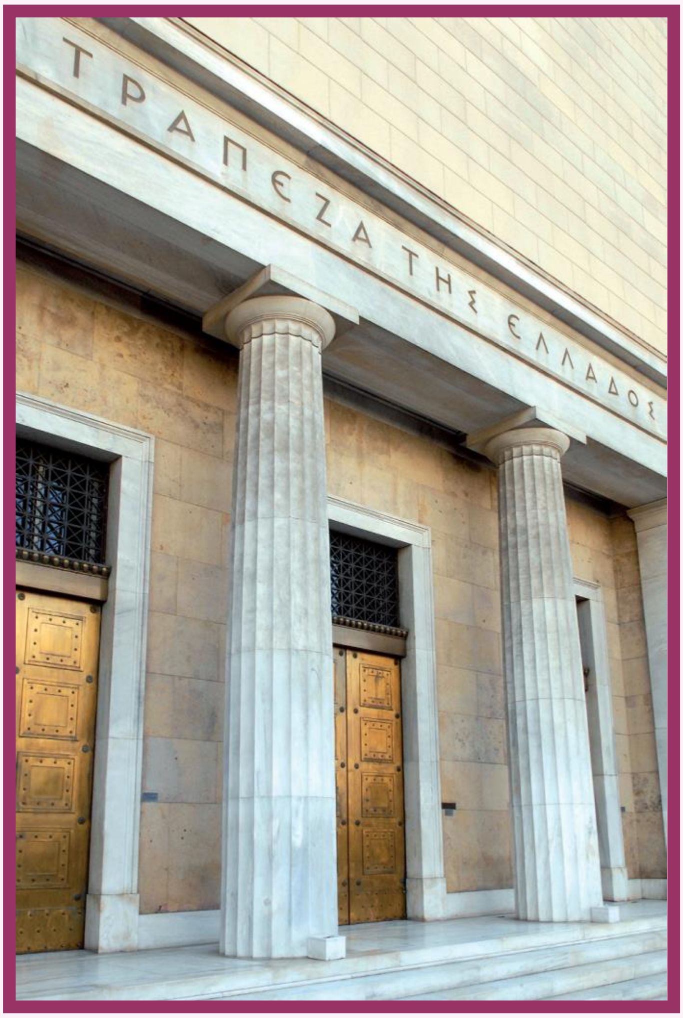
FINANCIAL STABILITY REVIEW

EXECUTIVE SUMMARY



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EUROSYSTEM

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ISSN: 2732-9402 (online)

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The macroeconomic fundamentals and prospects of the Greek economy have been improving throughout 2019, positively affecting the economic climate. This has been reflected in the operating environment of the banking sector, thus helping to enhance financial stability. As a result, the last remaining capital controls, in force since June 2015, i.e. those restricting fund transfers abroad by households and corporations, were lifted in September. This should act as a catalyst for attracting investment and bolstering economic activity.

Against the background of the lifting of capital controls and improving fiscal position, Standard and Poor's (S&P) upgraded Greece's sovereign credit rating once again in October 2019, to BB- from B+, with a positive outlook, signaling a further upgrade in the immediate future. However, Greece still has a non-investment grade rating.[1]

The aforementioned developments have contributed to the improvement of banking sector financing conditions and liquidity, enhancing the potential to perform its intermediating function. The environment of very low or even negative interest rates in the euro area exerts a downward pressure on banks' funding costs. Yet, access to money markets is still restricted for Greek banks, which can secure long-term financing only by providing collateral.

At the same time, the Greek banking sector is faced with important challenges relating to operating profitability, as well as the quality of assets and of regulatory own funds. In order to address these interrelated challenges effectively, either individually or collectively, account must be taken of the interplay of the results of each individual approach.

Within this framework, banks' operating profitability is inextricably linked with the structure of their assets. The particularly large stock of non-performing loans (NPLs) is a determinant of profitability, resulting in a persistently high cost of credit risk (June 2019: 1.8%). This cost consequently restricts the net profit margin of banks.

Efforts to effectively tackle the large NPL stock have indeed borne fruit. NPL balances have further declined by 7.9% or €6.4 billion, to €75.4 billion in June 2019, from €81.8 billion in December 2018 (on-balance sheet figures). It should be pointed out that the cumulative reduction of NPLs from their peak in March 2016 has amounted to 30% or €31.8 billion, bearing witness to the successful efforts of all stakeholders. Still, Greece has the highest NPL ratio (43.6%) among EU Member States, far exceeding the weighted European average of 3%.[2]

The negative correlation between asset quality and high NPL levels, coupled with the current credit contraction,[3] impacts profitability by leaving little room for its improvement. If the status quo is maintained, banks' profita-

[1] On the rating scales of Standard & Poor's, Fitch and DBRS, Greek sovereign debt falls short of the investment grade rating by three notches, whereas on Moody's rating scale, it falls short by four notches.

