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The Credit Impact Of A Grexit

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The Credit Impact Of A Grexit

On June 29, 2015, Standard & Poor's Ratings Services lowered its long-term rating on Greece to 'CCC-' from 'CCC' and assigned a negative outlook. We now believe the probability that Greece will exit the eurozone has increased to about 50%, following the Greek government's decision over the weekend to reject official creditors' loan proposals and instead schedule a national referendum on whether to accept the terms of the proposals (see "Greece Long-Term Ratings Lowered To 'CCC-'; Outlook Negative").

We would expect that a distressed Grexit from the European single currency would have severe consequences for the Greek economy, its banks, and nonfinancial companies. Greece would permanently lose access to financing from the European Central Bank (ECB), which, in our opinion, would create a serious foreign currency shortage for the private and public sectors. Without the Eurosystem's support—which, according to our estimates, currently exceeds 70% of GDP--Greece's payment system would shut down and its banks would not be able to operate. The value of euro-denominated public- and private-sector debt, as measured in the new currency, would increase as it depreciated against the euro, thereby exacerbating the situation.

Impact Of A Grexit: An Overview

Eurozone economies. We believe the economic impact of a Grexit on the rest of the eurozone would be somewhat contained. Nonetheless, it could potentially initially hurt the capital markets, causing an initial spike in yields, especially for those economies on the periphery perceived by the markets as fiscally more vulnerable.

Eurozone sovereign creditworthiness. A Grexit may not immediately have a negative rating impact for other eurozone sovereigns because of the more robust financial support architecture in place today in the Eurozone, as well as the marked reduction of financial linkages between Greece and the rest of the eurozone (see "Greece In Crisis: Frequently Asked Questions," June 30, 2015).

Greek and foreign banks and insurers. A Grexit would worsen an already desperate situation for the Greek banks (see: "Ratings On Four Greek Banks Lowered To 'SD' Following Restrictions Imposed On Deposits," June 30). However, the impact on foreign banks and insurers would be limited and would unlikely lead to rating actions, because these institutions have already limited their direct exposures against Greek entities (see "This Time, Foreign Banks Have Less To Fear About A "Grexit," March 10, 2015.)

Greek nonfinancial corporations. Although Greece-based corporates have reduced their exposure to Greece in recent years, the now substantially greater probability of a Grexit increases the credit risks of companies we rate. On July 1, 2015, we downgraded Greek companies with country risk exposure to the Greek economy (see "Greek Corporations Ellaktor, Public Power Corp., And OTE Long-Term Ratings Lowered Following Similar Action On Sovereign").

Greek structured finance transactions. We would expect a Grexit to have a severe impact on the creditworthiness of the 18 tranches that we currently rate on seven securitizations backed by Greek collateral. Nevertheless, these securitizations amount to only 0.3% of our outstanding European structured finance ratings universe by number of ratings.

All of the above leads us to believe that the financial contagion risk of a Grexit should be containable. As we have

repeatedly stated, the current situation is markedly different than in 2012, when a Grexit first became a live concern. Other eurozone members (periphery included) are now stronger, both economically and structurally, and the European Central Bank (ECB) has fully embarked on a substantial quantitative easing (QE) program.

The initial market reaction to Greece's default to the International Monetary Fund (IMF) and the lapse of its EU adjustment program appear to support this view.

Nonetheless, should Greece exit the single currency, the permanence of the monetary union will have been proved false, and this could throw into question assumptions underpinning more than two decades of political and economic policy. This could trigger longer-term consequences that are difficult to foresee. Markets could raise doubts about the institutional arrangements in Europe, the role of the official creditors, and the effectiveness of EU monitoring and enforcement of financial support programs. The environment could become less predictable, legal disputes could proliferate, and the fundamental commitment to the single currency could be called into question, exacerbating an already fragile economic situation in the region.

At the political level, a Grexit could fundamentally reinforce doubts about the commitment to strengthen the entire architecture underpinning the union. Although we think that anti-EU protest parties will likely lose ground after seeing the social and economic costs in Greece associated with a potential Grexit, this may not be the case. Electorates may instead react negatively if they believe that European leaders are not properly representing their views by pushing for a closer political union. The risk of Britain leaving the EU could take on even greater significance.

We therefore believe a Grexit would be such a unique event that we cannot discount a scenario that could bring severe contagion and long-term damage to political cohesiveness. This could lead to renewed financial fragmentation in the region, with negative implications for borrowers' creditworthiness in and outside Europe.

The Economic Impact Would Be Severe For Greece, Less So For The Rest Of The Eurozone

The overall economic impact of a Grexit would be severe for Greece but more contained for the rest of the eurozone, in our view, based on a simulation by Standard & Poor's and Oxford Economics. According to this study, real GDP in Greece would fall 20% below the baseline after four years. For the rest of the eurozone, the impact would be contained in terms of economic growth but potentially more meaningful via the capital markets channel on peripheral countries.

In early March of this year, we used Oxford Economics to try and quantify the possible macroeconomic impact of Greece leaving the European Economic and Monetary Union (EMU). At the time, we used a baseline forecast for Europe as a reference point that was slightly less positive on eurozone growth than our current forecast. In particular, we did not yet have the full details on actual Q1 growth or on the market reactions (very positive) to the introduction of a fully fledged QE program by the ECB. Nevertheless, the results summarized below offer a good estimate.

