# Panayotis Thomopoulos: The role of central banks as financial supervisors

Speech by Mr Panayotis Thomopoulos, Deputy Governor of the Bank of Greece, at The Economist Conferences 8th Banking Forum: Banking and the Economy in turbulent times, Athens, 26 January 2009.

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Ladies and Gentlemen,

I would like to thank the Economist Conferences and their representatives for Greece and Cyprus for inviting me to address this conference and its distinguished participants.

Representing the authority responsible for the supervision of Greek credit institutions, I am confident to state that the term “crisis” is not the suitable one to describe the current condition of the Greek banking system. There are problems more of a liquidity nature after the drying up of the London interbank market for small to medium sized banks. As well as there is need to guarantee the fluidity of the reduced liquidity to the real economy, which are both addressed thanks to the ECB funding and the state’s €28 billion banking support package.

On the other hand, due to the fact that Greece was not lured by the ephemeral fashion of detaching the supervisory functions from the Central Bank contributed to making more efficient both planks of the Bank of Greece’s functions and especially the supervisory role, for which the Bank has complete responsibility.

Recently, the new Governor Mr George Provopoulos, in order to further strengthen the Bank of Greece’s role in this very sensitive but key area, established a new department dedicated to the monitoring of financial stability.

Accordingly, under one roof there are now six different departments and, hence, there is a cross fertilisation of ideas, exchange of information and a decision making process encapsulating the knowledge, the analysis and points of view of these departments: the Economic Research Department, the Supervision of Credit and Related Financial Institutions Department, the Government Financial Operations and Accounts Department, the Payment Systems Department, the Financial Operations Department, and the Financial Stability Department. The end result is a synthesis reached by the Banking and Credit Committee, chaired by the Governor, with members the two deputy Governors and six directors.

After the presentation of the possible effects of the international financial turmoil on the Greek banking system and the challenges in implementing the aforementioned Greek state plan, I will make a short reference to what the international trends are with regard to possible supervisory reforms.

The first question is:

### How the current financial turmoil may affect the Greek banking system and the real economy.

I would like to remind you that fifteen years ago the Greek banking system was characterised by an oligopolistic nature, with one bank acting as a piper calling the tune, controlling almost 60% of the system, while there were many administrative shackles and high obligatory reserves to the tune of 12% restricting banks’ activities and limiting credit availability. In two words, it was an underdeveloped bureaucratic financial system and supervision was moulded accordingly. The liberalisation of the financial system completed after Greece’s entry into the euro area, and the merging of many small banks into bigger units made the banking system very competitive. I am dismayed when I hear about “banks’ cartel” as if the proponents of this thesis don’t see individual bank’s aggressiveness to gain market shares and the significant reallocation of the pie. During the last 10 years, supervision by the Bank of Greece was transformed and played a leading role in promoting a sound and competitive banking system, which was thus capable of extending its activities in S.E. Europe. Three years ago, the Bank of Greece asked individual banks to assess their future developments in view of the likely end of the expansionary phase of the economic cycle and their need to be prepared to endure lean years.

Today the soundness of the Greek banking system is not questioned; yet, the contagion from the global crisis has led to the drying-up of the interbank market and an increased dependence of banks on funding from the European Central Bank. It should, however, be noted that since the last week there are positive signs of a gradual normalization of the inter bank market concerning Greek banks. Rising risk premia have been increasingly reflected in widening interest rate spreads, leading to tighter credit conditions and, superimposed on the cyclical slowdown, should ultimately result in a marked slowdown in economic growth for 2009, as broadly forecast by international organisations. Indeed, the external shock has greatly reinforced the inherent weaknesses of the Greek economy.

A possible deterioration in the economic environment in the South East Europe should also have negative implications on the subsidiaries of Greek banks. However, as banks’ exposure to the S.E. European countries is less than 9% of total assets, the total impact on Greek banks will be relatively limited. Moreover, this impact was incorporated into a worst case stress scenario conducted by the Bank of Greece for the banks, which – under this unlikely event – assumed that NPLs would almost double (compared with the base scenario for 2008) and S.E. European countries’ currencies would devalue. The total effects from this very bad scenario were limited, and the Capital Adequacy Ratio (CAR) continued to be above the limits allowed.

Nonetheless, because the aim is for Greek banks to have sufficient capital and liquidity buffers as well as to minimise any negative spill-over effects on the Greek economy from the global financial crisis, the € 28 billion state banking support package has been arranged, thus ensuring that, even under the very bad scenario, Tier 1 capital will remain between 8-10% in 2009-2010.

