interest
5. The restructuring approach needs to be consistent and comprehensive, recognizing the losses early and communicating them to market participants in a transparent manner

The Greek government, the Bank of Greece as well as the 4 systemic banks have instigated many reforms, crisis fighting mechanisms and internal good bank/bad bank divisions to deal with the triple crisis. However, after six consecutive years of downturn a comprehensive NPL framework is still under discussion, with stakeholders failing to agree on an all-encompassing approach.

Many examples of private debt restructuring exist, and even in the aftermath of deep economic recessions or banking crises in all successful cases a systemic solution was put in place to deal with the ugly truth of value erosion and high levels of NPLs. Only one thing is certain: NPLs cannot be ignored and the quicker a system deals with them, the quicker liquidity can return to the market and values will eventually bounce back to the benefit of all stakeholders.

The advantage of not being alone in this is that we can profit from lessons learned. By weighting pros and cons of those structures that have already been tested, we can institute a panel of specialists under the guidance of the Bank of Greece, in cooperation with the four systemic Banks, through the Union of Bankers Association, that will create a solution that works best when applied in the Greek context.

However the success of such will in the end depend on the commitment from all (including the opposition parties) to help instigate a quick resolution of NPLs and through that accelerate economic growth and prosperity for the entire Greek nation, including a vibrant and rising real estate market.

SAREB
manages €55bn of mostly real estate assets, acquired at a discount of around 60%

TO DATE, NAMA HAS GENERATED €23BN IN CASH RECEIPTS OF WHICH €18BN FROM ASSET SALES AND HAS ALREADY **REDEEMED MORE THAN 60% OF ITS SENIOR DEBT, 2 YEARS AHEAD OF SCHEDULE**