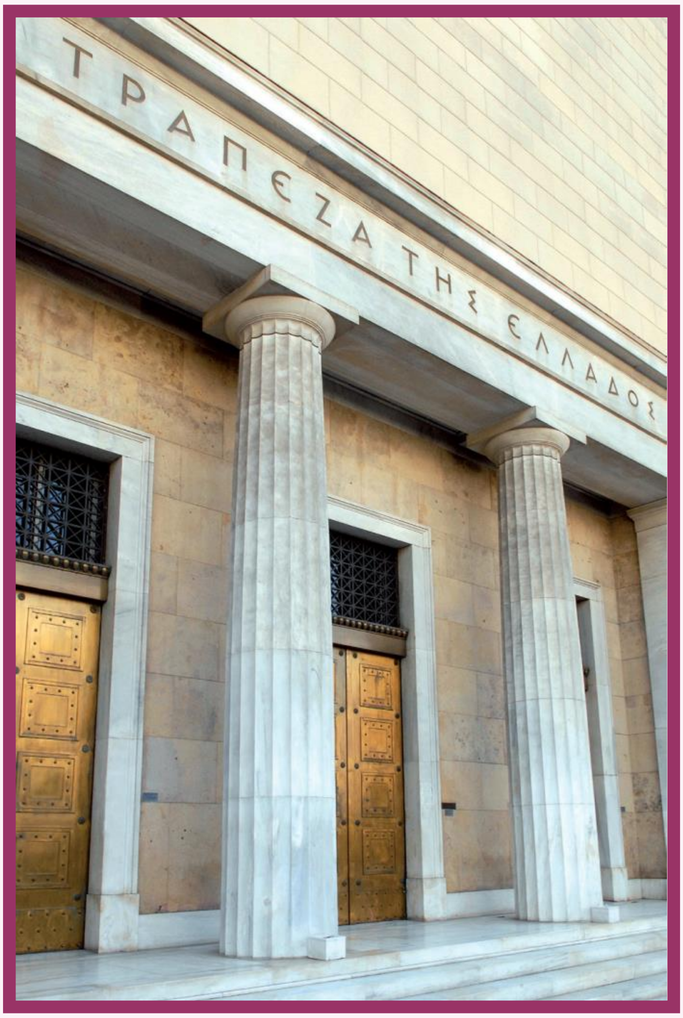
FINANCIAL STABILITY REVIEW

EXECUTIVE SUMMARY



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BANK OF GREECE

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In 2019, the fundamentals and prospects of the Greek economy improved, positively affecting the financial system. However, the COVID-19 pandemic crisis disrupted global financial stability and reversed the growth prospects of the Greek economy for 2020, which until then had been benign. Concurrently, the pandemic crisis heightened short- and medium-term risks for the Greek banking sector.

The unprecedented social distancing measures and the temporary lockdown of businesses across a broad range of activities, implemented in order to contain the COVID-19 pandemic, negatively impacted the financial system and banks' aggregates, notably asset quality, profitability and liquidity. However, the fiscal, monetary and supervisory measures put in place by the competent authorities both at national and at euro area level have considerably softened the impact of the pandemic.

Greece also benefitted from the decisions adopted by the European Central Bank (ECB), namely the lifting of the restrictions on Greek sovereign debt holdings by Greek commercial banks in February (which had been in the pipeline since the end of 2019) and the inclusion of Greek sovereign bonds in the pandemic emergency purchase programme (PEPP) in March.

Efforts towards lowering the large stock of non-performing loans (NPLs) in 2019 are considered fruitful. The NPL stock at end-2019 amounted to €68.5 billion, down by 16.2% (€13.3 billion) compared with end-2018 (€81.8 billion). Cumulatively, NPLs have been reduced by 36% (€38.7 billion) from their March-2016 peak. Moreover, this trend was strengthened in the first quarter of 2020, with NPLs reaching €60.9 billion as of March 2020, reduced by €7.6 billion (or 11.1%) from December 2019. This reduction is mainly due to an intragroup NPL transfer by a systemic bank in the context of a securitisation transaction entailing recourse to the Hellenic Asset Protection Scheme (HAPS). Nonetheless, the economic repercussions of the COVID-19 pandemic are expected to take their toll on banks' asset quality once again via the creation of new NPLs. This impact cannot be accurately measured as yet, *inter alia* due to the debt moratoria applicable until year-end, as per the decisions taken by banks in the context of measures put in place to support households and non-financial corporations adversely impacted by the pandemic.

It should be pointed out that the successful completion of NPL securitisation transactions with recourse to the Hellenic Asset Protection Scheme (HAPS) will further reduce the existing NPL stock. Nonetheless, based on Bank of Greece staff estimates, the NPL ratio is estimated to reach approximately 25%, remaining the highest in the European Union and a multiple of EU and Single Supervisory Mechanism averages (December 2019: 2.7% and 3.2%, respectively). Furthermore, it is estimated that the impact of such securitisation transactions on the Capital Adequacy Ratio (CAR) will reach 3 percentage points on average.[1] Further steps towards reducing the existing NPL stock are therefore needed.

