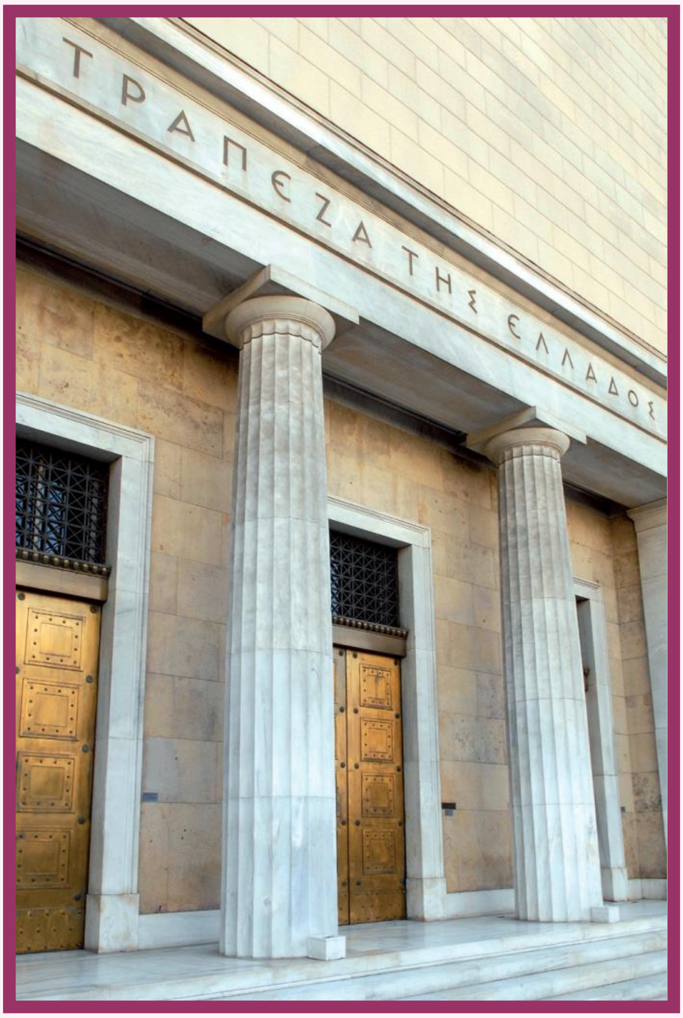
FINANCIAL STABILITY REVIEW

EXECUTIVE SUMMARY



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The COVID-19 pandemic was a key determinant in 2020, as it disrupted financial stability at a global level and weighed heavily on economic activity. In Greece, many businesses temporarily closed and tourist receipts dropped sharply, resulting in a sizeable output contraction as shown by the 8.5% decline in GDP in the first nine months of 2020, which is expected to be even larger for the whole year on the back of the second wave of the pandemic.

Heightened short- and medium-term risks facing the Greek banking sector mainly in four areas, asset quality, profitability, capital adequacy and liquidity, negatively affected the financial system. Nonetheless, fiscal, monetary and supervisory measures taken by the competent national and euro-area authorities have largerly mitigated the impact of the pandemic.

In terms of liquidity, catalysts have been the Eurosystem's collateral easing measures, which allowed the inclusion of Greek government bonds in the ECB's Pandemic Emergency Purchase Programme (PEPP) and their eligibility as collateral in Eurosystem refinancing operations, and the Greek government's measures to expand loan guarantee and co-financing schemes. Another particularly positive development was the decline of Greek government bond (GGB) yields, which continued on a downward path in the second half of 2020. This development allowed the Greek government to access international capital markets, thereby reducing the cost of financing for credit institutions.

Lower GGB yields also contributed to gains from financial operations, which partly offset lower net interest income and higher loan loss provisions. Yet, the impact of the pandemic on banks' medium-term profitability and asset quality is expected to be significant.

