OVERVIEW OF THE GREEK FINANCIAL SYSTEM
SPECIAL FEATURE

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A SYSTEMIC PROPOSAL FOR THE MANAGEMENT OF NON-PERFORMING EXPOSURES (NPES)

Spiros Pantelias

Introduction

By mid-2018, the four systemic banks in Greece had about €180 billion loans on a solo basis, of which €86 billion or 48% were non-performing exposures (NPEs). The coverage ratio was 49%, in particular 69% for consumer loans, 33% for mortgages and 53% for business loans. It is true that the stock of non-performing exposures has decreased, according to the initial framework of operational targets for the four banks (June 2016-2019), falling to €86 billion from €104.5 billion (see Chart 1). However, the NPE ratio remains high, primarily due to the absence of credit expansion as well as deleveraging of bank balance sheets.

Chart 1 Non-performing exposures (NPE) ratio

In this regard, it should come as no surprise that banks are still trying to restore satisfactory return on equity, as cost of credit risk corresponds to about 2% of net loans in the first half of 2018. This happens despite the admittedly positive track record in the elimination of recourse to the Emergency Liquidity Assistance (ELA), timely implementation of existing targets for reducing non-performing exposures and operating cost containment. At the same time, the capital adequacy ratios remain satisfactory and significant capital buffers do exist; that said the possibility of posting additional losses is limited by the repercussions of triggering legislation on deferred tax credits (DTCs)³.

With particular regard to DTCs, it must be noted that these were around €16 billion in mid-2018, equivalent to 57% of banks' regulatory capital⁴. It should be noted that, according to the provisions of Law 4465/2017, a credit institution that records losses during a given accounting year (as a result of losses arising from the transfer, write-off or impairment of loans in arrears) must increase its share capital in favour of the State, by an amount corresponding to the share of deferred tax asset, i.e. 29%. In essence, the State receives compensation in the form of new shares, thus increasing its stake in the credit institution.

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¹ Law 4465/2017 provides for the possibility of converting the deferred tax assets (DTAs) into final deferred tax credits against the State (DTCs), effective year 2016. In fact, according to the law, the deferred tax credit may be offset against the income tax due for a period of 20 years. The same period is also provided for the gradual amortisation of losses due to write-offs and disposals of non-performing loans.

² This analysis relates to DTC and does not include other deferred tax assets, which anyway do not count in the calculation of the capital adequacy ratio.

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³ The ratios have been calculated on the basis of on-balance sheet data.
institution (dilution) at the expense of course of private shareholders.

It is therefore understood that there is a constraint on credit institutions as regards the effective use of their regulatory capital for the purpose of improving the quality of their balance sheets. The Greek State replenishes 29% of the total loss (based on the current tax rate), which corresponds to the DTC, but the remaining loss depletes accounting and regulatory capital. A possible conversion of a sufficient portion of these credits into shares would cause a drastic reduction in the participation of private shareholders (dilution) and the acquisition of an overwhelming majority of equity by the State.

Under this scenario, the aforementioned chain of events would most likely be of no value to the Greek State. Losses reduce regulatory capital as well as relevant capital adequacy ratios, thereby resulting in a breach of minimum capital adequacy thresholds. However, this would, in turn, imply a need for recapitalisation (albeit after the Greek State has participated in the capital of Greek banks).

The following discussion provides an overview of the structure and characteristics of a systemic solution to the problem of NPEs by creating a centralised management scheme.

Proposal

The proposed scheme envisages the transfer of a significant part of non-performing exposures (NPEs) along with part of the deferred tax credits (DTCs), which are booked on bank balance sheets, to a Special Purpose Vehicle (SPV). Loans will be transferred at net book value (net of loan loss provisions). The amount of the deferred tax asset to be transferred will match additional loss, so that the valuations of these loans will approach market prices. Subsequently, legislation will be introduced enabling to transform the transferred deferred tax credit into an irrevocable claim of the SPV on the Greek State with a predetermined repayment schedule (according to the maturity of the transaction).

To finance the transfer, the Special Purpose Vehicle will proceed with a securitisation issue, comprising (indicatively) three classes of notes (senior, mezzanine, subordinated junior/equity). The lower class of notes (subordinated junior/equity) will be subscribed by banks (each participating by no more than 20%) and the Greek State.

