Third Greek Bank Recapitalisation

Only First Step Towards Restoring Financial Stability

Special Report

Ratings

	Long-Term IDR	Viability Rating
National Bank of Greece S.A.	RD	f
Piraeus Bank S.A.	RD	f
Eurobank Ergasias S.A.	RD	f
Alpha Bank AE	RD	f

Source: Fitch

Related Research

Recapitalising Greek Banks (July 2015)

Fitch: Greek Banks to Test BRRD's Discretionary Powers (September 2015)

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Recap Necessary Step: The recapitalisation of Greek banks after the European Central Bank's Comprehensive Assessment (CA) is a necessary step towards re-establishing the banking system's viability and restoring financial stability. If the banks' remedial actions are approved, they will address an identified capital shortfall of EUR14.4bn to cover problem assets and enhance loss-absorption buffers against the still highly challenging operating environment.

The aggregate capital improvement represents around 8% of Greece's GDP and will increase the banks pro forma common equity Tier 1 (CET1) ratios to an average of 14.8%. The capital injections will also improve banks' liquidity, particularly if they result in the reinstatement of the waiver allowing the ECB to accept Greek collateral for monetary policy operations.

A Long Road Ahead: However, this is the third recapitalisation since 2013 and alone is not enough to restore financial stability in Greece. The banking sector needs to regain customer confidence – having lost roughly EUR116bn private-sector deposits in six years (EUR43bn in the last 12 months) and built up vast non-performing exposures (NPE) – before capital controls can be lifted and, at least some, deposits can return to the system. At end-1H15 the banks' gross loans/deposits ratios ranged from 143% at NBG to 189% at Alpha Bank.

Vast NPEs: The Greek banks have exceptionally large volumes of problem loans that account for roughly 63% of the country's GDP and are high relative to their capital bases. Forthcoming legislative changes to improve Greece's insolvency framework may facilitate foreclosures and restructurings, but we believe any material improvement in asset quality will only arise in the medium term. Until then, the sector's viability will remain feeble.

CA Results Unsurprising: We believe the assumptions under the baseline and adverse scenarios are broadly reasonable, and the resulting capital needs do not deviate substantially from our preliminary estimates (see *Recapitalising Greek Banks* under *Related Research*) despite differences in approach and assumptions. The updated asset quality review (AQR) captures additional deterioration resulting from the weakened economy in Greece, while the stress test defines additional loss-absorption buffers the banks need to withstand shocks.

Precautionary Recapitalisation Instead of Resolution: The banks intend to cover at least the capital shortfalls under the baseline scenario through a combination of liability management exercises (LME), asset sales, equity issuances and other measures. However, the Hellenic Financial Stability Fund (HFSF) may also participate to address the gap to the shortfall in the adverse scenario, if any, through a combination of equity and coco injections.

In this case, HFSF's injections may be able to be treated as a precautionary recapitalisation under the Bank Recovery and Resolution Directive (BRRD) rather than as a resolution action, avoiding the need for the authorities to bail in 8% of liabilities and own funds.

Senior Debt Bail-in Problematic: Fitch believes certain senior and subordinated creditors will absorb losses via LMEs. However, any subsequent bail-in of privately held senior bonds (either under the November 2015 recapitalisation legislation or under the BRRD) to help cover the gap could be problematic and could expose the authorities to compensation claims.

DTA Conversion Postponed: The conversion of EUR12.8bn deferred tax assets (DTAs) held by banks at end-2014 into tax credits has been postponed until 2016, potentially preserving the incentive for private investors to participate in the recapitalisation.

Recapitalisation Necessary but Structural Problems Unaddressed

Positive Impacts on Capitalisation and Liquidity

Improvement in Solvency

Greek banks' solvency came under severe stress following the deterioration of their asset quality due to the political uncertainty in the country since December 2014. Reinforced solvency is therefore essential to support restoration of confidence. The recapitalisation of the banking sector will total EUR14.4bn, representing roughly 56% of the four banks' pre-CA CET1 base and 8.1% of the country's GDP, and will strengthen the banks' loss-absorption buffers. The pro forma CET1 ratios for the Greek banks could range between 14.1% for Eurobank and 15.6% for NBG.