A particularly large NPL stock restricts profitability, by keeping the cost of credit risk elevated. Depending on how heavily banks' balance sheets will be impacted by the crea-

[1] This impact is attributed to the necessary impairment of the loans to be sold through securitisation in order to achieve the minimum credit rating of BB- among senior tranches.

tion of new NPLs, this cost is expected to affect their net profit margin in the future and in turn negatively impact their overall profitability.

In March 2020, the Capital Adequacy Ratio stood at 16.2%, signalling that Greek banks have a considerable buffer to address the impact of the pandemic and the accelerating reduction of the NPL stock. However, it should be emphasised that deferred tax credits (DTCs) amounted to €15.5 billion in March 2020, accounting for 54% of total prudential own funds. The Bank of Greece staff expect that the share of DTCs in banks' total prudential own funds will reach 75% in the next 4 quarters, net of the impact from the pandemic.[2] As a result, for the most part, prudential own funds will not be paid-in (given that the timeframe for their payment is uncertain), while voting rights will be at the disposal of shareholders, whose capital will essentially dissipate, with unforeseeable consequences for the implementation of the principles of corporate governance.

This *Financial Stability Review* covers the entire financial system, albeit placing an emphasis on the analysis of banking developments, given that the banking sector is of particular importance for the Greek economy. The Special Feature presents the existing structure and operation of the Treasury Single Account at the Bank of Greece, as well as the Treasury Account System, which hold their funds with the Bank of Greece according to the relevant institutional framework.

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[2] This estimate takes into account the capital impact of the phasing in of IFRS 9, the realised or expected cost of securitisations and the credit expansion and organic profitability trends up until the first quarter of 2020.

In 2019, Greek banks' resilience was strengthened thanks to improvements in profitability and capital adequacy. Key factors behind this improvement were increased prudential own funds and profits after taxes and discontinued operations amounting to €211 million. In more detail, operating income rose year-on-year, as the decline in net interest income was offset by an increase in non-interest income. Operating costs were further reduced, mainly as a result of staff and branch network reduction. The cost of credit risk declined further in 2019, to 1.8% of loan balances, from 2.1% in 2018, reflecting a 16.8% year-on-year drop in loan loss provisions. Non-recurring losses and losses from discontinued operations increased. As a result of all the above, banking groups recorded profits after tax and discontinued operations, as against losses in previous years. Therefore, the return on assets (RoA) and return on equity (RoE) indicators of banking groups moved into positive territory (0.08% and 0.7%, respectively). In Q1 2020, the aforementioned trends in banks' resilience continued, given that the impact of the pandemic had not yet been factored in.

Greek banks' capital adequacy improved in 2019 thanks to an increase in their prudential own funds. In December 2019, the Capital Adequacy Ratio (CAR) rose to 17% on a consolidated basis, from 16% in December 2018 , and the Common Equity Tier 1 (CET1) ratio stood at 15.9%, up from 15.3%.

In order to address the extraordinary situation as a result of the pandemic, the ECB took unprecedented decisions to bolster liquidity, waiving the Eurosystem's eligibility requirements for securities issued by the Greek government and thus making them eligible for: (a) purchase under the ECB's pandemic emergency purchase programme (PEPP) with an initial size of €750 billion later increased to €1.35 trillion and (b) use by Greek commercial banks as collateral in the Eurosystem's liquidity-providing operations. In addition, the ECB took supervisory measures allowing banks to operate temporarily below the level of capital defined by the Pillar 2 Guidance (P2G), the capital conservation buffer (CCoB) and the liquidity coverage ratio (LCR). Banks are also allowed to partially use capital instruments that do not qualify as Common Equity Tier 1 (CET1) capital, for example Additional Tier 1 or Tier 2 instruments, to meet the Pillar 2 Requirements (P2R). The ECB has also given operational flexibility in the implementation of bank-specific supervisory measures, including the Guidance to banks on non-performing loans.

The rise in deposits continued despite the low level of deposit interest rates, as households cut their expenses; nonetheless, a further rise in the deposit base is uncertain.

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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.

At the beginning of 2020, insurance undertakings intensified their efforts to strengthen their risk management systems and during the first two months insurance premiums were on the rise. The COVID-19 pandemic reversed this trend, affecting mainly their operational and market risk. Regarding operational risk, insurance undertakings have effectively addressed business continuity challenges, while market risk seems to have flattened after a period of heightened volatility. Moreover, the low interest rate environment continues to influence their investment strategy and restricts their ability to cover the returns guaranteed to their 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. In the course of 2019, payment systems operated reliably and robustly, safeguarding the smooth operation of the interbank and retail payments market, while their availability was maintained 100% of the time. Regarding electronic payment instruments, transaction volumes continue their upward trend both for businesses and consumers.