The valuation of the loans to be transferred will be carried out by independent third parties, and the final structure of the transaction (including the tranches of the three classes of notes) will be determined by the arrangers subject to market conditions. It is anticipated that private investors will absorb part of the upper class of securities (senior) and a large portion of the intermediate part (mezzanine). The ability to absorb additional losses arising from the participation of Greek State (through the transformation of deferred tax credits into an irrevocable claim of the SPV) significantly enhances the probability of repayment of the senior bond classes (senior, mezzanine). At the same time, by participating in the lower class of notes (subordinated junior/equity),

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5 This proposal provides an alternative approach to the systemic treatment of the key problem facing the Greek banking sector in recent years. The proposal should not be seen as competitive to any other proposals, nor as binding on other authorities involved in the matter.

6 The structure and terms of issue, in particular the expected cash flows (cash-flow water-flow), will determine both the principal and interest payments on the two classes of securities (senior, mezzanine) and any residual payments to the Greek State and banks. In this context, it will be possible to determine the repayment schedule of the Greek State's participation, according to the duration of the scheme.
the Greek State and banks will be entitled to claim any excess value.

The scheme will be managed exclusively by private investors (servicing companies for loans and credits), and apparently there will be an asset class separation for each transaction and management operation (business, mortgage, consumer loans, etc.). It is understood that managers will be appointed following a competitive process and the management framework will be in line with best international transparency and supervisory practices.

It should be noted that, before completion of the transaction, banks are expected to proceed, in consultation with the supervisory arm of the European Central Bank, to a restatement of targets for NPE reduction, with the ultimate goal of achieving a single-digit ratio within three years.

**Illustrative example**

An illustrative example can assess the immediate impact of a transfer of about €40 billion of NPEs, namely all denounced loans and €7.4 billion of DTCs. In particular, the following are estimated (according to 2018H1 data):

- reduction in the stock of NPEs by 47%;
- reduction in the coverage ratio to 41% from 49%;
- improvement in NPE management as the Special Purpose Vehicle acquires and manages the most troubled assets (denounced loans);
- double-digit capital adequacy ratios for all systemic banks7. It should be noted that these estimates have not taken into account, strengthening of pre-tax income and possible adjustment of capital risk weights upon completion of the transaction;
- decline in the share of DTCs in regulatory capital to 30% from 57%.

**Key objectives**

The rapid resolution of “bad loans” has been recognised as a matter of paramount importance for restarting the economy and restoring significant and sustainable growth rates. The positive effects of resolving the problem are even greater in a small and open economy, such as the Greek one, where bank lending is the predominant source of corporate and household finance.

It is obvious that a move like the one described would bring about a direct and drastic reduction in the ratio of non-performing exposures and would allow, under certain conditions, to target single-digit ratio within 2-3 years. Moreover, it would establish favourable conditions for supporting operating profitability and internal capital generation, because of improved asset quality and resilience to shocks in any future crisis. Finally, it would enable to reshape the business model of banks and alleviate the uncertainty regarding their medium-term prospects.

Creating private management schemes can facilitate the effective resolution of private debt in Greece. At the same time, it can ensure improved coordination in syndicated loans. Finally, it allows banks to focus on core banking as well as on the management of that portion of their non-performing expos-

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7 The estimated reduction in the capital adequacy ratio CET1, according to the indicative example, is three points on average. However, taking into account existing buffers above the minimum Pillar II requirements, potential capital shortfalls, if they materialise upon the completion of the transaction, would be significantly lower.
sures which they assess to have true added value and better recoverability.

At this point, it is worth noting that in the medium term and in the context of addressing the problem of “bad loans” in the euro area, the supervisory cost of keeping such loans on their balance sheets will increase for banks, as suggested by a relevant press release of the Single Supervisory Mechanism. Moreover, it is necessary to emphasise that the proposal would underpin a totally different investment case for banks, improving their ability to raise capital from capital markets, by taking into account the following:

- accelerated improvement in asset quality (as opposed to the currently projected for NPE reduction over the next decade);
- improvement in operating profitability on a sustainable medium-term basis;
- reduction of the share of deferred tax credits in regulatory capital, greatly increasing the probability of gradually being offset with future profits.

In addition to these factors, a systemic settlement of the issue of “bad loans” would essentially release resources through the utilisation of tangible collateral by viable economic units or through reallocation of resources by the banking system towards supporting growth of the real economy. This factor alone makes a strong case for this bold step and the drastic solutions required of all stakeholders in order to effectively address these issues.

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Overview of the Greek financial system

January 2017