GREECE—Letter of Intent

Athens, […..], 2012

Ms. Christine Lagarde:
Managing Director
International Monetary Fund
Washington DC

Dear Ms. Lagarde:

Text

This letter is being copied to Messrs. Juncker, Rehn and Draghi.

Signatories

Greece—Memorandum of Economic and Financial Policies

. Strategy and Outlook

. Structural reforms

1. The government intends to build on recent labor market reforms to further improve the functioning of the labor market and encourage job creation: The labor reforms adopted in February 2012 under the program have already helped to lower unit labor costs, but unemployment remains unacceptably high and Greece continues to have a significant competitiveness gap. The government will sustain the reforms and apply them uniformly across the labor market. However, the minimum wage system in Greece remains complex and delinked from broader labor market conditions, while non-wage labor costs remain excessive, contributing to pressure for excess nominal wage declines, and placing barriers in front of employment creation. We have specified measures to tackle these issues, and the next steps towards a stronger labor framework for Greece:

• As a prior action for the review, the government [has established] a timetable to reform Greece's minimum wage. Under the new framework, the basic minimum wage and the maturity and marital allowances currently set in the national general collective agreement will be progressively replaced by a minimum wage mechanism legislated by the government after consultation with social partners and other stakeholders and independent experts. This system, which will become effective by April 1 2013, will include a single-rate statutory minimum wage as the binding floor for new labor agreements and contracts,, and the legally-binding maturity coefficients and allowances linked to the minimum wage will be phased out by [April 2015], with the first step to become effective at end-March 2013. The current freeze on the basic minimum wage will remain in place during the program period, and thereafter any adjustments will take account of economic circumstances, in particular the level of unemployment.

• To reduce non-wage labor costs, we will take a number of actions:

☐ Tax wedge. By September 30, 2013, as a new program structural benchmark, we will adopt legislation reforming the system of social security contributions to: (i) broaden the base for contributions; (ii) simplify the contribution schedule across the various funds; (iii) shift funding away from nuisance taxes and onto contributions; and (iv) reduce contribution rates by an average of 4 percentage points. The reforms will be phased in on January 1, 2014 and January 1, 2015, and will be revenue neutral and preserve the actuarial balance of the various funds. As an intermediate step, by end-June 2013, a draft of the legislation will be completed.

☐ Other non-wage labor costs. As a prior action for the review, the government has adopted legislation to reduce a host of other non-wage labor costs, which impede the efficient use of labor. The changes, defined in Annex II, will bring Greece closer to EU partners, and include:

o Greater flexibility of labor arrangements within the overall weekly limits on working time (covering the maximum number of workdays, working hours, and shift and leave restrictions).

o A reduction in administrative burden (related to extensive reporting and preapproval requirements of work arrangements).

o Lower dismissal costs. We will reduce the notification period to [3] months and cap minimum statutory severance pay at [12] months (while preserving the existing link between tenure and minimum severance for tenures below the cap). If the cap has already been surpassed on the date of the reform the amount accrued will be grandfathered, but with the amount beyond 12 months subject to a cap of 6 times the national monthly minimum wage. In addition, to secure equal and fair treatment for all employees and occupations, in those where severance costs set by law are in excess of the rule just described, the compensation for severance will be aligned with the latter.

• We will work to strengthen the safety net for those who become unemployed. As discussed below in the fiscal policy section, the government is enhancing unemployment benefits to help mitigate any short-term impact that labor market reforms may have. We will also work to improve the effectiveness of our training and job-matching programs, focusing on the young and the long-term unemployed (and better leverage anyavailable structural funds to this end).

• Next steps. As a general principle, we are committed to address any remaining features of our labor market that fall short of best European practices. As a first step, an independent assessment of the labor inspectorate will be completed by end-2012, with a particular focus on effective and efficient control procedures to fight undeclared work. On that basis the government will specify an action plan to implement procedures to more effectively detect cases of undeclared work, and to eliminate activities that increase administrative costs for firms without serving a justifiable public policy objective.

2. In light of the deep problems we have had to date with fully implementing structural reforms, the government will strengthen its management and monitoring mechanisms in this area. We will fully staff the directorate of planning, management, and monitoring of reforms at the [Office of the Prime Minister] and publish on a quarterly basis monitoring indicators for each reform initiative on the government's website.

It is an overarching objective of the government to ensure a viable and well-capitalized banking sector. This is a necessity to underpin Greece's medium-term recovery. Our strategy is to recapitalize banks while maintaining protection of depositors as a policy objective, minimizing fiscal costs, and keeping the banks under private ownership and management to the extent possible. Our strategy comprises four key pillars: (i)

recapitalization of viable banks; (ii) orderly resolution of nonviable banks; (iii) restructuring of banks; and (iv) strengthening governance, supervision and regulation.
19. We have now finalized our framework for recapitalizing banks

• Strategic assessment of the banking sector. The BoG completed this in March 2012, assisted by an international consultancy firm. The study assessed the viability of the banks based on quantitative and qualitative criteria. This study identified four core banks accounting for about 75 percent of banking sector assets.