**The enhanced preparedness of the Greek banking system.**

The current financial turmoil found the Greek banking system in a state of revision of its strategic priorities in line with Basel II. I will not cite the numerous and detailed Acts of the Bank of Greece (and individual consultations), which called the banks to strengthen internal control systems and risk management, built high capital ratios exceeding 11% and maintain high liquidity ratios. For this reason, the Bank of Greece, joining a small number of EU countries, imposed liquidity ratios in 2005, which, moreover, lean towards the severe side. Indeed, thanks to these buffers in October 2008, when, due to the increasing global uncertainty after Lehman’s debacle there were some withdrawals of deposits, the Greek banks surmounted the situation without great difficulties.

The Bank of Greece, since 2006, has asked banks to reduce their credit risk, control better their credit expansion, decrease the ratio of non performing loans and provide incentives for write-offs. By mid-2008, banks were already well engaged to meet the target of the 3½%-ratio for non performing loans for the end of 2008, but the global crisis has interrupted this downward trend of NPLs.

It should be noted that, the outburst of the ongoing financial turmoil found Greek credit institutions without exposures to toxic assets, quite solvent and in the midst of a tidying-up process. This also explains the continuing high rate of return on equity during the first nine months of 2009 (14%) and the CAR around 10½%.

Since the beginning of the global crisis in 2007, large banks were required to submit a strategic plan concerning the funding of their future activities.

On the basis of Pillar 2 of Basel 2 framework, Greek banks have been advised to adjust their risk appetite and to increase their capital base in accordance with the results of a series of stress tests, and in such a way that, despite an adverse global financial landscape and macroeconomic environment, their Tier 1 CAR would be maintained at 8-10% in 2009 and 2010, as already stated.

Within the Euro area co-ordinated framework, the €28 billion banking support package arranged by the Ministry of Economy and Finance in close co-operation with the Bank of Greece addresses both the issues of the capital base and liquidity of the banks, so as to minimize the risks from the global crisis on the real economy. The banks, in turn, will channel the available liquidity to the real economy, because this is also in their own interest, since their own profitability depends on giving loans.

To restore medium-term liquidity, the guarantee of the Greek State, will be provided to credit institutions for the issuance of new medium-term loans, as well as for notes that will be issued or refinanced up to the end of 2009 and for a maturity of up to 3 years. The total amount of this guarantee will not exceed €15 billion and it will be provided either against <u>a commission and the provision of adequate collateral</u> or without collateral, but against a higher commission.

### *Measures for strengthening the capital base:*

Credit institutions may benefit, on a voluntary basis, from the purchase by the Greek State of preference redeemable shares, up to an aggregate amount of €5 billion. These shares will pay a fixed annual return of 10% and they will be eligible as Tier I capital, allowing credit institutions to enhance their capital base.

The state plan has now entered its implementation phase and most of the banks are preparing their participation, but the impact of the measures will be felt more in the 2nd quarter of 2009.

Despite popular belief, Greek credit institutions are ready to make use of the measures. Although specific criteria have been already set, a fair distribution of the total available amount of €28 billion remains an extremely delicate task. It is also difficult to estimate how much each bank will ultimately draw and which part of the whole amount must be retained to be used in a later stage.

It should be noted that, in exchange of the Government bonds and guarantees, the Bank of Greece will have to assess, process and monitor on a continuous base the volume and the variety of the collaterals given by the banks. This means that we will have to be constantly alert and the relevant mechanisms at the Bank of Greece must operate efficiently at full capacity for as long as it will be deemed necessary.

Basically, the aim of the measures is to restore as far as possible normal market conditions and, along with the interest rate cuts announced by the ECB, to bring interest rates back to levels that do not hinder growth. The government guarantee should also contribute to the re-establishment of banks' mutual trust and to the normalisation of interbank lending. There are positive signs in this area as Greek banks have started lending each other bigger sums for longer duration than overnight or one week. However, the process may encounter unexpected hurdles and, therefore, may be lengthier than it is desirable.

### *Necessary regulatory changes:*

What changes might be envisaged to financial regulation and the structure of the financial sector as a result of the current crisis? I will try to answer taking into consideration what is under discussion in the various international fora, bearing in mind the global nature of the current turmoil.

As you are aware, a number of reforms have been put forward at the European and international level, notably by the ECOFIN Council and the Financial Stability Forum (FSF), and have recently been reflected in the declaration of the G20 summit.

However, we will have to bear in mind that any changes will be implemented gradually and, in some cases, only after the crisis is over, especially those aiming to the control of risk taking, as the system is currently in reverse mode.

There is a need for fair evaluation and strengthening of regulatory regimes, prudential oversight and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances. In the same vain and to the extent that they represent a substantial factor for the smooth functioning of markets, credit rating agencies will be required to meet specific standards. The philosophy of auto-regulation and "markets know best" as they care for the interests of the economy and of themselves has been wiped out by the ongoing traumatic experience. But we don't want to go to the other extreme of over-regulation and nationalisation of the banks.