Positive Impact on Liquidity

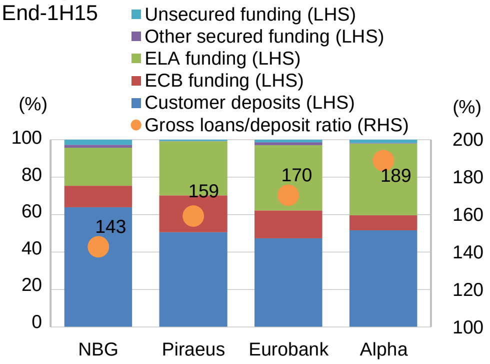
The sales of assets and capital injections in the form of cash or highly rated bonds will have a positive impact on banks' liquidity positions. Assuming the banks' recapitalisation plans are approved and completed, we calculate the four banks could increase liquidity buffers by EUR10bn-12bn.

At the same time, the baseline scenario assumes that the ECB will restore the waiver on accepting Greek collateral for monetary policy operations in 2016. Should this happen, the banks' available ECB-eligible collateral would increase as Greek government bonds, treasury bills and some covered bonds could become eligible for the Medium-Term Refinancing Operation programme. This way the banks would be able to replace a portion of their Emergency Liquidity Assistance funding with that from the ECB.

Figure 1

Four Largest Greek Banks: Funding Composition and LTD

End-1H15

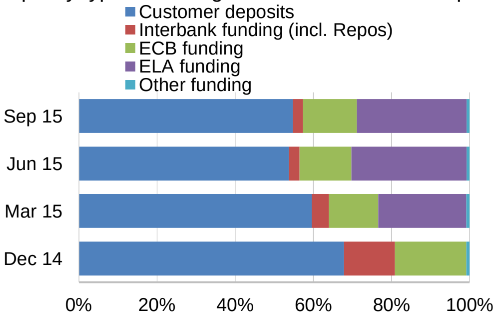


Source: Banks, Fitch

Figure 2

Greek Banking System: Funding Mix Evolution

Split by type of funding between Dec 14 and Sep 15



Note: Sep 15 estimated by Fitch
Source: Bank of Greece, Fitch

Funding Imbalances and Asset-Quality Problems Remain

High Eurosystem Funding Reliance

Despite the positive liquidity impact from capital inflows, we expect the banks to continue to tap Emergency Liquidity Assistance in the short term, and their overall reliance on Eurosystem funding will remain high at around 40% of total funding. At end-1H15 the banks' gross loans/deposit ratios ranged from 143% at NBG to 189% at Alpha Bank, indicating that funding imbalances are material. Debt capital markets are closed for Greek banks and the LME in itself will not help them issue unsecured instruments in the near term.

Deposits Still Sensitive to Politics

The Greek banking sector has lost almost EUR116bn private-sector deposits since end-September 2009. The largest outflows were in periods of political tension or in the context of elections. For example, in May and June 2012 the system lost roughly 9.3% (EUR15bn) of total deposits amid parliamentary elections. More recently, the protracted negotiations for a third Greek bail-out programme following the January 2015 elections resulted in EUR43bn deposit outflows (26% of the total since end-November 2014).

Related Criteria

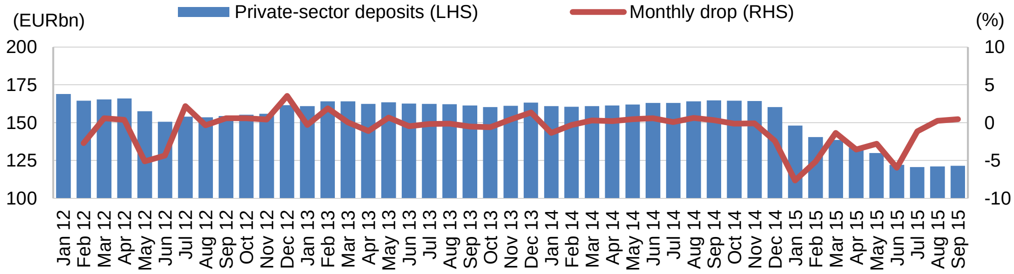
Global Bank Rating Criteria (March 2015)

The imposition of restrictions on deposit withdrawals on 29 June 2015 has prevented further outflows. Deposit levels have stabilised, in part reflecting the announcement of the agreement between the Greek government and its creditors in August 2015. However, customer behaviour remains highly sensitive to political developments. We believe increased tension between Greece and its creditors about the implementation of the bailout programme could result in increased risk of Greece exiting the eurozone, which would lead to additional deposit volatility.