Efforts to reduce the high NPL stock in the course of 2020 have been positively assessed. At end-September 2020 NPLs amounted to €58.7 billion, down by 14.3% or €9.8 billion from end-2019 (€68.5 billion), whereas the NPL ratio was 35.8%. Moreover, the total reduction in NPLs from their March 2016 peak was €48.5 billion. The trend to reduce NPLs was accelerated mainly on the back of an intragroup transfer of NPLs from a systemic bank by way of a hive down.[1] This will be the first securitisation, upon receipt of the Greek government's state guarantee, to have utilised the Hellenic Asset Protection Scheme (HAPS), while two other systemic banks have launched similar projects with a view to reducing their NPLs. According to Bank of Greece estimates, the NPL ratio should drop to around 25%[2] once such projects are completed, without taking account of new NPLs that will emerge as a result of the pandemic. This NPL ratio will remain, nonetheless, the highest among euro area countries and a multiple of the average of banks under the direct supervision of the Single Supervisory Mechanism (SSM) (2.9% as of June 2020). In addition, it is expected that the conduct of securitisation transactions will lower the capital adequacy ratio of banks by 3 percentage points on average.[3]

[1] The setup of this corporate transformation is presented in detail in a special Box under Section III of this Review.

[2] This estimate factors in only actions already under way by systemic banks in the context of their plans to reduce their NPL stock.

[3] This may be attributed, on the one hand to the necessary impairment of loans to be securitised in order to achieve the minimum threshold credit rating BB- for the senior notes, and on the other hand to the sale price of the mezzanine notes (i.e. notes with a medium order of repayment priority).

Banks' capital adequacy was reduced vis-à-vis December 2019, but remained at a satisfactory level, as the capital adequacy ratio was 16.3% in September 2020. It should be noted, however, that deferred tax credits (DTCs) amounted to €15.2 billion in September 2020, accounting for 54.5% of total prudential own funds. According to Bank of Greece estimates, DTCs are expected to reach 75%[4] of prudential own funds in the coming year, notwithstanding any impact from the pandemic, which negatively affects the quality of banks' prudential own funds.

In this context, it is important to note that the recording of new NPLs as a result of the pandemic in banks' balance sheets, the conduct of stress tests in the spring of 2021 and additional capital requirements from the phased-in implementation of IFRS 9 and the prudential backstop will weigh on capital adequacy while, at the same time, due to negative or low profitability, internal capital generation capacity seems unlikely.

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 relevance. The Special Feature discusses the revised EU macroprudential framework introduced by Directive (EU) 2019/878, the fifth Capital Requirements Directive (CRD V).

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Past experience has shown that economic crises such as the one we are currently going through severely impact the banking sector and particularly banks' asset quality. This has been the standard rule in almost all economic crises, be they global or national. For instance, over the previous decade, when Gross Domestic Product (GDP) contracted by more than 25% cumulatively, the rise in NPLs was one of the highest ever recorded in relevant literature. In more detail, from December 2009 to March 2016, NPLs surged by €81.5 billion (>300%), and the NPL ratio spiked to around 49%, from 9.5%.

As a result, it seems inevitable that following a sharp decline in GDP by around 10% over 2020 new NPLs will be recorded in banks' balance sheets in Greece (and those of most euro area countries). In particular, taking account of the asymmetric impact on sectors of economic activity and the fact that some beneficiaries (particularly small- and medium-sized enterprises) have been hit by the pandemic at a time when they had been recovering from the previous crisis and their financial condition had been weak. Indicatively, based on the latest available data for September 2020, the NPL ratio for small- and medium-sized enterprises (SMEs) reached 47% and for small business and professionals (SBP) 55%.

In order to mitigate the repercussions of the pandemic, the authorities took unprecedented fiscal and monetary support measures, while supervisory authorities have shown flexibility, mainly in terms of the supervisory handling of beneficiaries of debt moratoria and allowing banks to operate below Pillar 2 Requirements (P2R) in order to ensure the uninterrupted financing of the economy and to absorb the losses generated as a result of the pandemic due to asset quality deterioration.

In more detail, since the onset of the pandemic, banks in Greece and in the rest of Europe have implemented moratoria on loan obliga-

[4] Estimates include a fully-phased impact from IFRS 9, real or estimated securitisation costs and the trends for credit expansion and operating profitability up until the second quarter of 2020.

tions in order to provide relief to borrowers. These measures target natural and legal persons whose economic activities have been severely hit by the negative effects of the pandemic. Based on data submitted by credit institutions to the Bank of Greece in November 2020, loan obligations under debt moratoria on a consolidated basis amount to €21.0 billion, accounting for around 12% of total bank loans. More than 80% of loans under moratoria are performing loans (representing around 15% of performing loans) with relatively limited loan loss provisions (around 3%). Business loans represent 60% of loans under moratoria and loans to households 40%. The duration of a moratorium is defined *ad hoc* by each bank and for the most part expire end-2020 to early-2021. Regarding the sectoral breakdown, accommodation and food services represent 33% of total debt moratoria, followed by wholesale and retail trade (17%), transport/logistics and manufacturing (both accounting for 12% each).