The key assumptions in our March 2015 Grexit scenario were:

- Greece exits the eurozone on July 1, 2015. It becomes increasingly clear that a long-term agreement cannot be reached on what will succeed the bridging agreement, which expires end-June. It therefore becomes politically

more attractive for the Greek government to withdraw from the eurozone.

- Greece switches back to the drachma (GDR). Markets push the drachma down from its pre-conversion rate of GDR340/€1 to GDR540/€1 in Q4 2015. Over the following few quarters, there is a partial rebound to GDR440/€1, an overall drop of about 30%.
- Greece defaults and cuts its government debt from €314 billion to €164 billion. Remaining eurozone members "make good" the ECB's losses, raising their own debt.
- However, a massive confidence shock hits the Greek economy, equivalent to four times the impact on Greece from the Lehman fallout, which adversely impacts investment spending.
- Grexit prompts the ECB to respond aggressively by frontloading its QE in the quarters immediately following the event.

Simulated impact on the Greek economy

The simulation suggests that the immediate impact of an exit would be very significant. The banking sector would be very adversely affected, resulting in a sharp tightening in lending conditions. Furthermore, many corporates with debt that is denominated in euros would find themselves facing a sharp increase in their debt burden. As a result, in the two years following an exit, Greek GDP plunges by 25% (see charts 1 and 2).

