Yannis Stournaras: A systemic approach towards improving asset quality of Greek banks

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at an event "Tackling NPLs within the Greek Banking System", hosted by the Hellenic Bank Association and facilitated by PwC, Athens, 24 January 2019.

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It is a real honour for me to participate in this event and to be given the opportunity to discuss the crucial issue of dealing with non-performing loans (NPLs), by far the most significant legacy of the crisis and a major constraint on the efforts of the real economy to achieve faster and sustainable growth.

The completion of Greece's third financial support programme signaled the end of a long period of adjustment for the Greek economy. In this context, several structural reforms have been implemented, although further changes will be needed in the years ahead. This is our only option if we are to ensure that the progress achieved thus far will not be reversed.

The protracted and deep crisis that Greece experienced over the past ten years has brought about three major changes that are relevant to its growth model. First, bank lending, which used to be the main source of financing for households and businesses, has declined dramatically. Second, private investment has shrunk. Third, the production structure has become more outward-oriented, although this has occurred against a background of recession in the domestic economy.

Starting with the changes in the real economy, the transition to a new, more extrovert growth model has already begun and can be expected to continue. However, developments in productive investment, as a key driver of growth, have been less encouraging, pointing to a need for more progress in this area.

In 2017, net capital investment of enterprises, i.e. gross investment less depreciation, stood at –2.8 billion euros or 1.6% of nominal GDP; this disinvestment trend has since strengthened, with net capital investment amounting to –3.7 billion euros or –2.0% of nominal GDP in the second quarter of 2018 in annualised terms.

However, in order to increase the capital stock and thus the potential output of the Greek economy, positive net capital investment is indispensable. For this to happen, private investment must grow by about 50% within the next few years. In other words, the Greek economy needs an investment shock, with a focus on the most productive and extrovert business investment, to avoid output hysteresis and foster a rebalancing of the growth model in favour of tradeable goods and services.

In an environment of domestic bank lending scarcity and tighter credit standards, businesses have sought to cover their financing needs through alternative types of external financing, in addition to their own resources. At the same time, the domestic banking sector was faced with severe liquidity problems, as banks for a long period of time had limited market access and difficulties, due to lack of eligible collateral, to get financing through the Eurosystem's main refinancing operations and could only raise funds through the Emergency Liquidity Assistance of the Bank of Greece.

In addition, during the adjustment period, credit institutions faced strong pressures on their profitability and capital base, with the combined effect of:

(a) continuous outflows of deposits;

(b) the recession, but also the “strategic” choice of non-repayment of loans by a rather significant percentage of borrowers, effectively deteriorating the quality of loan portfolios;

(c) the restructuring of public debt;

(d) the inability to access international markets; and

(e) capital controls.

Policy response by the European Central Bank (ECB) and the Bank of Greece was crucial to restoring and strengthening monetary policy transmission to the real economy. At the European level, credit growth has returned to positive territory for some time now, while in Greece it would have been much more negative without the interventions to support the domestic banking system and liquidity.

Moreover, the domestic banking sector has undergone a major transformation, characterised by unprecedented consolidation, significant rationalisation of the cost structure and cost-cutting, and a re-orientation of banks’ business model through deleveraging and increased focus on domestic banking activities.

Restoring confidence in the Greek banking system crucially hinges upon a successful tackling of the high stock of non-performing loans (NPLs), which are mainly a result of the protracted crisis and its adverse impact on businesses and households. On a positive note, the decline in credit contraction, on an annual basis, which characterised the Greek crisis, appears to have eased, particularly as regards non-financial corporations. In particular, the amount of new originated loans to non-financial corporations with an agreed maturity increased in 2017, and this trend is confirmed for the first eleven months of 2018. Overall, credit to the private sector has contracted by 1.4% on average, slightly more intensely relative to the previous year.

Improving asset quality, through effective management of non-performing loans, is the most important challenge for the banking industry today. This will not only ease the burden on borrowers but will also enable credit institutions to free up funds that could be channeled to the most dynamic and extrovert businesses, thereby contributing to the overall restructuring of the economy in favour of the tradable goods and services sectors and raising total productivity and potential growth.

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 benefits stand to be even greater in a small and open economy, such as Greece, where bank lending is the predominant source of corporate and household finance.

Greek banks have already made substantial progress in reducing their NPLs. I will refer to this substantial progress later. However, and despite the fact that Greek banks fully achieve the targets set by the supervisor, individual bank loan sales, write-offs and curing will not lead to a rapid convergence of their NPL ratio to the European average, which is already less than 4%. If we think that it is desirable for the NPL ratio to converge rapidly to the European average, the Greek authorities must quickly form a consistent and coordinated approach to address the issue of NPLs in a systemic way, on top of banks’ individual efforts. I believe that the Bank of Greece proposal, about a sizable NPL&DTC carve-out, is effective since it systematically addresses two major problems in one go: NPL and DTC reduction. However, if the government decides to adopt the Asset Protection Scheme (APS), we will support it, since it is a step in the right direction. Ideally, both schemes should be assessed and banks should be provided with any alternative consistent with state aid rules and supervisory guidelines.

