Yannis Stournaras: The impact of the Greek sovereign crisis on the banking sector – challenges to financial stability and policy responses by the Bank of Greece

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Ladies and gentlemen,

It is a great pleasure to be here today and have the chance to share with you my thoughts on the impact of the Greek sovereign crisis on the Greek banking sector, outlining the challenges to financial stability and the policy initiatives taken primarily, but not only, by the Bank of Greece. At the outset, it is important to highlight that financial stability is a necessary condition for achieving the goals of prosperity and sustainable growth. That these goals are shared by all is amply reflected in the current mandates of central banks with their emphasis on price stability, support for the general economic environment and, more recently, the safeguarding of financial stability.

I will begin by briefly outlining the global landscape on which the effort to safeguard financial stability has been taking place. Then, I will discuss developments in the Greek banking sector. In particular, emphasis will be placed on: (i) first, the significant worsening of the macroeconomic environment and the subsequent deterioration of Greek banks' fundamentals, in general, and their asset quality, in particular; (ii) second, euro area monetary policy initiatives and their limited impact on Greece; (iii) third, the new role for the Bank of Greece that stems from its mandate that has been revised to address the current challenges. Finally, I conclude by outlining the challenges ahead and providing some thoughts on the way forward.

A. The setting – a broader context

Over the last seven years, the European Union has faced a series of unprecedented challenges; challenges that have tested the international financial system and the coherence and stability of the Union. The response to these challenges has shown that the EU is built upon solid ground as the bonds among Member States have become ever stronger.

The global financial crisis, triggered in 2008, provided a first challenge to stability and raised major issues related to "too-big–to-fail", "too-big-to-save" or "too-complex-to-resolve". The euro area sovereign debt crisis rapidly followed and real economic activity deteriorated considerably in certain parts of the euro area. A key lesson of that crisis has been that the establishment of a banking union is a vital prerequisite to make a monetary union sustainable.

More recently, with the recovery in the euro area still fragile, new geopolitical tensions have led to an unprecedented refugee crisis and increased uncertainty. Finally, matters such as the probability of Brexit, different approaches among Member States regarding banking union and the slow progress in establishing a single European deposit insurance scheme, have been hindering further progress towards securing a financial system architecture appropriate to ensure stability.

B. The sovereign crisis in Greece caused the Greek banking sector crisis

Unlike other recent experience with financial instability, the origins of the Greek crisis were not to be found in the banking sector. In the context of the unfavorable international

economic and financial landscape that I outlined above, Greece has been undergoing a serious sovereign crisis that has required three adjustment programmes, including, *inter alia*, substantial reforms and tough austerity measures. The rapid deterioration in the macroeconomic environment, reflected in a cumulative loss of more than 25% of the GDP, has shown that the crisis facing Greece is both deeper and more protracted than initially expected. In terms of the overall deterioration of key macroeconomic aggregates and the duration of the crisis, one could say that the Greek crisis has proved to be more severe than even the Great Depression.

At the outset, the deterioration in the macroeconomic environment, sovereign debt downgrades and rising sovereign spreads rendered access to international capital and money markets impossible for both the banks and the sovereign. Extremely tight liquidity conditions ensued and pressures on the banking sector grew. In this adverse macroeconomic landscape, unemployment increased to historic (post-war) levels, and disposable income dropped substantially.

As a consequence, the adverse developments in the banking sector were unprecedented; in particular, Greek banks' fundamentals and asset quality ratios deteriorated substantially. The extent of the deterioration may be described in terms of the impact of the restructuring of Greek government bonds held by the private sector (the so-called Private Sector Involvement or PSI): Greek banks suffered losses of about €38 billion in 2011, about 170% of their total Core Tier I (CT1) capital at that time.

Due to the liquidity squeeze, the intermediary role of banks has been undermined and the channels for financing the real economy have been restricted. In addition, deposits declined by €117 billion (i.e. a drop of –44%) between September 2009 and December 2015. Mainly, this decline reflected depositor uncertainty regarding the prospects of Greece within the euro area. But additionally, the decline in deposits reflects the negative loan growth throughout the period. In normal times, deposits do not just create loans, but loans also create deposits via the money multiplier; declines in loans analogously lead to endogenous declines in deposits. The significant deleveraging that Greek banks have undertaken – between end-2010 and end-2015, loans to the private sector fell by €54 billion – was partly a response to tight funding conditions and partly a consequence of the need to set aside more capital since the potential for unexpected risks rose considerably. As a consequence it became ever more difficult for banks to play their natural role, that of financing the real economy.

The considerable decline in household disposable income, a consequence of both wage cuts and the rise in unemployment, resulted in a significant increase of non-performing loans and impairments, thus undermining the prospects for bank profits. Banks from 2010 onwards began to experience losses, which eroded their capital base. Despite efforts to support profitability by reducing costs, the high level of loan loss provisions resulted in a series of loss-making results right up until the first quarter of 2016.

