

# NPLs in Greece: The make-or-break moment

Yiannis G. Sakkas and Yiannis G. Bazinas report on a crucial matter for Greek banks and the Greek economy as a whole



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**A**lmost a decade after the onset of the European debt crisis, Greece continues to struggle. While the country has managed to address many of its fiscal inconsistencies, the real economy has yet to reap the benefits of stabilisation, recording only a sluggish growth of 1.9% in 2018.<sup>1</sup>

A significant factor accounting for the country's economic stagnation is the high level of non-performing loans (NPLs) in the banking system, which negatively affects the availability of credit, tying up significant bank resources (financial and human) and depriving much needed funds from businesses and entrepreneurs. Furthermore, excessive private debt, combined with high levels of overall taxation, discourages foreign investment and continues to hamper private sector growth. At the same time, reducing private sector debt is a crucial component in Greece's efforts to meet the strict fiscal targets agreed as part of the recent debt package for the country<sup>2</sup>. As a result, dealing with the NPL issue has been elevated to the number one priority in the country's attempt to return to sustainable growth.

Greece does not only hold the sceptre in the NPL rate among EU peers, but it also has the lowest reduction rate.<sup>3</sup> By mid-2018, the four Greek systemic banks had about €36bn of NPLs on their balance sheets, representing 48% of total loans.<sup>4</sup> While these figures suggest that the stock of NPLs has been reduced over the last three years,<sup>5</sup> the NPL ratio continues to remain

high as a result of the absence of new credit. So far, banks have mostly relied on debt write-offs and outright sales of unsecured loan portfolios in reducing their exposures, reserving the use of insolvency and corporate reorganisation tools for the larger and more viable businesses. Nevertheless, as Greek banks and the Single Supervisory Mechanism (SSM) have agreed to dispose €50bn of problematic loans from their balance sheets until the end of 2021, it is evident that a more aggressive approach, which includes the bulk transfer of NPLs, will be required.

## Off-balance sheet schemes

In general, the main aim of off-balance sheet schemes, broadly termed Impaired Asset Measures (IAM),<sup>6</sup> is to remove troubled assets from the banks' balance sheets and thereby increase the quality of the bank's regulatory capital.

At the same time, the disposal of impaired assets can relieve banks from the logistical burden of managing NPL resolution, allowing them to refocus on their funding functions. The exact form of these schemes may vary widely, ranging from the establishment of centralised Asset Management Companies (AMCs), as in the case of NAMA in Ireland and SAREB in Spain, to securitisation techniques (with or without state involvement), such as the Italian GACS framework. In the case of Greece, an off-balance sheet scheme would reinforce market confidence on the stability of the banking system and provide a signal to markets that the country

has finally turned the corner. In that regard, while the establishment of a centralised AMC has long been considered, the upfront cost of such a scheme, combined with state aid considerations, have discouraged this initiative and have shifted the focus to alternative measures.

The main proposals that are currently on the table envisage the use of 'special-purpose vehicles' (SPVs) to achieve the securitisation of problematic assets and thus the transfer of credit risk to private investors. In particular, a proposal submitted by the Hellenic Financial Stability Fund (HFSF) is based on the adoption of the Italian GACS model. This scheme would involve the transfer of €15bn of NPLs, at market rates, to a centralised SPV. The SPV would finance this acquisition by issuing bonds in the amount of €7bn (considering that the average coverage ratio of NPLs is 50%), with the Greek government guaranteeing the senior tranche on market terms, in order to avoid any state aid implications.

This scheme would allow the banks to retain the senior tranche, thereby maintaining an exposure to the underlying assets (which are mostly collateralised business loans and residential mortgages), while the mezzanine tranche would be offered to private investors. This solution has the benefit of complying with EU state aid restrictions, thereby avoiding any complication with the country's program of fiscal consolidation. Eventually however, the success of the scheme will depend on the commercial attractiveness of the

mezzanine bonds. The pricing of the guarantee is also a significant issue, since calculating the applicable fees based on sovereign 'credit default swap' (CDS) spreads<sup>7</sup> would greatly increase the cost of the state guarantee and render the scheme non-viable.

An alternative proposal by the Bank of Greece envisages the establishment of a centralised SPV and the transfer of €40bn of NPLs along with about €7bn of Deferred Tax Credits (DTC) by the Greek banks. DTC currently constitutes part of the banks' regulatory capital<sup>8</sup> and would serve as the SPV's equity and absorb any losses resulting from the difference between the market value of NPLs, and their current net book value (including loss provisions).