• Capital needs. By end 2012, we will align our capital metrics to the minimum core tier I ratio of 9 percent of risk-weighted assets set out in the EBA recommendation on capital buffers. Banks will also have to the requirements we have set under Pillar II (to maintain a 7 percent core tier 1 capital ratio under a 3 year adverse stress scenario). To this end, the BoG has, as a prior action, informed all banks of their individual capital needs and has requested that they finalize the capital raising process by end April 2013. These capital needs account for the impact of PSI, the valuation losses on new Greek government bonds, and results of a stress test exercise with a 3-year horizon (which took into account [BlackRock] credit loss projections and banks' future pre-provisioning results). The BoG will publish a detailed report on individual banks' capital needs, the recapitalization process, and the methodology followed by end December 2012.

• Capitalization process. The legal framework for the recapitalization has been put into place (prior action). The recapitalization process will involve three broad steps:

☐ First, the HFSF will provide sufficient funds in the form of bridge capital to bring the core banks up to the minimum level of 9 percent CT1 under Pillar 1 before end-2012. The HFSF will also issue a commitment letter to subscribe to 100 percent of the remaining capital needs.

☐ In the second step, by end January 2013, the HFSF will subscribe to 100 percent of any convertible instruments that the banks will decide to issue.

☐ In the third stage, by end April 2013, the core banks will complete the rights issue and any shares not subscribed by the private sector will be acquired by the HFSF subscription to the common equity (structural benchmark).
Current or new shareholders will have control of the core banks, provided they are deemed fit and proper as already envisaged in the regulatory framework, and have subscribed no less than 10 percent of the newly issued common shares. While existing shareholders will be diluted during the recapitalization process, they or new investors will be allowed to participate in the rights issuance and, should the above 10 percent threshold of private sector participation be reached, will receive warrants to acquire the remaining shares from the HFSF within five years.

• Subsidiaries have been recapitalized by their parent banks. Agreements have been reached on the acquisition of Emporiki and Geniki by [Alpha Bank] and [Piraeus Bank], respectively, with a view to achieve further consolidation of the banking system while protecting the public sector from potential losses. We expect to approve these acquisitions subsequent to the completion of the due diligence process. These acquisitions will not require injection of additional public funds. [It has been agreed that Millennium will be recapitalized by its parent.]

• The recapitalization strategy for remaining undercapitalized non-core banks has also been finalized. Our strategic assessment shows that these institutions are less suitable candidates for public money. These banks must be fully capitalized by end-April 2013. They may also merge with other banks if they can demonstrate a credible business plan, meet recapitalization needs by [April 2013] and address all viability challenges.

20. We will complete the resolution of undercapitalized banks by [mid-June] 2013 and establish a framework to manage the assets of banks under liquidation:

• State-owned banks. ATE bank was resolved in July 2012 through a promptly conducted Purchase and Assumption (P&A) transaction with Piraeus Bank. The final resolution cost will be defined by an external audit of the transferred assets and liabilities. Additionally, Piraeus Bank [has presented to the EC] a restructuring plan to demonstrate that the new integrated bank will enhance its viability and cost-efficiency. Regarding Hellenic Postal Bank, we have initiated its orderly resolution with the aim to do so via a P&A transaction to be completed no later than [end-November] 2012 (structural benchmark). Finally, we will complete Nea Proton's restructuring by merging it before [mid-May] 2013 into one of the core banks or a group of other banks in an open bid process under the sponsorship of the HFSF.

• Other undercapitalized non-core banks. If the shareholders or new investors are unable to support these institutions as required above by end-April 2013 we plan to complete the resolution of these institutions [no later than mid June 2013] via P&A transactions with well capitalized banks, or, as a second best, the establishment of a bridge bank. To prevent market distortions and unsound banking activities, the BoG has placed all undercapitalized non-core banks under enhanced supervision.

• We will ensure that the assets of banks under liquidation are managed on the basis of best international practices. This includes the bad assets of banks that are resolved as part of the restructuring process. To this end, by [end-February] 2013 the BoG will publish an assessment report prepared by an international expert regarding policies and procedures required to ensure effective bank asset management and recovery. The report will identify the areas that could require further strengthening to maximize loan collection and help reduce bank resolution costs.

21. We are developing a strategy to address the on-going challenges for the cooperative banks. By end-February 2013 the BoG will complete its assessment of this sector and issue a final report. Based on this report, by end-May 2013, we will set out a comprehensive strategy to implement its recommendations.

