CRI Credit Research Initiative
Risk Management Institute, National University of Singapore
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Weekly Credit Brief Aug 21 - Aug 27

Greek banks' recovery path still saddled with risks

by Liu Hanlei

After eight years of international bailout programs, Greece marks a milestone on 20 Aug 2018 as it emerged from its final bailout program, the Eurozone's European Stability Mechanism. Despite hitting the milestone, the route to Greece's recovery is still long and tough. Disposable income and employment amongst Greeks have fallen by 33% and 17.6% respectively since 2009. The Greek government will also have to restrict government spending for decades as they have to achieve budget surplus averaging 2.2% of GDP until 2060 in order the keep its EUR 228bn debt pile sustainable. The Greek banking sector was also not spared as it shrunk from 40 banks before the crisis to 9 at present and some of the more important banks have been recapitalized during the crisis. The recovery of Greece's banking sector still faces challenges ahead due to the potential higher financing cost, high non-performing exposures and weak profitability.

After exiting the bailout program, the European Central Bank (ECB) stopped accepting Greek bonds as collateral for banks to get cheap financing as Greek debt are rated below investment grade by rating agencies. Greek bonds were previously waived from a rule by ECB that all collateral must be of investment grade. With the removal of ECB's waiver on Greek debt, it is estimated that Greek banks would need to secure liquidity of about EUR 4bn through more expensive facilities. Greek banks may have to turn to the Greek central bank's Emergency Liquidity Assistance (ELA) for more financing, which carries a higher interest rate of 1.5% higher than the ECB's main refinancing rate, currently at zero. As of May 2018, Greek banks obtained EUR 11.3bn from ECB for funding and Table 1 below lists the outstanding liabilities owed to the respective entities. Analysts have also estimated that lending rates would have been at least 0.5-0.7% lower if the waiver had stayed.

In addition to the challenge of higher financing cost, another big issue is the high level of non-performing exposure faced by Greek banks. As of March 2018, the non-performing exposure of the banking system stood at EUR 92.4bn which is equivalent to half of Greece's GDP and is the highest in the European Union. Among the four banks, Piraeus Bank's non-performing exposure (NPE) ratio over gross loans is the highest at 55.7% (see Table 1 below). Greek banks have been selling off bad loans to funds, amounting to EUR 6.9bn since June 2016 according to latest data from the central bank. Greek banks expect to sell an additional EUR 4.7bn by the end of 2019.

Bank	ELA (EUR bn)	ECB (EUR bn)	NPE (%)
National Bank of Greece	0	2.8	42.7
Alpha Bank AE	3	3.2	51.8
Eurobank Ergasias	3.9	1.3	41.8
Piraeus Bank SA	1	4	55.7

Table 1. Greek banks' outstanding liabilities owed to ELA and ECB as of May 2018 and NPE ratios as of March 2018. *Source: Company filings, Bloomberg.*

The high non-performing exposures together with higher financing does not put the banks in good stead in a contracting credit environment. Gross loans across the four banks have been decreasing over the past quarters while core income across all four banks (total of net interest income, net fee and commission income) have fallen as compared to Q1 2017. Alpha Bank and Eurobank Ergasias did not suffer that much of a fall in core income which could be attributed to a stable and increasing net interest margin (NIM) respectively across the four quarters.

