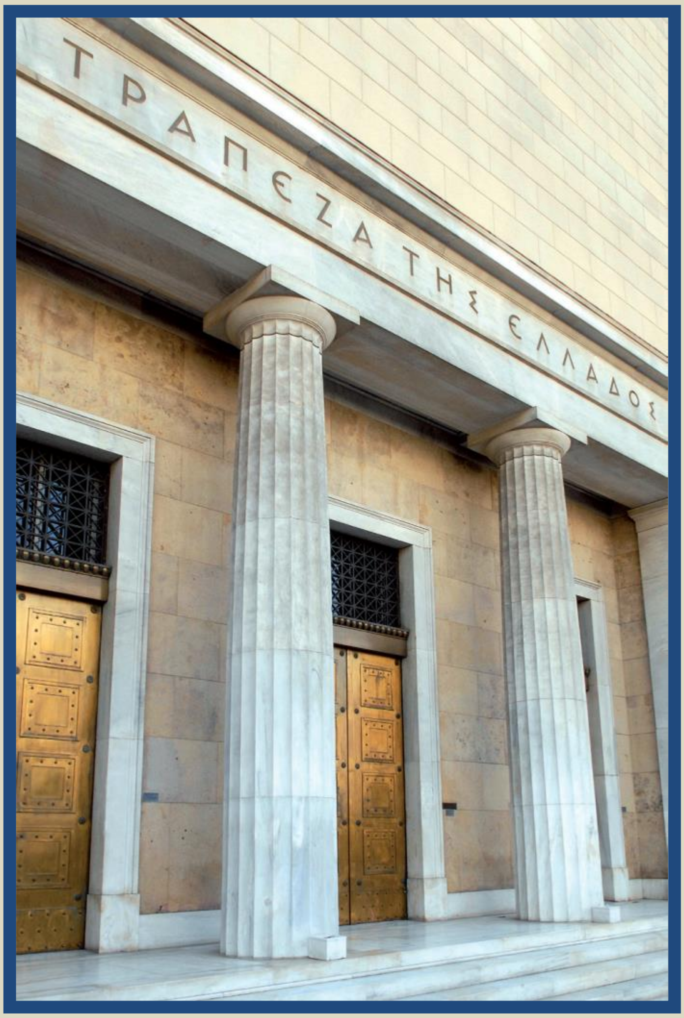
FINANCIAL STABILITY REVIEW

EXECUTIVE SUMMARY



November
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BANK OF GREECE
EUROSYSTEM

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BANK OF GREECE
21, E. Venizelos Street
GR - 102 50 Athens

www.bankofgreece.gr

Financial Stability Department
Tel. +30 210 320 5103
Fax +30 210 320 5419

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I. EXECUTIVE SUMMARY

In the first half of 2022, economic activity in Greece performed better than expected: real gross domestic product (GDP) grew by 7.8%, one of the highest growth rates in the European Union. This was mainly due to an improved performance of tourist receipts, as well as to strong increases in private consumption and investment, supported by pent-up demand following the lifting of the coronavirus (COVID-19) pandemic containment measures.

Strong economic growth has, to some extent, mitigated the adverse effects of uncertainty surrounding geopolitical and energy-related developments. However, the intensity and persistence of imported inflationary pressures, the deteriorating economic outlook, the heightened risk of an abrupt repricing of assets in international money and capital markets, as well as higher Greek government bond yields have led to increased risks to financial stability.

In the course of 2022, the Greek financial system continued to improve in terms of profitability, liquidity and asset quality. It is worth noting that all four significant banks have already achieved the operational target that they had set to reduce their non-performing loan (NPL) ratio to single digit by year-end. As regards liquidity, the deposit base was further strengthened in the first nine months of 2022, while the European Central Bank (ECB) Governing Council's decisions[1] to continue reinvesting, in full, the principal payments from maturing securities purchased under the asset purchase programme (APP) and the pandemic emergency purchase programme (PEPP) and, in particular, the introduction of a new transmission protection instrument (TPI)[2] have reinforced the tools available for the effective transmission of monetary policy and have contained the upward trend in bond yields. Against this background, an upgrade of the Greek sovereign to investment grade in the near future would be instrumental in easing funding cost pressures, as it would be a strong vote of confidence in the Greek economy and banking sector.

