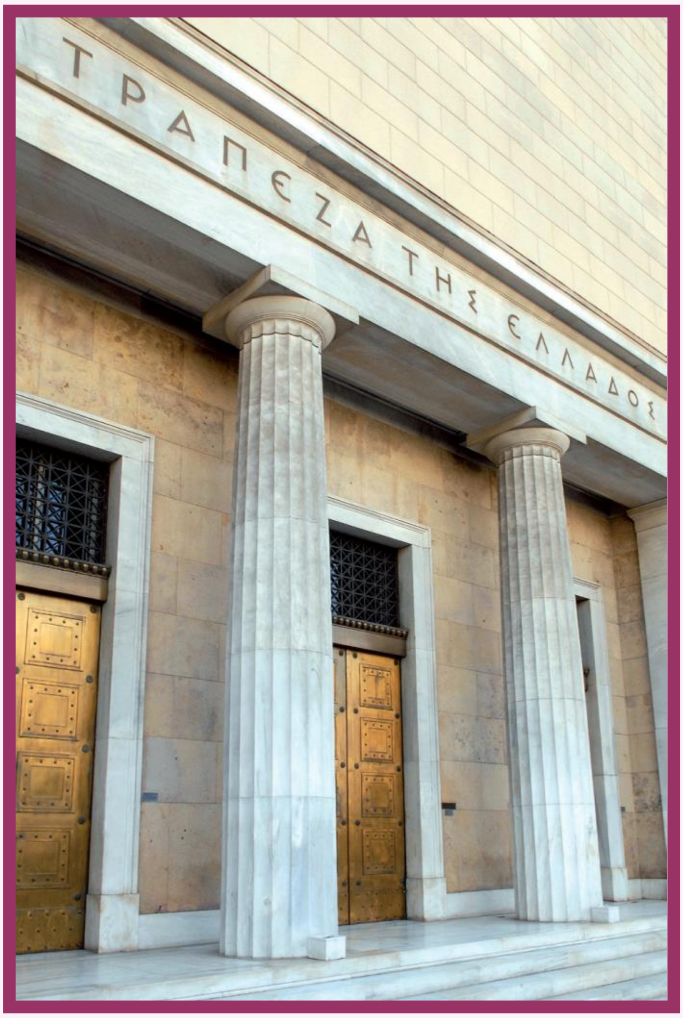
FINANCIAL STABILITY REVIEW

EXECUTIVE SUMMARY



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EUROSYSTEM

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In 2020, the COVID-19 health crisis shaped the course of the Greek economy. Real GDP dropped by 8.2%, mainly as a result of a decline in private consumption and tourism activity. However, a strongly expansionary fiscal policy, coupled with the euro area's accommodative single monetary policy, considerably mitigated the negative impact of the pandemic. The financial system experienced shocks at the outbreak of the pandemic, but soon stabilised thanks to the measures enacted by competent authorities.

The rollout of the vaccination programme to include more than one vaccine types for each age group and the stepping up of the vaccination campaign since May have raised consumer and business expectations about the economic outlook in the next few months and should underpin domestic demand. The activation of the European Recovery and Resilience Facility (RRF) has created prospects of an increase in fixed capital expenditure and accelerated growth. In this vein, the gradual phasing-out of support measures will help mitigate risks to the financial system, along with the economic recovery and the evolution of key fundamentals concerning banks' asset quality, profitability and capital adequacy.

This Financial Stability Review covers the entire financial system, focusing on an analysis of banking developments, since the banking sector is of particular relevance for the Greek economy. Special Feature I provides a more detailed insight into the bank-sovereign nexus, thoroughly examining the case of Greece. It discusses interaction channels, feedback loops, as well as the risks arising from the continuously strengthening interconnection between banks and sovereigns. Special Feature II outlines all the prudential and regulatory measures for the banking sector put in place at national and European level in an effort to curb the impact of the COVID-19 pandemic crisis.

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In terms of banking risks, Greek banks' liquidity has been significantly bolstered on the back of the eligibility of Greek government bonds (GGBs) both for purchases under the European Central Bank's Pandemic Emergency Purchase Programme (PEPP) and for acceptance as collateral by Greek banks in the Eurosystem's refinancing operations, as well as a notable increase in customer deposits. This development has contributed to a 13.3% increase in Greek banks' total assets in 2020, also boosting their bond holdings. These measures coupled with state support to address the economic fallout of the pandemic, particularly by means of state guarantees, contributed to positive credit growth to non-financial corporates, which could have been stronger given banks' liquidity conditions.

