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# Reforming the Greek Financial System: a decade of failure

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**ABSTRACT**

In this paper an attempt is made to describe the political economy of financial reforms in Greece. After a decade of deep crisis, Greek banks still suffer from the highest Non-Performing Loans (NPLs) ratio in the Eurozone, which occurred because of macroeconomic and bank-specific factors. However, due to the emphasis of policy makers on the macroeconomic determinants of NPLs and the contradicted incentives of the main stakeholders (bankers, politicians, regulators and investors), the need to improve the internal NPL management skills and the corporate governance of banks, both of which were poor, was neglected. As a result, the lost opportunity to restructure the Greek financial system aggravated the macroeconomic conditions for lack of a counter-cyclical lending policy.

Keywords: Non-performing loans, corporate governance, Greek banks, reforms

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## 1. Introduction

The financial reforms agreed, in the summer of 2015, between the Greek government and the Troika in the third memorandum of understanding (MoU) (European Commission 2015) included: i) addressing the non-performing loans (NPLs) in the banking sector, ii) recapitalizing banks and c) strengthening the governance of the Hellenic Financial Stability Fund (HFSF) as well as that of banks. Nevertheless, until the conclusion of the third MoU, the domestic banking fragility in Greece was interpreted solely as the result of the macroeconomic difficulties. Moreover, the emphasis throughout the first two MoUs on financial stability - rather than on reforming the domestic banking system - was certainly due to the very serious problems faced by Greek banks, especially after the sovereign debt restructuring (PSI) in 2012. It is noteworthy (Katsikas et al. 2018) that owing to the PSI, financial sector reforms increased in the second MoU to 16 compared to 9 in the first MoU. In general terms, 20% of the reforms in the first MoU and 25,3% in the second one were related to the restructuring of the financial sector. In short, the Greek financial system appeared to be just a passive recipient of all the planning reforms in order to merely preserve its stability through a long and fruitless recapitalization process.

As a matter of fact, the identification of the key determinants of bank failures is a fundamental issue for the banking supervisory authorities, since the implications for a regulatory policy strongly differ depending on its origin. If only macroeconomic factors influence banks' fragility, thus generating capital shortfalls, the need for an overall reform strategy is limited; consequently, capital injections are sufficient tools for restoring banks' soundness. On the other hand, in the case of bank-specific factors (e.g. poor managerial performance and corporate governance, insufficient micro-macroprudential supervision) impact banking stability, a comprehensive reform strategy enhancing NPLs management and strengthening the corporate governance of banks is required (ESM 2019a: 1). More specifically, a distinction needs to be made between ex-ante and ex-post management if the NPLs problem is to be addressed, that is, it is necessary to distinguish between: when impaired assets are incurred and before the problem arises (Athanasiou 2016: 2). In this context, ex-ante management is interwoven with efficient corporate governance and special internal management skills of banks. On the other hand, ex-post management is interconnected both with internal NPL resolution methods (e.g., securitization and direct sales to investors) and broader structural reforms (for example, out-of-court arrangements) or government-led NPL management, such as the creation of asset management companies. That said, the Greek banks failed to undertake internal resolution measures of NPLs; for that reason, the supervisory authorities (i.g. the Bank of Greece) employed an independent consultant to examine the NPL managerial ability of banks. Moreover, there was not any "radical solution to the governance issues that are at the root of the problems of the Greek banking system" (IMF 2015a:3). Several structural reforms also, regarding mainly court procedures, the creation of a secondary market for NPLs and debt collection ran behind. Lastly, the establishment of an asset management company ("bad" bank) was rejected by the Troika for political reasons. Hence, starting from the public sector, the crisis spread to the banking sector and back again, "in a self-feeding vicious circle of contagion between sovereign, banking sector and the real economy" (Pagoulatos 2014: 455). In the light of the above, Greek banks still suffer from low profitability and negative net credit expansion is counterbalanced by increased lending margins although in March 2019 banks fully repaid the costly emergency liquidity assistance (ELA) drawn from the domestic central bank. In particular, in November 2019, the annual growth rate of total credit extended to the domestic economy stood at -0.8% (Bank of Greece 2019). As a result, banks even now cannot focus on "what really matters for the future: modern business models, finding new profitable growth opportunities and activities, exploiting digital technologies, and above all, financing the real economy" (Stournaras 2019).

What does explain this failure? Despite a plethora of studies existing - as mentioned below - on the macroeconomic determinants for banks' misery in Greece, only a few studies scrutinize the political economy of financial reforms included in the MoUs. Avgouleas (2015) for example, argues that the recapitalization policy in Greece did not follow the international practice of bank rescue and reforming. It simply focused on safeguarding banks with significant amounts of state aid and further concentration of the Greek banking system. Thus, there was a plethora of disincentives created that undermined the efforts of a radical reform of Greek banks. The failing policies were primarily aimed at rescuing a small group of individuals (the major shareholders of the pre-2010 era). Therefore, this policy failure was a result of the institutional and political weaknesses of the Greek democracy, which affected two areas: the viability of the Greek banking system itself and its role as a provider of liquidity in the economy. In the same vein, Kolliopoulos (2020a) described the inertia of both the authorities and the bankers, which ended up in the sad state of full foreign ownership and control ("dehellenization") after the third recapitalization in late 2015. Explaining the high rate of NPLs in Greek banks, Panagiotarea (2016) claims that "weak cyclical conditions tell part of the story" for the policy failure. She argues also that "[d]emocratic politics have collided with reform ownership. Electoral and non-electoral pressures, multiple veto points, and private sector resistance have undermined majority-backed rules and regulations". Similarly, Munevar (2016), analyzing the recapitalization of Greek banks in the context of the third MoU, argues that behind policy failure "lies a story of financial recklessness, protection of vested interests and adoption of failed policies in the name of the sacrosanctity of debt in the Euro area". From a policy maker's viewpoint, Katseli (2017) claims that the lack of a systematic approach of the management of NPLs derives from the recognition that there are multiple stakeholders with different non-compatible interests in this NPLs market and significant information asymmetries among them.

Another major weakness is the fact that successful loans restructuring often requires enhanced internal management capacity on the part of banks, external funding, effective monitoring and the ability to intervene effectively. A final problem comes from the possibility of using NPL's for clientelistic reasons. Removing the loans from the banks minimizes the possibility of personal favours or enrichment.

Therefore, with a view to explaining the policy failure, an attempt is made in this paper to describe, as analytically as possible, the various phases and the political context of reforming the domestic financial system, in the areas of NPLs management and the corporate governance. Through this analysis, this paper sheds light on the bank-related determinants of the banks' fragility and the resulting reform failure by (a) exploring the literature on the determinants of NPLs and the significance of corporate governance of banks under the "Varieties of Capitalism" approach; (b) highlighting the poor banking practices prior to the Greek sovereign debt crisis onset; and (c) describing in detail the various phases and the political context of reforming the domestic financial system throughout the period of implementation of the three adjustment programmes.