Figure 3

Greek Banking System: Monthly Evolution of Domestic Private-Sector Deposits

Domestic private-sector deposits

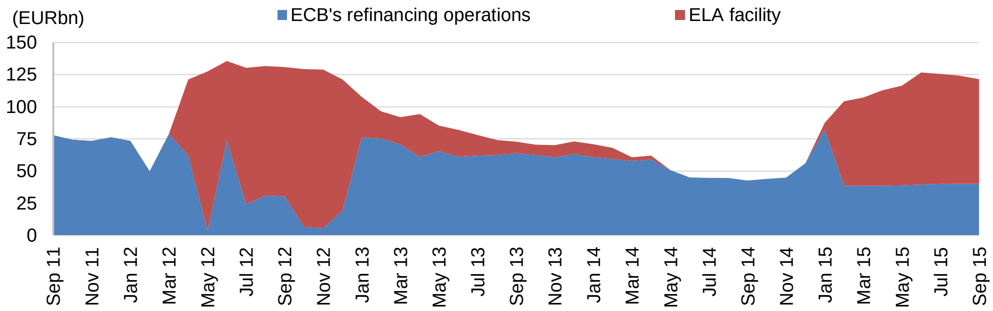


Source: Bank of Greece, Fitch

Figure 4

Greek Banking System: Central Bank Borrowings

Split into ECB and ELA between Sep 11 and Sep 15



Source: Bank of Greece, Fitch

Still Too Early to Lift Controls

The precedents of other European countries that have imposed capital controls in recent years suggest time is needed for the system to rebuild customer confidence before they can be lifted without jeopardising financial stability. Cyprus imposed capital controls in March 2013; the restrictions on deposit withdrawals lasted 14 months and the external capital controls remained in place until April 2015. Iceland imposed capital controls in 2008 and has not yet lifted them.

Greece's case is different because the capital controls only affect bank deposit withdrawals and not capital outflows from the country, as in Cyprus and Iceland, but we believe it may take a long period of political stability for Greek households to reintroduce their savings into the system. The increase in banknotes in circulation and other data provided by the banks suggest that a large portion of the total deposit outflows for the sector since November 2014, which we estimate at roughly EUR30bn, remain in the country in the form of cash and other instruments. However, customers' confidence needs to be restored and capital controls lifted before these savings return to the banking system.

Managing NPEs Challenging

Several years of deep recession and the increased political uncertainty since December 2014 have significantly eroded Greek banks' asset quality. Following the AQR, NPEs for the four large banks total EUR112bn, accounting for 63% of GDP. NPEs ranged between 42% of total loans for Eurobank and 52% for Piraeus at end-1H15 (see Figure 5). Coverage has improved but remains relatively low considering the continued decline in collateral values at 53% or less.

Figure 5

Asset Quality and Capitalisation After Recapitalisation

End-1H15	NBG	Piraeus[2]	Eurobank	Alpha[2]
Non-performing exposures (EURbn)	20.8	38.2	22.0	31.0
NPE ratio (%)	45.4	51.8	41.7	50.0
NPE reserve coverage ratio (%)	53.1	44.0	53.3	49.0
Unreserved NPEs (EURbn)	9.8	21.4	10.3	15.8
CET1 pro forma[1] post-recap (EURbn)	9.8	8.1	5.5	7.9
CET1 ratio pro forma[1] post-recap (%)	15.6	14.7	14.1	15.0
Unreserved NPEs/ CET1 pro forma post recap (%)	99.5	265.3	187.1	200.1

[1] Pro forma adding recapitalisation in the adverse scenario to the post-AQR CET1 base.
[2] NPEs and reserve coverages as of end-September 2015.
Source: Banks, ECB, Fitch

Reducing problem loans remains the primary challenge for Greek banks. The prospective reform to the country's insolvency framework could facilitate foreclosures and accelerate restructurings, helping recoveries, potentially via forbearance. However, we expect material improvements to asset quality to come through only in the medium term and until this happens the sector's viability will remain feeble.

We expect the exceptionally large volumes of unreserved NPEs to still account for a high proportion of the banks' CET1 bases even after the recapitalisation is completed (see Figure 5). This reflects the continued vulnerability of the banks' solvency to additional asset-quality shocks in the context of a still very weak operating environment with high unemployment and private indebtedness, and muted prospects for the domestic property sector.

