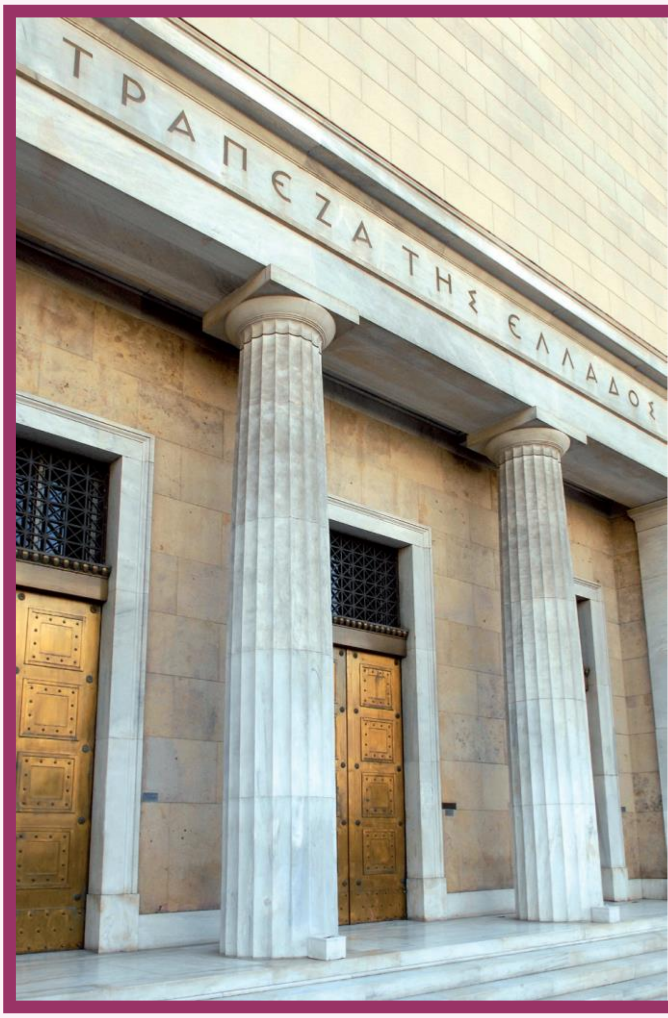
FINANCIAL STABILITY REVIEW

EXECUTIVE SUMMARY



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In 2021, economic activity in Greece recovered at a rapid pace following a deep recession of 9.0% in 2020 as a result of the COVID-19 pandemic and the related lockdown and containment measures. GDP (based on seasonally adjusted data) rose by 6.3% in the first half of 2021, on the back of a 16.2% recovery in the second quarter. The recovery was mainly driven by higher private consumption and increased disposable income, and was also significantly underpinned by exports of goods and services, government consumption and gross fixed capital formation.

The financial system recorded a buildup in liquidity and increased credit provision in the context of the accommodative stance of the single monetary policy in the euro area. Persisting challenges nonetheless remain: an elevated stock of non-performing loans, the low quality of Greek banks' prudential own funds, structurally low profitability and the continuously intensifying interconnection between banks and central government (bank-sovereign nexus).

Sustained economic recovery hinges upon the flow of credit from the financial system to the real economy, which presupposes a strong banking sector. Thus, efforts to address the abovementioned challenges need to be stepped up, particularly after the pandemic-related support measures for borrowers are permanently lifted, which could lead to an emergence of new NPLs. Meanwhile, the activation of the Recovery and Resilience Facility (RRF) creates positive prospects and can be expected to decisively help increase credit flows.

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 looks at the issue of climate change and its interaction with the banking sector. It analyses the risks and the initiatives undertaken at the global and EU level and, more specifically, at national level by the Bank of Greece to address climate change and safeguard financial stability.

Special Feature II presents the key aspects of the review of the bank crisis management framework in the context of the public consultation launched by the European Commission. It also sets out in greater detail the Bank of Greece's take on the main points of the regulatory framework in need of improvement and relevant proposals for addressing its shortcomings.

Special Feature III describes the Bank of Greece's regulatory sandbox as a mechanism that facilitates innovation and as a supervisory tool. It examines the objectives and terms of admission to the sandbox, as well as its operational framework.

Special Feature IV discusses the operation of big tech companies and their impact on the financial system's operation. It points out institutional and regulatory challenges and highlights financial stability risks arising from their activity.

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Liquidity conditions in the banking sector continued to improve in 2021. Private sector deposits increased by €28.6 billion in the period March 2020 - September 2021. Half of this increase (€14.4 billion) represented household savings, while the other half (€14.2 billion) was held by non-financial corporations (including micro enterprises).

Deposits increased on the back of fiscal stimulus and other support measures (such as repayable advances amounting to €8.3 billion, household income support, loan and other moratoria), but also as a result of precautionary saving. This is reflected in the substantial rise in private sector savings to around 16% of GDP, up from 6% in 2019.

