European Central Bank: Press conference - introductory statement

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, and Mr Lucas Papademos, Vice-President of the European Central Bank, Frankfurt am Main, 2 June 2005.

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Ladies and gentlemen, it is our pleasure to welcome you to this press conference. The Vice-President and I will now report on the outcome of today's meeting of the Governing Council of the ECB, which was also attended by Commissioner Almunia.

Overall, on the basis of our regular economic and monetary analyses, we expect euro area underlying inflationary pressures to remain contained in the medium term. Accordingly, we have left the **key ECB interest rates** unchanged. The exceptionally low level of interest rates across the entire maturity spectrum continues to provide considerable support to economic growth in the euro area, which currently shows only moderate dynamics. At the same time, we will remain vigilant with regard to upside risks to price stability.

I shall now explain our assessment in more detail, turning first to the **economic analysis**. According to Eurostat's flash estimate, real GDP grew by 0.5% quarter on quarter in the first quarter of 2005, compared with 0.2% in the previous quarter. However, figures for real GDP growth over the last two quarters partly reflect statistical effects related to working-day adjustments to the data. This has led to some understatement of growth dynamics in the last quarter of 2004 and to some overstatement in the first quarter of 2005. Most recent indicators for economic activity remain, on balance, on the downside.

The moderation in economic activity observed since mid-2004 is partly related to the rise in oil prices. Looking ahead, there is scope for positive fundamental factors to again shape the outlook, assuming that the effects from adverse developments gradually diminish. Notably, global economic activity is expected to remain strong, despite some moderation from the record levels observed last year. This continues to support euro area exports and should have a potential positive impact also on investment. Investment is expected to benefit from robust earnings, improvements in business efficiency and the very favourable financing conditions. At the same time, consumption growth is expected to develop in line with real income growth.

This assessment is broadly consistent with the new Eurosystem staff projections, which will be published today. Euro area real GDP is projected to grow at rates of between 1.1% and 1.7% in 2005, and between 1.5% and 2.5% in 2006. Recent forecasts from international and private sector organisations give similar indications. In comparison with the March ECB staff projections, the ranges projected for real GDP growth in 2005 and 2006 have been adjusted slightly downwards.

All in all, our judgement remains that real economic growth will gradually improve over the period ahead. At the same time, recent data have heightened the uncertainties surrounding the short-term evolution of domestic demand, and persistently high oil prices and global imbalances may pose downside risks to the projections for economic growth.

Turning to price developments in the euro area, according to Eurostat's flash estimate, annual HICP inflation was 2.0% in May, compared with 2.1% in April. Over the coming months, annual HICP inflation rates are expected to remain broadly around current levels. On the one hand, energy prices are exerting upward pressure on HICP inflation. On the other hand, underlying inflationary pressure has been rather contained and, on average, wage increases have remained moderate over recent quarters.

According to the Eurosystem staff projections, average annual HICP inflation is seen to lie between 1.8% and 2.2% in 2005, and between 0.9% and 2.1% in 2006. Compared with the ECB staff projections published in March 2005, the inflation projections for 2005 have been revised slightly upwards and for 2006 slightly downwards. In 2006, this largely reflects the expected statistical effect of a planned health care reform in one euro area country, the Netherlands, which is estimated to imply a one-off reduction of 0.2 percentage point in the euro area inflation rate for 2006. This effect should be excluded from the assessment of the medium-term outlook for price stability.

Taking into account the assumptions underlying the projections, upside risks to the inflation projections prevail. These risks relate notably to future oil price developments, indirect taxes and administered prices. Furthermore, ongoing vigilance is required in order to ensure that past price increases do not lead to second-round effects in wage and price-setting throughout the economy. In this respect, continued responsibility on the part of social partners is very important.

The **monetary analysis** provides further insight into the risks to price stability over the medium to longer term. Over the past few months, money and credit have continued to grow robustly in the euro area. These developments mainly reflect the stimulative effect of the low level of interest rates in the euro area. The monetary dynamics are driven by the strong growth of the most liquid components of broad money contained in the narrow aggregate M1. At the same time, the euro area private sector's demand for MFI loans, in particular for house purchase, has remained strong.

The assessment of ample liquidity in the euro area is confirmed by all indicators. Also in the light of the increasingly liquid nature of monetary expansion, the accumulated stock of the broad monetary aggregate M3 may entail upside risks to price stability over the medium to longer term.

To sum up, the economic analysis suggests that underlying domestic inflationary pressures remain contained in the medium term. At the same time, it is necessary to underline the conditionality of this assessment and the related upside risks to price stability. **Cross-checking** with the monetary analysis supports the case for ongoing vigilance.

