Yannis Stournaras: Intervention

Intervention by Mr Yannis Stournaras, Governor of the Bank of Greece, Athens, 15 January 2021.

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1. The euro area Banking System: From the Global Financial Crisis to the COVID-19 pandemic.

The shape of the next crisis has been a popular topic in public debates about macroeconomics and finance over the past few years. In late 2019, a decade after the Global Financial Crisis, no one could foresee what was coming. The scenario for an acute global economic disruption due to a pandemic was nothing more than a rare tail event. Unfortunately, this scenario materialized and had a tremendous impact on the social and economic activity worldwide.

As seen in past crises, banks (along with the State Budget) are usually the first in line to take the hit, taking into consideration their close links with the real economy. However, the banking system in the euro area has entered this new crisis with stronger fundamentals and has been in better position to absorb shocks. In the aftermath of the Global Financial Crisis, policy makers and supervisors had already taken a number of measures –inter alia- to increase the quality and quantity of regulatory capital, to improve governance functions and the measurement of risks in credit institutions, to facilitate the resolvability of failing banks, etc. There is no doubt that at the time when the pandemic hit the Eurozone, the banking system, as a whole, was financially sound with low NPLs, adequate capital levels and ample liquidity.

According to EBA data, the average Capital Adequacy Ratio of EU banks was 19,3% in December 2019 – the highest level we have ever seen for years- mostly the result of capital enhancement actions taken by EU banks. At the same time, asset quality metrics had been materially improved with the average NPL ratio declining to 2.7% which is again the best performance seen since the previous crisis. EU banks also enjoyed ample liquidity with the average Liquidity Coverage Ratio being at circa 150%, well above the regulatory minimum of 100%.

Of course, not all banks in the Eurozone had managed to fully recover from the previous crisis. Despite the progress made, some banks (especially in the EU periphery) were still struggling to address legacy issues and notably the high stock of non-performing loans. Still, it is safe to conclude that the banking system in the Eurozone emerged safer and stronger from the previous crisis.

2. How European Regulators responded to the crisis

This time the response by the regulatory authorities to the crisis was immediate and (so far) effective. There are two reasons behind this prompt reaction:

- First, the previous crisis was very recent and the lessons learnt had not yet been forgotten, and
- Second, the pandemic is a symmetric shock and hit hard all member states. This facilitated the decision making process by regulators, amid a period when monetary and fiscal authorities also provided enormous support. In fact, all players in the Eurozone were fully aligned; central bankers, regulators, political authorities. In a nutshell, rapid common action is now the name of the game, unlike in previous crises.

The relief measures taken by the regulatory authorities are more or less known. I would like though to comment on two of them which I think are relevant for future policy actions but also for

a potential review of the existing framework:
The first has to do with the usability of buffers. Despite the accommodative monetary policy that provided ample liquidity to credit institutions and the clear communication from the supervisory authorities on the timeline for the flexibility granted, we notice that most banks across the globe are reluctant to dive into their buffers. Recall that the essence of macro prudential buffers is to support the real economy during an economic downturn, thus mitigating procyclicality. I can think of several reasons behind this but I believe that the primary reason is the uncertainty about the true impact of the pandemic to the balance sheet of corporates and households. Policy makers should review this issue and the effectiveness of macroprudential buffers after the end of the ongoing crisis.
The second has to do with the recognition of credit losses. Here the authorities also acted quickly and clarified the interplay between loan moratoria and loan categorization. However, there is a widespread view that many banks in the euro-area underestimate their credit losses due to the pandemic, especially for the performing customers that are currently benefiting from payment deferrals. The recent letter by the Chair of the SSM regarding the identification and measurement of credit risk in the context of the Covid-19 pandemic communicates clearly the supervisory expectations. Therefore, it seems (correctly in my view) that the asset quality of European lenders will be in the epicenter of the supervisory action this year.