[2] European Banking Authority, Risk Dashboard – Q2 2019.

[3] According to Bank of Greece data, the annual rate of change of total credit to the private sector in June 2019 was -0.2%, having remained unchanged from the previous month. The monthly net flow of total credit to the private sector was positive, at €936 million, compared with a negative net flow of -€324 million the previous month.

bility will not be easily altered given the specified room for reduction of other operating costs. Special Feature 1 of this Financial Stability Report looks into the negative correlation between banks' profitability and asset quality and, more specifically, the large legacy NPL stock on their balance sheets.

The capital adequacy of credit institutions remained satisfactory with the Common Equity Tier 1 (CET1) ratio at 15.6% as of June 2019. However, the quality of regulatory own funds is worthy of caution, given that the deferred tax credits (DTCs)[4] at sector level exceeded 60% of CET1 capital in June 2019.[5] It should be pointed out that the high DTC share in the regulatory own funds of banks restricts their ability to accelerate the reduction of the NPL stock, as they are unwilling to use this portion of regulatory own funds to absorb losses.[6] In this context, any additional regulatory capital requirements resulting from the phasing in of IFRS 9, the 2020 stress test, and the introduction of the prudential backstop will act as further aggravating factors.

As a result, proactive measures aimed at improving the conditions in the above areas are a key priority to bolster financial stability. Credit risk at sector level has been reduced compared with previous years, but further rapid reduction of the existing NPL stock is now of utmost importance. Adopting a holistic approach is an imperative in order for banks to proceed with the necessary transformation of their business models, increase their efficiency and thus ensure the necessary conditions for internal capital generation.

This Financial Stability Report covers the entire financial system, albeit placing an emphasis on the analysis of banking developments, given that the banking sector is of particular relevance. The Report is complemented by special features highlighting topical issues of broader interest.

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The resilience of Greek banking groups was strengthened in the first half of 2019 as a result of improvements in capital adequacy and most efficiency indicators. Key drivers behind this are the elevated regulatory own funds and a €390 million profit after tax and discontinued operations, compared with losses in the corresponding period of 2018.

In more detail, operating income fell marginally on an annual basis, as the decline in net interest income was largely offset by the increase in non-interest income. As regards the former, the decline in interest income exceeded in absolute terms the corresponding decline in interest expense. Operating expenses were further reduced, mainly as a result of banks' ongoing restructuring, i.e. staff and branch network reduction. Against this background, Greek banks' operating profits picked up in the first half of 2019 and their cost-to-income ratio improved.

The return to profitability was positively affected by profits from discontinued operations, mainly related to profits from the sale of subsidiaries and affiliated companies of Greek banks.

Banking groups recorded profits after tax and discontinued operations, compared with losses in the corresponding periods of previous years. Therefore, the return on assets (RoA) and return on equity (RoE) indicators of

[4] Without factoring in deferred tax assets (DTAs).
[5] DTCs account for 54% of the total capital base in the reference period.
[6] Under Law 4172/2013, this stock shall, in the case of profits, be offset against the amounts of income tax payable by credit institutions and, in the case of losses, determine the amount of banks' capital increases in favour of the Greek state, resulting in equity dilution.

banking groups moved into positive territory (0.3 and 2.7 respectively). However, they fall significantly short of the corresponding indicators for medium-sized banks in the EU (0.5 and 6.6 respectively).[7]

The capital adequacy of Greek banking groups was improved in the first half of 2019 on the back of higher regulatory own funds. The Capital adequacy Ratio (CaR) on a consolidated basis rose to 16.5% in June 2019 from 16% in December 2018 and the CET1 ratio rose to 15.6% from 15.3% respectively. Greek banks' leveraging also improved vis-à-vis 2018.

Liquidity conditions for credit institutions have been continuously improving on the back of an expanding deposit base and broadening funding sources, such as subordinated debt, covered bonds, interbank and repo transactions on more favourable terms, as well as securitisations in the domestic and international markets. At the same time, bank deposits – a solid source of funding – continued to rise. It is worth pointing out that the upward trend in total deposits was sustained despite persistently low deposit rates. Furthermore, corporations used part of their time deposits to purchase capital goods.[8] This reflects the belief that the country has entered a virtuous circle of economic growth, in which corporations are in a position to take calculated business risks.