As regards **fiscal policies**, developments in the euro area remain of concern. While a few countries are succeeding in maintaining sound budgetary positions, in several countries it is essential that fiscal consolidation is given the highest priority in view of the budgetary situation. Moreover, the revised rules and procedures for the Stability and Growth Pact, expected to take effect soon, need to be implemented in a strict manner to ensure credibility and to promote a timely return to sound budgetary positions.

With respect to **structural reforms**, the so-called "Integrated Guidelines" for 2005-2008, covering both the new Broad Economic Policy Guidelines and the new Employment Guidelines, are soon to be adopted. These guidelines for economic and employment policies will, in turn, serve as the basis for action at the EU level and for Member States to draw up national reform programmes by the autumn of this year. The new governance structure of the Lisbon agenda should provide new impetus to structural reforms in Europe. These reforms are vital for Europe's ability to respond to the challenges arising from an ongoing deepening in the global division of labour, the fast process of technological change and the ageing of the population. A determined approach in addressing these challenges and successful communication that convinces the public of the benefits of the reforms hold the key to both improving the economic outlook in the short run and sustaining the prosperity of European citizens in the longer term.

We are now at your disposal for questions.

Nicholas C Garganas: On the practice of financial stability in Greece - the implications of Basel II

Speech by Mr Nicholas C Garganas, Governor of the Bank of Greece, at the Conference on Financial Stability and Implications of Basel II, Central Bank of the Republic of Turkey, Istanbul, 16 May 2005.

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Ladies and Gentlemen,

I thank the organizers of this conference for inviting me to be here today. I am especially pleased to be speaking on such an important issue. The concept of financial stability, considered from different perspectives, which is the main focus of the Conference, is appropriately receiving considerable attention in the light of the variety of risks confronting financial systems. My presentation will deal with the practice of financial stability assessment in Greece, key aspects of the Basel II implementation process in Greece, and some implications of Basel II for financial stability.

It is generally agreed that the objective of financial stability assessment is to review the main sources of risks and vulnerabilities likely to affect the stability of the financial sector and to evaluate its capacity to absorb the impact of adverse disturbances.

The Bank of Greece's assessment of the stability of the Greek financial sector is contained in a section devoted to that issue of its semi-annual report to the Greek Parliament. Moreover, the Bank's Annual Report to the General Meeting of its shareholders also contains a section on the stability and the supervision of the Greek banking sector.

Before presenting the Bank's approach to financial stability assessment, let me provide some key aspects of the Greek supervisory framework and of the Greek financial sector.

Effectively there are three bodies responsible for supervision of the financial system as a whole.

- The Bank of Greece regulates and supervises credit institutions and some special institutions such as credit companies, financial leasing and factoring companies, etc. It also has a mandate to contribute to the overall stability of the financial sector.
- The Hellenic Capital Market Commission regulates the capital markets and supervises investment firms and collective investment funds.
- Finally, the recently-established Commission for the Supervision of Private Insurance is responsible for insurance companies.

Cooperation between the three domestic supervisory authorities is crucial to the pursuit of financial stability. To this end, a Memorandum of Understanding has been signed between the Bank and the Capital Markets Commission which lays down the practical arrangements for cooperation; in addition a representative of the Bank sits on the Commission's Board. Cooperation with the new supervisory body for the insurance industry is expected to be organized along similar lines once the authority is fully operational.

Banks dominate the Greek financial sector, accounting in terms of assets for approximately 85% of the entire financial sector. The banking sector itself is characterized by relatively high concentration with the 5 largest banks controlling 65% of the total assets of the banking sector. The Bank of Greece's regulatory framework is essentially based on the relevant EU Directives which are closely aligned to the Basel I framework. In the Greek context, credit risk is the main component of banking risks. Overall the profitability and capital adequacy of Greek banking groups is satisfactory. On a consolidated basis, the rate of return on equity and the rate of return on assets before taxes were respectively 16,1% and 1% for 2004 and the capital adequacy ratio reached 12,8% at the end of 2004.

In view of the dominance of the banking sector in the Greek financial system, I will focus on this sector.

First, let me outline the approach followed by the Bank to assess the stability of the Greek banking sector. On the one hand, this approach involves an evaluation of the information provided by a number of indicators relating to the risk profile of banks and the economic condition of households and firms, and an assessment from a stability perspective, of developments in key macroeconomic variables and markets. On the other hand, the Bank seeks to determine the banking sector's capacity to absorb negative shocks. For this purpose, it utilizes data on bank profitability and capital adequacy and also takes account of the results obtained from stress tests.

To derive the main indicators, the Bank makes use of information submitted by banks in their supervisory reports on exposures in default, provisions, concentration ratios and credit migrations of individual exposures. Alongside ratios calculated from this source, data from household and firm surveys on both debt and income/profit levels provide information on the debt-bearing capacity of the household and business sectors.

Data from supervisory returns also provide information on market and liquidity risks. In its evaluation of the information provided by all these indicators, the Bank takes into account the corresponding EU and Eurozone average values of these indicators where available.