The quality of Greek banks' loan portfolios continued to improve in 2020. Non-performing loans (NPLs) declined further: the total NPL stock (including on-balance-sheet items) amounted to €47.2 billion in 2020, down by 31.1% or €21.3 billion compared with end-2019 (€68.5 billion). Although the NPL ratio remains elevated at 30.1%, it should be noted that the overall reduction in NPLs from their March 2016 peak (€107.2 billion) is 56% or €60 billion.

The material reduction in the NPL stock is mainly attributed to write-offs and intercompany NPL sale transactions, through loan securitisations, which were accompanied by hive-downs.[1] Concurrently, the activation of the Hellenic Asset Protection Scheme (HAPS) providing Greek State guarantees to the aforementioned securitisations had a positive impact. The NPL ratio however remains the highest among euro area countries and a multiple of the average of similarly sized credit institutions under the direct supervision of the Single Supervisory Mechanism (SSM) (2.6% in December 2020). It is therefore clear that further measures are needed to facilitate the front-loaded recognition of losses resulting from a pandemic-induced increase in credit risk and the consolidation of banks' balance sheets, along with addressing the issue of deferred tax credits (DTCs).

The timely and full recognition in bank balance sheets of any new NPLs that will emerge as a result of the COVID-19 pandemic crisis is of utmost importance to the selection of the appropriate tools in view of reducing the NPL stock and strengthening the banking sector.

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In 2020, the resilience of Greek banking groups and the implementation of NPL reduction strategies were affected by the COVID-19 pandemic. Greek banks reported heavy losses after taxes and discontinued operations in 2020 amounting to €2,057 million, compared with profits of €203 million in 2019, mainly as a result of increased impairments for credit risk. More specifically, loan loss provisions in 2020 amounted to €5.6 billion (compared with €2.7 billion in 2019), which is broken down as follows: €1 billion reflects the more pessimistic macroeconomic projections in bank models prompted by the pandemic in terms of calculating impairment costs; €1.5 billion reflects the sale of a large volume of NPLs by one systemic bank in the context of the HAPS; and another €3.1 billion reflects general and special loan loss provisions.

The abovementioned negative impact was partly offset by an increase in operating income, chiefly as a result of the tripling of gains from financial transactions underpinned by non-recurring gains from the Greek Government bond (GGB) portfolio. Net interest income, the key source of income for Greek banks, has remained almost unchanged.

Capital adequacy has declined compared with 2019, but remained at a satisfactory level. In particular, the Common Equity Tier 1 ratio (CET1 ratio) on a consolidated basis dropped to 14.9% in December 2020 from 16.2% in December 2019, and the Total Capital Ratio (TCR) to 16.6% from 17.3% respectively. This is mainly due to a decline in the prudential own funds of Greek banking groups, negatively impacted by the phasing-in of IFRS 9 and reported after-tax losses. Taking into account the fully phased-in impact of the IFRS 9, the fully-loaded CET1 ratio was 12.5% and the Total Capital Ratio was 14.2%. Moreover, a crucial parameter is the low quality of Greek banks' prudential own funds. In December 2020, Deferred Tax Credits (DTCs) amounted to €15.1 billion, accounting for 53% of total prudential own funds. A positive development in the first months of 2021 has been the completion of capital increase transactions, such as Piraeus Bank's share capital increase worth €1.4 billion and the €600 million Additional Tier 1 bond issuance, as well as Alpha Bank's €500 million Tier 2 bond

[1] A detailed presentation of the setup of such corporate transformations may be found in a special Box of the January 2021 *Financial Stability Review*, available at: https://www.bankofgreece.gr/ekdoseis-ereyna/ekdoseis/ekthesh-xrhmatopistwtikhs-statherothtas

issuance and its upcoming share capital increase.

It should be pointed out that the measures of the European Central Bank (ECB) and the Bank of Greece for temporary relief in capital requirements on credit institutions under their direct supervision with a view to addressing the impact of the COVID-19 pandemic will remain in force at least until the end of 2022.[2]

In terms of the outlook for capital adequacy, two factors should be taken into account: the currently ongoing EU-wide stress test which uses the standard methodology,[3] the results of which will be published by 31 July 2021, as well as the gradual implementation of the prudential backstop.[4]

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In 2020, the risks assumed by insurance undertakings, arising from either their insurance activities or their investment portfolios, did not change significantly compared with 2019. As at 31 December 2020, the Greek insurance market, albeit impacted by the pandemic, remains sufficiently capitalised with high quality capital.