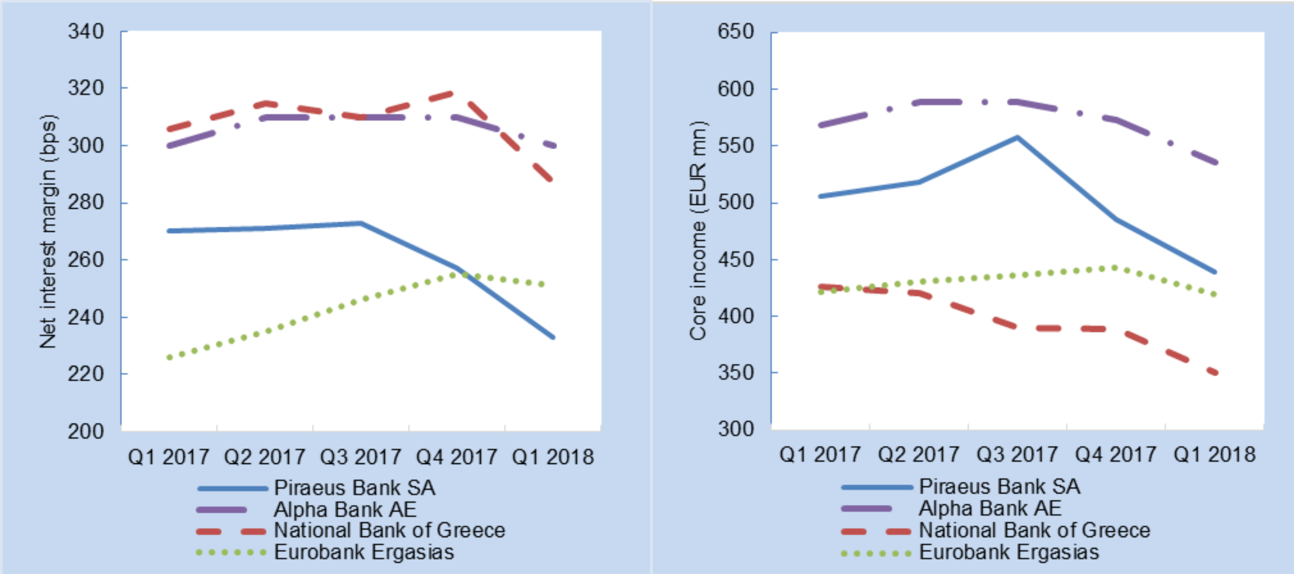

Figure 1. Key financial metrics of Greek banks. *Source: Company filings, Bloomberg*

With the potential to be affected by higher financing charges, high non-performing exposures and weakening profitability, the RMI-CRI 1-year Probability of Default (PD) of the four Greek banks reached its highest level over the past year in mid-August 2018. Piraeus Bank SA's RMI-CRI 1-year PD is highest among the four banks which coincides with its highest non-performing exposures and a relatively larger decrease in core income over the quarters.

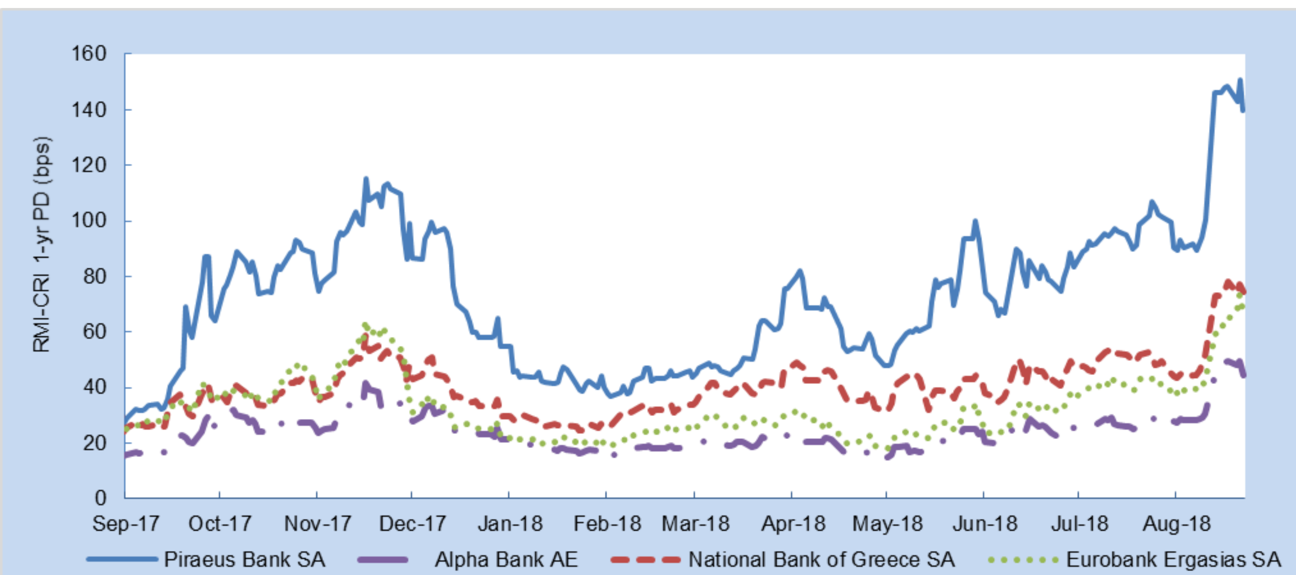

Figure 2: RMI-CRI 1-year PD for the four Greek banks. *Source: RMI-CRI*

In a [May 2018 stress test] conducted by the ECB, Piraeus Bank was also the worst performer as it saw its Common Equity Tier 1 ratio (CET1 ratio) declined the most in the adverse scenario while Alpha Bank performed the best. The results from the ECB stress test is also in line with RMI-CRI's Bottom-up Default Analysis (BuDA). BuDA is a toolkit for credit stress testing that projects corporate PDs under different macroeconomic scenarios. In this case, Greece's GDP growth rate is being put through different scenarios to analyze the impact of the PDs of the four Greek banks, represented as the RMI-CRI 1-year stress PD. The assumptions for Greece's GDP growth rate is based on [ECB's stress test] and categorized into adverse and baseline scenario as seen in Table 2 below. Taking reference from Figure 2, the focus will be on Alpha Bank and Piraeus Bank as these two banks are at the extremes. The RMI-CRI 1-year stress PD for National Bank of Greece and Eurobank Ergasias have the same trend as Alpha Bank therefore only Piraeus Bank's and Alpha Bank's RMI-CRI 1-year stress PD is shown in Figure 3 below. Piraeus Bank's RMI-CRI 1-year stress PD increased over the next 2 years and is the highest among the banks while Alpha Bank's RMI-CRI 1-year stress PD is the lowest, representing the strongest credit profile among the banks.