As regards macroeconomic variables and markets that may affect the stability of the banking sector, the Bank focuses on developments in the GDP growth rate, interest rates and exchange rates, and in the stock and real-estate markets. The direct impact on the financial condition of the banking sector of adverse developments in interest rates and exchange rates and in share and real-estate prices can be quantified using data on bank exposures to each of these risk factors. The indirect impact on banks of adverse developments in GDP growth and the aforementioned risk factors on banks mainly consists of an increase in credit risk arising from the effect of such developments on the financial condition of households and enterprises and thus on their debt-servicing ability. At present, the Bank makes only a broad qualitative assessment of this indirect impact in its published stability analysis.

In order to assess the banking sector's capacity to absorb the impact of adverse disturbances, the Bank focuses on a number of developments in banks' financial condition and makes use of stress testing. The latter involves the Bank asking banks to quantify the impact on their own funds and capital adequacy ratios of pre-specified adverse changes in the values of certain basic risk factors. The risk factors considered are the probability of default and the loss given default, interest rates, share prices and exchange rates. In addition, the Bank is working towards developing a macro stress-testing framework, especially for credit risk.

Let me now move on to discuss issues related to Basel II, which represents a major change in the supervisory framework and a challenge to both supervisors and banks. Before considering some implications of Basel II for the stability of the banking sector, I would like to refer to the preparations for Basel II implementation in Greece and to the choices Greek banks are expected to make between the alternative approaches for calculating capital requirements.

A large majority of Greek banks are expected to adopt the standardized approach in determining capital requirements for credit risk. However, a number of banks, comprising a share of around 50% of the total assets of the banking sector, are reasonably expected to adopt the foundation IRB approach for a significant part of their total portfolio. The Bank of Greece is encouraging banks to move to the IRB approach because this approach will require an improvement in their risk measurement and management systems. Thus, it will strengthen their competitive position and their capacity to successfully adapt to changes in the economic environment.

For operational risk, although the majority of Greek banks are expected to adopt the basic indicator approach to determine capital requirements, most of the large banks plan to adopt the more refined standardized approach.

The Bank of Greece is working closely with the banks to help them prepare for the implementation of the new rules. In this connection, it has already put out 5 consultation documents dealing with issues where there is national discretion. These documents discuss measures which the Bank intends to adopt as well as other matters requiring clarification and supervisory guidance. Detailed consultations with each bank planning to use the IRB approach have begun so that problems can be identified and resolved, while the preparations of banks intending to use the standardized approach will be reviewed at a later stage - sometime before the end of 2006. An important issue for the Bank of Greece is to evaluate not only the technical aspects of the banks' internal systems and the methodologies used to validate their output, but also to ascertain whether the output of these systems is utilized in managerial decision-making in such areas as loan approval and pricing, provisioning, and capital allocation.

At this stage it is difficult to determine the overall impact of Basel II on the total capital requirements of the Greek banking sector. The impact will depend not only on the alternative approaches adopted by the banks, but also on the composition and quality of their assets, both of which are affected by economic conditions. However, one limited preliminary indication was provided by the result of the 2003 quantitative impact study. For the 6 Greek banks that participated using only the standardized approach at that time, there was a 7.5% net increase in the combined capital requirement for credit and operating risk compared to the corresponding requirement under the existing framework (a 2.5% decrease of the requirement for credit risk and a 10% increase for operating risk).

Pillar II on supervisory review requires the conduct of risk-based supervision and the existence of detailed systems and policies at each bank to determine, maintain and allocate economic capital in accordance with its risk profile. This increases the pressure on supervisory resources as well as banks. In Greece, supervision has traditionally focused more on examining the accuracy of supervisory returns submitted by the banks, on a point-in-time evaluation of the quality of loan portfolios, and on the technical calculation of capital requirements to cover credit and market risk. In recent years, however, increasing emphasis has been placed on the assessment of internal control and risk-management systems, taking into account the risk profile of each bank. In this respect, the Bank of Greece found it necessary to impose a minimum capital adequacy ratio above the statutory minimum of 8% on some banks. To enhance its ability to conduct risk-based supervision, the Bank has taken steps to improve the skills of existing supervisory staff through specialized training and has also recruited personnel with skills in quantitative risk analysis. The banks have also strengthened their risk management units, but, in order to successfully implement Pillar II further efforts will be required.

Pillar III enhances market discipline by requiring credit institutions to disclose appropriate risk information, allowing the market to reward well-managed and well-capitalized credit institutions.

Let me now turn to some implications of Basel II for the stability of the banking sector.