The smooth operation of financial market infrastructures, i.e. payment, clearance and settlement systems, contributed favourably to the stability of the domestic financial system in 2020 through the successful completion of transactions. As regards electronic means of payment, their use was still elevated in both volume and value terms, despite a decline in card payments in the first half of 2020.

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As regards the future economic outlook, the Bank of Greece forecasts strong GDP growth of 4.2% for 2021 and 5.3% for 2022, against the background of a recovery in both external and domestic demand in the second half of 2021, also supported by funds from the "Next Generation EU" (NGEU) instrument.

The pace of the recovery will depend on how quickly the population reaches immunity and how the epidemiological situation unfolds, determining in turn tourist receipts. Any delays in the absorption of NGEU funds will have a negative impact. Conversely, a faster absorption of funds will accelerate Greece's GDP growth rate both in 2021 and in the next few years.

The banking sector must adapt promptly to this new environment in order to rise to the challenges it is faced with, thus ensuring financial stability and a smooth flow of credit to the real economy in the post-COVID era.

As regards profitability, the medium-term outlook is inextricably linked with how the pandemic evolves and how it affects the real economy. The low interest rate environment exerts pressure on banks' net interest income, highlighting the need for alternative income sources and a further rationalisation of costs. Accelerating the digital transformation of banks may contribute to this end, as customers have become more receptive to such changes during the pandemic. However, the expected increase in credit risk for banks as a result of the worsened financial situation of firms and households will call for increased

[2] See Special Feature II discussing the prudential and regulatory measures for the financial system enacted in the context of the COVID-19 pandemic.

[3] The 2021 stress test does not include a pass/fail threshold, to facilitate incorporation into each bank's unique Supervisory Review and Evaluation Process (SREP).

[4] Regulation (EU) 2019/630 amended Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR) as regards minimum loss coverage for non-performing exposures (NPEs). On the basis of a common definition of non-performing loans (NPLs), the new rules introduce a minimum capital requirement to cover losses caused by future loans that turn non-performing. For more details, see: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/1183-Statutory-prudential-backstops-addressing-insufficient-provisioning-for-newly-originated-loans-that-turn-non-performing_el.

loan loss provisioning, further restricting their internal capital generation capacity. Hence, developing a sustainable business model that will deliver satisfactory operating profitability is one of the challenges facing the Greek banking sector.

Furthermore, attention should be paid to the issue of the strong and continuously intensifying interaction between banks and central government (bank-sovereign nexus). While in June 2018 banks' total exposures to central government amounted to 13.8%[5] as a percentage of total assets and 18.4% as a percentage of GDP, at end-2020 it rose to 21.4% of total assets and 36.5% of GDP.[6] Given the high share of GGB holdings in bank assets and the currently still high bond valuations, an abrupt adjustment in their values as a result of an unexpected deterioration in macroeconomic conditions and credit tightening could lead to a volatility spike and liquidity squeeze.

Overall, Greek systemic banks' exposures to Greek government securities are expected to remain at high levels for a considerable amount of time and, as a result, the risk of GGB valuation adjustments will persist. Accordingly, the interconnection between systemic banks and central government through the high share of DTCs amounting to 53% of Greek banks' prudential own funds as at end-2020 should also rise in the absence of any measures. The reason is that, upon the implementation of securitisation transactions in order to clear banks' balance sheets from NPLs, capital is depleted to cover losses, thus increasing the total share of DTCs in banks' prudential own funds.

Finally, the NPL ratio remains exceptionally high, a multiple of the European average. It is also expected that new NPLs will emerge as COVID-related moratoria on loan obligations and fiscal policy measures are phased out in the course of 2021.

In conclusion, it is clear that measures and initiatives to strengthen the banking sector, including the timely recognition of the pandemic's impact on bank balance sheets in line with supervisory guidance, the development and implementation of strategies for an effective management of new NPLs, as well as decisions on strengthening the capital base, are all steps in the right direction. A quick transition to the new post-COVID normal requires the active involvement of the banking sector, which should be able to provide a smooth flow of credit to the real economy, thereby fulfilling its intermediation role.

[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 do not include all guarantees granted in the context of pandemic-related measures to support borrowers.

[6] See Special Feature I.

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