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In Greece, the "other" sectors of the financial system account for only a small fraction thereof, having a correspondingly limited impact on financial stability. However, their connection with the banking sector calls for a continuous monitoring of their activities, given their impact on economic developments.

Insurance firms continued to readjust their investment portfolios in the course of 2019 in order to limit any inconsistencies with their insurance obligations, on the back of declining interest rates. The low interest rate environment restricts the ability of insurance firms to cover the returns guaranteed to their policyholders, whereas it concurrently strengthens the trend for the provision of insurance policies, the investment risks of which are borne by the policyholders.

The stability of the domestic financial system was also positively affected by the smooth operation of payment, clearance and settlement systems, i.e. market infrastructures, which contributed to the successful completion of transactions. As regards electronic means of payment, their use is still elevated both in terms of the volume and the value of transactions, despite the decline in transactions conducted with the use of payment cards in the first half of 2019, compared with the second half of 2018.

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The Greek economy grew by 1.5% in the first half of 2019, while, for the whole year, based on the available macroeconomic indicators and the economic policy pursued, the real GDP growth is expected to remain broadly at last year's levels. Nevertheless, it is important to point out that there are still risks emanating mainly from the external environment, which

[7] Source: European Central Bank, Statistical Data Warehouse.

[8] According to data from the Bank of Greece, time deposits held by corporations fell from €4 billion in September 2018 to €3.8 billion in December 2018 and to €3.6 billion in September 2019. In accordance with data from the Hellenic Statistical Authority (ELSTAT), imports of capital goods from the EU increased cumulatively in the period from January 2019 to September 2019. By way of indication, the value of imports of machinery and transport equipment rose to €5.2 billion during this period from €4.9 billion in the period from January 2018 to September 2018.

affect the Greek banking sector and financial stability.

The banking sector is also needed to play an active role – albeit not instrumental, given its existing weaknesses – in achieving sustainable rates of economic growth and improving macroeconomic aggregates.

The large legacy NPL stock, which impacts profitability, coupled with the low quality of regulatory own funds burden the operating environment of banks. NPL reduction has accelerated, but this pace is not enough to ensure a rapid de-escalation so that the Greek banking sector comes closer to the European average.

The recent initiative of establishing a Hellenic Asset Protection Scheme (HAPS) is a welcomed development, contributing towards improving banks' asset quality. Although it is an important step in the right direction, it should be complemented by other actions aimed at, on the one hand, effectively tackling the large NPL stock, and, on the other hand, at improving the quality of regulatory own funds of banks. In this vein, the Bank of Greece has set up a dedicated working group to develop alternative strategies and proposals on its initial plan[9] regarding the avenues for simultaneously reducing NPLs and DTCs, the latter as a share of banks' regulatory own funds. This would give a more long-term boost to bank profitability and liquidity.

The need for a definitive solution to the NPL stock, apart from its particular significance from a financial stability perspective, is also premised on the need to bolster financing of the real economy, given the existing credit gap.[10]

A successful tackling of NPL levels will not only help reduce credit risk for banks, but also lay the groundwork for limiting financial risk for households and corporations, as the economy recovers and there is subsequently a higher valuation of existing assets given the higher yields on capital and real estate. This will enable credit institutions to channel credit to the more dynamic and export-oriented businesses. They will thus be able to contribute to the overall restructuring of the economy, having a beneficial impact on the sectors of goods and services, in turn, resulting in higher rates of total productivity and potential GDP growth.

In addition, an improved quality of regulatory own funds of banks will favourably affect efforts to attract new investors. A strong capital base will create a new environment for banks to do business in, by improving the prospects of the banking system as a whole.

Finally, banks must intensify their efforts aimed at faster restructuring of viable businesses, a unified approach to debtors with multiple creditors, identifying "strategic defaulters" and putting in place a definitive solution for non-viable businesses.

The path towards a new era for the banking sector goes through the active participation of all involved parties, given that it is an imperative need and an overarching objective to restore the banking sector's intermediating

[9] This plan was put forward in November 2018 in the Special Feature entitled "A systemic proposal for the management of non-performing exposures" of the Bank of Greece's *Overview of the Greek Financial System*, available on the Bank of Greece's website, at: https://www.bankofgreece.gr/Publications/OVERVIEW%20OF%20THE%20GREEK%20FINANCIAL%20SYSTEM_NOV%202018.pdf.

[10] The credit gap has been estimated at €59 billion in the first half of 2019. This assessment is based on a static approach in the context of the methodology used for setting the Countercyclical Capital Buffer rate (CCyB rate).

function, in the context of safeguarding financial stability.

ISSN: 2732-9402 (online)