



Cracks in the Greek banking sector still present despite falling NPLs and government support

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- **The NUS-CRI Agg PD demonstrates the improving credit health of Greek banks on the back of falling NPLs and strong liquidity**
- **However, as intervention by the Greek government and ECB ebbs, Greek banks face significant downside risks amid a possible rise in NPLs, persistent weak profitability and the sector’s growing interdependency with the health of the sovereign state**

At the height of the COVID-19 pandemic, the credit health of the Greek banking sector¹ (Greek banks) plummeted, and the sector saw its credit risk reach the highest level within the EU. Compared to the EU banking sector’s NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) which peaked at 23bps, the Agg PD for Greek banks reached 164bps in Mar-2020, surpassing the BB- upper bound according to the PDiR2.0. Their credit profile relative to the riskiest EU banks also deteriorated sharply, with the sector’s Agg PD soaring above the EU banks’ 75th percentile Agg PD (See Figure 1a). With the implementation of government support to reduce Non-Performing Loans (NPLs) and boost liquidity, the Greek banking sector’s credit health has seen a recovery since the second half of 2020, with Agg PD stabilizing around 12bps since the start of this year. However, as moratoria expire, the credit outlook for the Greek banking sector could worsen as Greek banks continue to struggle with weak profitability, historically negative rates of loan growth, and the effects of the ongoing COVID-19 pandemic.

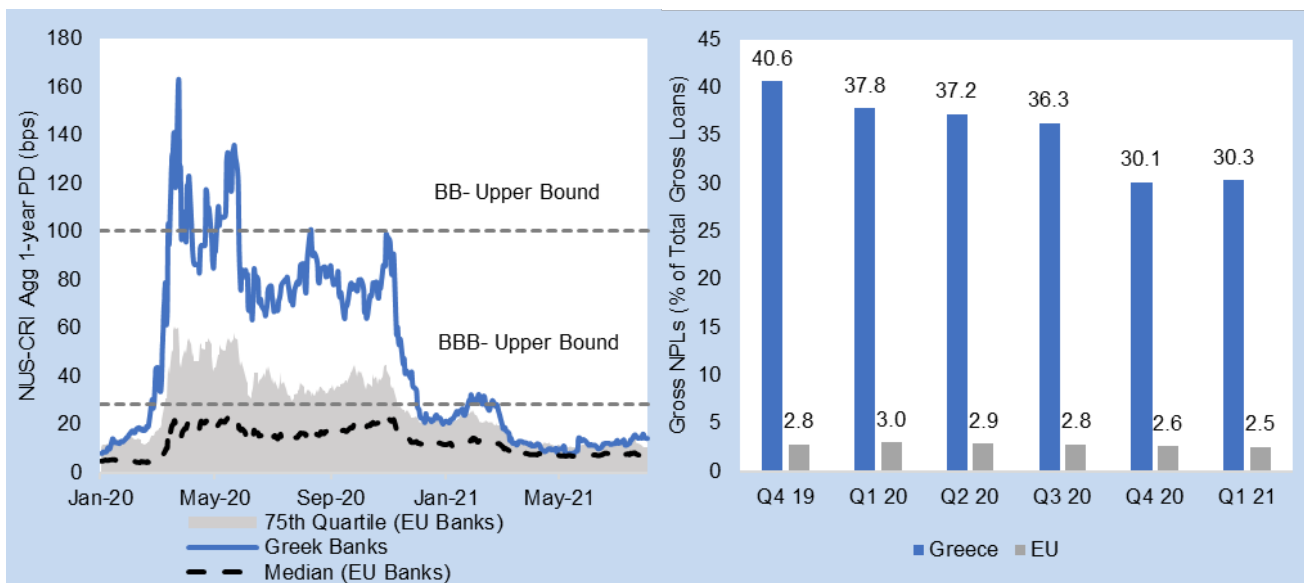


Figure 1a (LHS): NUS-CRI Aggregate (median) 1-year PD for EU and Greece-domiciled public banks and the NUS-CRI Aggregate (upper quartile) 1-year PD for EU banks from Jan-2020 to Aug-2021 with reference to PDiR2.0² bound. Fig 1b (RHS): Gross NPL ratio for all credit institutions headquartered in the EU and Greece. Source: NUS-CRI, [European Central Bank](#)

¹ The referred universe includes all public commercial banks domiciled in Greece: Piraeus Financial Holdings SA, National Bank of Greece SA, Alpha Bank AE, Eurobank Ergasias Services and Holdings SA and Attica Bank SA.