Credible Comprehensive Assessment

Results Broadly in Line with Expectations

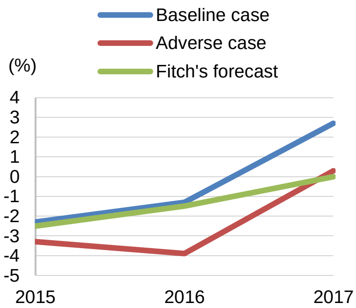
The 2015 CA on Greek banks showed an aggregate capital shortfall of EUR4.4bn in the baseline scenario and EUR14.4bn in the adverse scenario. The exercise consisted of an AQR and a stress test. Although based on a different approach and assumptions, our initial estimates of the capital needs for Greek banks are broadly in line with the outcome of this exercise (see *Recapitalising Greek Banks*).

AQR Adjustments Capture Weaker Fundamentals

Greek banks were also subject to an AQR in October 2014, based on end-2013 data, but the economic environment in Greece has deteriorated sharply since December 2014. The updated AQR is based on 1H15 data and reflects adjustments to Greek banks' NPE, as defined by the European Banking Authority, and reserve coverage with an aggregate capital impact of EUR9.2bn.

Figure 6

Real GDP Growth Assumptions



Source: ECB, Fitch

Macroeconomic Assumptions Reasonable

The baseline scenario reflects the forecast considered under Greece's official economic adjustment programme, while in the adverse scenario some of the risks to which the Greek and the world economy are exposed materialise. Fitch's expectations for the Greek economy fall within the range of assumptions in both scenarios. The main difference between the baseline scenario and the Fitch forecast is 2017 GDP growth, where the agency forecasts an anaemic 0.5% real GDP growth, against the baseline scenario's 2.7%.

The adverse scenario is a significant shock to the baseline, although it does not capture the economic dislocations that would arise from a "Grexit" from the eurozone. However, we consider there would be little point in attempting to capitalise the banks to withstand this.

Broad Differences between Banks

Piraeus and National Bank of Greece (NBG) had the largest capital needs under both scenarios (see Figure 7). Piraeus has been highly acquisitive in the past four years, integrating the credit portfolios of several failed banks. Fitch considers it plausible that the bank had the largest capital impact from the AQR due to the relatively weaker underwriting standards of these acquired books: these may have caused its asset quality to deteriorate more than peers' since the 2014 AQR.

NBG suffered the largest capital depletion among all four banks under the adverse scenario, which relative to the baseline stressed its international operations further and required larger impairments on its Greek sovereign exposure. Alpha Bank had the lowest adjustment in the AQR and Eurobank remained the most resilient in the adverse scenario, probably helped by its relatively more resilient mortgage book.

The Recapitalisation Process

Short Timeline

Greek banks submitted their recapitalisation plans on 6 November 2015. These involve LME, sales of assets and subsidiaries, rights offerings to private investors, other mitigating factors and capital injections from the HFSF. The recapitalisation plans will then have to be approved by the authorities and are likely to be executed by end-2015.

Precautionary Recapitalisation Treatment

Fitch believes that as long as the banks cover at least the baseline shortfalls by their own means, HFSF's capital injections may be able to be treated as a precautionary recapitalisation under BRRD as all four banks reported AQR-adjusted capital ratios above the minimum requirement – Piraeus Bank the lowest with a CET1 ratio of 5.5%. A precautionary recapitalisation must meet two major conditions: the shortfall must be identified by a stress test and the public investment must be of a 'precautionary and temporary' nature.

