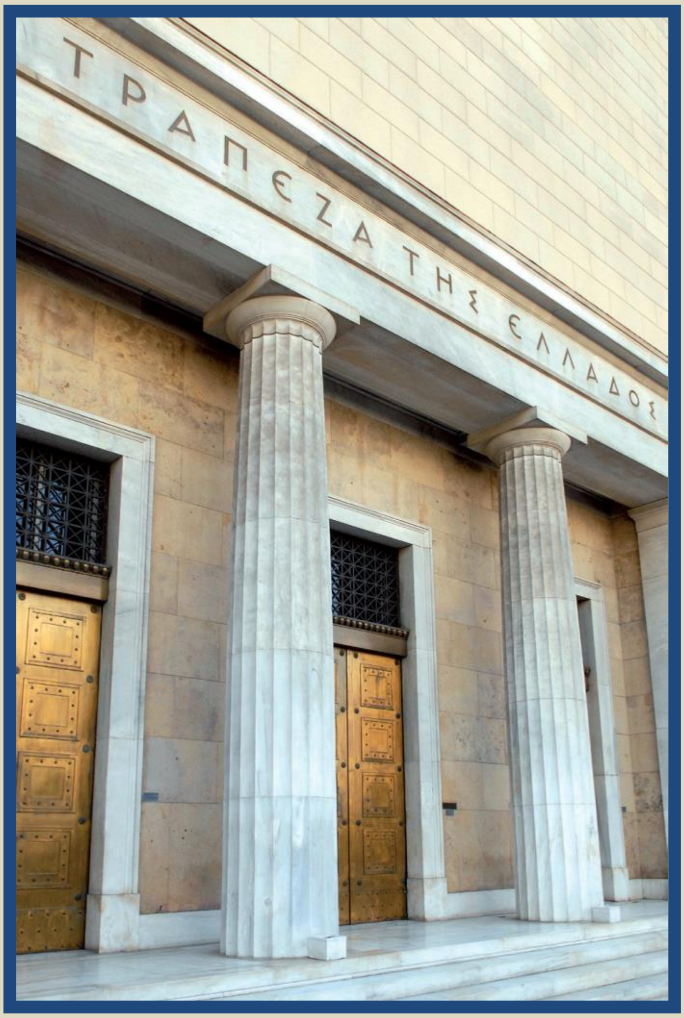
FINANCIAL STABILITY REVIEW

EXECUTIVE SUMMARY



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EXECUTIVE SUMMARY

Economic activity in Greece significantly recovered in 2021, as real GDP grew by 8.3%, marking one of the best performances in the euro area. This rebound greatly offset the 2020 GDP contraction of 9% and confirmed expectations of a V-shaped recovery. Coupled with expectations of continued growth in 2022 and a positive long-term economic outlook, this development has contributed to the recent upgrades of Greece's credit rating by Standard and Poor's (S&P) and DBRS Morningstar,[1] thus bringing Greek government bonds to just one notch short of investment grade. Attaining the latter will mark the end of a cycle which began with the onset of Greece's sovereign debt crisis and, at the same time, will be a strong vote of confidence in Greece and help attract foreign investment.

Nonetheless, the Russian invasion of Ukraine has altered economic conditions, weakening short-term growth prospects. Inflationary pressures mainly fuelled by the energy crisis, compounded by the uncertainty surrounding the duration of the war and its impact on the real economy, are acting as a deterrent to economic decisions on the part of businesses and households.

The liquidity and asset quality of the Greek financial system improved in the course of 2021, underpinning the financing of the real economy. The continuation of the European Central Bank's (ECB) accommodative monetary policy measures ensured Greek banks' uninterrupted access to low-cost funding. In addition, the recent ECB Governing Council decision[2] to continue to accept Greek government bonds (GGBs) as eligible collateral in its monetary policy operations (coupled with their acceptance in reinvestments under the Pandemic Emergency Purchase Programme – PEPP), despite the gradual lifting of pandemic-related support measures, creates favourable financing conditions over the medium term.

Banks accelerated their balance sheet clean-up, achieving a substantial reduction in the stock of non-performing loans (NPLs). However, the persistently high legacy stock of NPLs remains a significant challenge, along with the potential emergence of new NPLs after the full withdrawal of pandemic-related support measures. The repercussions of the war constitute an additional source of uncertainty surrounding banks' asset quality, as a result of falling household disposable income and rising business operating costs.

In this context, banks' capital adequacy, which is directly affected by balance sheet clean-up and the phasing in of International Financial Reporting Standard 9 (IFRS 9), in conjunction with the low quality of regulatory capital, due to the high share of Deferred Tax Credits (DTCs), and structurally low operating profitability, is posing challenges to Greek banks. At the same time, the risk of a further strengthening of the sovereign-bank nexus is another area of concern. In this light, banks' initiatives to boost their capital base are a welcome step towards mitigating emerging pressures.