To successfully implement Basel II, Greek banks will need to further improve their risk measurement and management systems and to develop their contingency planning. This will enable them to react more promptly and effectively to disturbances affecting their risk profile. In addition, the Bank of Greece, in its stability assessment, will utilize the output of the banks' improved internal systems to undertake more timely and accurate estimates of the total impact of alternative stress scenarios on the risk exposures and capital adequacy of the banking sector. Therefore, it will be in a better position to evaluate the sector's overall resilience.

It has been argued that Basel II is likely to produce a procyclical effect. According to this line of reasoning, for banks using the IRB approach, capital requirements for credit risk will increase during cyclical downturns because of a deterioration in the quality of loan portfolios and, conversely, decrease during cyclical upturns. As a result, bank capital adequacy will deteriorate during downturns, given the difficulty of raising new capital in such conditions. Consequently, Banks will be under pressure to restrict their lending during downturns, while during upturns they will tend to unduly expand it. It should be kept in mind, however, that bank lending is likely to be pro-cyclical to some degree, irrespective of the supervisory framework. Yet, the possible additional pro-cyclical effect arising from the IRB approach can be mitigated. In the context of Pillar II, supervisors should insist that banks hold capital comfortably above minimum requirements under normal conditions and also require banks to conduct rigorous stress tests in order to assess the adequacy of capital buffers. In addition, it would be advisable to encourage banks to adopt a more forward-looking through-the-cycle approach in their credit quality assessments and in their provisioning policy. At present, even the more sophisticated Greek banks tend to employ only a point-in-time approach to determine the values of the main credit risk parameters.

In its consultation document regarding the minimum requirements for the Internal Rating Systems, the Bank of Greece has announced that, although it will accept Point in Time systems, it encourages banks to incorporate the effects of the economic cycle in their assessments.

During the various consultation phases preceding the finalization of Basel II, concerns were also expressed with respect to the impact of Basel II on small and medium enterprises (SMEs). It was argued that capital requirements applicable to loans to these firms, especially under the IRB approach, would increase compared to the existing framework, leading to an increase in their financing costs or, possibly, to a decrease in the amount of credit supplied to them. Both these factors would adversely affect their financial condition. This, in turn, would have negative consequences for economic growth and employment and would impact on financial stability, particularly in countries such as Greece, where SMEs account for a large share of total output and employment. I believe, however, that the final version of Basel II substantially alleviates these concerns. In Greece, the majority of banks will adopt the standardized approach. For the significant part of their total exposures to SMEs, which will qualify as retail exposures, the applicable risk weight will actually decrease compared to the existing framework. For most of the remainder, the risk weight will remain unchanged. Even in the case of banks adopting the IRB approach, most of their SME customers are expected to derive some benefit either from the firm-size adjustment for corporate exposures or from the generally lower risk-weight function for retail exposures.

Increased disclosure under Pillar III is expected to strengthen market discipline by increasing transparency. This will have a positive effect on stability to the extent that anticipated market reaction dampens banks' incentives to assume excessive risks. However, the influence on bank behavior of the direct market discipline exercised by depositors, other creditors, and shareholders, is often limited either because these stakeholders lack sufficiently strong incentives or because, in some cases, the interests of the different stakeholders do not coincide. In particular, the actual or presumed existence of public safety nets may dampen the incentives of depositors to exercise discipline. Wider and more pertinent public disclosure is expected to enhance the information content of listed banks' share prices and of interest spreads on subordinated bank debt. This will increase the accuracy and predictive power of fragility indicators based on market data, such as the distance to default, an indicator derived from market prices of bank shares. At this point, I may mention that the 10 banks whose shares are listed in the Athens Stock Exchange account for over 75% of the total assets of all credit institutions operating in Greece. Based on empirical evidence, changes in the distance to default represent a useful forward-looking indicator for stability assessment purposes, especially if based on weighted average values for the entire banking sector rather than for each individual bank. In general, market-based fragility indicators are a useful supplement to supervisory data, which are derived as a rule from accounting records.

In concluding, I would like to stress the increasing importance of maintaining financial stability in the increasingly competitive environment of recent years, following the deregulation of the Greek financial system and the liberalization of capital movements. These changes have made the Greek banking system more sensitive to international capital flows, which can sometimes be volatile and unpredictable. The internationalization of the activities of Greek banking groups, Greece's entry into the eurozone, and the integration of European financial markets, although generating significant benefits, have also increased the exposure of the Greek financial system to contagion risks. In the light of these developments, the Bank of Greece has instituted - and continues to institute - changes that improve the quality of its financial stability analysis, so that timely and accurate assessment of risks be made and, where necessary, appropriate policy responses can be formulated. I believe that the implementation of Basel II in Greece will yield significant benefits because of its effects on the risk profile and the risk management systems of banks in the evaluation of their capital adequacy. This, after all, is a key determinant of their capacity to absorb adverse shocks. Therefore, both from a supervisory and a financial stability perspective, the difficult task of implementing Basel II in Greece will be well worth the effort.

Thank you for your attention.