Figure 7

Greek Banks Summary CA Results and Recapitalisation Plans

	Capital shortfall (EURm)		
	Baseline	**Adverse**	**Preliminary recapitalisation plan**
National Bank of Greece (NBG)	1,576	4,602	**Baseline shortfall** + about EUR1.6bn: Share capital increase. **Adverse shortfall** + about EUR0.7bn: LME or mandatory conversion of senior bonds. + about EUR0.3bn: LME or mandatory conversion of hybrid bonds. The outstanding EUR1.4bn state preference shares (maturing in 2017) will also be converted into common equity, although this would not mitigate the shortfall as these instruments are already considered CET1. + about EUR0.5bn: Capital injection from the HFSF. + about EUR1.5bn: Cocos from the HFSF. However, NBG plans to sell its full stake in Finansbank, its Turkish subsidiary, and expects to be in a position to repay the cocos once the sale has been completed. Depending on the terms of the transaction the bank may be able to more than offset the impact from the repayment of the EUR1.5bn cocos.
Piraeus Bank	2,213	4,933	**Baseline shortfall** + about EUR0.2bn: LME or mandatory conversion of junior bonds. + about EUR0.4bn: LME or mandatory conversion of senior bonds. + about EUR0.2bn: Asset disposals, including subsidiaries in Egypt and an insurance company in Greece. + about EUR0.2bn: Combination of the increased available for sale revaluation reserve, reduced credit valuation adjustment and 3Q15 operating results exceeding preliminary CA estimates. + about EUR0.5bn: increased DTA allowance in CET1 due to the overall capital increase. + about EUR0.7bn: Share capital increase focusing on at least covering the rest of the shortfall in the baseline scenario. **Adverse shortfall** + about EUR2.7bn: Common equity and cocos from the HFSF to cover the gap to the adverse shortfall.
Eurobank	339	2,122	**Baseline and Adverse shortfall** + about EUR2.1bn: Share capital increase to cover the adverse shortfall. This may include the share allocation to the outstanding senior and junior bondholders that accept the tender offer under the LME (maximum of EUR877m). • The bank does not plan to repay outstanding EUR1bn state preference shares (maturing in 2017) still considered CET1 with the proceeds of the share capital increase.
Alpha Bank	263	2,744	• Recapitalisation plan has not been announced.

Source: Banks, Fitch

Treatment of the capital injections as a precautionary recapitalisation instead of a resolution is likely to avoid the requirement to bail in 8% of liabilities and own funds. The Greek implementation of the BRRD in July 2015 opted to defer the introduction of the BRRD bail-in tool until January 2016. However, the new November 2015 bank recapitalisation framework in Greece establishes that for any bank to receive state support its junior and senior bonds may be subject to burden sharing. Moreover the EU Commission’s 2013 state aid rules also require burden sharing for junior debt. Consequently, all four banks have launched LMEs.

Under Greece’s economic adjustment programme the HFSF has EUR25bn available to recapitalise Greek banks. It can support banks by injecting either common equity (the first 25%) or convertible bonds (cocos; the remaining 75%). The latter are perpetual subordinated bonds that automatically convert into equity should a bank’s regulatory CET1 ratio fall below 7%. The cocos will also be converted into equity if the bank misses two coupon payments or at the HFSF’s discretion after 2022. The use of cocos to recapitalise some of the Greek banks may provide incentives to private investors to participate in the capital increases, as these instruments do not grant voting rights to the HFSF. However, the cocos are costly for the banks as they will carry a 8% cumulative coupon rate.

Senior Bondholders’ Burden Sharing

The Eurogroup’s statement in August 2015 explicitly mentioned the possibility of including senior creditors in the burden-sharing process and the new Greek bank recapitalisation framework considers the bail-in of these instruments if a bank is to receive HFSF’s support to address the gap from the baseline to the adverse shortfall. However, bailing in senior bondholders may expose the authorities to compensation claims under the "no creditor worse off than in liquidation" safeguard as contractually these creditors rank pari passu with other senior creditors, notably non-preferred depositors.

DTA Conversion Postponed to 2016

Under the new legislation the banks will not be able to recognise further deferred tax credit-eligible DTAs from July 2015. The CA therefore does not allow any capital benefit from the projected generation of new DTAs as a result of stressed losses.

At end-2014 Greek banks held EUR12.8bn DTAs eligible for conversion into tax credits and therefore included in the regulatory capital ratios. In Greece, DTAs convert into tax credits if the banks report net losses in a given fiscal year. The proportion of eligible DTAs to be converted is equivalent to the proportion of the net losses compared to the CET1. The conversion of DTAs into tax credits also gives the Greek state the right to obtain common shares of the bank worth 110% of the tax credit value.

Initially the conversion of DTAs into deferred tax credits was envisaged for 2015. However, the application of the conversion rule has been postponed until 2016. We believe this measure helps preserve the incentive for private investors to participate in the Greek banks equity-raising because the losses related to the AQR provisions could have triggered the conversion in 2015.