Increased financing of the real economy is a prerequisite for a sustained economic recovery and calls for a strong banking sector. Hence, efforts to address the above challenges must be stepped up in order to considerably boost the provision of credit to the real economy. In this light, the use of the Recovery and Resilience Facility (RRF) creates a positive outlook and can play a significant

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[1] As of 30.4.2022, Greece's credit ratings are: BB+ (S&P), BBH (DBRS, equivalent to BB+), BB (Fitch), and BA3 (Moody's).

[2] https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220324~8b7f2ff5ea.en.html.

role in supporting financing, with a view to mitigating the economic impact of the COVID-19 pandemic and rendering European economies more sustainable, more resilient and better prepared to address the challenges and the opportunities arising from the green and digital transition.

This brings into sharper focus the importance of an appropriate macroprudential policy to avoid the build-up of systemic risks, taking into account prevailing macroeconomic and financial conditions. Implementing appropriate macroprudential policy measures, mainly in the form of capital buffers over the medium term, will help create sufficient macroprudential space that will positively affect financial stability.

This Financial Stability Review covers the entire financial system, focusing on an analysis of banking developments, given the particular relevance of the banking sector for the Greek economy, and includes several Special Features.

Special Feature I analyses trends in deposits during the COVID-19 pandemic by type of holder (i.e. households and businesses) and size of account balance.

Special Feature II discusses the changes introduced by the new bankruptcy code (Law 4738/2020), which overhauls the legal framework for addressing insolvency, collective satisfaction of creditors and discharge of debt for any person that undertakes an economic activity by providing economic actors with a second chance.

Special Feature III presents the main proposals formulated by the European Systemic Risk Board (ESRB), the European Banking Authority (EBA) and the ECB in the context of the review of the macroprudential policy framework of the European Union (EU), aimed at improving its operation and efficiency over the medium term.

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Liquidity conditions in the Greek banking sector continued to improve in 2021 on the back of higher private sector deposits and the Eurosystem's accomodative monetary policy, which maintained favourable financing conditions. Furthermore, improved asset quality facilitated access to money and capital markets. The upward trend in deposits continued throughout 2021, despite lower deposit rates, with the balance of business and household deposits reaching a ten-year high of €180 billion in December 2021.[3] The surge in deposits is associated with fiscal support measures, while real income was boosted by the dynamic economic rebound in 2021, as shown by the substantially higher number of paid employees (mainly in retail and tourism). Meanwhile, banks' liquidity improved, benefiting from their participation in the Eurosystem's Targeted Longer-Term Refinancing Operations (TLTRO III) and the acceptance of Greek government bonds as eligible collateral in Eurosystem refinancing operations, as well as from recent bond issuance on international markets. It should be pointed out that Greek banks' financing by the Eurosystem rose to €50.8 billion in December 2021, compared with €41.2 billion in December 2020.

In a similar vein, banks' asset quality improved further in 2021. The reduction in NPLs accelerated, bringing the NPL ratio (NPLs to total loans) down to 12.8% (from 30.1% at end-2020) and the total NPL stock to €18.4 billion, down by 61% or €28.8 billion (from €47.2 billion at end-

[3] In March 2022, deposits declined slightly month-on-month.

2020).[4] In this respect, it should be pointed out that two significant banks achieved their operational targets of single-digit NPL ratios by end-2021, and given ongoing NPL management actions, the entire Greek banking sector should achieve single-digit NPL ratios by end-2022. Overall, NPLs have dropped by 82.8% or €88.8 billion from their March 2016 peak.

The NPL stock reduction in 2021 was mainly driven by loan securitisations – which, in the case of three significant banks, were accompanied by hive-downs – and direct loan sale agreements.[5] Such transactions made use of the Hellenic Asset Protection Scheme (HAPS) providing Greek State guarantees to senior tranches of NPL securitisations. This scheme was extended in 2021 by another 18 months,[6] thus offering the possibility of additional Greek State guarantees of up to €12 billion.[7] Nonetheless, the NPL ratio of the Greek banking sector remains elevated, well above the EU average (2.0% in December 2021[8]). As a result, banks must step up efforts towards reducing the NPL stock, particularly against the background of new emerging challenges.