## 2. The determinants of NPLs

Curtailing NPLs and enhancing corporate governance are preconditions for sustainable profitability, which plays a vital role for the stability of banks (García-Herrero et al. 2009) and the economic growth of the national economies (Sinha and Sharma 2016). The sustainable growth of banks is essential, as it enables them to support the "real" economy; as a matter of fact, empirical studies have shown that the economic growth is positively related to growth in the banking system (for example, Levine and Zervos 1998, Levine et. al. 1999, Beck and Levine 2004, Haris et al. 2019). Conversely, high levels of NPLs on banks' balance sheets have negative effects on lending to the "real" economy (IMF 2015b, Vouldis 2015, Louri and Migiakis 2019) and on unemployment rates as well (for example, see Katsikas and Filinis 2015). This happens through 3 major channels: i) Lower profitability related to less net operating income as a result of the existence of a large bulk of NPLs. ii) Higher capital requirements for banks in order to meet greater risk weights. iii) Higher funding cost because of the low level of creditworthiness of banks that hold large amounts of risky assets (Athanasiou 2016: 4).

Regarding the determinants of the ratio of NPLs to total bank loans, it can be attributed to macroeconomic and bank-specific factors. On the one hand, macroeconomic factors focus on the relationship between the business cycle and the capacity of borrowers to service their loans. Empirical evidence (Crespi and Aliano 2017: 58) suggests that NPLs exhibit anti-cyclical behavior: in economic expansions borrowers' income improves and thus, their capacity to service their debts. On the other hand, when economic activity slows down, NPLs increase as unemployment rises, disposable incomes decline and borrowers face difficulties in repaying their debt obligations. In the Greek case particularly, Charalambakis et al. (2017) found that unemployment and inflation, which became stronger after 2012, determined the NPLs of the Greek banking system. The increase in NPLs also opened a vicious cycle between them and unemployment, further worsening the macroeconomic environment. Their findings, therefore, support that a high level of NPLs can be mainly attributed to macroeconomic deterioration and political uncertainty. Similarly, Monokroussos et al. (2016) showed that the sharp increase in non-performing loans in Greece, following the outbreak of the sovereign debt crisis, can be traced back to the unprecedented contraction of domestic economic activity. Furthermore, Katsikas and Filinis (2015) highlighted the reverse causality; they examined the negative role of credit contraction in the macroeconomic environment (e.g. poor performance in labor market) of the Greek economy.

Meanwhile, bank-specific factors focus primarily on the impact of lending strategies on financial institutions (Berger and DeYoung 1997, Berger and Humphrey 1997, Podpiera and Weill, 2008 Adeyemi et al. 2011, Aebi et al. 2012, Homburg et al. 2016). In addition, the deregulation process strengthened competition among banks, increasing banks' credit risk and relaxing borrowing criteria. In the case of the Greek banking system, Charalambakis et al. (2017), found that bank specific variables, like changes in equity and the loans-to-deposits significantly determined the NPLs of the Greek banks only during the period before 2012. This may be in line with the double-digit growth of domestic bank lending in the post euro-entry years. However, Monokroussos et al. (2016) did not find empirical evidence in support of examined hypotheses assuming overly aggressive lending practices by the systemic Greek banks.

Nevertheless, it would be imprecise to conclude that macroeconomic and bank-related factors preclude each other in explaining the evolution of credit risk. On the contrary, several studies (Louzis et al. 2012, Makri et al. 2014, Makri 2015, Konstantakis et al. 2016) confirmed that the macroeconomic environment and accounting factors (past performance of loan quality, capital adequacy, liquidity and profitability) seem to influence credit risk both in Greece and in the Eurozone. Empirical findings revealed, therefore, a two-way causality between them in the Greek financial system: a worsening in the broader macroeconomic conditions may lead to a deterioration in banks' cost efficiency as a result of increased operating costs to deal with NPLs. Consequently, low cost efficiency and poor management skills in loan underwriting, monitoring and control may escalate the NPL ratio to total loans of banks.

## 3. The role of corporate governance in national financial systems

As it turns out, the efficiency of the NPL management is interwoven with the quality of the corporate governance framework. Moreover, the banking sector has two significant differences with respect to non-financial firms: In the first place, banks are generally less transparent than non-financial firms. Secondly, evidence suggests that these informational asymmetries are larger with banks (Levine 2004: 3). The special interest in banks' governance is justified by the fact that (Basel Committee on Banking Supervision 2015: 3) "poor corporate governance may contribute to bank failures and the possibility of broader macroeconomic implications. For that reason, effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole".

In general, the OECD (2015: 9) defines corporate governance as a "set of relationships between a company's management, its board, its shareholders and other stakeholders". Corporate governance also provides "shareholders, board members and executives as well as financial intermediaries and service providers with the right incentives to perform their roles within a framework of checks and balances" (OECD 2015: 9). In other words, corporate governance rules allocate rights and responsibilities among different agents stakeholders of every firm. Although corporate governance aims, primarily, at changing the rules under which the agent operates and restores the principal's interests, there is "significant divergence in national financial systems" in the political organization of financial systems and their private governance structures (Mitchell 2016: 43). The Varieties of Capitalism literature explores this divergence by examining whether the interaction between financial interests and political parties will drive movements to reform or reinforce existing corporate governance regimes (Mitchell 2016: 43). As a result, corporate governance practices are not a "one size fits all" regime; they vary across nations and firms (OECD 2012: 47). This variety reflects distinct societal values, different ownership structures, business circumstances and competitive conditions. Consequently, various corporate governance theories have been developed: agency, stakeholders and resource dependency theory, stewardship theory, social contract theory, legitimacy theory and political theory (for a comprehensive analysis on corporate governance theories, see Yusoff and Alhaji 2012; and Turnbull 2000).