It should be noted that 34% of loans under moratoria have significantly higher credit risk under IFRS 9 (Stage 2). This increases the risk of a new cycle of non-performing loans by borrowers who will not be able to deal with the current adverse economic juncture. The latest Bank of Greece estimates on the basis of its econometric models and revised macroeconomic projections are for new NPLs worth €8-10 billion in 2021, without being able to estimate the share of currently performing borrowers turning red.

It is understood that despite measures in the right direction taken by the State to support non-financial corporations and households and the measures already announced by banks for the phasing-out of moratoria, new NPLs will emerge in the wake of the pandemic. The timing of these impacts becoming visible will depend on the duration and extent of the lockdown, the depth of the recession and the subsequent upward trajectory of the economy, any additional measures to support borrowers taken by the State within its means and the efficiency of the measures that banks will be able to offer.

In any event, it is clear that banks must recognise in their balance sheets the increased credit risk and build the necessary capital reserves to be able to address an eventual spike in NPLs. Greek banks are called upon to address the impact of the current crisis from a position of disadvantage vis-à-vis their competitors, given the comparatively much higher legacy NPL ratios prior to the pandemic. The lessons learned from past crisis – not only in Greece, but also in other countries, show us that front-loaded recognition and resolution of NPLs is the only way for swiftly restoring the robustness of the banking sector and a key lever for underpinning the economic recovery.

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Between January and September 2020, Greek banks reported heavy losses after taxes and discontinued operations amounting to €688 million, compared with profits in the corresponding period of 2019. Operating income in the first nine months of 2020 grew considerably year-on-year on the back of an increase in non-interest income. Net non-interest income, for the most part non-recurring, picked up by 85% year-on-year. Income from financial operations more than doubled compared with the corresponding period of 2019, mainly on the back of financial gains from Greek government bonds. As regards the cost of credit risk, its downward trend was reversed in the period from January to September 2020, as provisioning against credit risk doubled year-on-year. In particular, in the first nine months of 2020 loan loss provisions amounted to €4 billion, compared with €2 billion in the corresponding period of 2019. This is broken down as follows: €1 billion reflects the more pessimistic macroeconomic projections in bank models as a result of the pandemic in terms of calculating impairment costs, €1.5 billion reflects the sale of a large volume of NPLs by one systemic bank, and another €1.5 billion reflects general and special loan loss provisions.

In the first nine months of 2020, capital adequacy deteriorated but remained at a satisfactory level. In more detail, in September 2020 the Common Equity Tier 1 (CET1) ratio dropped to 14.6% and the Capital Adequacy Ratio on a consolidated basis fell to 16.3%, from 16.2% and 17.3% in December 2019 respectively. With a fully-phased impact from IFRS 9, the fully-loaded CET1 ratio was 12.1% and the Capital Adequacy ratio was 13.9%. This development is mainly attributed to the reduction in prudential own funds of Greek banking groups by 9.4% in the first nine months of 2020 from December 2019. Prudential own funds have been negatively affected by the phasing-in of IFRS 9 and after-tax losses. Concurrently, risk-weighted assets have declined by 3.5% in the first nine months of 2020 as a result of increased credit risk impairments and the sale of NPL portfolios.

The pandemic weighed heavily on the liquidity in the Greek banking sector towards the end of the first quarter of 2020, significantly reducing interbank and repo transactions. However, coordinated initiatives at European and national level contributed to the stabilisation of liquidity conditions from the second quarter onwards and initiatives at a European level helped the market recover and eased liquidity pressures.

At national level, timely fiscal measures helped improve household income, support consumption and mitigate the negative impact on the real economy. As a result of all these actions, bank deposits of the non-financial private sector have continued to increase as a result of higher precautionary saving, a postponement of consumer and other spending, direct State aid credited into corporate accounts in order to support liquidity, and the use of moratoria on loan and tax obligations.