² The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P’s historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

After years of stagnation on the bad debt issue in the Greek banking sector, the rollout of the Hercules Asset Protection Scheme (HAPS)³ in [Dec-2019](#) has spurred significant improvement in the asset quality of Greek banks. Ever since the global financial crisis, Greece has been grappling with Europe's heaviest burden of NPLs. In Q4 2019, Greek banks' NPL ratio stood at 40.6%, 37.8 percentage points above the EU average (See Figure 1b). Since the scheme became operational in the [second half of 2020](#), all four of Greece's major banks have ramped up their NPL reductions via securitizations under HAPS, with NPLs falling to 30.1% by the end of Q4 2020.

Apart from the HAPS, NPL reduction in Greece could also be facilitated by the ECB's [recent approval](#) of amendments to existing legislation on Deferred Tax Credits (DTCs). Under the current laws, losses could trigger the conversion of DTCs into equity held by the state, diluting private sector stock ownership. By allowing banks to offset losses for an extended 20-year period, the new amendment effectively removes a constraint on the Greek banks' bad debt clean-up by giving them the leeway to more aggressively securitize NPLs and book resultant losses without diluting the stakes of existing shareholders. As of 2020, DTCs accounted for [61.1%](#) of the CET1 capital of Greek banks⁴ and had been one of the key issues faced by Greek banks with regards to their capital position and their bad debt clean-up capabilities.

Compared to the banking crisis in the 2010s, Greek banks have also had ample liquidity to tide through the COVID-19 pandemic so far, facilitated by a broadening [deposit base](#) and the ECB's more accommodative monetary stance. The ECB's ultra-cheap longer-term refinancing operations (LTRO) and targeted LTRO (TLTRO) mechanisms have allowed Greek banks to obtain funding at a base interest rate of [-0.5%](#) (to as low as -1%), boosting the banks' liquidity and partially alleviating pandemic-related profitability and financing pressures. In Apr-2020, the ECB also [eased collateral rules](#), approving the use of Greek government bonds as collateral and causing a [sharp increase](#) in Greek banks' holdings of ECB funding. Compared to 131% at end-2019, the Greek banking sector's liquidity coverage ratio improved to [175%](#) by end-2020. However, the pandemic-related incentives could be pulled back as early as [Jun-2022](#), and hence may pose a risk to Greek banks' liquidity conditions in the medium to long term.