The different governance regimes adopted by capitalist systems may be differentiated by the manner in which the social partners and institutional systems are structured in each particular context. The theory of Varieties of Capitalism (VoC) seeks to explain how legal, market and social institutions shape firms' strategy. The basic idea is that firms are the central actors in the economy whose behavior is crucial for economic prosperity (Hall and Soskice, 2001: 6-8). Adopting a relational view of the firm, the VoC approach assumes that success in each of these endeavors depends on efficient coordination with other actors. As a theory of institutional complementarities, the efficient coordination with other actors is crucial for the VoC approach. The VoC framework draws a distinction between two modes of coordination: Coordinated market economies (CMEs) and liberal market economies (LMEs). In LMEs, firms coordinate with an "arm's length exchange of goods or services in a context of competition and formal contracting" (Hall and Soskice, 2001: 8). By contrast, in CMEs firms rely more on collaborative relationships to resolve their coordination problems. Nevertheless, the southern European states are not clearly adapted into the two ideal types. An alternative formulation for the southern European states is provided by Molina and Rhodes (2005). Working within the VoC framework, they propose an additional model: that of Mixed Market Economies (MMEs). In MMEs, unions and employers have stronger organizational structures than in LMEs. However, due to their fragmentation (Featherstone 2008), they are unable to deliver collective goods or create strong autonomous forms of coordination as CMEs do. In MMEs rather, "organized interests use their resources to lobby the state for protection or compensation" (Hassel 2014: 7). Consequently, they appear as hybrid systems or "a cluster of countries in transition with only partially formed institutional ecologies" (Hancke et al., 2007: 4).

On that account, Zysman (1983) developed a theory on how bank activities created a structure that influenced government capacity to steer the economy and shaped government-business interactions. He outlined three main varieties of financial capitalism (government-led credit-based, bank credit-based and capital market-based) based on the potential pressures on non-financial firms from holders of their debt and equity. The maturity of bank lending, either short or long-term, was an important part of his distinction between financial systems. CMEs and MMEs are, therefore, focused toward stakeholders, while LMEs lean toward shareholders. CMEs and MMEs involve major state control and are influenced by employee associations and labour organizations. The stakeholder-focused system is based on banks' financing, involving debt financing and closely interconnected relational networks across companies and other actors. By contrast, LMEs involve countries characterised by a major market prevalence, prioritising the rights of shareholders. In this model, the interactions, which are short-term, are based on capital market. This in turn favors those firms that can rapidly maximize shareholder value. However, bank-based systems, because they involve long-term funding, imply corporatist arrangements which allow easier coordination. In a similar vein, Roe (2003) emphasizes the impact of political factors on firms. He argues that politics can affect a firm in many ways: "it can determine who owns it, how big it can grow, what it can produce profitably, how it raises capital, who has the capital to invest, how managers or employees see themselves and one another, and how authority is distributed inside the firm" (Roe 2003: 1). Roe makes a distinction between social democracies and the American model. In the former countries, managers are discouraged to downsize and take risks that would affect the workplace. On the other hand, American managers face weaker political pressures to expand their span of control and avoid risks (Roe 2003: 4,5).

In this regard, the importance of the corporate governance framework in national economies depends determinately on the degree of ownership dispersion (La Porta et al. 2000). In LMEs, where financing by the capital market prevails, ownership dispersion is larger. Significant informational asymmetries between managers and small shareholders- and the large costs associated with monitoring managers - keep diffused shareholders far from effectively exerting corporate control. As a result, firms need a comprehensive corporate governance framework to protect the interests of dispersed shareholders. Otherwise, the firms failing to secure the investors' protection might be constrained by market discipline. By contrast, in CMEs firms are less exposed to market discipline and might feel less pressure to create strong corporate governance mechanisms. In these economies particularly, large shareholders can elect their representatives in the board of directors and limit managerial control of the board of directors. Large shareholders will also be more effective in exercising their voting rights. However, as ownership becomes more concentrated, large shareholders may engage in undesirable behavior at the expense of minority shareholders, thus increasing - rather than reducing - the agency cost. Moreover, because of the long-term maturity of bank lending in the CMEs and MMEs, there may be a relationship-based financing developed. In this case, Jappeli and Pagano (2000: 8,10) argue that reputation concerns ensure "the truthfulness of the information exchanged about a customer. But much of this exchange of information takes place via formal mechanisms".

Nevertheless, relationship-based financing may foster political connections, which in turn may "politicize" the corporate governance mechanisms of financial and non-financial firms. In this context, Fonseca and González (2005), for example, analyzed how regional and local governments in Spain exert a decisive power in the renewal of the governing bodies and the establishment of the savings banks' strategy. Similarly, García-Meca and Sánchez-Ballesta (2014) analyzed whether the influence of the chairman's banking experience matters. The results did not provide evidence that the politicization of the boards of saving banks have made banks' performance more volatile. However, they showed that saving banks run by a chairman with previous banking experience are likely to be significantly more solvent. In a similar vein, German saving banks (Sparkassen), unlike in other European countries, keep strict ties with local political communities (Markgraf and Veron 2018). That said, political connections may increase the risk of agency problems. On the other hand, politically connected firms face low risk by virtue of their access to higher credit and financial bailouts during times of distress (for a detailed account on the determinants of bank bailouts in Greece, see Kolliopoulos 2020b). Empirical findings suggest that politically connected banks face also higher risk by cause of injecting larger credit to politically connected firms at a lower cost with easy terms (Haris et al:

2). Furthermore, Maurizio et al. (2019) using firm-level data from six Central and Eastern European economies, showed that politically connected firms: (i) have high levels of leverage, (ii) have low levels of profitability, (iii) are less capitalized, (iv) have low marginal productivity of capital, and (v) do not invest more than unconnected firms.

Relationship-based financing is present in Greece as well. As the structure of the Greek economy is marked by very few large enterprises and very many micro- and small-firms, this feature has multiple consequences for the state's role in the economy and for interest mediation (Featherstone 2008: 17). Several studies (e.g. Pagoulatos, 2003; Lavdas, 1997) have examined both the fragmented and rent-seeking character of interest mediation of small firms, as the character of large enterprises (i.e. systemic banks) interest mediation (Pagoulatos, 2014; 2003). In the latter case, Pagoulatos (2003: 142) argues that banking liberalization after the second half of the 1990s transformed the statist politics of bank-government relations into "perhaps equally oligopolistic structure of relations, but one in which banking market actors were substantially better resourced and the state divested of crucial interventionist instruments held in the past". Triangle deals between banks, businessmen and other banks or political allies ("crony banking") in Greece are evident from several lending scandals that culminated in a number of prosecutions of senior bankers and businessmen (Avgouleas and Papadimitriou, 2015: 2). Moreover, crony banking relations were favored by the lax corporate governance norms that allowed Greek banks to appoint businessmen, union leaders and politicians to their boards (see below). In this regard, institutional features of the Greek bank-centered economy, along with aspects of low quality of governance in Greece -such as government effectiveness, bureaucratic efficiency, corruption, rule of law and regulatory quality- may point to crucial specificities of domestic institutional infrastructure which can account for possible poor reform performance in crises times (Paraskevopoulos 2017: 32).