Chart 1

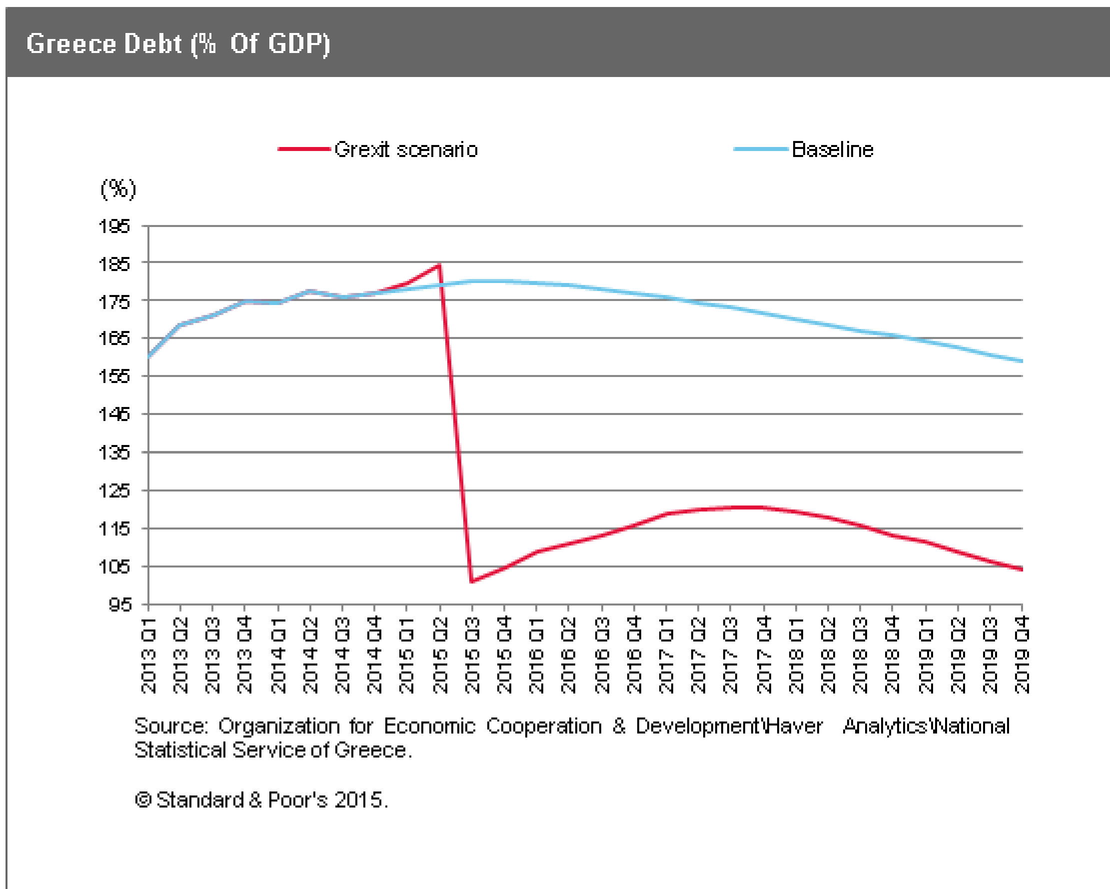
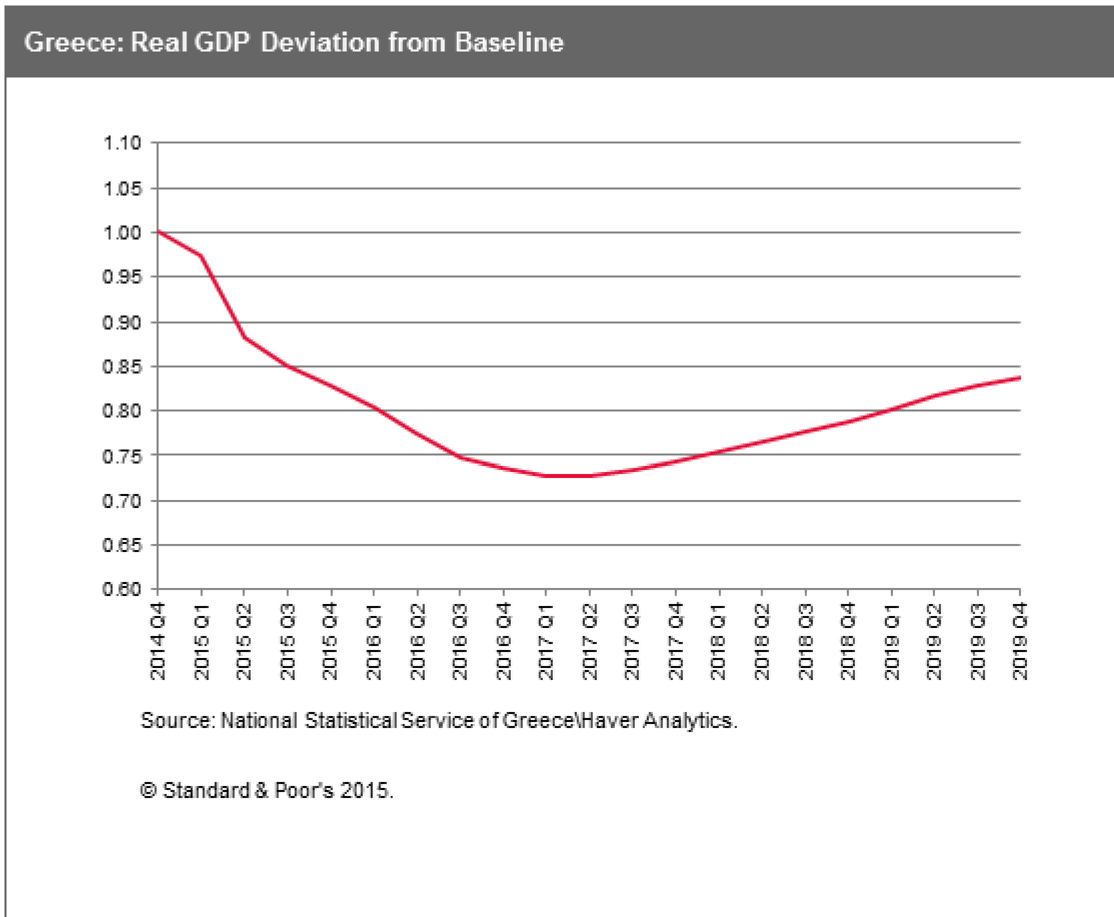
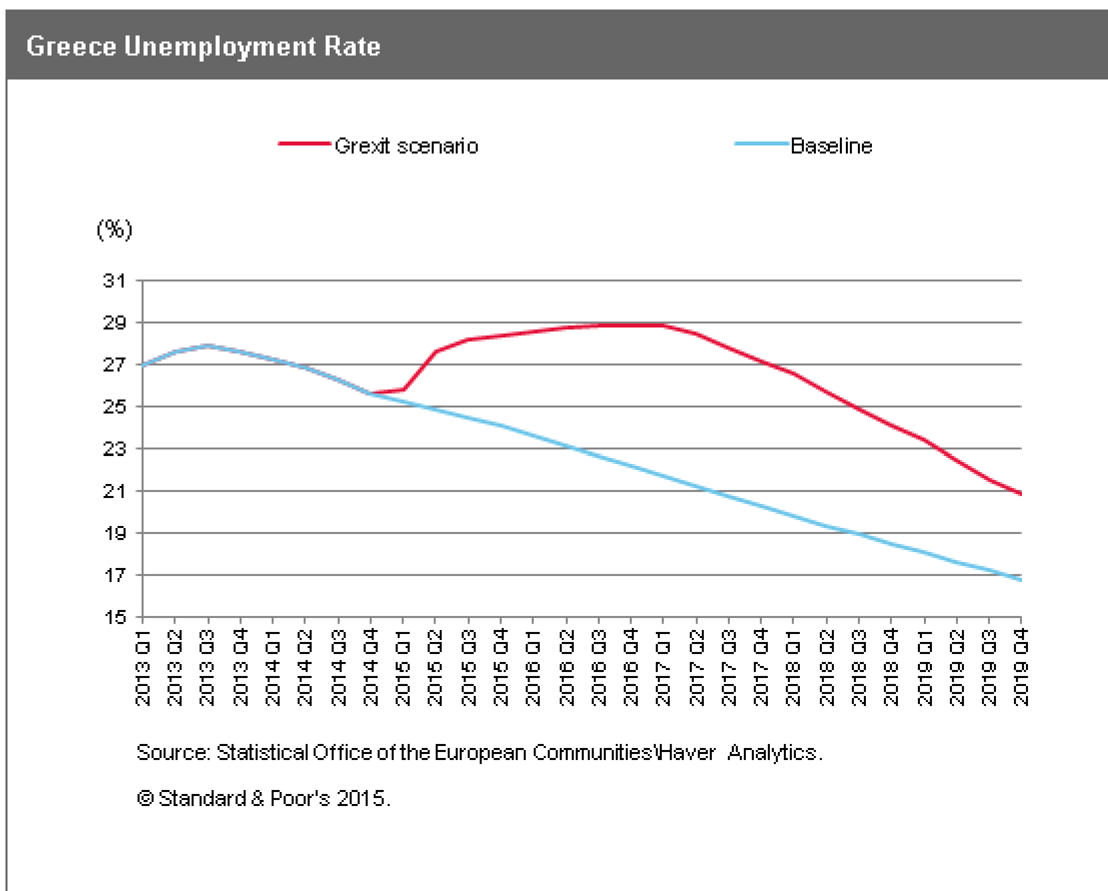


Chart 2



The inflation rate rises sharply, but second-round effects on prices and wages are assumed to be small, reflecting the large amount of spare capacity in the economy. Accordingly, inflation falls below 6%, two years after exit. Unemployment jumps to 29% but then begins to recede gradually (see chart 3). In the simulation, however, Greece never regains its pre-2008 growth path, as plummeting investment in the post-exit years creates a permanent loss in potential output.