3. Country specific responses

The Bank of Greece has acted similarly to other NCAs on the regulatory front and adopted similar measures with that of the SSM for the Less Systemic Institutions that fall under our supervisory competence.
In addition, and as we did not have in place countercyclical capital buffer to release, we decided to ‘freeze’ the level of Other Systemically Important Institutions Buffer at the existing levels for a year.
Banks also announced in the early stage of the crisis, a system-wide loan moratorium that is compatible with the relevant EBA Guidelines. The initial expiration date of December 2020 will now be extended in line with new EBA Guidelines, within the cap of the 9-month period.
At the same time, the Greek government has taken a series of fiscal and labor market measures to support businesses and employment. These measures are similar to the ones taken in other jurisdictions and include the subsidization of loan installements of small and medium sized enterprises hit by the pandemic. The fiscal support measures and the recession have led to a sharp reversal of the general government budget surplus into deficit for 2020 and, combined with deflation, to a significant increase in the debt-to-GDP ratio.
However, the inclusion of Greek government bonds in the Pandemic Emergency Purchase Programme (PEPP) of the ECB, their acceptance as collateral in the Eurosystem’s liquidity-providing operations as well as the positive developments in international financial markets, contributed to the uninterrupted access of the Greek State to capital markets and the further decline of the government bond yields.
I would like now to say a few words about our proposal to set up an Asset Management Company (AMC) that addresses the top two challenges for Greek banks (the high level of NPLs and the high share of DTCs in bank capital) simultaneously, by introducing a straightforward market-based approach. This proposal is currently under review by the Greek Government and if adopted could be a decisive country response to the crisis and a relevant precedent for other jurisdictions.
The proposed AMC could take up the legacy NPLs on top of those envisaged to be taken up by the Hellenic Asset Protection Scheme (HAPS), about €30 billion, as well as the new NPLs resulting from the pandemic (estimated at about 8-10 billion euros). Hence, a total of about €40 billion.
In a nutshell, according to the BoG proposal:

- An NPL transfer at net book value to the AMC creates incentives for banks with higher coverage ratios and eliminates asymmetries in the cost associated with participation in the proposed scheme.

- Banks undertake the cost of cleaning their balance sheets, not the taxpayer. Banks will eventually bear costs for implementing a market-based solution. However, banks may benefit from the introduction of a gradual loss recognition mechanism that allows strengthening of capital adequacy reserves, if necessary.
- Shareholders are not subjected to undue dilution because of loss-triggered DTC conversion.
- The proposed AMC is not envisaged to perform as a servicer; on the contrary, the scheme will utilize and build upon existing contractual terms of loan servicing companies.

As seen in the recent communication published by the European Commission in December 2020, the set-up of AMCs (either at national or at European level) is a policy proposal that is now favored by the European authorities and could lead to a swift cleanup of banks' loan books.

4. The main challenges facing banks in Europe

Euro area banks face a number of challenges; new due to Covid-19 outbreak and existing ones:

First, banks are tied-up to macroeconomic and monetary policy developments. Despite the projected recovery of the European economy in 2021, risks to the projections remain elevated. The resurgence of the pandemic and the new round of restrictive measures across Europe could lead to a longer and deeper recession associated with a wave of corporate defaults, rising non-performing loans and job losses.

The low interest rate environment, combined with a sluggish economic recovery, remains a big challenge for European banks, with clear implications for their core profitability and capital generation capacity.

A large number of banks' obligors is under loan moratoria, which differ across countries and sectors. As I previously mentioned, even though the relevant EBA Guidelines on moratoria do not eliminate the banks' obligation to perform the so-called 'unlikely to pay' assessment and record the relevant loan loss provisions, there is a widespread feeling that the credit losses from the pandemic are underestimated. The expiration of public support measures, especially those related to fiscal support, could have negative implications to banks' cost of credit risk. Banks should take action that will facilitate the frontloaded recognition of credit losses as well as the swift clean-up of banks' balance sheet through systemic solutions. As already said, the Bank of Greece has proposed to the Greek Government such a systemic solution in the form of an AMC to be used along with the HAPS.

There are pockets of risk in the non-bank financial sector that is continuously increasing its size. For instance, banks have reduced their NPL's by transferring a large share of them to funds outside the official banking sector.

Climate-related risks that seemed a distant possibility some years ago are rapidly gaining importance in the risk heat map.

In addition, at the level of individual banks and jurisdictions, banks face additional challenges that have to do with legacy issues or idiosyncratic characteristics of the domestic banking sector. To give you some more information for Greek banks:

Despite the reduction of NPLs by about €50 billion since their peak in March 2016, the NPL ratio at the end of September 2020 remained at exceptionally high levels of 35.8%, far above the EU average.

The capital adequacy ratios of Greek banks are above the minimum required, but will be challenged by several factors in the coming years, such as:

- i) the full impact from IFRS9,
- ii) the cost of their NPL strategy as seen in recent planned or executed transactions,
- iii) the fact that more than half of banks' capital is in the form of Deferred Tax Credits (DTC),

which is perceived by the markets as ‘low quality capital’.

Bank profitability is still weak on the back of low business volumes and high cost of credit risk. Finally, banks will need to gradually tap the markets over the next few years to meet their MREL target.