	Adverse scenario			Baseline scenario		
Year	2018	2019	2020	2018	2019	2020
GDP growth	-1.3%	-2.1%	0.2%	2.4%	2.5%	2.4%

Table 2: Assumptions for GDP growth in the adverse and baseline scenario. *Source: ECB*

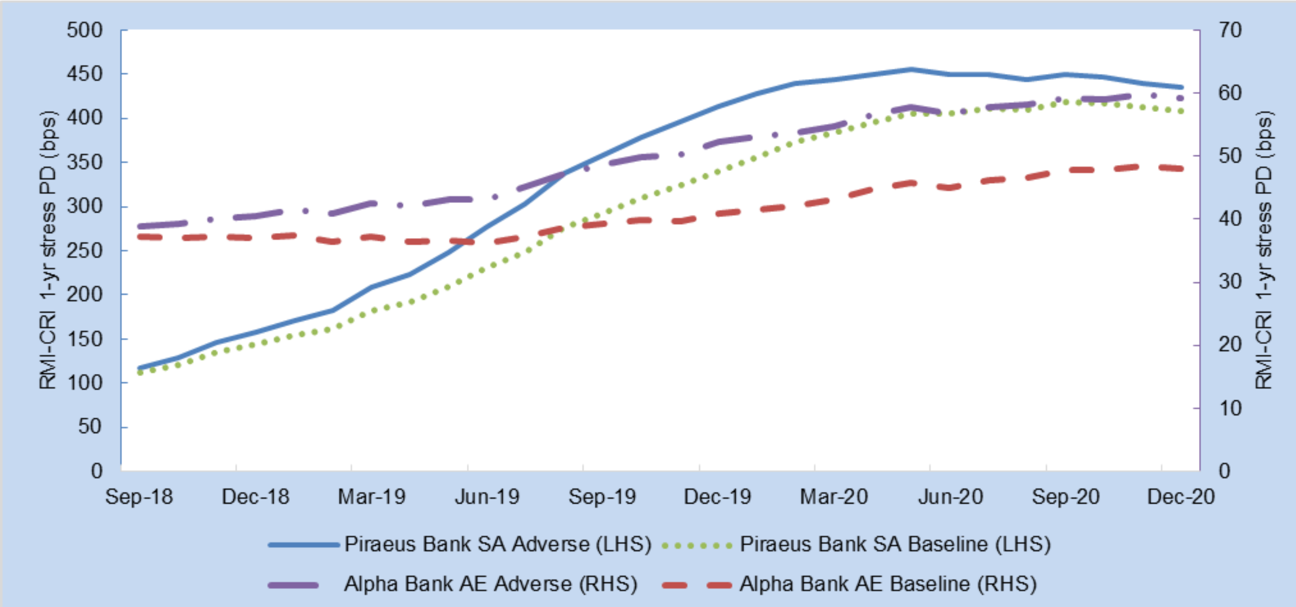

Figure 3: RMI-CRI 1-yr stress PD for Piraeus Bank SA and Alpha Bank AE under adverse scenario and baseline scenario. *Source: RMI-CRI*

The Greek economy is projected to grow 2.4% in 2018 and 2.5% in 2019 on a base case but is likely to slow down thereafter according to ECB's projections. With the aftermath of the crisis still weighing on the Greek economy, the banking sector can be a key contributor to the recovery of the economy. Fortunately, the Greek authorities have strengthened regulatory frameworks to help in the resolution of non-performing assets together with indebted companies. One such direction is by the central bank's resolution to solve the banking sector's non-performing loans by targeting sales of NPLs more intensively and putting more pressure on strategic defaulters. While cleaning up of balance sheet may be a near term solution, more work has to be done to restore confidence in the financial system and banks' intermediary role in the economy.