Chart 3



Effects on the eurozone economy are mainly felt via higher yields

Because Greece is a small economy and traditionally more closed than many of its other small counterparts in the bloc, the direct trade effects of an exit for other economies would be small. If Cyprus is excluded (19% of its exports went to Greece in 2013), then only two economies export more than 2% of their total exports to Greece--Macedonia (4.2%) and Malta (3.3%). Even if Greek imports plunged by 50% in the year after an exit, the direct effect of this on Germany, France, and Italy would be to reduce total export demand by between 0.3% and 0.5% over the same period. Such a drop would reduce GDP in these economies by 0.2% to 0.3% (see chart 4).

But the main effect of a Grexit on the rest of the eurozone, especially its periphery, would be through capital markets. The simulation suggests that the most significant impact of a Greek exit would be to re-introduce a currency risk premium into bond yields across the region, as membership of the eurozone is no longer perceived as irrevocable. Contagion is likely to cause an initial spike in yields, especially for those economies perceived by the markets as fiscally more vulnerable (see charts 5 and 6). The ECB's QE program would eventually be able to cap the rise in yields, but a currency risk premium is likely to be permanent. In the simulation, increased funding costs for the eurozone as a whole over 2015/2016 amount to about €30 billion. But the increase is unevenly distributed, with Italy likely to face the biggest absolute increase of €11 billion.