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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, they are intertwined with the banking sector, and their activity needs to be monitored given their role on economic developments.

The COVID-19 pandemic has radically changed the modus operandi of insurance undertakings, accelerating their transition to digital customer service provision and recourse to novel distribution channels for their products. However, the measures to protect economic activity against the impact of the pandemic and central bank monetary easing help maintain the current low-for-long interest rate environment, feeding into a vicious circle of negative impacts both on insurance undertakings' long-term income and their long-term liabilities. In particular, insurance undertakings with guaranteed returns policies are the most affected, given that their ability to cover the guaranteed returns has been limited.

The smooth operation of financial market infrastructures, i.e. payment, clearing and settlement systems, contributed favourably to the stability of the domestic financial system through the successful completion of transactions. As regards electronic means of payment, their use is still elevated both in terms of the volume and the value of transactions, despite the decline in transactions conducted with the use of payment cards in the first half of 2020, compared with the second half of 2019.

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In 2020 the pandemic generated conditions of extreme uncertainty about which economic policy to follow, the efficiency of fiscal measures, as well as macroeconomic and fiscal forecasts. The highly expansionary fiscal policy, in conjunction with an accommodative single monetary policy, has supported the economy, mitigating the pandemic's adverse effects on economic activity. Against this backdrop, projections about the growth rate mainly depend on the way in which the pandemic unfolds.

The baseline scenario of the Bank of Greece expects a deep recession, i.e. economic activity is expected to contract by 10% in 2020. A recovery is anticipated in 2021 and 2022, with GDP growing by 4.2% and 4.8%, respectively, driven by a significant pick-up in both domestic and external demand.

As regards the risks surrounding the baseline scenario of the Bank of Greece, the major risk relates to the duration and severity of the pandemic both at domestic and international level. Additional risks would arise from a potential significant increase in NPLs as a result of the contraction of economic activity, a worsening of geopolitical tensions and the uncertainty surrounding the implementation of the Brexit deal between the UK and the European Union (EU). By contrast, a more positive than anticipated outcome could arise from the timelier and more efficient utilisation of the funds available under the "Next Generation EU" (NGEU) recovery instrument and a faster roll-out of vaccines to fight the COVID-19 pandemic.

The banking sector is called upon to adjust immediately to this new environment in order to rise to the challenges that it is faced with, ensuring both financial stability and the uninterrupted financing of the real economy, particularly in the post-COVID era.

The NPL ratio remains very high, a multiple of the EU average, while the pandemic is expected to further hit asset quality. Given the extension of borrower protection measures in the form of loan moratoria and given their phasing-out in the course of 2021, the amount of new NPLs that will be generated due to the pandemic cannot be accurately estimated. Nonetheless, the impact on asset quality will be significant and closely linked with the recovery of the economic activity. Moreover, a potential early withdrawal of public support measures might increase further the credit risk cost for banks.

Given the current juncture, the important institutional changes introduced in 2020, such as the reform of insolvency law and the activation of the Hellenic Asset Protection Scheme (HAPS), as well as the initiatives that had been taken in previous years towards reducing NPLs are in the right direction but not sufficient. That is why the Bank of Greece has proposed the creation of an Asset Management Company (AMC). Establishing a central scheme for the management of NPLs is a strategy aimed at finding a comprehensive solution for the problems facing the Greek banking sector. It provides the ability to reshape the banking sector by fully consolidating Greek banks' balance sheets, while at the same time addressing the problem of NPLs and DTCs.

It should be made clear that the adjustment of the Greek banking sector to the new reality imposes a comprehensive strategy for addressing the issue of NPLs. The need for such a strategy is promoted and rendered imperative by the European Commission's action plan which sets out the guidelines that Member States must follow. A unilateral approach to the challenges of the banking sector could not be equally effective as it will not give the impetus needed to restart the economy.

Addressing the impact of the pandemic will mainly depend on the implementation of the growth plan for the Greek economy by capitalising on NGEU funds. But a swift return to normality post-COVID requires the banking sector's input and presupposes that it would be able to carry out its intermediating function for the smooth flow of credit to the Greek economy. In conclusion, decisions must be made to implement a comprehensive strategy and to involve all the stakeholders towards boosting the stability of the financial system.

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