I will conclude my intervention for the challenges faced by banks in the Eurozone with the missing parts of the Banking Union and the need to strengthen further the banks’ crisis management framework. I refer to a) the introduction of the European Deposit Insurance Scheme (EDIS), b) the existing deficiencies in the Bank Recovery and Resolution Directive (BRRD) that cannot address systemic crises where financial stability is at risk and offers no clear strategy for dealing with the failure of small and mid-sized banks that are primarily deposit-funded, c) the need to harmonize different national liquidation procedures.

- The recent Eurogroup agreement (November 30, 2020) to establish a common backstop to the Single Resolution Fund (SRF) in the form of a credit line from the ESM, which will enter into force in the beginning of 2021, is an important step towards a more robust banking sector. Still, liquidity needs in resolution may easily surpass what is currently provided for. Drawing from the experience of the Bank of England, the establishment of a special credit line by the ECB could be considered, subject to appropriate safeguards.
- Similarly, and as already mentioned, the European Commission communication of December 2020 on tackling NPLs through a network of National AMC’s and the further development of the secondary market for loan securitization, as well as the possibility to grant precautionary recapitalization aid to viable banks so as to facilitate the transfer of NPLs under certain conditions, is also an important step in the right direction.

5. Outlook for the European banking system for 2021- 2022

The outlook for the European banking system is closely related to the developments in the economy and the fight against the pandemic. Therefore, I would like first to comment on this before I move on to the outlook of the banking system per se:

- On the health factor, it seems that the news will be positive especially after the vaccination of a large part of the population within the 1st quarter of the year that will ensure the necessary immunization from the virus.
- According to the latest baseline scenario of the Eurosystem staff macroeconomic projections, the economic growth will return to positive territory this year. Real GDP is projected to increase by 3.9% in 2021 and 4.2% in 2022, due to the recovery of both domestic and external demand.
- Fiscal policy is expected to remain expansionary until a very large proportion of the population is vaccinated and, particularly, the European economy returns to a stable growth path. Monetary policy will remain accommodative until inflation converges to the target of 2 percent in a sustainable and robust way. With available data, inflation in 2023 is expected to remain well below 2 percent.
- The impact from the creation of the EU recovery tool (NGEU) will be visible in 2021. NGEU will finance growth initiatives, in the period 2021-2026, worth €750 billion at constant 2018 prices. The recovery tool will be funded through the issuance of mutual debt at the EU level, which will be repaid between 2028 and 2058.

For some small European economies such as Greece, the funds available through the NGEU will provide significant opportunities for the modernization, the green transition and the digital transformation of the economy.

Moving now to the banking system; Even though I remain on the optimistic side about the medium-term prospects, I am afraid that the scars from the pandemic will be more visible in 2021. The loan moratoria and the fiscal support measures averted the massive defaults of borrowers during 2020. Inevitably, new defaults will arise at some point within 2021 and will affect asset quality and profitability of European lenders, particularly so as support measures will be gradually lifted.

- Note that the burden from new Covid-19 related defaults will be higher for banks that already had a high stock of NPLs such as Greek banks, where a big chunk (if not all) of the existing buffers was meant to be used to address part of their legacy NPLs.
- Another point I would like to make here is the significant role of the banking system in avoiding the creation of 'zombie' companies and permanent (structural) scars to the economy. Banks should act decisively and address new delinquencies at a cost for their capital. NPL servicers will also have an important role here, as moving NPLs outside the banking sector does not imply that credit risk is removed away from the financial system. Only the effective workout of these loans will essentially remove the burden to obligors and reduce the credit risk, eventually allowing a better allocation of resources in the economy.

As banks come out from a very tough year and have to cope with the existing and the new challenges we discussed earlier, they need to have a credible plan about the next day and need to boost their resilience.

- I believe that further consolidation will occur in 2021 and 2022. European banks have currently a gap compared to their US peers, both in terms of efficiency (Return on Equity) and valuation (Price-to-Book). The pandemic may amplify existing vulnerabilities of European banks and widen further this gap. Consolidation (either at national level or cross-border) is not a panacea but could certainly be supportive, especially on the cost effectiveness.
- Another significant development in 2021 is digitalization. The pandemic has changed not only the way we work and socialize, but also our relationship with banks. It is a catalyst for digitalization and is pushing banks to invest more in digital infrastructure. This trend will shape the competition landscape and will probably drive the laggards off the market in the medium-term.
- Climate change will gain more importance in 2021 and banks will play a critical role in sustainable finance and in embracing further environmental, social and governance (ESG) commitments.

I will stop here. Banks will face a number of challenges in 2021 but also significant opportunities. The pandemic is changing the way they are making business. They also have to adapt as they have an important role to play in providing liquidity to the economy, transmitting the stabilizing stance of monetary policy to all sectors of the economy and facilitating the mobility of resources towards a more optimal allocation.

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