Credit News

Italian banks face high risk choice over domestic debt

Aug 26. Falling foreign demand for Italian government bonds are pressuring domestic banks to step into the breach, as they did during the euro zone crisis. Italian banks have stepped up purchases after the recent sell-off, increasing their holdings and hitting a one-year high at EUR 370bn in June. However, banks may face greater challenges in fulfilling such a role owing to the end of ECB's bond-buying program and the greater risk of a deterioration in banks' capital ratios/ratings caused by the weaknesses in the sovereign market. In fact, Italy's top two banks, UniCredit and Intesa, both lost roughly one third of a percentage point in core capital due to the sell-off, though Intesa was able to offset the hit by issuing new shares to reward employees and by converting savings shares. Nevertheless, analysts are still expecting a further 0.15 to 0.20 percentage point capital erosion for the two banks this quarter. (Gulf News)

South African bond selloff resumes as Turkey contagion stokes local risks

Aug 25. South Africa bonds suffered twice the outflows of the next worst-hit emerging market at the height of the Turkey crisis as foreign investors are trying to reduce volatility in their portfolios. Investors are dumping South Africa's debt in an increasing speed even though forward markets are heavily pricing in interest rates hike this year, which would boost the yield on local bonds. International Institute of Finance (IIF) showed

ZAR 12bn bled out of South African bonds from the start of the month up to 17 August which was the most among emerging market. The Reserve Bank stated in July that it was ready to tighten its monetary policy amidst concern on inflation and its exchange rate's volatility. (Money Web)

Providers of debt advice warn of funding crisis

Aug 24. UK's two biggest debt advice providers warned that they do not have enough resources to cope with the increasing demand for debt advice services, where demand has already outstripped supply. PayPlan, which provided free debt advice services to public, reported a 50% increase in demand for its services since January and expected a 200% increase by early 2020 if this trend continue. Under the current model, debt advice providers are paid voluntarily around 12% of the money recouped from the repayment plans in order to cover their costs. While banks and credit card companies support this model, a growing number of non-traditional lenders refuse to follow the current system. Wyman Review argues for a fair system in which all members of trade bodies are required to pay the voluntary levy. (FT)

World Bank launches first public blockchain bond

Aug 24. The World Bank has launched the world's first public bond created and managed using only blockchain in a step to move bond issuances away from manual processes towards faster and cheaper automation. Commonwealth Bank of Australia, the sole manager of the deal said that the bond is the first time that capital is raised from public investors through a legally valid bond issuance that uses blockchain from start to finish. It is said that the bonds will be managed on a private Ethereum network in which validators must have permission using Microsoft's cloud computing platform. (Straits Times)

Indonesia wants foreigners to own less bonds in long run

Aug 23. Indonesia is seeking to halve the foreign ownership of its sovereign bonds in five years to protect its assets from external shocks and reduce overreliance on foreign inflows to finance its deficits. Indonesia has been one of the hardest-hit Asian emerging markets since the emerging-market selloff began in January this year, triggered by rising U.S. interest rates and a stronger dollar. To reduce its vulnerability to outflows, the government seeks to keep about 70-75% in local currency debt for the new bond issuance next year. However, analysts believe that lowering its reliance on foreign funds would be challenging as the local market is not deep enough to absorb the large supply of securities (Bloomberg)

China rating firm banned from assessing bonds for a year (Business Times)

Insolvency drill to benefit banks (Telegraph India)

Puerto Rico creditors say claims at risk in island bank's restructuring (Reuters)

Regulatory Updates

China injects USD 22bn into banking system through loans

Aug 24. The People's Bank of China (PBoC) pumped RMB 149bn into China's banking system in a move to encourage stronger credit flows to companies and local governments. With the Medium-Term Lending Facility (MLF) to provide one-year loans to commercial banks at a rate of 3.3% and reserve repos worth RMB 90bn maturing on Friday, the net MLF loans injection was RMB 59bn. Analysts say the PBoC wants to flatten China's yield curve by increasing short-term rates and supply of long-term cash to enable purchases of longer-term corporate and local government bonds. Furthermore, the official China securities journal reported that China's banking regulator will likely reduce risk weightings for banks holding local government bonds from the current 20% to 0% and thus enabling banks to expand their purchases of such bonds without affecting their capital adequacy ratio. (FT)

Fed issues interim final rule regarding the treatment of certain municipal securities as high-quality liquid assets

Aug 22. U.S. banking regulators are easing liquidity rules on the treatment of certain municipal securities, allowing “investment grade” and “liquid and readily-marketable” municipal securities to be treated as “high quality liquid assets”, similar to cash and U.S. Treasury bonds. Under the change, the municipal securities can be counted toward calculating a bank’s liquidity coverage ratio, and thus would help banks which are heavily invested in municipal debts to meet the liquidity requirements. The regulatory change would take effect immediately once it is published in the Federal Register. (Reuters)

ECB upbeat on strategy to wind down quantitative easing (FT)

PBOC joins forces with Powell to hit the brakes on dollar rally (Bloomberg)

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