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Bankers: stop putting all your eggs in one basket!

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In the last few months, we have experienced a period of extreme uncertainty in our banking sector and the economy as a whole, mainly because of the massive losses of our banks from the Greek debt restructuring. An amount of about five billion euros has been wiped out from our banks' balance sheets with the implementation of the famous Public Sector Involvement (PSI), that's almost 30% of the country's GDP for 2011! Since then we have witnessed desperate efforts by the banks to achieve the recapitalization targets needed by the European Banking Authority by the end of June. After it seemed impossible to find the capital needed from private investors, the government was forced to step in to help by underwriting the issuance of capital that needs to be raised for Laiki bank – an amount of ?1.8 billion, which is almost 10% of the country's GDP!

The top management and board of directors of these banks received massive criticism and accusations for their actions, mainly for speculating (or gambling) with investors' and depositors' money and investing in the risky Greek government bonds. Several accusations were also targeted to the former Governor of the Central Bank for failing to monitor and supervise appropriately the actions of these banks. Although these accusations maybe valid, in my opinion the main criticism should be centered on the failure of these banks to diversify their portfolio. Basic knowledge of finance tells you that you should NEVER put all your eggs in one basket. By combining various assets in your portfolio, you gain the benefits of diversification that can help to eliminate the idiosyncratic (or issuer-specific) risk, leaving you with the systematic (or undiversifiable) risk. For example, if banks held a diversified portfolio, then any losses resulting from the Greek haircut could have been offset by gains in other assets in their portfolio. Investing in risky securities is not a sin and investors can come with different risk appetites, but it's certainly not wise to not properly diversify your portfolio.

We have also heard extensively the excuse from bankers that sovereign debt is risk-free and no one expected at the time that Greece would fail to repay their debt. Although there is some truth to that, in the sense that Greece is part of a monetary union of European member states, we know from our experience in the past that lots of countries defaulted on their sovereign debt (prime examples are Russia in 1998 and Argentina in 2002). Since we know now that part of the acquisition of Greek government bonds were from the secondary market (i.e. from third parties) and not the primary market (i.e. the direct issuance of the bonds from the Greek government) at a time when these bonds were trading at large discounts, it should have raised a big red flag to these banks that this can be a very risky investment. Furthermore, it should have been a warning sign about the dangers of their massive, expansionary Greek operations. But it seems that they decided to take the gamble in order to achieve high returns, without having a well-diversified portfolio. In the end, it turned out that this risky investment failed to pay out.

I agree with all those people that argue for a thorough investigation into what went wrong (and the parties responsible) that led to these massive losses. If the above situation happened to other industries, one can say that this could have been an internal issue to be dealt by the existing shareholders. However, the banking sector is an entirely different case as it carries systemic risk that can lead to the collapse of the whole economy (especially in Cyprus where we have such a massive banking sector in relation to the country's GDP). That is why the government had no other option but to intervene, underwrite the new issuance, and bring back some stability and security to the market (I would argue though here that this action should have occurred months ago rather than wait until the last minute). Let's hope next month Greece puts together a government that is pro-euro and continues with its necessary reforms, the banks achieve the desired recapitalization, and our government keeps its promise to bring down the budget deficit to 2.5% for 2012 and comes up with effective measures for promoting growth. Only then we can be optimistic that better days lie ahead.

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