However, one cannot overlook the impact of the normalisation of monetary policy by gradually raising key ECB interest rates to levels that will ensure a timely return of inflation to its medium-term target of 2%. Higher interest rates undeniably make a positive contribution to tackling inflation, as well as to enhancing bank profitability in the short term. Nonetheless, the rise in firms' operating costs, the negative impact on household real disposable income and heightened funding costs, among other factors, could dampen bank profitability and would point to a weaker economic outlook. Moreover, the worsening financial condition of households and firms, combined with rising financing costs, could lead to a new wave of NPLs in the medium term, which would again affect banks' asset quality.

In the first half of 2022, capital adequacy developments were mainly driven by the phasing-in of International Financial Reporting Standard 9 (IFRS 9), profitability and an increase in risk-weighted assets. The low quality of prudential own funds, due to the high share of Deferred Tax Credits (DTCs), remains a challenge, whereas putting in place the right conditions for internal

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[1] ECB, Monetary policy decisions - June 2022 and July 2022.

[2] TPI purchases will be focused on public sector securities (marketable debt securities issued by central and regional governments as well as agencies, as defined by the ECB), with a remaining maturity of between one and ten years (see https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220721~973e6e7273.en.html).

capital generation is now becoming a priority, given the increased cost of market-based funding. The bank-sovereign nexus is also a source of concern.

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 three Special Features.

Special Feature I provides a joint examination of the evolution and structure of GDP on the basis of gross value added by sector of economic activity, of respective bank credit to firms and of non-performing exposures.

Special Feature II presents the European and national regulatory framework for Information and Communications Technology (ICT) and security risk management by financial institutions.

Special Feature III explains the reforms to rationalise the channelling of public funds by the Bank of Greece through the System of Treasury Accounts, including digitalisation of procedures and services provided to general government entities.

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Liquidity conditions in the Greek banking sector in 2022 presented a mixed picture. Against the backdrop of rising Greek bond yields and expectations of a further increase in the key policy rates by the ECB, access to capital markets became more difficult for Greek banks. However, customer deposits continued their upward trend, albeit at a slower pace compared with the previous year, reflecting strong economic growth and credit expansion, notably to non-financial corporations.

The outstanding amount of business and household deposits reached a ten-year high of €185.5 billion in September 2022 (December 2021: €180 billion).[3] This rise was mainly driven by saving deposits, reflecting the strong growth of the Greek economy and an increase in bank lending, both of which enhanced depositors' saving capacity. In particular, the outstanding amount of deposits held by non-financial corporations stood at €41.9 billion in September 2022,[4] with a reduced growth rate since the beginning of the year, as businesses drew down on their deposits in the face of strong increases in energy prices and business operating costs. Meanwhile, banks' liquidity continued to be supported by their participation in the Eurosystem's Targeted Longer-Term Refinancing Operations (TLTROs III) and the acceptance of Greek government bonds as eligible collateral in Eurosystem refinancing operations, as well as by recent bond issuance on international markets.[5] It should be pointed out that the outstanding amount of financing of Greek banks by the Eurosystem remained at €50.7 billion during this period, unchanged from December 2021.

The first half of 2022 saw further improvements in the quality of credit institutions' loan portfolios. The NPL ratio stood at 10.1% in June 2022, down from 12.8% in December 2021. This reduction reflected the progress achieved towards cleaning up bank balance sheets. As already mentioned, all four significant banks have attained their operational target of a single-digit NPL

[3] Source: Bank of Greece, Monetary financial institutions (MFI) assets and liabilities, https://www.bankofgreece.gr/en/statistics/monetary-and-banking-statistics/deposits

[4] Source: Bank of Greece, Monetary financial institutions (MFI) assets and liabilities, https://www.bankofgreece.gr/en/statistics/monetary-and-banking-statistics/deposits

[5] Eurobank launched a bond issue of €500 million in June and Alpha Bank a €400 million at end-October.

ratio by end-2022. However, the NPL ratio of less significant banks is very high, at 49.7% (which also relates to the unsuitability of the government guarantee scheme for most smaller banks). In addition, the system-wide NPL ratio remains a multiple of the European average (June 2022: 1.8%[6]), implying that banks must continue and step up their efforts to reduce their existing NPL stock, especially in the light of emerging challenges.