Chart 4

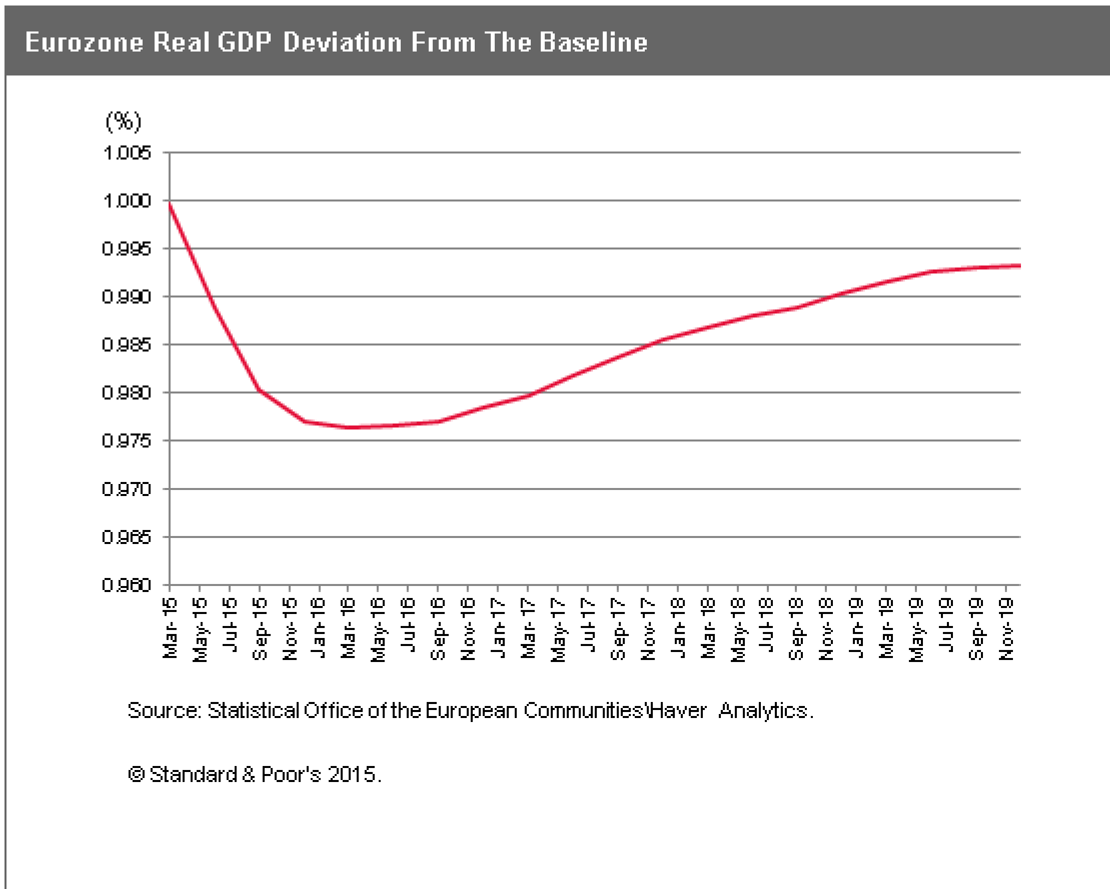


Chart 5

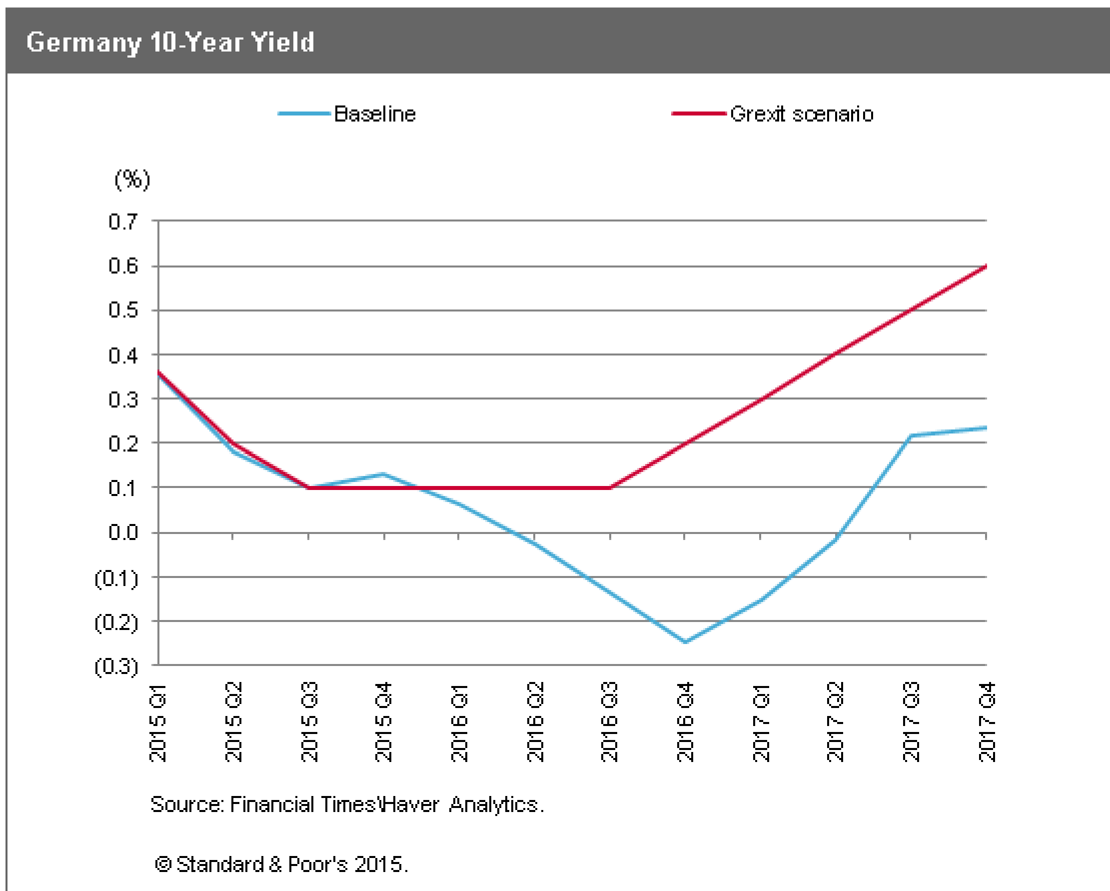
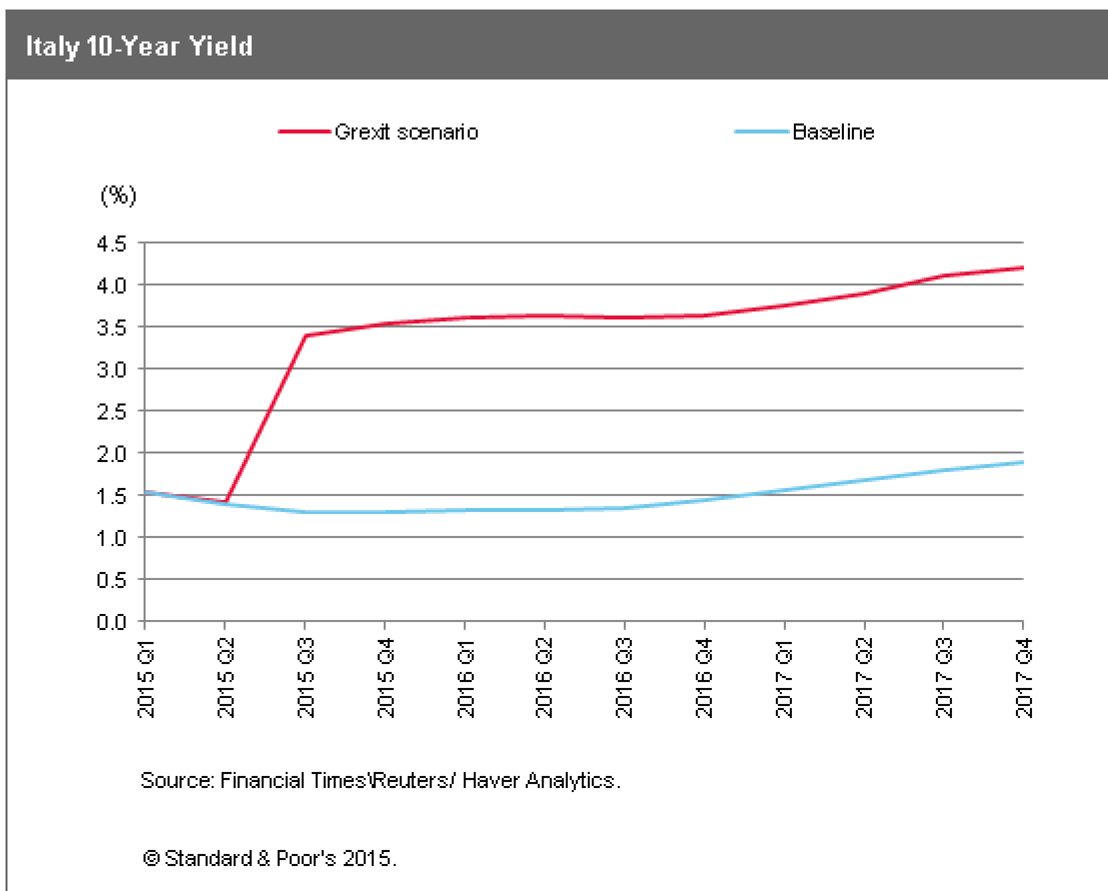