Before proceeding to a brief presentation of the Bank of Greece systemic proposal, I would like to clarify once more that banks have individual plans to reduce NPLs aggressively, and are executing them with tangible results. The two additional tools under discussion are supporting banks' efforts aiming at a rapid convergence of their NPL ratio to the European average without diluting private shareholders.

The Bank of Greece recently outlined its proposal aimed to rapidly reduce the stock of NPLs through the setting up of several privately managed Asset Management Companies (AMCs) as well as through market-based funding. The proposal is intended to provide a systemic solution to this problem, without imposing any additional burden on the Greek taxpayer.

As said before, this proposal effectively addresses two key issues faced by Greek banks: NPLs and deferred tax credits (DTCs), currently accumulated on banks' balance sheets.

At present, capital adequacy ratios remain satisfactory and significant capital buffers are in place, although the probability of posting additional losses is limited by the possibility of triggering legislation on deferred tax credits. Under the current legal framework, a credit institution which in a given financial year records losses as a result of transfer, write-off or impairment of NPLs must increase its capital in favour of the State, by an amount equal to the share of the deferred tax asset, i.e. 29%. In effect, the State receives compensation in the form of new equity, thus diluting private shareholders.

It is therefore understood that there is a limitation on credit institutions as regards the effective use of their own funds for the purpose of improving the quality of their balance sheets. Possible conversion of a sufficient portion of these credits into shares would cause the drastic reduction of the participation of private shareholders and the acquisition of an overwhelming majority of equity by the State.

Instead, a move along the lines proposed by the Bank of Greece would bring about a direct and drastic reduction in the ratio of non-performing loans and would allow, under certain conditions, to target a single-digit ratio within three 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 the event of a future crisis. Finally, it would enable the reshaping of the business model of banks and alleviate the uncertainty regarding their medium-term prospects.

It should also be noted that the implementation of such an initiative would benefit the sector by correcting what is currently perceived as a large share of DTCs in capital adequacy ratios, while it would allow banks to access market opportunities through a different investment case.

The main elements and characteristics of the Bank of Greece proposal are as follows:

- The proposed scheme envisages the transfer of a significant part of non-performing loans (NPLs) along with part of the deferred tax credits (DTCs), which are booked on the banks' balance sheets, to a number of Special Purpose Vehicles (SPVs). Loans will be transferred to the 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 in order to transform the transferred deferred tax credit to an irrevocable claim of the SPVs against the Greek State with a predetermined repayment schedule (according to the maturity of the transaction).
- To finance the transfer, the Special Purpose Vehicles will proceed with a securitization issue where (indicative) there will three classes of notes (senior, mezzanine, subordinated junior/equity).
- 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) by the arrangers subject to market conditions. It is anticipated that private investors will absorb part of the upper class of securities (senior) and the vast majority of the

intermediate part (mezzanine).

- 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, housing, consumer, etc.). It is understood that the mandates to managers will arise following a competitive process and the management framework will be in line with international transparency and supervision practices.

It must be noted that, before completion of the transaction, banks are expected to proceed, in consultation with the supervisory arm of the European Central Bank (SSM), to a restatement of targets for NPL reduction, with the ultimate goal of achieving a single digit rate within three years.

An absolutely indicative example can assess the immediate impact of a transfer of about €40 billion of NPLs, namely all denounced loans and €7.4 billion of DTCs. In particular, it is estimated that (according to 1st half 2018 data) the following results are expected:

- Reduction in the stock of NPLs by 47%.
- Reduction of the coverage ratio to 41% from 49%.
- Double digit capital adequacy ratios for all systemic banks. Those estimates have not taken into account benefits from staff transfer, strengthening of pre-tax income and possible adjustment of risk weights for risk undertaken upon completion of the transaction.
- Limit contribution of DTCs to regulatory capital to 30% from 57%.
- Improvement of NPL management as the Special Purpose Vehicles receive and manage mostly denounced loans.

It is certainly positive that very important steps have been taken in recent years in terms of legislation, regulation and actions of credit institutions, towards the effective management of non-performing loans.

The strategy for NPL reduction has so far moved along three lines of action.

The first line of action is associated with the strengthening of the existing legislative and regulatory framework governing the management of NPLs.

At an operational level, Greek banks now have:

- set up specialized units for the management of non-performing loans;
- established clear criteria for the transfer of non-performing loans to these units;
- adopted the necessary internal procedures and manuals;
- finalised proper segmentation of non-performing loan portfolios;
- developed a range of short- and long-term loan restructuring options.

It must be noted however that, until recently, a rather disproportionate part of NPL restructurings were of a short-term nature, which, far from offering a real solution to the problem, simply postpones a final decision to the future. Effective management of common borrowers is also a challenge, requiring coordinated action and good cooperation among the multiple creditors involved.