22. The government of Greece has established a framework to ensure continued restructuring and strengthening of the banking system after the recapitalization process is complete:

• Banks that receive state-aid will need to provide clear and realistic business plans for their restructuring:

☐ Operational restructuring. Following the recapitalization of the core and non-core banks, all institutions should update their restructuring plans and submit them for validation by the EC. These should be finalized by [end-June] 2013. However, banks that acquire other institutions through P&A transactions sponsored by the HFSF will have until end-July 2013 to submit such revised plans (structural benchmark). The restructuring plans should take into consideration the updated macroeconomic framework set out in the most recent program review. The HFSF will monitor banks' adherence to their restructuring plans on a semi-annual basis and report to the EC/ECB on progress.

☐ NPL resolution. The HFSF will request that banks assess, by [June 2013] whether their established frameworks and policies to deal with troubled assets are effective. International work-out specialists should be invited to assist in the process.

☐ Funding. As part of the new restructuring plans, banks will set out their intentions to broaden their funding base and reduce over time their reliance on emergency liquidity provided by the central bank. The BoG, following the procedures and rules of the Eurosystem, will stand ready to continue disbursing adequate and appropriate emergency liquidity support in a timely manner if needed.

• We will strengthen the insolvency framework. In consultation with the EC/ECB/IMF staff, we will by [end-December 2012], on the basis of best international practices, review the insolvency framework for households and SMEs as well as the framework for out of court negotiations between banks and troubled borrowers and prepare an assessment identifying areas for improvement. The aim will be to achieve predictable, equitable and transparent allocation of risks among all interested parties and maximizing value for the economy in general. By [end-February] 2013, we will revise, with technical support of international experts, the existing framework to [better] facilitate workouts with over-indebted household borrowers that preserves bank solvency and credit discipline, avoids the use of fiscal resources to protect private borrowers and minimizes moral hazard by targeting borrowers that are in real need. We will refrain from supporting any initiative that may undermine the payment culture in Greece.

• Follow up stress testing. To ensure that the system remains sufficiently well-capitalized, the BoG will, by end-December 2013, conduct a new stress test exercise, based on end-June 2013 data, using a methodology determined in consultation with the EC/ECB/IMF (we propose to shift the existing structural benchmark on this action to this new date).

23. We are committed to ensure that the financial system operates with maximum safeguards to ensure stability and continued viability. The relevant prior actions in the following bullets are summarized in Annex IV:

• The HFSF will complete the due diligence of core banks. This will, inter alia, focus on a review of governance including loans to related parties, asset quality, and risk concentration, and any findings of interest to the supervisor will be communicated to the BoG (prior action). The BoG will address these promptly, including via removal of board members and managers, and/or suspension of private shareholders (which would prevent them from participating in bank recapitalization framework). By end-March 2013 banks will submit to the BoG plans to address identified operational governance weaknesses with clear timetables for full implementation by end-December 2013.

• Monitoring trustees will be appointed in all banks under restructuring to submit quarterly reports on governance and operations, as well as ad-hoc reports as needed. The monitoring trustee will work under the direction of the EC, within the terms of reference agreed with the EC/ECB/IMF and will liaise closely with the EC/ECB observers at the HFSF and share their report with the HFSF. In line with the EU state aid rules the trustees will be responsible for overseeing the implementation of restructuring plans. This includes, inter alia, verifying proper governance and the use of commercial-basis criteria in key policy decisions even in the absence of an approved restructuring plan. The monitoring trustees will closely follow the banks' operations and shall have permanent access to Board meeting minutes, and be observers at the executive committees and other critical committees, including risk management and internal audit functions. [To this end the trustee shall have a quasi-permanent presence in the banks.] These trustees shall be a respected international auditing or consulting firm (that will include the participation of overseas based partners and managers) which needs to be endorsed by the EC on the basis of its competence, its independence from the banks and the absence of any potential conflict of interest. We have agreed a terms of reference with the EC/ECB/IMF and this has been communicated to the banks with instructions for the trustees to begin work no later than [mid-January 2013] (prior action).

• We will ensure adequate reporting of HFSF operations, and enhance the EC and ECB observers access to information at the HFSF. Starting at end-January 2013, the HFSF will initiate semi-annual public reporting on its main activities. As a prior action, we will amend HFSF by-laws to clearly stipulate that the HFSF Board, including the observers, must be informed of all decisions of the core banks having an impact on the HFSF's rights as a shareholder/investor, as soon as received by and through the senior executive of the HFSF, and a minimum [1] day in advance.