Chart 6



A Grexit Would Worsen An Already Desperate Situation For Greek Banks

The capital controls imposed on Greek banks by its government over the weekend--including a €60 cash withdrawal daily limit, the closure of bank branches for a full working week, and the prohibition of money transfers out of Greece unless authorized by the Greek Ministry of Finance--constitute a selective default under our criteria. We have consequently lowered our long-term counterparty credit ratings on the four Greek banks we currently rate--Alpha Bank A.E. (Alpha), Eurobank Ergasias S.A. (Eurobank), National Bank of Greece S.A. (NBG), and Piraeus Bank S.A. (Piraeus)--to 'SD' (selective default). The rating actions reflect our opinion that private individuals' lack of access to their deposits on a timely and in-full basis, and the constraints to their ability to transfer funds, constitute a selective default under our criteria.

The Greek government's capital controls and limits on deposit withdrawals to avoid an acceleration of banks' deposit outflows we have seen in the past few months will undoubtedly worsen an already desperate situation for Greek banks. The last official figure indicated that Greek banks have lost about €35 billion of deposit. This represents 20% of GDP, from Nov. 30, 2014, to April 30, 2015, according to Bank of Greece (BoG) data. We estimate, however, that the outflow continued during the past two months, reaching about €54 billion at June 28, 2015, or 30% of GDP. The sharp decline in deposits in recent months and weeks has resulted in the Greek banks depending on ECB funding for an estimated

amount equal to more than 70% of GDP by the end of June. The ECB's decision on June 27 to maintain the Emergency Liquidity Assistance (ELA) provided to Greek banks at the level set on Friday June 26, of around €89 billion has left the Greek banks, in our opinion, with very limited liquidity buffers to cover their upcoming funding needs.

In the now heightened likelihood of Greece exiting the eurozone, we envisage economic conditions weakening quickly. The financial performance of Greek banks is already very weak. Nonperforming assets (NPAs), including restructured loans, amounted to an extremely high 45% of gross loans at end-December 2014, according to our estimate. Accumulated loan-loss provisions since the beginning of the recession totaled about 20% of loans, and we expect 8%-9% additional losses in 2015 and 2016. In the context of a Grexit, we would expect asset quality to deteriorate significantly further, with NPAs and losses increasing beyond current levels and asset recovery becoming increasingly difficult. Earning prospects will weaken as a result of an unfavorable economic environment, persistently high funding costs, and very high credit losses. This will lead to deterioration in solvency ratios and Greek banks requiring additional capital.

A Grexit would also imply the redenomination to a new currency. This will exacerbate the trends mentioned above. It will also create a mismatch in the balance sheet if any contracts remain in euros.

The Impact For Foreign Banks And Insurers Would Be Limited

We do not currently expect that a Grexit would lead to rating changes for foreign banks because the direct and indirect impact would be limited, in our view. Foreign banks' direct exposures against Greek entities amounted to $47 billion plus an additional potential amount in the form of derivatives, guarantees, and commitments of $22 billion as of end-December 2014, according to the last information published by the Bank for International Settlements (BIS). Banks in Germany, the U.K. and the U.S. concentrate 80% of those numbers, but in all three cases, it represents less than 0.60% of the total banking-sector foreign direct exposure. The current level of exposure is likely to be even lower than that suggested by the BIS, not only given the existence of provisions, collateral, and offsetting derivatives, but also due to a likely decline in amounts since the January election.

Our central scenario assumes a Grexit would likely go along with a period of market volatility, with an impact on Western European banks' stock prices, widening spreads in particular for banks operating in Southern European countries, and ensuing increasing funding costs from record lows achieved over past weeks. But as long as accommodating monetary policies persist in Europe, funding costs are likely to remain low for most Western European banks. It can as well affect banks' issuance plans or any market-related operations, like divestments or IPOs. However, we do not think this market volatility and the subsequent uncertainty, which is always a risk for confidence-sensitive institutions like banks, would substantiality affect the credit fundamentals of Western European banks.

If, contrary to our base-case expectation, a Grexit results in higher contagion and renewed pressure on other peripheral eurozone countries, the impact on these banks in these countries could be more material. In addition, certain Western European banks continue to have sizable exposures to peripheral eurozone countries besides Greece,

and a renewed economic downturn could affect credit fundamentals in such a scenario.