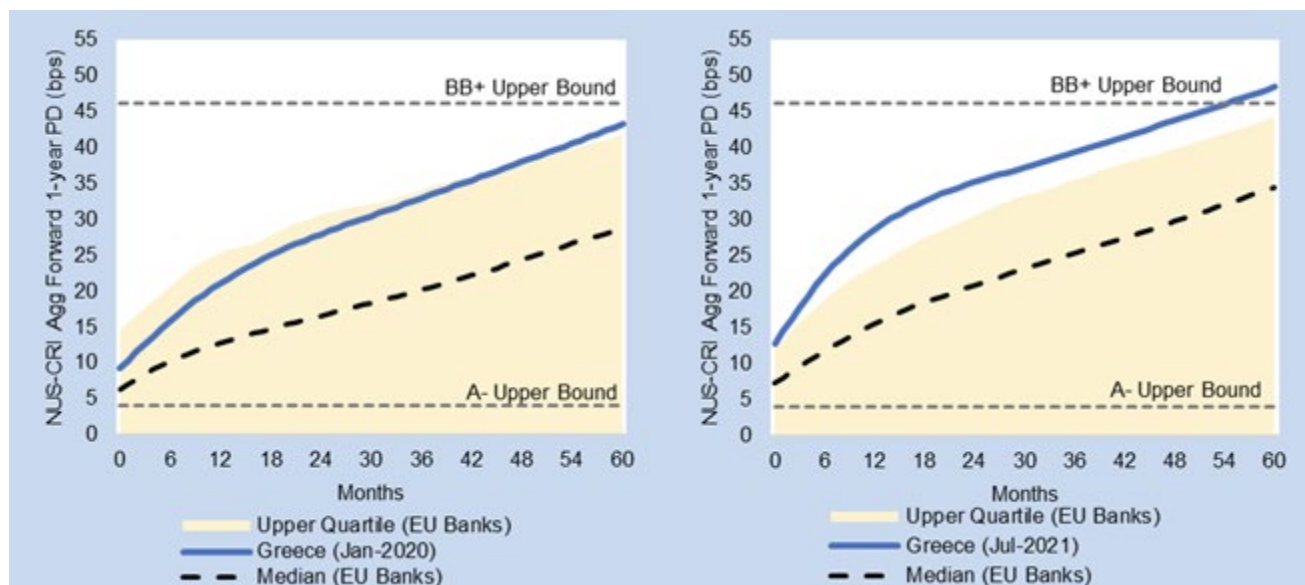


Figure 2a: NUS-CRI Forward 1-year PD⁵ for Greek and EU banks in Oct-2019 with reference to PDiR2.0 bound. Figure 2b: NUS-CRI Forward 1-year PD for Greek and EU banks in Jul-2021 with reference to PDiR2.0 bound. Source: NUS-CRI

³ Under HAPS, a Special Purpose Vehicle (SPV) buys the NPLs, which finances the purchases by issuing three tranches of notes, of which the least risky is backed by the government. As debt collectors recover assets from defaulters, proceeds flow to the investors, with the riskiest getting repaid last. The use of government guarantees increase the creditworthiness of senior tranches and provide better pricing, allowing banks to minimize their losses and averting the [previous problem](#), where banks had been unable to sell bad debts because of the trade-off with profitability caused by the difference in bid-offer prices.

⁴ During the banking crisis, Greek banks (and other southern European countries) converted their deferred tax assets, which do not count towards core capital, to DTCs, which do, to boost their capital base.

⁵ The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

Suffice to say, Greek banks are still in rough waters due to the fallout of the COVID-19 pandemic. Though government policies such as HAPS, subsidies on loan payments for businesses, and [regulatory forbearance](#) have [offset](#) much of the adverse impact of the pandemic on the recognition of NPLs for Greek banks; as moratoria expire, total NPLs are [expected](#) to rise. A comparison between the Oct-2019 and Jul-2021 NUS-CRI Agg 1-year Forward PD shows the Greek banking sector's median short-term outlook has migrated upwards after the onset of the COVID-19 crisis, with credit risk in the Greek banking sector currently above the upper quartile of EU banks (See Figure 2b).

Apart from the possible deterioration in asset quality, profitability in the Greek banking sector has also been under pressure. After the 2011 crisis, Greek banks became conservative in their lending⁶. The change in the total volume of loans in the Greek banking sector has been negative for nearly [every year](#) after Q2 2011, even as lending in the Euro area remained generally stable. Austerity measures had left the economy unstable, resulting in low loan demand and a high rate of defaults which in turn made banks more [hesitant](#) to extend credit that could add to their existing book of bad loans. Although this historical vicious cycle showed signs of abating in 2019, the COVID-19 pandemic could re-trigger the decline in loan volume as Greek banks face increasing NPLs. Recent data from the ECB underscores the worrying trend of Greek banks, revealing that in Q1 2021, Greek banks were the worst-performing in the EU in terms of profitability, with Greece being the [only country](#) with a negative return on equity (ROE) of [-0.27%](#) compared to the EU aggregate ROE of 1.62%.