• We will ensure arms length governance of core banks' business activities. By [end-March] 2013, the HFSF will publish relationship frameworks with each bank on the basis of best international practices, with a view to define the responsibilities of bank managers and board members and the role of HFSF as a shareholder, to ensure the core banks are run on a commercial basis. A draft for discussion based on international best practices will be developed with the EC, ECB, and IMF staff by [end-January] 2013.

24. With a view of adapting the supervision of the Greek banking sector to the changed banking environment we are taking important steps:

• Updating the supervisory model. The BoG will complete a review of its supervisory approach in light of the new challenges ahead, by end-June 2013, with technical support provided by a banking supervision expert. Key enhancements will include: (i) the refocusing of our off-site analytical capacity to assess the business models of the core banks and be able to monitor and critically analyze the implementation of their business plans and the direction that banks may be taking; (ii) updating onsite supervisory procedures and prudential regulation in light of the findings of the ongoing reviews; and (iii) an action plan to monitor credit risk concentration, in line with best practices, such as enhancing the monitoring of large business groups (including those related to bank owners) by end-July 2013.

• Standardizing asset quality disclosure. To enhance information available on banks' asset quality, provisioning and income recognition, the BoG and the Hellenic Capital Markets Commission (HCMC) will issue guidelines in accordance with their respective competences, in order to align banks' disclosure practices to international best practices. This is particularly relevant regarding the accounting for provisioning and the reporting of restructured loans. By [end-August] 2013 with the assistance of a leading consulting firm, such practices will be benchmarked against those followed by top European institutions and will be reflected in the banks' end-2013 financial statements.

• Undertaking a Basel Core Principles (BCP) assessment. We will request the IMF to undertake a stand-alone assessment by end-2014. The BoG will prepare in advance (by end-June 2014) a self-assessment of compliance with the BCP with the support of independent experts.

• Clarifying competencies and responsibilities. We will develop and publish a memorandum of understanding governing the relationship of the HFSF as a shareholder and the BoG's role regarding the oversight of banks that have received state aid.

. Fiscal Policy

. Fiscal Institutional Reforms

Annex I.1: Product Market Prior Action

Annex I.2 Regulated Professions Prior Action
Annex I.3 Regulated Professions Prior Action
Annex II: Labor Market Prior Action

Setting of minimum wage

• The government will establish a timetable to reform Greece's minimum wage. Under the new framework, the basic minimum wage and the maturity and marital allowances currently set in the national general collective agreement will be replaced by a minimum wage mechanism legislated by the government after consultation with social partners and other stakeholders and independent experts. This system, which will become effective by end-March 2013, will include a single-rate statutory minimum wage as a legally binding floor, and the maturity coefficients and allowances linked to the minimum wage will be phased out by [April 2015], with the first step to become effective at end-March 2013.

Non-wage labor costs

• Concerning dismissal costs, we will reduce the notification period to 3 months and cap minimum statutory severance pay at 12 months (while preserving the existing link between tenure and minimum severance for tenures below the cap). If the cap has already been surpassed on the date of the reform the amount accrued will be grandfathered, but with the amount beyond 12 months subject to a cap of 6 times the national monthly minimum wage. In addition, to secure equal and fair treatment for all employees and occupations, in those where severance costs set by law are in excess of the rule just described, the compensation for severance will be aligned with the latter.

• Reduce administrative burden by eliminating requirement for ex-ante submission of work schedules to labor inspectorates and remove preapproval by labor inspectorates of overtime work.

• Increase work flexibility, within the overall limits of the work week, by allowing on a contractual (or mutual agreement) basis: (i) agreements on compensatory work time arrangements between the employee and employer outside of the context of collective agreements; (ii).extension of the number of maximum workdays to 6 days per week for all sectors; (iii) resetting the minimum daily rest to 11 hours; (iv) the consecutive two week leave requirement to be taken anytime during the year in seasonal sectors.

Annex III. Privatization Prior Action

Annex IV. Prior Action to Strengthen Financial Sector Governance

• The HFSF will complete a due diligence of core banks. This will include a review of governance, such as loans to related parties, asset quality, and risk concentration and any findings of interest to the supervisor will be communicated to the BoG. These will be addressed promptly, including removal of board members and managers, and/or suspension of private shareholders (which would prevent them from participating in bank recapitalization framework),

• Communicate a terms of reference for bank monitoring trustees to the banks, with instructions for the trustees to begin work no later than [mid-January 2013].

• Amend HFSF by-laws to clearly stipulate that the HFSF Board, including the observers, must be informed of all decisions of the core banks having an impact on the HFSF's rights as a shareholder/investor, as soon as received by and through the senior executive of the HFSF, and a minimum [1] day in advance.

Annex V. Fiscal Measures

Annex VI. Tax Administration Prior Action

Appendix I. Access and Phasing
[Table to be inserted]

Appendix II. Privatization Program
[Table to be inserted]

www.fpress.gr