C. European policy initiatives

The response of Europe to the global and European financial crisis has been effective despite the initial lack of crisis mechanisms and the unfavorable and challenging environment – an environment in which fires were often being fought simultaneously on a number of fronts. The initial response came in the form of monetary policy and a significant easing of the monetary policy stance. Indeed, in October 2008, six major central banks, including the ECB, implemented a coordinated and simultaneous cut in interest rates. Additionally, at that time euro area Member States set out an action plan of coordinated measures (including, *inter alia*, the granting of government guarantees to bank debt issuance and the recapitalization of banks) to restore confidence and improve financial conditions. With the eruption of the euro area sovereign debt crisis the malfunctioning of the monetary transmission mechanism led the ECB to resort increasingly to nonstandard monetary tools. Additionally, Europe set up the European Financial Stability Facility (EFSF) to provide

financial assistance to distressed Member States. The EFSF was replaced by the more powerful European Stability Mechanism (ESM) in October 2012.

The sovereign debt crisis also revealed strong negative feedback loops between banks and sovereigns, irrespective of whether the crisis originated with the sovereign or the banks, as well as contagion among national financial markets. In response to these developments, in 2012, European leaders initiated the creation of a banking union – which is a complementary and integral part of a genuine Economic and Financial Union. Its three pillars are: the Single Supervisory Mechanism, the Single Resolution Mechanism and the still-to-be completed common deposit guarantee system. Apart from the elements of the banking union, a number of important regulatory initiatives have been taken, covering almost all aspects of financial sector and activities (namely the Bank Recovery and Resolution Directive – BRRD, Capital requirements regulation and directive – CRR/CRD IV for the banking sector, Solvency II for Insurance, European Market Infrastructure Regulation – EMIR for financial markets and infrastructure and so on).

Turning to monetary policy initiatives, the ECB has been addressing the severe and persistent disinflationary forces in the euro area economy with a broad set of measures. Initially, it moved to refinancing operations at a fixed rate and with full allotment. It also extended the time horizon of refinancing operations, providing for 3-year maturities instead of the usual 3-month. More recently, with the so-called Targeted Long-Term Refinancing Operations (TLTROs), it seeks to incentivize banks to on-lend to the private sector by providing finance for up to 4 years. Finally there are the various asset purchase programmes where the Eurosystem purchases marketable assets including public sector/government bonds, corporate bonds, ABSs, uncovered bank bonds, etc.

These non-standard measures are being implemented to meet a variety of goals. First, to support financial markets which are malfunctioning. Second, to provide liquidity to banks for longer periods. It should be recalled that in the wake of the international financial crisis, the interbank market dried up completely as counterparty risk rose; to this day, it remains fragile. Third, to kick-start lending to the real economy. Ultimately, of course, the goal is to prevent deflation and raise inflation in the euro area to target.

To a great extent, these measures have helped to improve financial conditions in the euro area. Work done at the Bank of Greece shows that financial conditions have responded positively to the non-standard measures, even if the measures have not yet restored inflation to its target of below, but close to, 2 per cent. However, with respect to Greece, the anticipated positive effects of the expansionary monetary policy stance have yet to be realized. Financial conditions in Greece, whilst not at their lows of 2012, are still extremely tight by historical standards. Moreover, conditions have been virtually unchanged since the beginning of 2013, despite all the non-standard measures employed by the ECB.

What factors might account for this outcome? The Eurosystem lends to commercial banks against collateral. The collateral framework defines what is eligible and this is related to an asset's rating. Greek banks have often found themselves constrained by the amount of eligible collateral. Moreover, haircuts are applied to eligible collateral. That is, a €100 bond will not necessarily give a bank access to €100 of refinancing. Greek assets are now rated much lower than they were before the crisis. Thus some assets have become ineligible and, for those assets that are still eligible, the haircuts have increased. This has, on occasion, restricted access to refinancing operations. Since February 2015, Greek banks were unable to use Greek government bonds in refinancing operations, since they have a rating that is lower than the minimum acceptable under the collateral framework. A waiver was introduced for countries that are in an adjustment programme and completing the associated reviews successfully. In February 2015, the Governing Council decided that Greece did not meet these criteria and hence the waiver was withdrawn.

Furthermore, Greek banks have at various times been suspended as eligible counterparties with the Eurosystem. This occurred after the PSI and before the banks were recapitalized.

Under such circumstances, banks turn to the Emergency Liquidity Assistance provided by the Bank of Greece. But ELA carries a stigma, is more expensive and banks, through what are known as funding plans, have to explain how they plan to reduce their recourse to ELA over a reasonably short period. Suspension, for example, prevented Greek banks from participating in the second LTRO.