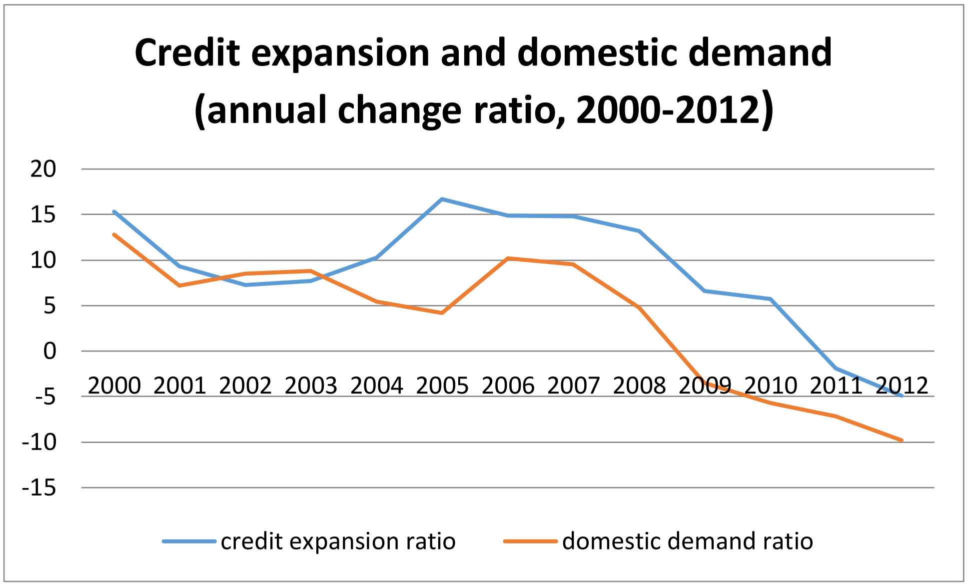
# 4. Unsustainable credit expansion and poor banking practices prior to sovereign debt crisis onset

## 4.1 Out of control credit expansion

Against a backdrop of a severe macroeconomic turmoil, it is important to note that the problems of the bank business models preceded the sovereign debt crisis. Greece's participation in the euro area was accompanied by an unprecedented credit expansion. The "mutually convenient model of debt-driven growth" meant that the rapid credit expansion under the euro, apart from the multiplying banking sector profitability, also served a government objective of delivering "politically effortless societal prosperity" (Pagoulatos 2014: 454). The average annual growth rate of private debt was 18,5% in the decade preceding 2009, while the annual growth rate of government debt was 9,7%. Public debt at the end of 1999 was €118,6 billion, while by 2009 it had increased from €181,1 billion to €299,7 billion. Consequently, 60% of the debt at the onset of the crisis had accumulated over the decade of the country's participation in EMU. In terms of private debt, 93% had accumulated over the same period, from €45,3 billion in 1999 to €247,7 billion in 2009 (Bank of Greece 2011). At the same time, there were domestic demand growth rates of between 5% and 10% over long periods (Figure 1), especially in an economy with a relatively small export sector, which "it reasonably raises the suspicion of widening exposures to an already troubled external balance" (Sardelis 2013: 6). The outbreak of crisis in the Greek economy was therefore "a matter of time".

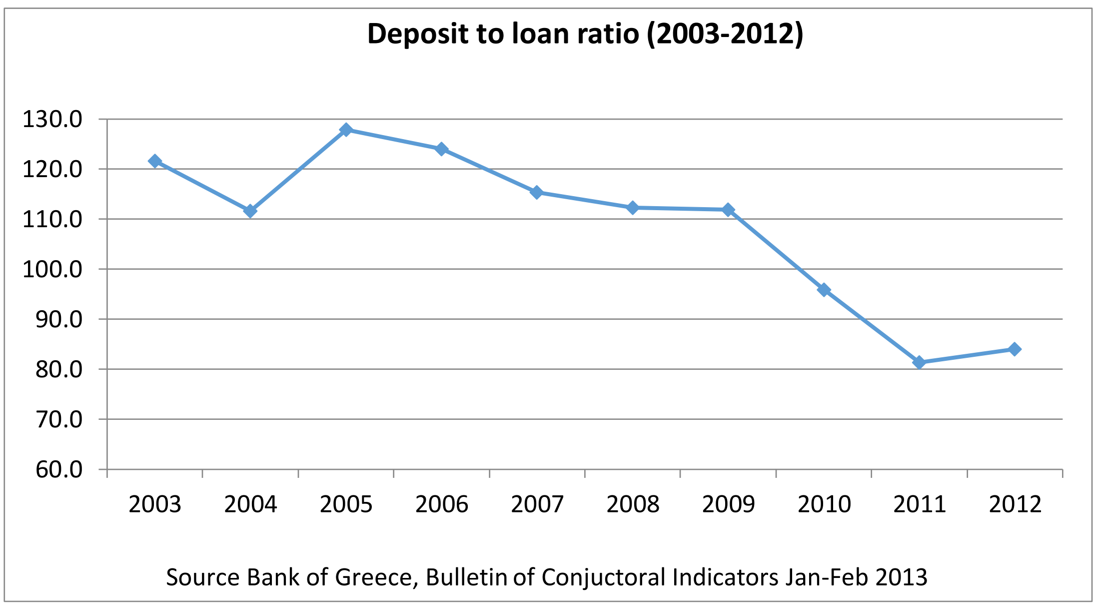
However, the most crucial problem of Greek banks before 2008 was not the rapid credit expansion *per se*, but that credit growth was fueled by lending from the interbank market and not by deposits. Under normal circumstances, the ratio of deposit to loan must move above 100% in order to minimize liquidity risk - in such a case, credit growth might not signal credit booms (Barrell *et al*. 2019). Yet, this ratio had been declining since 2005 (Figure 2). The ratio decline was much more pronounced after 2009 standing at 80%. This made the system more vulnerable mainly because of the post-2009 disruption being on the deposits side. Deposits are considered not only the cheapest financing for banks but also the most stable financing resource. As a consequence, when Greek banks lost wholesale market access to fund their activities by the end of 2009, they became increasingly reliant on much more expensive emergency liquidity assistance provided by the Bank of Greece and the Eurosystem (Sardelis 2013: 38,40).