The banking system will probably have to operate with higher capital buffers than prior to the crisis, in order to address specific loopholes revealed by the crisis, to meet increased capital requirements calculated under Pillar 2, especially after the data concerning the crisis period will be fed into the internal capital calculations. The merits of introducing a limit on the leverage ratio of financial institutions are also under examination, which also might call for more capital.

Liquidity risk now urges for more attention by both banks and regulators. In this respect, liquidity buffers have to be higher than before although several challenges involved have to be addressed, such as how to design relatively simple measures for funding liquidity risk and whether to impose minimum liquidity buffers.

Markets have excessively rewarded short-term profits at the expense of lower long-term performance or plain losses. The excessive focus on the short-term has resulted in a significant underestimation of low probability but high impact risks, as well as in an increase of risk-taking behaviour. In this context, there is a need to create an incentive framework that adequately assesses and rewards performance over the medium to longer term.

There are no doubts that the financial system has a natural tendency to amplify business cycles and there is a need to mitigate pro-cyclical effects stemming from the current regulatory framework. A number of potential areas need to be investigated, including capital requirements, valuation and leverage, banks' compensation schemes and provisioning regimes. A key issue for regulators is how to make use of the build-up of risks and leverage during boom times – for example, through countercyclical capital and liquidity buffers that would be accumulated during booms and allowed to run down during periods of downturns and stress in the financial system.

Weaknesses in bank transparency and valuation practices for complex products have contributed to the build-up of concentrations in illiquid structured credit products and the undermining of confidence in the banking sector. In this respect, concrete and solid industry practices must be promoted.

The availability of aggregate information regarding the main risks to the financial system needs to be significantly enhanced. Information should be available concerning institutions, instruments and markets that are currently unregulated but whose risks raise financial stability concerns given their potential systemic impact.

The effectiveness of the financial safety net composed of deposit insurance and access to emergency lending facilities at the central bank was also tested. The role of lightly regulated investment banks, and other financial institutions is dwindling under the international trend for more regulation and supervision.

The need for more cross border co-operation between central banks, especially with regard to liquidity, and the spread of toxic structured products around the world became evident during the crisis[1]. New arrangements to facilitate the future cross-border liquidity management of banks are necessary, like the establishment of swap lines and auctions of foreign liquidity, and the acceptance of foreign collateral, as some major central banks do already.

**Issues related to the potential evolution of the financial sector: These are discussed in international fora and also within the Bank of Greece, in order to be ready to apply the new regulations on time.**

Higher capital and liquidity buffers and higher risk premia will entail a higher cost of capital and credit than before the crisis. That is not necessarily bad, as in hindsight it seems that risk has been underpriced.

Financial firms basing their business models on cheap access to funding in wholesale markets will either have to adapt or disappear. Competition for deposit financing will also be intense for a while.

On the product side, simpler products will be considered more attractive because regulators and investors will remain sceptical of complex structured products.

The originate-to-distribute model remains to be fixed, and the interests of all the various players in the securitisation chain have to be better aligned. However, that does not mean that the model will disappear. At the fundamental level, the idea of distributing risk away from the institutions at the core of the financial system to investors that are willing and able to share in the risks is basically sound. But banks have to see that the leverage of the institutional investors is not excessive, because, in the end, banks may discover to their surprise that they are the ultimate investors.

Finally, the financial sector will become smaller and less leveraged, but the weight of traditional banks should increase, in the interests of soundness and profitability over the long term.

## The supervisory role of central banks

Some years ago, when the separation of supervisory and central bank functions was considered as a politically correct action, there were voices arguing against this mode, and in many countries central banks succeeded to retain the supervisory function despite strong national and international pressures.

The experience on the financial market turmoil confirms and reinforces the arguments in favour of a strong interaction between the prudential supervisory and central banking functions. We at the Bank of Greece resisted proposals for the establishment of a single national supervisory authority in the form of UK's FSA. I am sure that, if this division of responsibilities had taken place, we would be now collecting the pieces of some of the Greek banks. Many argue that cases like Northern Rock failure could be avoided if supervisory and central bank functions were not separated.

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[1] Cross-border strains in dollar funding markets have been dealt with through swap lines between central banks and the auction of dollar term liquidity by the ECB and the Swiss National Bank, the Bank of England, the Bank of Japan and the Bank of Canada.

There are three main arguments, also confirmed during the present crisis, in favour of combining prudential supervision with central banking, namely (i) information-related synergies between supervision and core central banking functions; (ii) the macroprudential approach argument; and (iii) independence and technical expertise.