Meanwhile, the liquidity of banks improved further, benefiting from their participation in the Eurosystem's Targeted Longer-Term Refinancing Operations (TLTROs III), the eligibility of Greek government bonds as collateral in refinancing from the Eurosystem, as well as recent bond issuance.

Correspondingly, banks' asset quality improved further in the first half of 2021. The reduction in non-performing loans (NPLs) continued, bringing the NPL ratio (NPLs to total loans) down to 20.3% at end-June 2021 (from 30.1% at end-December 2020) and the total NPL stock to €29.4 billion, down by 37.8% or €17.8 billion from €47.2 billion at end-December 2020.[1] The overall reduction in NPLs since their March 2016 peak was 73% or €78 billion.

The NPL stock reduction was mainly achieved with (i) Alpha Bank's NPL sale through loan securitisation, accompanied by a hive-down; and (ii) Piraeus Bank's NPL sale through loan securitisation. These transactions use the Hellenic Asset Protection Scheme (HAPS) providing Greek State guarantees to senior tranches of NPL securitisations. This scheme was extended in the first half of 2021 for another 18 months, thus offering the possibility of additional Greek State guarantees of up to €12 billion.[2]

However, despite the reduction in the NPL ratio, nearly 40% of NPLs and 9% of performing loans are forborne, which makes them high risk. At the same time, high-risk categories under IFRS 9[3], i.e. stages 2 and 3, account for 13% and 20% of loans respectively, while loans worth €9 billion are 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).

It is therefore clear that the impact of the COVID-19 pandemic on banks' asset quality is not yet fully visible, which renders the swift and full recording of new NPLs on banks' balance sheets an immediate priority for improving the resilience of the banking sector.

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In the first half of 2021, Greek banks posted high after-tax losses amounting to €4 billion, compared with losses of €0.9 billion in the same period of 2020, mainly as a result of losses on NPL portfolio sales. In more detail, Greek banks' loan loss provisions for credit risk amounted to €6.4 billion in the first half of 2021 (compared with €3.5 billion in the same period of 2020), €5.4 billion of which concern NPL sales. Greek banks' operating income increased mainly on the back of higher net com-

[1] On-balance sheet items.

[2] The initial amount approved for the HAPS was €12 billion and the scheme was originally due to expire in April 2021.

[3] Under IFRS 9, financial assets are classified in three stages of impairment. Stage 1 assets are financial instruments that either have not deteriorated significantly in credit quality since initial recognition or have low credit risk. Under this stage, performing exposures are recognised based on the possibility of a loan defaulting in the next 12 months. Stage 2 assets are financial instruments that have deteriorated significantly in credit quality since initial recognition. Stage 3 refers to credit impaired assets. Under Stages 2 and 3 the risk of default is over the expected life of the loan.

mission income and gains from financial transactions. Operating expenses were also elevated on account of one-off expenditure, such as provisioning for voluntary exit schemes, hive-downs and impairment of goodwill and other intangible assets. Excluding one-offs, i.e. gains from financial transactions, one-off operating expenditure and losses on NPL sales, Greek banking groups would have posted limited profits.

Negative economic results also affected Greek banking groups' capital adequacy. In particular, the Common Equity Tier 1 (CET1) ratio on a consolidated basis fell to 12.5% in June 2021 from 15% in December 2020, and the Total Capital Ratio (TCR) to 15% from 16.6%. These ratios are well below the average for credit institutions supervised directly by the ECB in the Banking Union (CET1 ratio 15.6% and TCR 19.4% in June 2021). Taking into account the fully phased-in impact of IFRS 9, the fully-loaded CET1 ratio and TCR of Greek banks stood at 10.6% and 13.1%, respectively.

Furthermore, the quality of Greek banks' prudential own funds deteriorated further; in June 2021, deferred tax credits (DTCs) amounted to €14.8 billion, i.e. 62% of total prudential own funds (up from 53% in December 2020). This share accounts for 71.5% of total prudential own funds when taking into account a fully phased-in impact of IFRS 9 (from 62.8% in December 2020). Moreover, deferred tax assets (DTAs) of €1.9 billion are included in Greek banking groups' prudential own funds (on a fully phased IFRS 9 basis), accounting for 9% of their total prudential own funds. It should be pointed out that, although DTAs of €4.5 billion are not included in banks' prudential own funds, sufficient future profitability is needed in order for them not to pose risks for banks' capital base in the long term.

A positive development was the conduct of capital increases and issuance of bonds qualifying as prudential own funds.

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The Bank of Greece, in its capacity as designated macroprudential authority, has: (i) set the Countercyclical Capital Buffer (CCyB) rate to 0% in 2021, i.e. the minimum, given the absence of excessive credit growth signals; (ii) defined Other Systemically Important Institutions (O-SIIs) in Greece for 2020 in accordance with the relevant European Banking Authority (EBA) guidelines; and (iii) set the O-SII buffer rate to 0.50% in 2021.