**Figure 1.**



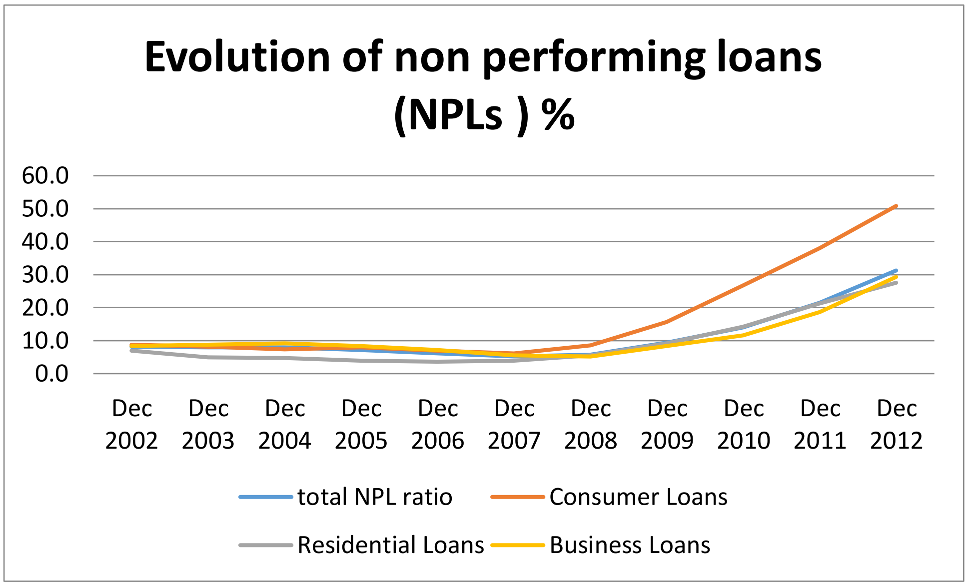

Source: Bank of Greece, Bulletin of Conjunctural Indicators Jan-Feb 2013

**Figure 2.**




On the whole, even before taking into account the capital shortfall of banks affected by the debt restructuring in 2012, the four systemic banks were already facing an insolvency crisis given the sharp increase of NPLs from a share of 4,5% of total loans in 2007 to 22,9% in 2012. By 2011, therefore, it was clear that damages on bank loan portfolios represented the most significant trouble of the Greek financial system. In the same vein, it becomes clear that while business the NPLs ratio was slightly higher than household debts (including both consumer debt and mortgages) up until 2008, from 2009 onwards this trend has reversed (Figure 3). In other words, the recession that started in 2009 did not affect as much the performance of "real economy's debt" as the unsustainable household credit boom.

**Figure 3.**




Source: Bank of Greece

## 4.2 Poor banking practices

Beyond unsustainable debt-driven growth up to the debt crisis, the Greek financial system suffered by poor banking practices due to triangle deals between banks, businessmen and other banks or political allies. Certain corruption cases are quite indicative of a system of power which lacks transparency and effective supervision. For example, the total losses which the State suffered from the state bank TT Hellenic Postbank in the period from 2006 to 2012, when its administration issued bad loans before its liquidation in 2013, are estimated according to authorities at €500 million. Greece's bank rescue fund, Hellenic Financial Stability Fund, took over the portfolio with bad loans and sold the "good" entity to Eurobank in late 2013 as part of a wave of consolidation. These non-performing loans were granted to prominent Greek businessmen without securing the necessary guarantees acting as a closed circuit to finance a favored clientele; among the favored magnates was the major stakeholder of a small bank, Proton Bank. In the case of Proton Bank, the major stakeholder of the entity loaned himself and an associated network of companies with nearly €600 million. Finally, the head of Proton Bank was jailed while awaiting prosecution on charges of fraud, embezzlement and money laundering (Reuters 2012a).

The case of the Marfin Popular Bank (MPB) is another instance of a triangle deal. In 2006, MPB was the outcome of the purchase of a minority stake at Laiki Bank in Cyprus by the Greek company of Marfin Investment Group (MIG). Poor supervisory practices permitted MIG' CEO to be member of the governing boards of both companies representing thus a clear conflict of interest. Up to 2010, MPB provided loans to business groups related to MIG in Greece with MIG shares as collateral. Cypriot authorities took over the failed bank in 2011 and it was estimated that MPB had a dubious quality loan portfolio in Greece of €12 billion (Reuters 2012b). Another instance of poor banking practices is the Agricultural Bank of Greece. According to the Greek authorities combating corruption, more than 1.300 loans between 2000-2010, amounting at least to €5 billion, were issued to "media owners, select businessmen and agricultural cooperatives" without the necessary guarantees being demanded by the bank. The Agricultural Bank was absorbed by Piraeus Bank in 2013 (ekathimerini 2015).

# 5. The political economy of financial reforms

## 5.1 The politics of protecting mortgage portfolios

Ensuring domestic financial stability has been one of the main pillars of Greek economic adjustment programs. To achieve this, the programs included conditions to enhance the soundness and resilience of the bailed out financial institutions, that is to say conditions in order to ensure adequate liquidity, to tackle non-performing loans (NPLs) and to improve corporate governance. However, several terms of the programs were not measurable. More specifically, the first two programs focused on bank recapitalization and liquidity provision, but no effective measures were taken on the management of NPLs and corporate governance rules. Banks, borrowers and politicians for different reasons converged in delaying dealing with NPLs until the creditors' pressure became inescapable. In the Greek case, the management of NPLs through the creation of an asset management company (AMC), which is one of the most widely used solutions internationally, was not included by MoU due to financial constraints, diversification of non-performing loans, governance issues and EU state-aid consideration (European Court of Auditors 2017: 53). In a similar vein, the systemic banks in Greece took a cautious stance on a systemic strategy, preferring to make forecasts and manage the NPLs themselves rather than write off or sell non-performing loan portfolios (Katseli 2017). However, Greek banks had hardly sufficient internal capacity to deal with the problem through specialized units for the management of NPLs.

In principle, the management of loans collateralized by primary residence remained as the essential problem. More generally, the politics of management of mortgage portfolios entails over time social conflicts and power games between politicians and bankers. For example, in the 1930s the Home Owners' Loan Corporation, introduced by the Roosevelt administration, helped to refinance home mortgages that were in default or at risk of foreclosure. Instead, in the aftermath of the subprime crisis, the Obama administration responded with a set of limited legislative initiatives for banks to reduce interest rates for four million homeowners unable to make their monthly payments by the Home Affordable Modification Program; "fewer than one to thirty homeowners were helped by these government program, compared to one in ten in the 1930s". Barry Eichengreen explains this discrepancy as a result of the banks' persistence as a powerful lobby even after 2007/8: "community banks lobbied against legislation to allow bankruptcy judges to meddle with their mortgage portfolios, just as they had lobbied against deposit insurance in 1930 […] some loans might have to be written down, but the banks preferred to realize these losses later, when their condition was stronger" (Eichengreen 2015: 316-317).

That is the case of the legislative initiative taken by PASOK government in 2010 to establish by in-court insolvency procedures a system for the protection of primary residences under the Law

3869/2010 (“Katselis Law”). The intention of the government was to “strengthen the borrower's bargaining power over financial institutions”; and to “improve the position of the citizens and borrowers vis-à-vis financial institutions, as […] the banks get forced to make arrangements and reconcile”; allowing thus “the judiciary to assess the ability of each borrower to pay off his debt…” (Katseli 2010: 351). Essentially, Katselis Law nominated a third and impartial party (i.e. judges) to assess the debt payment ability, removing this privilege from banks.