The SPV would also issue bonds to finance the acquisition, with the four systemic banks and the government subscribing to the lower class and private investors receiving the senior and mezzanine tranches. This constitutes a more radical approach and aims, not only at reducing NPLs but also at improving the quality of bank assets by reducing the share of DTC in regulatory capital. Nevertheless, the feasibility of DTC conversion remains to be clarified, while the EU Commission's approval will be required due to state aid considerations. More importantly however, the sheer amount of transferred assets is likely to expose the banks to significant losses; it is expected banks will need an additional €7bn in capital injections upon completion of this plan, echoing fears of a bail-in with the participation of depositors.

### The moment of truth

It is evident that the envisaged schemes would be a significant step towards a drastic resolution of Greece's NPL problem and would provide certainty as regards the medium term prospects of the Greek banking system. These securitisation measures would assist in overcoming coordination

problems<sup>9</sup> and also allow banks to retain some exposure to the underlying collateral, thereby benefiting from a potential upside in the price of real estate. However, these solutions are front-loaded and thus threaten to expose the Greek banking system to additional capital needs.

On the one hand, the Greek banking system's model would have a clear and immediate adverse impact on capital adequacy, while on the other hand investors remain wary about the asset-guarantee scheme and the commercial attractiveness of the SPV's bonds. In general, there is widespread uncertainty regarding the impact of these schemes on the capital adequacy and the ability of the Greek banks to fund them. The cost of this uncertainty is being reflected on the market performance of bank shares that have lost over 50% of their value in the last six months,<sup>10</sup> as important market players seem to suggest that more funds will be required, a development that is sure to cause significant dilution of existing shareholders.

Since the announcement of these plans, one of the four systemic banks, Eurobank, has rejected them and presented its own independent plan to deal with NPLs.<sup>11</sup> This suggests that, even within the banking community, there is considerable doubt as to the viability of a centralised impaired asset scheme. At the same time, banks are likely to face additional pressure, as the government is planning to introduce a new consumer insolvency law,<sup>12</sup> which would apply to consumers with debts less than €120,000, and provide insolvency protection to their assets, especially primary residence, up to €200,000 in value. The significant value of real property that the law would shield from enforcement could encourage a new wave of strategic defaulters, putting additional pressure on the banks' balance sheets. It therefore seems that time is running out and that Greek banks will finally have to face their "make or break" moment. ■



#### Footnotes:

- 1 Based on estimates by the Hellenic Statistical Authority (ELSTAT)
- 2 Y. G. Sakkas, Y. G. Bazinas, *Greek debt deal: Breakthrough or ball and chain?* Eurofenix, Autumn 2018.
- 3 European Central Bank data
- 4 Bank of Greece data
- 5 Since 2016, when NPLs amounted to €100bn, see BoG data
- 6 EC Staff Working Document. AMC Blueprint accompanying the Second Progress Report on the Reduction of Non-Performing Loans in Europe, 14.3.2018
- 7 Deloitte, "Italian non-performing loans-State guarantee and securitisation scheme... Unlocking the NPL log-kam?", 2016 available at [www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-italian-nonperforming-loans.pdf](http://www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-italian-nonperforming-loans.pdf)
- 8 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.
- 9 Alexander Lehmann, "After the ESM: Options for Greek bank restructuring", Bruegel Blog Post, January 2019
- 10 Athens Stock Exchange data
- 11 Eurobank decided to merge with a subsidiary Real Estate Investment Company (Grivalia Properties), in order to strengthen its regulatory capital and adopt a more proactive resolution approach to NPL resolution. In this context, the bank aims to adopt a scheme that would involve a securitisation of €9bn of collateralised NPLs in a specialised SPV, in an effort to reduce its NPL ratio to single digits by 2021. See [www.bloomberg.com/news/articles/2018-11-26/eurobank-grivalia-properties-to-merge-securitize-npes](http://www.bloomberg.com/news/articles/2018-11-26/eurobank-grivalia-properties-to-merge-securitize-npes)
- 12 The pre-existing consumer insolvency legislation was envisaged as an emergency measure and the protection provided to consumers' assets expired in 2018.



THE ENVISAGED SCHEMES WOULD BE A SIGNIFICANT STEP TOWARDS A DRASTIC RESOLUTION OF GREECE'S NPL PROBLEM