The protracted war in Ukraine, with the ensuing energy crisis, has been a crucial factor behind the increase in imported inflationary pressures, weighing heavily on household real disposable income and business operating costs. The strong economic growth recorded on the basis of data for the first half of 2022 has helped to alleviate pressures. However, the normalisation of ECB monetary policy, resulting in a higher interest rate environment, clearly indicates that both the cost of financing and the debt repayment capacity of households and corporations will be adversely affected. By contrast, a positive impact is expected on deposit interest rates via the partial pass-through of increased key rates. This environment, combined with weaker near-term economic growth prospects, would again affect the quality of banks' loan portfolios due to the creation of new NPLs. The amount of new NPLs is difficult to estimate though, amid uncertainty about the evolution of parameters related to the geopolitical and energy-related crisis, especially in the event that the crisis should prove more prolonged than expected or escalate further.

Finally, it should be noted that the transfer of NPLs out of the banking sector does not automatically mean the removal of debt from the economy. The debt remains and is now managed by credit servicing firms (CSFs). The smooth functioning of the NPL secondary market is therefore key to a definitive debt resolution and to this end the effective use of all available tools is a prerequisite. Rehabilitation of borrowers with viable and bankable investment plans should be put forward as an option that can help towards both a definitive resolution of private debt overhang and the growth of the real economy.

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In the first half of 2022, Greek banking groups posted profits, after tax and discontinued operations, amounting to €2.3 billion, compared with losses of €4.0 billion in the corresponding period of 2021, returning to profitability after two loss-making years. In more detail, in the first half of 2022 Greek banks' operating income increased year-on-year, mainly owing to an increase in non-recurring income, such as gains from financial operations and hedging instruments, as well as income from the separation and sale of the merchant acquiring business by three major banks. However, core income (i.e. net interest and fee income) decreased by 5%, as lower net interest income more than offset higher net fee income. Operating costs fell by 9.1%, mainly due to a reduction in staff costs via voluntary retirement schemes in previous years and one-off corporate transformation costs in the first half of 2021. The cost of credit risk fell significantly, as loan-loss provisions totalled €1.0 billion in the first half of 2022, compared with €6.4 billion in the first half of 2021.[7]

[6] Source: European Banking Authority, Risk Dashboard, Q2 2022 EBA Dashboard - Q2 2022.pdf (europa.eu)
[7] It should be noted that a large part of loan-loss provisions in the first half of 2021 reflected NPL portfolio sales.

The capital adequacy of banking groups declined marginally in the first half of 2022, mainly owing to an increase in risk-weighted assets, as the negative impact from the phasing-in of International Financial Reporting Standard 9 (IFRS 9) on prudential own funds was offset by the positive impact of half-year profits. In particular, the Common Equity Tier 1 (CET1) ratio on a consolidated basis fell to 13.2% in June 2022 from 13.6% in December 2021, and the Total Capital Ratio (TCR) to 15.9% from 16.2%, respectively. These ratios are well below the average for credit institutions supervised directly by the ECB in the Banking Union (CET1 ratio 15% and TCR 18.9% in June 2022). Taking into account the fully phased-in impact of IFRS 9, the fully loaded CET1 ratio of banking groups stood at 12.1% and the TCR at 14.8%.