Although HAPS and the prompt policy response by the Greek government and ECB have helped Greece avert a sudden credit contraction, they have also inadvertently [strengthened](#) interdependencies between the Greek banks and the state, tightening the "sovereign-bank" nexus. In Mar-2020, the ECB [removed](#) the cap on Greek banks' holdings of sovereign debt in a bid to [boost demand](#) for Greek bonds. Subsequently, Greek banks increased their exposure to state debt⁷, reporting more than [20% QoQ](#) growth in their holdings of government securities in Q2 2020. Fiscal support measures have also created more interdependencies, partially through the state and banks' links with domestic corporations. The Agg PD for the Greek banking sector (previously shown in Figure 1a) heightened in tandem with a surge in sovereign stress levels as proxied by SovCISS⁸ (Composite Indicator for Sovereign Stress) for Greece. Going forward, as banks become more reliant on government support measures, the credit health of the sector may also become increasingly sensitive to the sovereign risks in the Greek state.

Despite the significant improvements that Greek banks have made, in the ECB's latest stress test, [three out of four](#) of Greece's main banks showed core capital ratios falling to 8% or lower under an adverse scenario. As the potential influx of new NPLs arising because of the ongoing effects of the pandemic threatens to undermine the progress made by Greek banks to reduce their NPLs, the Greek government has announced the extension of the HAPS for another 18 months to Oct-2022. Additionally, through the creation of a national asset manager, the bad-debt clean-up could be [sped up](#). The establishment of a Greek national AMC could allow banks to focus on ramping up lending and providing fresh cash for economic recovery instead of being occupied with the management of NPLs. Though these strides are positive for the banks' credit health, the underlying economic environment, as well as the country's position in the wider EU market, Greek banks may still face headwinds in the near future.

⁶ This could be due to the emergence of a [vicious feedback cycle](#), where in the event of adverse macroeconomic shocks, capital losses prompt banks to cut lending, generating externalities that further propagate the cycle.

⁷ During the peak of the pandemic, [many banks](#) in countries within the euro area also increased their exposures to the state.

⁸ The [SovCISS](#) measures sovereign bond market stress in the euro area by integrating measures of credit risk, volatility, and liquidity. It takes into account the fact that bond market stress could also manifest as an increase in volatility and fall in liquidity, in addition to the conventional use of yield spreads.

Credit News

Battered bond bears give a cautious cheer as yield slump pauses

Aug 8. The consistent rally in Treasuries finally paused this week, as 10-year yields increased for the first time since June. Better-than-expected jobs report and comments by Fed Vice-chairman Richard Claria regarding tapering fueled the advance in treasury yields. However, uncertainties related to the delta variant of coronavirus, inflation, and Fed policy continue to threaten further increases in yield. The consumer price inflation report and bond auctions in the coming week will be important tests that will influence the rally in yields. Fed Chief Jerome Powell is expected to use the opportunity to provide greater detail on the central banks' thoughts on policy tightening in the near-future. ([Bloomberg](#))

Defaults on UK's emergency Covid loans set to be up to GBP 5bn

Aug 4. Default on state-backed government COVID-19 emergency loans could be as much as GBP 5bn. The estimation is based on the debt servicing in previous months when 5%-10% of small and medium-sized companies that tapped the support scheme missed payments. Bankers said the stronger-than-expected economic rebounds had helped companies regain their financial independence. The losses are much lower than previously feared, but the government may have pushed back the problems through the 'pay as you grow' scheme, which offers repayment holidays and extended loan terms. This scheme was rushed out last year to support smaller businesses at risk of collapse due to coronavirus restrictions, and banks could offer state-guaranteed loans to them. As all loans come with a 90-day repayment period and repayments on the first borrowings started in June, banks will have to start assessing early defaults in their portfolio in the coming weeks ([FT](#))