The Russian invasion of Ukraine and the ensuing energy crisis have exacerbated inflationary pressures, negatively affecting household disposable income and business operating costs. Consequently, given the high degree of uncertainty surrounding the outcome and duration of the war, and the expected full withdrawal of pandemic-related support measures to borrowers in the course of 2022,[9] a new wave of NPLs cannot be ruled out, especially if the geopolitical crisis is prolonged or escalates further. This renders the swift and full recognition of any new NPLs on banks' balance sheets an immediate priority for improving the resilience of the banking sector.

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Banking sector resilience indicators declined in 2021, mainly as a result of NPL reduction strategies. More specifically, Greek banks posted elevated after-tax losses in 2021, amounting to €4.8 billion, compared with losses of €2.1 billion in 2020, mainly as a result of losses on NPL portfolio sales. Operating income fell by 10.4% year-on-year, on account of reduced net interest income and income from financial operations. However, net fee and commission income and other income increased. Operating expenses picked up marginally, negatively impacted by one-off expenditure, such as provisioning for voluntary exit schemes, hive downs and impairment of goodwill and other intangible assets. Overall, it should be noted that one-offs account for a substantial share of banks' profitability in 2021.

Accelerated balance sheet clean-up by means of NPL portfolio sales resulted in a higher cost of credit risk. In detail, loan-loss provisions totalled €8.5 billion in 2021 (compared with €5.6 billion in 2020), of which €7.2 billion reflect NPL portfolio sales by two significant banks.

Greek banking groups' capital adequacy declined in 2021 mainly as a result of losses on NPL portfolio sales and the phasing in of IFRS 9, which more than offset the positive impact of capital increases in the course of 2021. In particular, the Common Equity Tier 1 (CET1) ratio on a consolidated basis fell to 12.6% in December 2021 from 15% in December 2020, and the Total Capital Ratio (TCR) to 15.2% from 16.6%, respectively. These ratios are well below the average for

[4] On-balance-sheet items.
[5] Securitisation transactions are presented in detail in Box V.1, which discusses securitisations as a tool for NPL reduction.
[6] The scheme was originally due to expire in April 2021.
[7] The initial amount approved for the HAPS was €12 billion, while as at end-2021 guarantees granted stood at €18.7 billion.
[8] Source: EBA, *Risk Dashboard Q4 2021*.
[9] According to December 2021 data on significant institutions, loans amounting to €9.4 billion were still under some sort of protection or payment facilitation in the context of pandemic-related borrower support measures (e.g. "Gefyra" programme, banks' step-up programmes).

credit institutions supervised directly by the ECB in the Banking Union (CET1 ratio 15.5% and TCR 19.5% in December 2021). Taking into account the fully phased-in impact of IFRS 9, the fully-loaded CET1 ratio and TCR of Greek banking groups stood at 10.7% and 13.4%, respectively.

Furthermore, the quality of Greek banks' prudential own funds deteriorated further; in 2021, deferred tax credits (DTCs) amounted to €14.4 billion, i.e. 63% of total prudential own funds (up from 53% in 2020). This share accounts for 73% of total prudential own funds when taking into account a fully phased-in impact of IFRS 9 (from 63% in 2020). Moreover, deferred tax assets (DTAs) of €1.7 billion are included in Greek banking groups' prudential own funds (on a fully phased IFRS 9 basis), accounting for 8% of their total prudential own funds. It should be pointed out that, although DTAs of €5.1 billion are not included in banks' prudential own funds, sufficient future profitability is needed in order for them not to pose risks to banks' capital base in the medium to long term.

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The Bank of Greece, in its capacity as macroprudential authority, assesses developments in the financial system and identifies potential systemic risks. In more detail, it assesses the intensity of cyclical systemic risk and the appropriateness of the Countercyclical Capital Buffer (CCyB) rate, if necessary. In the absence of excessive credit growth signals, this rate was maintained at 0%, i.e. the minimum level, in 2021 and the first two quarters of 2022. Also, the Bank of Greece identified Other Systemically Important Institutions (O-SIIs) in Greece for 2021 in accordance with the relevant EBA guidelines and set the O-SII buffer rate at 0.75% for 2022.

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In 2021, the operating environment of the Greek insurance market did not change substantially. However, the low interest rate environment and the impact of the COVID-19 pandemic accelerated board decisions to proceed with mergers and acquisitions. The risks for insurance undertakings, as reflected in solvency capital requirements, have not changed markedly vis-à-vis 2020. Nonetheless, many insurance undertakings are reviewing their business model and investment reallocation framework, in order to address existing and emerging risks. In this vein, maintaining portfolio sustainability hinges on a reassessment of the macroeconomic environment and climate change impact management.

The smooth operation of financial market infrastructures, i.e. payment, clearing and settlement systems, contributed positively to the stability of the domestic financial system through the successful processing of transactions. As regards electronic means of payment, their use remained elevated in 2021, in terms of both transaction volume and value.