Furthermore, the quality of Greek banks' prudential own funds remains low: in June 2022, deferred tax credits (DTCs) amounted to €14 billion, representing 58% of total prudential own funds (down from 59% in December 2021). Taking into account a fully phased-in impact of IFRS 9, this share comes to 63% of total prudential own funds (compared with 68% in December 2021). Finally, deferred tax assets (DTAs) of €2.2 billion are included in banking groups' prudential own funds (with a fully phased-in impact of IFRS 9), accounting for around 9% of their total prudential own funds. It should be pointed out that, although DTAs of €4.8 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, monitors and assesses developments in the financial system and implements measures to reduce the build-up of systemic risks and strengthen the resilience of the financial system. Specifically, it conducts a quarterly assessment of the intensity of cyclical systemic risk and the appropriateness of the Countercyclical Capital Buffer (CCyB) rate for Greece and sets or adjusts it, if necessary. In the course of 2022 this rate was maintained at 0%, i.e. the minimum level, in the absence of excessive credit growth signals. Also, the Bank of Greece identified Other Systemically Important Institutions (O-SIIs) in Greece for 2022 in accordance with the relevant EBA guidelines and set the O-SII buffer rate at 1% for 2023.

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In the first half of 2022, the key financial aggregates of the Greek private insurance market showed no significant change. While their capital adequacy remained broadly unchanged from 2021 levels, insurance undertakings continued their efforts to adjust their business models and review their pricing and investment policies. The continued viability of their portfolios will hinge on the macroeconomic environment and the ability to tackle climate change.

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 efficient processing of transactions. It should be pointed out that energy derivatives have caused significant volatility in the European energy market as, amid the surge in gas and electricity prices, energy companies have had to deposit increasing amounts of collateral with central counterparties.

The use of electronic means of payment rose significantly in the first half of 2022, in terms of both volume and value.

Based on June 2022 data, total exposures managed by CSFs amounted to €92.7 billion, excluding accrued interest and write-offs. In the first half of 2022, there was an increase in debt repayments, collateral liquidations and write-offs on exposures managed by CSFs on behalf of credit acquiring firms, while between 2019 and June 2022 loan portfolios totalling €1.15 billion were sold on the secondary market. The ability of CSFs to manage loans on behalf of credit acquiring firms and credit institutions is hampered by the recent Supreme Court judgment no. 822/2022[8] that upheld the relevant appellate rulings regarding their standing to institute and participate in enforcement proceedings entailing auctions of foreclosed properties. However, the effectiveness of CSFs is expected to become visible in the coming months with the lifting of the above restrictions, along with the recent launch of the digital auction platform for the principal residence of vulnerable households, which will apply until its transfer to the Sale and Lease Back Organisation.[9]

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For 2022, the Greek economy, based on the latest Bank of Greece projections, is estimated to grow at 6.2%, much higher than initially forecast. Combined with high inflation, nominal GDP growth is expected to stand well above the implicit interest rate on government debt, thereby helping to significantly reduce the government debt-to-GDP ratio. For the euro area, GDP growth in 2022 is projected at 3.1%. For the following year, increased flows expected from the European recovery instrument Next Generation EU (NGEU) will finance the implementation of major investment projects and structural reforms, thus helping to sustain positive growth in Greece.

However, lower economic growth prospects, higher inflation and tighter financing conditions put strain on the debt servicing capacity of non-financial corporations and households. At the same time, any further geopolitical or economic shocks would represent additional downside risks to the economic outlook.

The growing uncertainties and challenges in the macroeconomic and financial environment, both at European and domestic level, have highlighted the importance of macroprudential policy, which was reflected in the September 2022 "Warning of the European Systemic Risk Board on vulnerabilities in the Union financial system".[10] In particular, this general warning identified three main sources of systemic risk: (a) the deterioration in the macroeconomic outlook; (b) risks to financial stability stemming from a sharp fall in asset prices; and (c) the impact of these developments on the asset quality of credit institutions. In this context and over the medium term, the implementation of the appropriate macroprudential policy measures, notably in the form of capital

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[8] Supreme Court of Greece – Court Decision 822/2022 (CIVIL CASES - A2) (areiospagos.gr)

[9] Sale and Lease Back Organisation as referred to in Article 218 of the new Bankruptcy Law 4738/2020 (Government Gazette A 207).