Why Unitranche loans grew from niche to billions

Aug 7. Unitranche loan is a hybrid loan structure that combines senior debts and subordinated debts, with all debts, created equally. The lenders typically hold Unitranche loans for the life of the loans, thus are not exposed to the price volatility in the secondary bond markets. From Q2 2016 to Q2 2021, Unitranche deals grew from USD 3bn to USD 21.6bn, with the record-high deal in Jul-2021 reaching USD 2.6bn. Private equity firms to finance institutional buyouts mainly issue this type of loan. The Unitranche lending for mid-size companies is driven by insufficient bank loans and surging private credits. These higher-return loans have advantages in speed, certainty, and privacy, but they have not been tested in any major economic downturns. ([Bloomberg](#))

Bundled commercial real-estate loans climb to sales record

Aug 3. Backed by expectations of an economic recovery, sales of securities backed by commercial real estate loans have surged to a record high. Firms sold USD 24.5bn of commercial real estate collateralized loan obligations (CRE CLOs) in the first seven months of the year, compared to USD 19bn in all of FY2019. The record sales display a rebound from levels seen in 2020 when pandemic restrictions resulted in delays and missed interest payments. Analysts believe that strong economic growth and high inflation in the U.S. will lead the Fed to raise rates sooner. This expectation has led to the record issuance of floating rate corporate bonds and CLOs that buy low-rated corporate loans. Sales of CRE CLOs have for the first time exceeded the issuance of conduit commercial mortgage-backed securities, which generally make up the largest source of supply in the mortgage bond market. ([WSJ](#))

Credit-market cracks emerge as delta strain sows reopening angst

Aug 6. Amid growing concern over coronavirus resurgence, the credit market shows weakening signs. The average spread on junk-rated bonds is climbing again after hitting a low of 2.62% on July 6, 2021. The difference in the yield spread between companies rated BB and B rose by 26bps last month, reflecting the increased risk in lower-quality bonds, which are more likely to be hampered by any delay in economic recovery. Deteriorating investor sentiment also affects companies' ability to access markets, as several leveraged loans have had to increase their pricing wide recently. The market volatility led to an increase of the volume of distressed bonds and loans to USD 72.5bn as of early August, from a one-year low of about

USD 58bn in early June. Credit tensions in China are also weighing heavily. The recent turmoil could signal further credit weakness ([Bloomberg](#))

Evergrande bond selloff deepens on court concern, downgrades ([Bloomberg](#))

How China bonds became the new JGBs ([Bloomberg](#))

U.S. High-Grade bonds braced for \$30 billion in late summer dash ([Bloomberg](#))

Regulatory Updates

Brazil raises key interest rate by the most since 2003

Aug 5. Banco Central do Brasil (BCB) increased their interest rates by 100bps from 4.25 percent to 5.25 percent on August 4, 2021, in light of the spiraling inflation in Brazil. Accelerated prices due to the recovery from Covid-19 contribute to the surge in inflation, which exceeded 8 percent in the 12 months to Jun-2021. Although Brazil's GDP is still below the 2014 deep recession, an interest rate hike, to balance off inflation, is required. The BCB is facing a challenging target to reduce the inflation rate by 50% to relieve the heavy stress from high living costs and a record-high unemployment rate. ([FT](#))

Joe Manchin says fed should reverse easy-money policies

Aug 5. Sen. Joe Manchin raised concerns about inflation to Fed Chairman Jerome Powell as the Fed continues to stimulate the US economy, which had a strong recovery from recession. There are worries that the record amounts of stimulus injected - including cutting interest rates to near zero and a USD 120bn per month purchase of securities by the Fed - would cause overheating and inevitable inflation taxes that could hurt working Americans. Furthermore, Mr. Manchin's concerns could prove to be pivotal in the passing of the Democrats' climate, education, and healthcare package. They may also be vital later in the year when the Senate considers nominees for the new chair of the Fed. ([Bloomberg](#))

RBI amends guidelines for smoother Libor transition ([Live Mint](#))

Romania holds EU's highest key rate as CPI pressure builds ([Bloomberg](#))