The second line of action is associated with the removal of obstacles to active management of non-performing loans.

The Bank of Greece, in cooperation with the State, proposed a series of legislative initiatives that aimed at lifting various obstacles to the effective management of NPLs.

In particular, by amendments to the Code of Civil Procedures and the Bankruptcy Code, Greek authorities were able to:

(1) enhance the seniority of the rights of secured creditors in the distribution of NPL liquidation proceeds;

(2) set up a framework for electronic auctions;

(3) introduce an out-of-court workout (OCW) framework in order to accelerate restructuring of all types of debt (owed both to private and public entities);

(4) simplify procedures for filing bankruptcy claims for small businesses;

(5) establish, under the auspices of the Hellenic Bank Association, a special platform to address the issue of common borrowers;

(6) provide legal protection from civil and criminal liability for public sector and bank employees involved in loan restructuring and write-offs.

Moreover, the Bank of Greece, in cooperation with the Ministry of Finance, took certain initiatives aimed at removing tax obstacles to the active management of non-performing loans. In particular, differences between the treatment of IFRS (International Financial Reporting Standards) and Greek GAAP (Generally Accepted Accounting Principles) were addressed through relevant legislation in order to allow for proper reporting of accounting losses resulting from loan write-offs and sales. With the latest amendment, deferred tax assets, converted into DTCs, can be offset against the income tax due for a period of 20 years. The same period is also provided for the gradual depreciation of losses due to write-offs and disposals of non-performing loans, provided that the origin of the losses is clearly identified.

The third line of action is associated to the development of a secondary market for the management of non-performing loans.

Greek authorities established a comprehensive legislative and regulatory framework for the licensing and supervision of servicing companies for NPLs. Specifically, the law lays down different provisions for companies that intend to exercise only loan management and for those who intend to engage in refinancing of such obligations. It should be noted that, based on this framework, there are now sixteen licensed companies operating in Greece, which are supervised by the Bank of Greece and subject to strict rules regarding consumer protection.

The development of this secondary NPL market will also facilitate portfolio sales, providing prospective investors with multiple options for effective management.

As mentioned before, thanks to the administrative and legislative measures under the three lines of action outlined above, coupled with the significant efforts of supervised banks, substantial progress has been made, as reflected in a reduction in the volume of non-performing loans. NPLs reached €84.7 billion at end-September 2018, down by about €9.7 billion from December 2017 and by around €22.5 billion from their March 2016 peak. The decline in the stock of NPLs during 2018 was mainly due to write-offs (€4.4 billion) and sales (€5.2 billion). The ratio of non-performing loans to total loans remained high in September 2018 at 46.7%.

Greek banks have already submitted revised operational targets for NPLs covering the period until 2021. In the period ahead, loan sales, collections, collateral liquidation and curing are anticipated to be the key drivers for the NPL ratio to drop below 20% by the end of 2021. This figure, however, although significantly lower than today, will still be well above the European average, which, as already mentioned above, is currently less than 4%.

The Bank of Greece has repeatedly stressed the importance of a systemic solution to the problem of the high stock of NPLs, if Greek banks are to converge to the EU average in the foreseeable future.

If these targets are achieved, the drastic reduction of the high stock of NPLs will have a major effect on economic activity and productivity, through two channels:

(a) an increase in loan supply; and

(b) the effective restructuring of major productive sectors.

According to Bank of Greece research, the decrease of the NPL ratio would help to reduce financial risks and funding costs for banks, thus improving their internal capital generation capacity. Moreover, it is estimated that a significant reduction of the NPL ratio would improve core profitability on a sustainable basis.

Greek banks continue to accumulate loan loss reserves of about 2% of their risk-weighted assets on average on an annual basis. These costs cannot be reduced as long as the NPL ratio is around 40%. Additionally, considering the minimum capital requirements under Pillar 2, there appears to be no reasonable scenario that these requirements will fall, unless there is a significant improvement on the NPL front.

This improvement would enable a gradual increase in loan supply and a decline in borrowing costs for businesses and households. At the same time, we can expect a reduction in business and household financial risk as the economy recovers, thus increasing the valuation of their existing assets and their collateral value, due to higher net returns on capital and real estate. As a result, households and businesses will gradually become more creditworthy, and more likely to obtain bank credit to finance their investments.

Ladies and gentlemen,

A wide array of measures and policies has been successfully implemented so far and we are clearly in a much better position than we were in previous years. However, it cannot be stressed enough that, despite all the reforms completed to address the issue of non-performing loans, the stock of NPLs remains very high compared with the European average.

In fact, even if the operational targets are fully attained by the end of 2021, the NPL stock will continue to be significantly higher than any European average benchmark.

Therefore, it is of utmost importance that all relevant authorities, Greek and European, take additional policy initiatives, in order to support the banking sector and address the NPL problem in a decisive and systematic way. This will allow banks to focus on what really matters for the future: modern business models, finding new profitable growth opportunities and activities, exploiting digital technologies, and above all, financing the real economy.