The law was intended to be temporary and expired at the end of February 2019 following an exceptional two-month extension. This law concerned over-indebted individuals and provided an opportunity not only to rescue their primary residence from being auctioned but also to settle their total debt to creditors. Moreover, the Article 19 of Katselis Law initially banned until 30 June of 2011 the auction of the sole or primary residence of debtors - except traders. Although the injunction was by law prescribed to be (i) no longer than six months and (ii) only granted if the court believed the debtor’s application to be probable on its merits, in practice courts very generously granted the injunction in almost all cases. Applicants, through subsequent petitions, could roll the six-month injunction over multiple times until the final hearing date, which could be years from the date of initial application. In combination with the low institutional capacity of magistrate courts, because of the small number of judges and their limited financial literacy (IMF 2019: 40,41), a moral hazard for strategic defaulters was created. Bankers fiercely opposed Katselis Law because the legislation allowed bankruptcy judges to meddle with their mortgage portfolios. Despite the real peril of strategic choice of non-repayment of loans, it is dubious for two reasons if banks’ threat for foreclosure, as an instrument to reclaim some of the NPLs, was credible. Firstly, mass foreclosures are not desirable from a social perspective, especially in the midst of a crisis. Social deprivation and conflict was a guaranteed repercussion of potential mass foreclosures. Secondly, mass foreclosures are not desirable from an economic perspective as well, given that higher recurrent real estate taxes imposed from the fiscal adjustment measures affected property prices and mortgages in Greece (European Court of Auditors 2017: 30). As a result, in an economy lacking demand for real estate investments, property prices were set at lower levels, discouraging banks to accelerate mass foreclosures.

In 2013, the government stepped up to impose stricter requirements for the protection of primary residence by the Law 4224/2013, thus connecting the protection of the primary residence with the indispensable proof of the owner’s current economic situation, as well as with the obligation to pay a percentage of personal income for as long as the protection lasted, i.e. until the end of 2014. Nevertheless, towards the second half of 2014, “the Samaras government had exhausted its political capital and was basically unable to move toward any significant structural reform. The government had, therefore, fallen behind with some benchmarks agreed with the IMF, which were effectively not met" (ESM 2019b: 199). That is because in the aftermath of the May 2014 European elections, "the Samaras government implemented a cabinet reshuffle that signaled a populist shift, by the rise of SYRIZA and under the spectre of early elections in early 2015" (Pagoulatos 2018: 11). Consequently, weakened bargaining power of the Samaras government along with the Troika's pressure for full release of auctions were followed by a long period of inactivity, which led to the abolishment of the primary residence protection for the year 2015. However, throughout that year, the primary residence protection was informally extended, as a result of an onerous agreement between the government and bankers in order to rescue primary residences from auctioning and liquidation. In short, since no one wanted to take a responsible decision because of the consequent political cost, the authorities systematically postponed the solution to the problem.

The results of the continuing irresponsible policy were coupled with the heavy pressures of the Troika for total liberalization of the auctions, particularly after SYRIZA coming to power. Following the expiry of Article 9 of 3869/2010 (Katselis Law), SYRIZA government set out the new legal framework for the protection of the primary residence (Law 4605/2019) and made significant amendments to the Code of Civil Procedures and the Bankruptcy Code introducing, inter alia, electronic auctions; out-of-court workout (OCW) framework in order to accelerate restructuring of all types of debt; reform of household and corporate insolvency legislation. The Law 4605/2019 enables the borrower's primary residence to be rescued by submitting an application on an electronic platform and not by a court order such as in Katselis Law. Thus, judges ceased to meddle with banks mortgage portfolios and the banks regained significant bargaining power vis à vis debtors.

Moreover, the eligibility criteria are much stricter in the new framework (Law 4605/2019) in the following categories: The outstanding balance of the non-performing loan, the taxable price ("objective value") of the main residence, income level, the total value of one's properties and bank deposits. The process begins by applying in an electronic platform and it is not universal, that is, not all household obligations are included; only loans secured by the primary residences. If the application is definitively rejected, the borrower may request from the court to protect his primary residence under the same conditions provided for in the regulation through the platform. But it is important to underline that if the court considers the applicant ineligible, it rejects the application and imposes a fine of € 1.500- €5.000. With this provision the new framework provides disincentives for a debtor to proceed to in-court insolvency procedures.

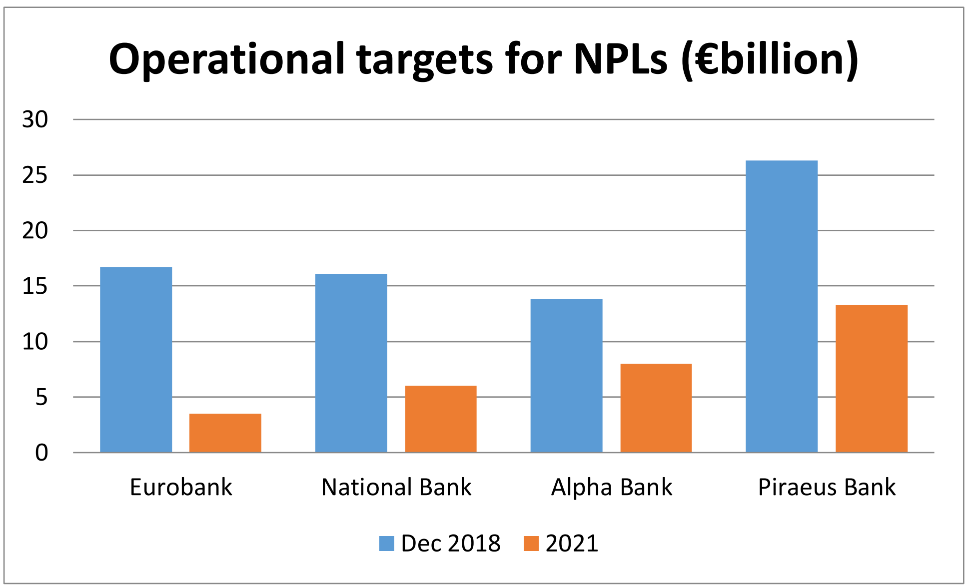
## 5.2 The long way for the establishment of the secondary market for NPLs