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In the course of 2019 and in Q1 2020 until the COVID-19 outbreak, the Greek economy maintained its growth trajectory, despite the slowdown of the global economy. In 2019, GDP increased by 1.9%, mainly driven by exports of goods and services, while in Q1 2020 it declined by 0.9% year-on-year and by 1.6% compared with Q4 2019. Nonetheless, against the backdrop of the pandemic and the shift in the international environment, macroeconomic projections are surrounded with great uncertainty. This is why the Bank of Greece has, in addition to its baseline scenario, also considered two alternative scenarios, one milder and one more adverse.

According to the Bank of Greece baseline scenario, economic activity is forecast to decline substantially in 2020, with real GDP contracting by 5.8%. In 2021, economic activity is expected to recover, posting a growth rate of 5.6%, while in 2022 growth will be 3.7%. According to the mild scenario, which assumes a shorter period of transition to normality, real GDP is expected to decline by 4.4% in 2020 and increase by 5.8% in 2021 and 3.8% in 2022. The adverse scenario, associated with a possible second wave of COVID-19, assumes a more severe and protracted impact of the pandemic and a slower recovery, with GDP falling by 9.4% in 2020, before rebounding to 5.7% in 2021 and 4.5% in 2022.

The banking sector should adjust to this new environment in order to address the challenges facing it and to safeguard financial stability and the financing of the real economy. Against this backdrop, strategy- and policy-making for the banking sector should meet the following objectives:

- Addressing, decisively and concurrently, the problems arising from the elevated NPL stock and the high share of DTCs, contributing to the clean-up of banks' balance sheets.
- Strengthening operating profitability so that banks can improve their internal capital generation capacity on a sustainable basis.
- Avoiding an undue dilution of existing shareholders to ensure strong incentives for participating in potential future capital increases.
- Abstaining from using government subsidies in order to address the existing NPL stock.
- Ensuring transparency regarding the appropriate recognition of current and future losses on the loan book.
- Reshaping banks' business model to underpin an attractive investment proposition.

The recovery from the COVID-19 pandemic and the return to economic growth hinge crucially upon the contribution of the financial sector. Hence, addressing the problems of the banking sector in a piecemeal manner would be less effective as it would not provide the necessary impetus to jump-start growth.

Addressing the elevated stock of NPLs, which is expected to increase further in the near future reflecting macroeconomic aggregates, is an immediate priority. The existing tools, including the Hellenic Asset Protection Scheme, are in the right direction. Nonetheless, taking into account that the NPL ratio stood at 37.3% in March 2020, the uncertainty regarding the potential further deterioration in asset quality, the low internal capital generation capacity of Greek banks due to their low operating profitability, the anticipated deterioration in the ratio of DTCs to prudential own funds, as well as the pressing need to ensure the financing of the real economy, it becomes apparent that additional initiatives are required, both by banks and the authorities.

Against this backdrop, the Bank of Greece is developing a proposal for a scheme that involves the set-up of an Asset Management Company (AMC) in order to comprehensively tackle Greek banks' troubled assets. Specifically, the proposed scheme will fully utilise banks' existing infrastructures as well as the NPL servicing platforms of third-party providers. Moreover, potential losses related to the existing NPL legacy stock will be covered only by the private sector and not by the Greek taxpayer, up to the level of the minimum capital adequacy requirement. Hence, financial stability is safeguarded and the implementation of this scheme cannot be related under any circumstances to the potential imposition of resolution measures to banks. Lastly, it should be emphasised that this proposal aims not only at capital relief, but also at conducting transactions at market terms with the participation of private investors.

Concurrently, the reform of the private debt resolution framework is deemed necessary. The streamlining of procedures and the reduction of the time needed to realise collateral and settle debt will be mutually beneficial both for banks/NPL servicers and borrowers. Furthermore, moral hazard will be reduced by curtailing the ability of strategic defaulters to exploit blind spots of the framework.

The impact of the COVID-19 pandemic on the economy and the financial sector will be undoubtedly large, although its exact magnitude is still surrounded by uncertainty. That said, the rapid recovery and return to normality will depend to a large extent on the ability of the banking sector to provide funding to the real economy.

The current juncture should be regarded as a “window of opportunity” for a fresh start towards a sustainable economic model, acknowledging the necessity of transforming the existing bank business model. Procrastination and lack of determination in taking action will jeopardise the progress achieved so far. It is evident that the economic recovery and the adjustment to the new environment are of utmost importance. In this vein, the implementation of the Growth Plan for the Greek economy and the European Commission proposal for a new recovery instrument, “Next Generation EU”, will underpin the recovery.

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