Currently, 23 credit servicing firms (CSFs) operate in Greece; these firms manage, either for the account of credit acquiring firms[10] or for the account of credit institutions, exposures worth €123 billion, including non-accrued interest. The bulk of these exposures (84%) are in arrears.

Despite an increase in liquidations and debt repayments in the second half of 2021, it is important to monitor the evolution of loans managed by credit servicing firms (CSFs), in order to assess the efficiency of their management. Particularly as regards non-viable borrowers, CSFs should effectively make the most of idle collateral, which should be redirected to new productive uses; on the

[10] Article 1 Law 4354/2015.

other hand, viable borrowers should be offered effective restructuring solutions ensuring financial soundness and allowing for the reintegration of their loans, under certain conditions, into banks' balance sheets.

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The Greek economy is expected to continue to grow in 2022, albeit at a slower pace. Heightened economic uncertainty, on the back of a high and persistent inflation as well as Russia's invasion of Ukraine, is denting the expectations of economic agents and negatively affecting their decisions. Consumption, investment and exports will continue to have a positive contribution, although the adverse impact of inflation on real household disposable income will contain private consumption growth. Rising production costs and lower consumption may negatively impact business profitability and, amid generalised uncertainty, lead to a postponement or even cancellation of investment decisions.

On the upside, the use of the European recovery instrument "Next Generation EU" (NGEU) in 2022 is expected to provide funding for major investment projects and structural reforms, thus positively contributing to sustained economic growth.

The banking sector is called upon to adapt to a highly volatile environment in order to ensure a smooth flow of credit to the real economy. There is no room for complacency as banks need to address the following challenges efficiently:

First of all, the high legacy stock of NPLs. Despite the marked reduction in the NPL stock of the Greek banking sector, the NPL ratio remains elevated (December 2021: 12.8%) and a multiple of the average of EU banks (December 2021: 2%[11]). By achieving their operational targets, banks will bring this ratio to single-digit levels by end-2022 and thus be on track towards the successful conclusion of a long-standing effort. However, in light of geopolitical tensions triggered by Russia's invasion of Ukraine and the ongoing energy crisis, which have fuelled widespread inflationary pressures across products and services, there will inevitably be indirect effects on asset quality in the Greek banking sector. The final impact on the financial situation of households and businesses cannot be accurately assessed at the current stage, but is clearly an area of concern.

Second, low operating profitability. Increased operating profitability and the ensuing internal capital generation capacity are prerequisites not only for higher capital adequacy, but also for the overall bolstering of the banking sector. Given the impact on banks' profitability from their ongoing balance sheet clean-up efforts, it is clear that higher profitability is inextricably linked with stronger financing. The phasing out of the ECB's emergency monetary policy measures to contain the impact of the COVID-19 pandemic will push up interest expenses, whereas further pressure will be exerted on banks as a result of increased debt issuance needs (Additional Tier 1, Tier 2 and main debt) to meet prudential capital requirements, including minimum requirements for prudential own funds and eligible liabilities (MREL). Banks' actions to cut operating costs, including by stepping up digitalisation, will mitigate the final impact on operating results.

Third, banks' capital adequacy levels coupled with the low quality of their prudential own funds. Banks' capital adequacy remains at satisfactory levels, but faces significant challenges associated with the costs of implementing NPL reduction strategies and sufficient provisioning

[11] Source: EBA, *Risk Dashboard Q4 2021*, available at: https://www.eba.europa.eu/sites/default/documents/files/document_library/Risk Analysis and Data/Risk dashboard/Q4 2021/1029360/EBA Dashboard - Q4 2021 for publication.pdf.

for credit risk arising from any new NPLs that may emerge, as well as the phasing in of IFRS 9 and the need to strengthen their intermediation function by extending more credit to the real economy. Against this background, the already significant share of DTCs will increase further.

Regarding the need to extend more credit to the real economy, it should be noted that banks have long supported the Greek economy, even in crisis times, by making the most of any support measures, in the form of both government recapitalisations and state guarantees. In this vein, NGEU funding, along with additional financing on the part of banks, will help support the economy to achieve sustainable growth over the long term. Overall financing will greatly depend on the availability of viable investment projects.

Consequently, banks should accelerate their business plans to provide credit to healthy enterprises, concurrently with the use of NGEU funds, and households, by applying prudent credit standards. At the same time, they have to further develop alternative income sources in the context of a more efficient management of savings. Accelerating banks' digitalisation would be a welcome step in this direction. Developing sustainable business models that allow satisfactory operating profitability will improve the banking sector's ability to cushion the impact of potential (endogenous or exogenous) shocks and will help safeguard financial stability.

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