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.

* * *

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.