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The insurance market remained well capitalised in the first half of 2021, maintaining good quality capital despite the COVID-19 pandemic's impact and reduced profitability amid the low interest rate environment. However, in order to address the long-term impact of market risks, insurance undertakings should consider revising their business models and reviewing their pricing policies.

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 completion of transactions. As regards electronic means of payment, their use remained elevated in the first half of 2021, in both volume and value terms.

As at June 2021, 25 credit servicing firms (CSFs) operated in Greece; these firms manage, either for their own account or for the account of credit institutions, exposures worth €131 billion, including non-accrued interest. The bulk of these exposures (83%) are in arrears.

Managing such exposures efficiently and addressing the NPL problem depends on the flexibility and expertise of credit servicing firms, which should capitalise on: (i) recent institutional reforms (such as the out-of-court debt settlement mechanism and recently adopted legislation on debt settlement and second chance scheme for borrowers); and (ii) the ability to restructure NPLs in a viable manner and refinance credit through transparent procedures and in line with applicable regulatory and legislative provisions.

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Projections for economic growth in 2021 and 2022 remain exceptionally favourable. Crucial medium-term parameters are the Multiannual Financial Framework 2021-2027 and the new European recovery instrument Next Generation EU (NGEU), which are expected to provide funding for major structural reforms and investment projects.

However, these projections are subject to uncertainties. An upside risk is associated with a stronger rebound in private consumption driven by household savings accumulated during the COVID-19 pandemic and a faster-than-expected implementation of structural reforms leading to more efficient utilisation of NGEU funds. There are also downside risks, associated with the impact of the fourth wave of the COVID-19 pandemic, a rise in NPLs after government support measures are lifted and potential low absorption rates of NGEU funds.

The banking sector must adapt promptly to this new environment in order to perform its intermediary role and ensure a smooth flow of credit to the real economy.

As regards the medium-term profitability outlook, NPL portfolio sales coupled with the low interest rate environment exert downward pressure on banks' interest income. Furthermore, the phasing out of extraordinary monetary policy measures put in place by the ECB to contain the impact of the pandemic will weigh on interest expenses. The need for debt issuance (Additional Tier 1, Tier 2 and main debt) to meet prudential capital requirements, including minimum requirements for prudential own funds and eligible liabilities (MREL), will put further pressure on banks.

At the same time, the prospects for Greek banks' capital adequacy face major challenges, including uncertainty regarding internal capital generation capacity in the low interest rate environment; the costs of implementing NPL reduction strategies; and the need to extend more credit to the real economy.

The NPL ratio of the Greek banking sector has been considerably reduced, but still remains elevated (at 20.3% in June 2021) and a multiple of the average of EU banks (2.3% in June 2021[4]). This leaves no room for complacency, and banks should step up their efforts towards consolidating their balance sheets.

Another issue worthy of attention is the intensifying bank-sovereign nexus. Sovereign exposure[5] accounted for 26.3% of total bank assets and 44.8% of GDP in June 2021, up from

[4] European Banking Authority Risk Dashboard.

[5] Note that total exposures to central government comprise exposures to Greek government debt securities, DTCs and all of the Greek state guarantees granted in the context of the HAPS. They exclude all guarantees granted in the context of pandemic-related measures to support borrowers. Sources: European Banking Authority (EBA), *2020 EU-wide transparency exercise* and Bank of Greece, *Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)*.

21.4% of total assets and 36.5% of GDP in December 2020.[6]

As far as extending more credit to the real economy is concerned, significant impetus will come from the activation of NGEU, while overall funding will greatly depend on the availability of viable investment projects.

In the same direction, risk-sharing between the banking and public sector lowers the risk assumed by banks, as well as the financing costs of businesses, thereby positively impacting both supply and demand of credit. Given that credit risk premiums, particularly for SMEs, will remain elevated in the near future, risk-sharing through low-interest loans from the RRF and guarantees by the Guarantee Fund for Greek SMEs of the Hellenic Development Bank will significantly contribute to faster supply of credit to the real economy and the implementation of necessary investment in order for the Greek economy to get on track to stronger, sustainable growth. However, in the context of prudential risk management, banks must assess the risk/return ratio and the viability of the investment projects they finance.

Given that environmental and climate risks and the policies to address them feature among the key priorities and challenges that economies around the world and the global financial system have been facing in the past few years, Greek banks are called upon to develop business models that incorporate sustainable finance principles.

Finally, banks should step up the implementation of their business plans aimed to contain operating costs and to further develop alternative income sources in the context of a more efficient management of savings. Accelerating banks' digital transformation can play a decisive role in this direction.

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