First, the experience of the central banks of the Eurosystem highlighted the existence, in practice, of relevant information-related synergies between the central banking and the prudential supervisory function. In general, the sharing of supervisory information was facilitated when the central bank had the possibility of direct access to information on individual financial institutions that was properly assessed and fully understood given its operational supervisory involvement.

In terms of content of information exchange, the central banks normally sought information on individual institutions' liquidity positions and forecasts, intra-group and inter-bank exposures, bank's liquidity and funding policies, and data related to potential channels of contagion. Central banks are the lender of last resort and the activation of the Emergency Liquidity Assistance (ELA) in the euro area requires speed and detailed information regarding conditions of vulnerable banking groups seeking assistance. NCBs cannot give blank cheques and, therefore, this necessitates NCBs to have full knowledge and advance preparation that only NCBs with the supervisory responsibility can do. On their part, supervisory authorities sought information on money and financial markets, banks' liquidity positions and collateral provided by banks in open market operations, patterns of banks' recourse to payment systems (e.g., timing of flows during the intraday session; ratio between available and used intraday credit), and volumes in post-trading systems. The monitoring of the Target and other payment systems by the Eurosystem (including the NCBs) is a decisive advantage in this area.

This information is necessary to central banks (CBs) as a basic input for conducting their monetary policy. CBs are required to estimate the liquidity deficit of the banking system and in accordance to their policy objectives to determine the size of their intervention through open market operations, with the view to steer market rates to desired level (which of course should be consistent with the official rates).This is why CBs are required to know among others and on a daily basis the amount and the quality of the available collateral. Moreover, according to E.U Treaty, Central Banks (and the Eurosystem) are responsible for overseeing payment systems (domestically and cross border operating). In this respect the Eurosystem runs the Target 2 system for both cross border and within the country transfers of funds in Euro. Thus, ensuring the real time execution of the orders, as the transfers are in central bank money. Privately run payment system do not provide to the same extend this guarantee. In addition, it was decided that the Eurosystem will develop the Target 2 security settlements system (the TS2) operating on a centralized platform, thus providing additional guarantee that the movement of cash and titles will automatically match. This removes the counterparty risk of not fulfilling contractual obligations. The smooth functioning of cross border payments and settlement systems are essential for preserving the stability of the financial system and for the timely execution of individual banks' commitments. These services provided by central banks give an important advantage to them over FSAs, especially in times of crisis.

Second, the experience of the turmoil confirmed the need for strengthening in general the interplay between the financial stability assessment of central banks and the prudential oversight of individual financial institutions. This stems from the fact that the turmoil has been characterised by a combination of disruptions in the functioning of some markets, including money markets, and concerns over the state of health of individual financial institutions. In practice, the supervision of individual institutions should benefit from the outcome of the financial stability assessment of central banks, which in turn should rely also on input coming from supervisors. The close linkage between the two functions is also recognised in the reform projects in the UK and the US where the envisaged reinforcement of the financial stability role of the central bank is always accompanied by the possibility for the latter to have direct access to supervisory information.

Third, the independence and expertise argument highlights the quality of the contributions central banks can make to financial stability, also benefiting from their independence.

Allow me at this point to say a few words about the role of the ECB. First, without the liquidity injection of almost €1 trillion by the ECB the euro area banking system could not have overcome the financial crisis. Second, I would like to underline the important role that the Vice-President of the ECB, Mr Lucas Papademos – as responsible for Financial Stability in the ECB – has played for the preparation of the EU banking support package framework. The recognition also by the EU governments of the crucial role of the ECB during the present financial crisis, in addition to the growing calls for a EU banking co-ordinator in the regulation and supervision field, augurs well that if a decision is taken on this issue the role of the ECB in this area should be further enhanced.

## Conclusions

In conclusion and given that the severe stress in global financial markets and its impact on the Greek economy will probably last for some time yet, we can argue that the measures taken by the Greek state represent a necessary and proportionate package to enhance, first, financial stability and hence ensure the deposits and the savings of the population (which is one of the key obligations of supervisory authorities) and, second, confidence in the Greek economy, provided that during the initial implementation phase, all parties involved will perform their tasks in the best possible manner. Moreover, there are a number of positive factors: no Greek bank has faced any crisis; in 2008 their high profit rates will be sufficient to help banks to further increase their capital base.

Of course, many questions remain on the adequacy of the measures at the euro area level and on the volume and pattern both of the state financial support and fiscal stimulus. Examples of repetitive packages introduced in some countries and calls by non-euro area countries to be assisted may lead – in the end – to bigger packages than presently envisaged. As far as it concerns the exit strategy, this is still lacking, but first things first.