During the implementation of the second economic adjustment program, greater priority was given to the ability of banks to deal with the bulk of NPLs by relying mostly on their internal NPL management which had proved largely ineffective. Consequently, only with the third program were tangible reforms introduced for the banks to improve their internal management procedures (European Court of Auditors 2017: 54,55). The second program included requirements for bank operation plans by the end of July 2013. Nevertheless, this target was subject to various interpretations and the lack of appropriate performance indicators did not allow the achievement of efficiency targets; as a result, significant delays in its implementation took place. Only in the supplemental memorandum of understanding of April 2014 were more concrete provisions introduced for enhancing supervision and the management of troubled assets (European Commission 2014: 46). The external pressure for enhancing supervision and the management of NPLs by revising the BoG's organizational structure and banks' internal capabilities was triggered by the transfer of supervisory responsibility to the Single Supervisory Mechanism in September 2014. More specifically, the BoG was committed to introduce Key Performance Indicators (KPIs) to monitoring banks' progress in reducing their large NPLs portfolios. In turn, banks were committed to begin gradual reporting under these KPIs by June 2014, in order to evaluate options for improving recovery from assets under liquidation. They will also fully implement the recommendations of technical assistance to this end by June 2014, while they were committed as well to engage specialists to assist the BoG with the supervision of NPL portfolios by May 2014 (IMF 2014: 178). Thus, the creation of the European Banking Union rushed the establishment of member states' plans and ensured the common implementation of rules regarding comprehensive assessment of banks' financial health in the Eurozone.

In this context, the Bank of Greece took certain initiatives to facilitate the active management of non-performing loans. In particular, with the Executive Committee Act 42/2014, it obliged banks to establish independent management units for non-performing exposures; to adopt a clear management strategy for these exposures; to categorize non-performing loans in their portfolio based on clear criteria and characteristics; to better assess the financial situation of borrowers; to ensure that management implementation is supported by appropriate IT systems, processes and administrative information systems; to provide the Bank of Greece with updated information on the evolution of the bulk of non-performing exposures.

Subsequently, only the third program included more imperative requirements for the creation of an active secondary market for management and sales of NPLs. In this direction, on August 2, 2016, the Bank of Greece issued a reviewed Code of Conduct for the interaction of banks with borrowers. The Code seeks to manage non-performing private debt. At an operational level, Greek banks have already set up specialized units for the management of non-performing loans; they have established clear criteria for the transfer of non-performing loans to these units; they have adopted the necessary internal procedures and manuals; they have finalized proper segmentation of non-performing loan portfolios; they have developed a range of short- and long-term loan restructuring options. In this context, the Bank of Greece also established a comprehensive legislative and regulatory framework for the licensing and supervision of servicing companies for NPLs. Moreover, Greek banks have already submitted revised operational targets for NPLs covering €50 billion of total non-performing exposures by the end of 2021 (Figure 4). Banks have individual plans to reduce NPLs, and are executing them with tangible outcomes; loan sales, collections, collateral liquidation and potential asset protection schemes are anticipated to contribute more aggressively towards NPLs reduction.

**Figure 4.**




Source: Bank of Greece

In addition to the revival of secondary markets, in October 2019 the European Commission approved a Greek asset protection scheme proposed by the government, stating that state guarantees, which are to be remunerated on market terms according to the risk taken, are in accordance with state aid EU rules. The plan is called "Hercules" and is comparable to the Italian GACS scheme[2] providing state guarantees on NPL securitisations estimated to be worth €9 billion. Hercules plan involves special purpose vehicles (SPVs) that will purchase NPL exposures amounting to €30 billion out of some €75 billion in soured debt held by Greek banks. That sale would be financed by notes issued by the SPV with a government guarantee for senior

[2] Up to mid-February 2019, the GACS scheme has removed approximately €63 billion (gross book value) of non-performing loans from the Italian banking system (European Commission 2019).

tranches (Surala 2019). The Hercules Asset Protection Scheme aims to bring down the amount of bad loans, without distorting the market through government subsidies.

However, central banker Yannis Stournaras, called Hercules plan “a positive step in the right direction, but a small step” that would need additional measures, because “Hercules covers nearly 40% of NPLs, leaving out 60% which must be dealt with in other ways” (ekathimerini 2019). For this purpose, the Bank of Greece presented an additional plan to deal with 60% of nonperforming loans (NPLs) not covered by the Hercules plan. The proposed scheme envisages the transfer of a significant part of non performing exposures worth around €40 billion along with part of the deferred tax credits (DTCs) -worth around €8 billion-, which are booked on bank balance sheets, to a Special Purpose Vehicle (SPV). Subsequently, legislation was required to be introduced enabling banks to turn the transferred deferred tax credit into an irrevocable claim of the SPV on the Greek State with a predetermined repayment schedule. To finance the transfer, the SPV will proceed with a securitisation issue, comprising three classes of notes (senior, mezzanine, and junior). It is anticipated that “private investors will absorb part of the upper class of securities (senior) and the vast majority of the intermediate part (mezzanine). The plan will be voluntary and will be managed exclusively by private investors (servicing companies for loans and credits) and apparently there will be an asset class separation for each transaction and management operation (business, housing, consumer, etc.)” (Stournaras 2019).

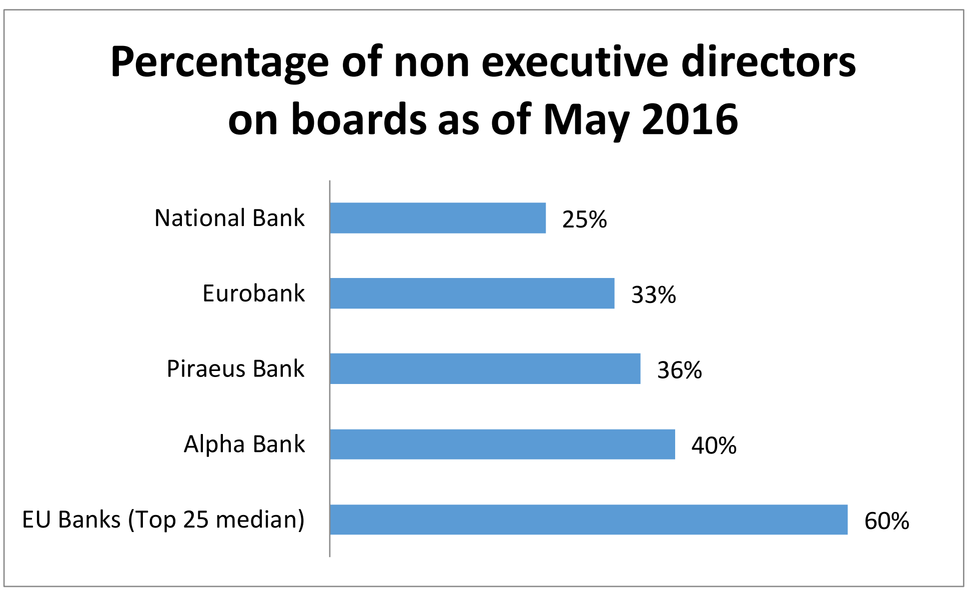
## 5.3 Draconian corporate governance rules in the era of the third MoU

Though financial reforms constituted an important pillar of the first MoU, hardly any measures were taken to improve the corporate governance of banks. However, governance problems had existed long before the crisis, as the corporate governance of the Greek banking system was significantly lagging in respect to the European standards. The second MoU envisaged that the four systemic banks would be recapitalized mainly through the HFSF's resources, but without sufficient control over their private management. "Contrary to international practices, the ownership changes that led to the almost complete nationalization of the domestic banking industry in 2013 were not accompanied by corresponding changes in most bank boards". In principle, "the management remained at the hands of historical shareholders and the HFSF was not entitled to evaluate it in terms of experience, reputation and independence" (European Court of Auditors 2017: 56). Moreover, reforms in the financial sector were not sufficiently focused on the governance and domestic supervision of the less important banks.