[10] This is the first such warning by the ESRB, which is responsible for monitoring and preventing risks to the financial system in Europe, since its creation in 2010, shortly before the euro area debt crisis. https://www.esrb.europa.eu/pub/pdf/warnings/esrb.warning220929_on_vulnerabilities_union_financial_system~6ae5572939.en.pdf.

buffers, can contribute to the creation of sufficient macroprudential space that will have a positive effect on financial stability.

The Greek financial system needs to promptly adjust to the emerging conditions. The uninterrupted flow of credit to the Greek economy presupposes a strong banking sector, so action to enhance its resilience is necessary. Undoubtedly, the progress made in the past few years towards cleaning up bank balance sheets has been instrumental in improving the aggregates of the banking sector. However, uncertainty about the inflation trajectory and the effects of monetary policy normalisation, the weaker growth prospects of the Greek economy, the risk of a sharp repricing of assets and the escalating geopolitical and energy crisis leave no room for complacency. In this context, the following challenges can be identified, calling for action on the part of the banking sector:

First, the high stock of NPLs. Progress towards NPL reduction in the Greek banking sector has been remarkable, with the NPL ratio standing at 10.1% in June 2022. However, the NPL ratio remains high and a multiple of the respective EU average of 1.8%[11]. It should be noted that the implementation of banks' NPL reduction strategies has largely relied on securitisations, making use of the Hellenic Asset Protection Scheme (HAPS), and on outright sales of loans on the secondary market, which makes the continuation of these actions more difficult in light of emerging pressures on capital adequacy. Moreover, given the ongoing normalisation of monetary policy with interest rate increases, the impact on firms' operating costs and on household real disposable income could also affect borrowers' debt servicing capacity. Combined with the emerging lower economic growth prospects, this could lead to the creation of new NPLs, with adverse implications for banks' asset quality. The ultimate impact cannot be precisely assessed at present, but is a source of concern.

Second, low core profitability. The increase in key ECB interest rates will boost banks' net interest income in the short term, as a very large part of existing loans carry floating rates. In the medium term, however, a potential slowdown in economic activity, rising production costs and a decline in household real disposable income, combined with an increase in debt servicing costs for existing loans, would put strain on the financial condition of households and businesses, and banks' credit risk costs could increase as a result. In addition, banks' interest expenses are expected to grow due to the phasing out of favourable TLTRO funding rates and of other pandemic-related accommodative monetary policy measures, as well as due to increased debt issuance needs to meet prudential capital requirements, notably the Minimum Requirement for own funds and Eligible Liabilities (MREL).

Third, banks' capital adequacy level. Currently, the capital adequacy of the banking sector is satisfactory. In the short term, however, it will be affected by a number of factors: (a) possible constraints on internal capital generation capacity amid growing macroeconomic challenges and monetary policy normalisation; (b) the costs of implementing NPL reduction strategies and sufficient provisioning for credit risk, particularly in light of the potential emergence of new NPLs; (c) the implementation of capital-enhancement actions (e.g. synthetic securitisations) and the cost

[11] Source: European Banking Authority, Risk Dashboard, EBA Dashboard - Q4 2021 for publication.pdf (europa.eu)

of issuing capital instruments (Additional Tier 1, Tier 2) to meet regulatory capital requirements, including the cost of issuing MREL-eligible bonds; and (d) the evolution of new loan disbursements to households and non-financial corporations. Against this background, there is a risk of a further increase in the existing share of DTCs in banks' regulatory capital.

Safeguarding financial stability in an international environment of mounting risks requires vigilance from all stakeholders. As monetary policy is normalised, risks of fragmentation could arise in the euro area. For this reason, the ECB adopted the TPI. However, complementary action, particularly in the areas of energy and fiscal policies, is needed to reduce risks to financial stability. At the same time, banks should continue to clean up their balance sheets and further step up the financing of healthy and export-oriented businesses so that, together with the funds available under the Recovery and Resilience Facility, the Greek economy can be shielded against mounting risks (both domestic and imported). In this context, improving banks' core profitability, by speeding up digitalisation and cutting down operating expenses, will contribute to strengthening their resilience.

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