Social Europe

ECB, Greece And The Ticking NPL Time-Bomb

by Marcello Minenna on 22 November 2017

After the ECB regulatory tightening on banks' *non-performing loans (NPLs)*, announced with the well-known "*addendum*" to its guidance to banks of October 5, a barrage of anger came from the Italian banks and institutions (even the Minister of Economy Pier Carlo Padoan and the Bank of Italy took a stand) to defend the threatened stability of the Italian banking system.

At first, Daniele Nouy, chair of the SSM Supervisory Board, answered Padoan's objections by hoping for an immediate implementation of the new rules as the Eurogroup broadly backed them. So far, the Law Office of the European Parliament seems to have ruled out the competence of the ECB to regulate banks in such a binding manner, giving space to a predictable delay of its entry into force well after the suggested date of January 1.

Given the clash between Italy and the ECB, it seems surprising that from Athens and other southern European capitals the only response has been a deafening silence – or even louder!. Yet the Greek banking system remains the most exposed to the NPL problem: in June there were still outstanding bad loans of €72.4 billion (gross) on Greek banks' balance sheets, only marginally decreasing from the peak of €79bn registered at the beginning of 2016 or 35% of the total loans.

The enforced disposal of the NPL stock, which is envisaged for the Greek banks over the next two years, is causing tremors. According to the ambitious roadmap agreed with Brussels, Athens should reduce its NPL stock by €12bn (16.5%) in 2018 and €13bn in 2019 (21%), mainly through an accelerated fire-sale on the market together with wide use of extensions and restructuring.

The monitoring of ECB banking supervisors over Greek banks has been unsurprisingly tight, with a set of control variables, quarterly reports and the threat of drastic "corrective measures". To date, the Greek banking system has managed to meet its targets by reducing the NPL stock by €7bn, but the acceleration due to be imposed in 2018 will be a different order of magnitude.

Added insecurity

But it does not end there. The situation for banks is far worse than the figures sketched in the reduction program would suggest, despite the good reserves coverage rate (47%, not far from 50% shown by Italy's banks). There are hidden pitfalls that the ECB's *addendum* will burst into the open.

For sure, one problem appears to be unavoidable: more than half of the Greek NPL stock consists of *unsecured* (i.e. unguaranteed) loans to manufacturing enterprises active on domestic markets that were pretty uncompetitive at the beginning of the crisis and which went then bust during the ensuing six-year economic depression.

This is an unfortunate circumstance that implies NPL expected recovery rates close to zero and very poor ratings by specialized operators. To understand the scale: in Italy 41% of the bad debt is linked to the construction sector, where mortgage clauses enable one (almost) always to obtain an acceptable recovery rate, while only 22% involves lending to the manufacturing sector.

According to ECB provisions, 100% of new unsecured NPLs will have to be covered with fresh capital within two years. Without any real recovery in the economy (Greece should reach at best 0.8% GDP growth for 2017), the rate of creating new NPLs would remain very high: 10% of the total loans, that is about €3bn a year, is likely for the three-year period 2017-2019. In Italy, we stand at a more normal 2.3%.

In one way or another, within 2019 the banking system in Athens will have to find not only the €25bn needed to clean out over 30% of the pre-existing NPL stock from balance-sheets, but another €10bn related to the new ECB regulation. In total, over €35bn of additional liquidity.

Of course, even on *secured* positions the fact that the Greek judicial system moves at the slowest pace in Europe does not help. From European Banking Authority data, it can be inferred that 1580 days are necessary to resolve a trivial commercial dispute by obtaining a first order judgment against thedocility –already too many -1120 days needed in Italy and the 395 days required in France.

Syriza sweats

The disposal of NPLs by Greek banks is transforming a difficult mission into an impossible one. Further ECB regulation that would also impact the NPL stock, (expected by some ECB officials for spring 2018), could prove fatal. For sure, in May 2018 a special stress test devoted exclusively to the revaluation of the capital adequacy of Greek banks is already planned.

The nightmare for Tsipras and the Bank of Greece would be having to cope with a further round of forced recapitalizations after those of 2012, 2013 and 2015, just as Athens should be facing the end of the bail-out program with a sudden stop in the flux of loans coming from Brussels. This threat could explain the submissiveness of the Greek government and institutions in the face of ECB’s regulation tightening. Certainly, it is hard to imagine that private investors, especially foreign ones, would be interested in such a financial nightmare characterized by the highest risk and very low profitability.

A new financial storm is hence approaching Greece. On the horizon, I see a predictable outcome: an European Stability Mechanism intervention *in prorogatio* to further recapitalize the banking system and continue with the NPL disposal program.

Of course, I could imagine there will be other heavy “structural reforms” to be implemented for the good of the Greek economy, *ça va sans dire*. A blind alley that will furtherly weaken the faith of Greek citizens in the Euro and the European Union, already at the historical low as more than half of all Greeks agree it was a mistake ever to have joined the Eurozone.

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