As a result, until the third MoU was signed in the summer of 2015 few changes had been made; to highlight this inertia, the IMF reported that there is not any "radical solution to the governance issues that are at the root of the problems of the Greek banking system"(IMF 2015: 3). In line with the requirements of the third MoU, the HFSF has been empowered to evaluate the corporate governance framework of bailed out banks according to the new framework. More specifically, the new framework requires the members of the Board of Directors that the following should be fulfilled: (a) to have at least ten years of senior management experience in the areas of banking, auditing, or risk management, of which, especially for non-executive members, a past tenure of at least three years as a member Board of Directors at an international financial institution. b) Not to perform, or to have been assigned a significant public position in the last four years prior to his/her appointment. Specifically for three members (independent non-executive members of the Board of Directors who have to be foreign) they must have at least fifteen years of experience in relevant financial institutions, of which at least three years as members of an international banking group not operating in the Greek market. Moreover, these members should not have any relationship with credit institutions operating in Greece for the past ten years. The aforementioned independent non-executive members chair all the committees of the Board. Moreover, at least one member of the Board of Directors must have international experience of at least five years in risk management or managing non-performing loans. In this context, with the assistance of an international consulting firm, the HFSF evaluated the Boards of directors of the Greek systemic banks. The evaluation was completed in July 2016 (HFSF 2017: 11). As of the end of 2016 significant changes took place: 44% of the total board headcount (excluding State and HFSF Representatives) and 58% of the total non-executive directors (excluding State and HFSF Representatives) were replaced (HFSF 2017: 11).

In conclusion, while the new corporate governance framework improves governing boards' independence against the political system, on the other hand it cuts off its necessary connection with the real economy. Greek banks traditionally had businessmen, union leaders and politicians on their boards (Figure 5). But under the third MoU, Greece agreed to 'de-politicise' relations between governmental officials and the bankers. Under the pressure of international creditors, amid fierce lobbying by bankers against the framework mentioned above, the Hellenic Parliament established the new corporate governance rules, which in effect banished "local business magnates and former politicians. The result is a small pool of eligible directors and a large pool of frustrated elites" (The Wall Street Journal 2016). It is interesting to note that creditors' pressure (particularly by the ECB's Single Supervisory Mechanism) was so aggressive that the first Director who stepped down from her position was a former parliamentarian Louka Katseli, head of National Bank of Greece. As member of the PASOK government, Katseli took on the responsibility of the primary residence protection scheme. Later, she passed to SYRIZA and in March 2015 was nominated Director of the National Bank of Greece. However, because of the Draconian governance rules she failed to meet the new eligibility criteria, due to her political position in the past four years.

**Figure 5.**




Source: The Wall Street Journal

Lastly, the third Memorandum brought about significant changes in the HFSF'S corporate governance framework as well. Until then, 34 executive members of the HFSF' board had changed in the first six years, including four presidents and four CEOs, "a practice that entailed a risk of knowledge gaps and diminished influence in the banks in which HFSF held shares" (European Court of Auditors 2017: 57). More analytically, a Selection Panel is established (article 4A of Law 3864/2010) for the nomination of the members of the Executive Board and the General Council of the HFSF. The Selection Panel is composed of six independent members of recognized expertise, of which three (including the Chairman) are appointed by the European Commission, the European Central Bank and the European Stability Mechanism; similarly, two by the Minister of Finance; and one by the Bank of Greece.

## 6. Conclusion

Many studies have revealed the macroeconomic factors that affected banks' performance and raised the non-performing loans (NPLs) ratio to total loans in the Greek financial sector. However, little has been said about the bank-related factors which exacerbated the fiscal difficulties and the macroeconomic environment in the Greek economy. Bank-specific determinants of a crisis include weak corporate governance, poor internal NPL management skills, absence of well-designed NPL resolution mechanism, and inefficient debt recovery and collection frameworks. That said, when we talk about reforming the financial system we mean, principally, three categories of measures: i) ensuring banks resilience through increasing bank capital and maintaining adequate liquidity, ii) tackling non-performing loans and iii) improving corporate governance and supervision for banks. However, the first two financial assistance programmes for Greece focused on bank recapitalizations and liquidity provision, but no effective measures were taken on the management of NPLs and on enhancing corporate governance rules.

More specifically, despite heavy provisioning and rapid increases in non-performing loans - the highest rate in the Eurozone -, banks did not write off significant amounts of bad debt for several reasons. First, the management of NPLs through the creation of an asset management company - a widely used solution internationally - was rejected by the Troika due to political and bank-related operational reasons. Secondly, although in the second economic adjustment program greater priority was given to the ability of banks to reduce the NPLs ratio by relying mostly on their internal management skills, the latter had proven insufficient. Consequently, only in the third program were reforms introduced to improve banks' internal management procedures and more imperative requirements for the creation of an active secondary market for management and sales of NPLs were established. Moreover, contradicting incentives and political uncertainty made the main stakeholders - regulators, elected politicians, bankers, and investors - delay structural reforms in crucial areas, such as the Code of Civil Procedures and the Bankruptcy Code introducing: electronic auctions; out-of-court workout framework in order to accelerate restructuring of all types of debt; and household as well as corporate insolvency legislation. Regarding the corporate governance of banks, only after the third recapitalization in late 2015 were more substantive measures taken. In 2016, under extreme pressure from the Troika, banks introduced a new corporate governance framework with which they appointed new governing board members aiming to regain the confidence of all stakeholders.

In conclusion, authorities and banks were both trapped in a vicious cycle of inactivity that aggravated the crisis in the Greek economy. Therefore, the initial - i.e. macroeconomic - causal relationship ceased to be one-sided: the lost opportunity for a radical reorganization of bank business models deepened recession and aggravated macroeconomic conditions in Greece due to the anemic provision of credit to the real economy.

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