We believe the impact of a Grexit on rated insurers will be similarly limited. European insurers have significantly reduced their direct exposure to Greece since 2010, although a significant part of this reflects incurred credit losses on their Greek bond holdings. There has also been a general trend for insurers in the core eurozone countries to reduce exposures in the periphery in recent years, reducing the investment risks that could result from a country leaving the eurozone.

We do not have any ratings on Greece-domiciled insurers. However, some of the largest Greek insurers are owned by rated foreign insurance groups. The direct exposure of these groups to domestic Greek assets is only a small proportion of their total investment portfolio. Moreover, we observe that some of the local Greek subsidiaries of these groups invest the majority of their assets outside of Greece. This reduces the direct credit risk in their asset portfolios and provides a degree of balance-sheet protection from currency redenomination risk.

Heightened Exit Risk Throws A Spotlight On Rated Greek Corporates' Credit Quality

Greek companies have had a few years to plan for a potential exit of Greece from the eurozone. They have reduced risks by diversifying business operations outside of Greece, moving headquarters to other jurisdictions, pooling cash in international money center banks, minimizing the amount of local debt exposed to redenomination risk, and managing counterparty credit risk. Yet, the heightened risk of a Grexit from monetary union significantly raises the risks to corporates operating in Greece, with potential credit implications if no agreement is reached between Greece and their creditors quickly after the referendum.

So far, electronic payments within Greece do not appear to have been affected, although with restrictions imposed on accessing cash we would expect that many payments will be delayed or cancelled, and future provision of goods and services will inevitably require advance payment. The severe economic uncertainty and paralysis in the Greek banking sector will likely place significant strains on the corporate cash flow and liquidity of the three rated companies with greater than 50% country risk exposure to Greece--defined as proportion of revenues, assets, or earnings generated locally.

Because we now assess the risk of Greece exiting the euro at a heightened 50% probability, we subject rated corporates with more than 25% country risk exposure to Greece--and more than 10% exposure for Greece-domiciled companies--to very severe macro-economic and financial stress assumptions. These more severe stress assumptions include:

- A 50% devaluation versus the euro;
- Freezing of all deposits held with Greek banks;
- Redenomination of all Greek law debt into a new local currency; and
- An assumption that these projections are stressed for at least one year.

The purpose is to assess the ability of companies to service their debt obligations, particularly foreign currency, in the event of a hypothetical sovereign default and the inevitable legal and regulatory uncertainty that this would entail.

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Essentially, these stresses would broadly replicate the environment that would prevail in the event of a Grexit materializing, with Greece's Transfer and Convertibility assessment likely falling to 'CCC'.

In this context, we currently rate seven Greek nonfinancial corporates, of which four are currently above the 'CCC-/Negative' rating on the sovereign (see table).

Greek Corporate Ratings And Country Risk Exposures

Company	Long-term corporate credit rating	Outlook/CreditWatch	Rating date	% assets held in Greece	% revenues in Greece	Local law debt as % of total
Titan Cement Co. S.A.	BB	Positive	29-Jun-15	10-40	0-10	0-20
Intralot S.A.	B+	Negative	30-Apr-15	0-10	0-10	0
Frigoglass SAIC	B+	Stable	4-Jun-14	0-10	0-10	0
Hellenic Telecommunications Organization S.A.	B	Watch Neg	1-Jul-15	80-100	60-80	0
Yioula Glassworks S.A.	CCC-	Developing	3-Apr-15	10-40	10-40	0-20
Ellaktor S.A.	CCC-	Negative	1-Jul-15	N.A.	60-80	60-80
Public Power Corp. S.A.	CCC-	Negative	1-Jul-15	80-100	100	40-60

Source: Standard & Poor's Ratings. Ratings data as of July 1, 2015. N.A.--Not available.

Three rated corporations have more than 50% country risk exposure to the Greek economy:

- Greek power incumbent Public Power Corp. S.A.'s (PPC) (CCC-/Negative) rating is aligned with the Greek sovereign rating given that PPC is a government-related entity and benefits from a "moderate" likelihood, in our view, that the Greek government would provide timely and sufficient extraordinary support if required. The negative outlook on PPC reflects that on Greece and our concern that PPC faces material liquidity risks in the coming months given PPC's heavy reliance on the weak Greek banking system.
- Greek concessions and construction group Ellaktor S.A. (CCC-/Negative) generates about 60%-80% of its revenues in Greece, and its liquidity position is highly dependent on government and bank funding from Greece as well as its ability to access cash balances held with Greek banks. In our view, the heightened risk of a Grexit could place significant pressure on Ellaktor's liquidity and warrants capping the rating at the level of the sovereign rating.
- Hellenic Telecommunications Organization S.A.'s (B/Watch Neg) (OTE) current CreditWatch placement indicates that we could lower the long-term rating on OTE by one or several notches if Greece were to leave the eurozone, if materially weaker economic conditions in Greece have a significant adverse effect on OTE's operating prospects or liquidity, or if we believe that OTE's free operation cash flow generation would weaken.However, we continue to expect that OTE is unlikely to default in a hypothetical stress scenario that would likely accompany a sovereign default of Greece or an exit of Greece from the eurozone. OTE benefits from having no redenomination risk, as all debt is raised under English law. It also holds almost all of its cash balances at large international banks outside Greece.

The other four Greek rated entities have only limited country risk exposure to Greece:

- We assess Greece-based cement producer Titan Cement Co. S.A.'s (BB/Positive) sensitivity to Greek country risk as only "moderate". We classify it as an exporting natural-resource producer because although about 25% sales are sourced from Titan's Greece-based plants, approximately 75% is exported. The positive outlook reflects our view that Titan's credit metrics will improve, led by its U.S and Egyptian businesses. We believe that Titan's performance and liquidity is effectively delinked from Greek sovereign risk and that Titan can maintain adequate liquidity.

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- We see the country risk exposure of Greece-headquartered ice cold merchandise maker Frigoglass SAIC (B+/Stable) as very limited because it has very little production and sales activity in Greece. It has no exposure to Greek banks in Greece but has some exposure to subsidiaries of Greek banks in the CEE region. However, these bank subsidiaries based outside Greece are subject to local banking laws.
- Greece-based international gaming company Intralot S.A. (B+/Negative) only has limited operations in Greece, and all debt has been arranged offshore by Intralot's overseas subsidiaries. The negative outlook primarily reflects the likelihood that Intralot's financial performance may not recover as we expect if certain of Intralot's main markets, including Greece, remain weak.
- The rating on Greece-based glass container manufacturer Yioula Glassworks S.A. (CCC-/Developing) reflects its negative free operating cash flow and weak liquidity position not helped by the deteriorating economic and financial climate in Greece.

Securitizations Backed By Greek Collateral Would Likely Ultimately Default

We would expect a Grexit to have a severe impact on the creditworthiness of the 18 tranches that we currently rate on seven securitizations backed by Greek collateral. That said, these securitizations account for only 0.3% of our outstanding European structured finance universe by number of ratings. The combined rated debt had an original balance of €5.9 billion, but this has now amortized to about €2 billion. No ratings on securities from these transactions are currently higher than 'B-'.

All but one of these ratings are on residential mortgage-backed securities (RMBS), while the other rating is on a repack transaction. In the RMBS transactions, a Greek sovereign default could indirectly lead to payment disruptions if there are payment holidays for mortgage borrowers and/or capital controls that may not allow banks acting as counterparties in the transactions to transfer funds when required to pay noteholders. More significant, however, would be the likely deterioration in credit performance if the underlying borrowers' incomes--and possibly the securitized mortgage loan contracts--were redenominated into a new domestic currency, with the transactions' liabilities remaining euro-denominated. We do not believe the liabilities could be redenominated, as the issuing vehicles for these transactions are not based in Greece and contracts are in English law. With the new currency likely to devalue relative to the euro, the transactions could effectively become significantly under-collateralized in euro terms, as well as potentially being left with large, unhedged foreign exchange risk.

Although the resulting collateral performance deterioration may not necessarily lead to immediate defaults of rated securitizations, it would cause a sharp deterioration in collateral credit quality and would likely lead to tranche defaults in the short to medium term, in our opinion.

The Potential Rating Effects Of Leaving A Monetary Union

In our "Credit FAQ: What Are The Potential Rating Effects If A Country Exits A Monetary Union?," published Oct. 4, 2012, we provide more details on how an exit from monetary union could affect ratings of entities in a country, and also on the likely rating action sequence in the event that a sovereign announces various interventions, including a redenomination of domestic financial obligations that we expect to result in a distressed exchange.

When there is a significant risk that a sovereign could exit a monetary union, we use "Scenario C: Significant risk of exiting a monetary union" from "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013 (RAS criteria), to assess the impact of the sovereign rating on ratings on entities or transactions in that jurisdiction, for example to determine whether a specific entity could have a rating above the sovereign. Under this scenario, in addition to other specific assumptions on economic conditions, inflation, and sovereign securities, we assume a deposit freeze and redenomination of liabilities into the new local currency--at an assumed government-mandated conversion rate that is 50% of the market foreign exchange rate. (For the treatment of structured finance transactions see "Methodology And Assumptions For Ratings Above The Sovereign--Single-Jurisdiction Structured Finance," May 29, 2015.)

In addition, exit from the eurozone would also lead us to revise our transfer and convertibility assessment on that country. In case the case of Greece, the current transfer and convertibility assessment is 'AAA' because it is part of the eurozone. In case of an exit, Greece's transfer and convertibility assessment would most likely be downgraded to 'CCC' from 'AAA' to reflect the loss of a reserve currency and the foreign currency shortage this would create.

If a sovereign rating moves to 'D' or 'SD', ratings on entities and transactions within that jurisdiction do not automatically move to 'D' or 'SD' unless the entity or transaction is in default, and are assessed in line with RAS criteria.

Related Criteria And Research

- Greek Corporations Ellaktor, Public Power Corp., And OTE Long-Term Ratings Lowered Following Similar Action On Sovereign, July 1, 2015
- Greece In Crisis: Frequently Asked Questions, June 30, 2015
- Ratings On Four Greek Banks Lowered To 'SD' Following Restrictions Imposed On Deposits, June 30, 2015
- Greece Long-Term Ratings Lowered To 'CCC-'; Outlook Negative, June 29, 2015
- Methodology And Assumptions For Ratings Above The Sovereign--Single-Jurisdiction Structured Finance, May 29, 2015
- This Time, Foreign Banks Have Less To Fear About A "Grexit," March 10, 2015
- A Greek Exit From The Eurozone Would Have Limited Direct Contagion Risks For Other Sovereign Ratings, Feb. 19, 2015
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Credit FAQ: What Are The Potential Rating Effects If A Country Exits A Monetary Union?, Oct. 4, 2012

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