Finally, Greece does not benefit from the asset purchase programmes. The covered bond and ABS programmes are aimed at banks. But Greek banks cannot issue covered bonds or ABSs that meet the rating criterion. Similarly Greek corporates issue limited bonds which again do not meet the rating criterion. With respect to the public sector asset purchase programme, Greek government bonds have been ineligible since the country was not "in a programme".

Thus financial conditions in Greece have not benefited significantly from the raft of non-standard measures that have been introduced during the crisis. Conditions, however, can be expected to improve with the passing of the 1st review and the reinstatement of the waiver.

D. The response of the Greek authorities, including the Bank of Greece

I now turn to the response of the Greek authorities. The role of central banks throughout the EU has been considerably increased due to the challenges faced by banking systems in the wake of the Lehman Brothers' failure. One manifestation of this increased role is that mandates have been amended to explicitly refer to financial stability as a core central bank task. At the same time, the toolbox available has been expanded to include macro-prudential policy tools and enhanced micro-prudential policy tools both for the SSM and the national authorities.

The Greek authorities are no exception to this trend. Throughout the crisis, the Bank of Greece has been the guardian of financial stability, protecting fully all depositors (regardless of type and size) and supporting the economy and the public interest. Initially, this was accomplished through the 2008 Law which provided capital support to Greek banks and allowed banks to issue government guaranteed bonds which could be used in refinancing operations. Similar laws were enacted throughout the EU. With the onset of the sovereign debt crisis, however, the situation intensified requiring continuous action by the Bank of Greece on two broad fronts: ensuring adequate provision of liquidity and managing recapitalization, resolution and restructuring.

With respect to liquidity provision, the Bank has been critical in ensuring continuous liquidity provision to banks using one of the oldest macro-prudential tools available, that of the lender of last resort. On various occasions, the Bank of Greece has extended ELA to the banking system. This has helped preserve financial stability by ensuring that liquidity problems do not turn into solvency problems.

With respect to managing recapitalization, resolution and restructuring, the Bank's strategy, in the context of the adjustment programmes, aimed at strengthening viable institutions and winding down non-viable institutions whilst safeguarding financial stability. To this end, viability assessments and capital needs assessments were undertaken. Those banks deemed viable were recapitalized. The first round of recapitalization, following the losses incurred from PSI, was completed in June 2013. A combination of both private capital and resources from the Hellenic Financial Stability Fund were used. The second recapitalization took place in 2014, following a macro-prudential stress test, but involved only private equity capital injections.

A further recapitalization took place at the end of 2015, mainly due to the uncertainty that prevailed in the first half of that year, which had a negative impact on macroeconomic and financial fundamentals. Following agreement on the third adjustment programme, a financial envelope of €25 billion was provided for the banking system. In August 2015, the ECB launched an Asset Quality Review and stress-test exercise for the four systemic Greek

banks. The ECB was the appropriate authority because, since November 2014, the four systemic banks have been supervised by the Single Supervisory Mechanism (SSM). The Bank of Greece undertook a similar exercise for the smaller banks. The result of this exercise was identification of capital needs under both a baseline and an adverse macroeconomic scenario. The actual amount of capital raised was that identified under the adverse scenario, namely €14.4 billion. Thanks to the coordinated efforts of the Greek authorities and the Bank of Greece, successful rights issues resulted in the full coverage of the shortfall by December 2015, with private investors subscribing about €9 billion. These efforts minimized HFSF participation and helped to restore confidence in the longer-term viability of Greek banks. As a consequence, Greek banks now have among the highest capital ratios of banks in the euro area.

Those deemed non-viable were resolved with their 'good' part absorbed by systemic banks. The resolution tool used had to meet two main criteria. First, resolution had to be done in such a way as to ensure continued stability of the financial system. To that end, all deposits from resolved banks were transferred to systemic banks. This process also ensured a minimum of disruption for customers of resolved banks. The second criterion was to minimize the costs of restructuring for tax-payers. The Bank of Greece assessed that the costs of using the purchase and assumption resolution tool were lower than any alternative. With 14 such resolutions having successfully taken place since 2011, this process has also facilitated considerable restructuring of the banking system, eliminating excess market capacity.

E. Challenges ahead, the way forward and concluding remarks

Ladies and gentlemen,

With the successful completion of the first review, a number of positive benefits are likely to ensue for the banking system. The reinstatement of the waiver will allow Greek government bonds to once again be eligible collateral in Eurosystem refinancing operations. Greek banks are expected to participate in the coming targeted long-term refinancing operation. These developments will considerably reduce funding costs for Greek banks. At the same time, later this year, Greek government bonds could also become eligible for the public sector asset purchase programme. Falling spreads will impact positively on the banking system since the sovereign effectively acts as a floor on the interest rates at which banks can do business and on their ratings. However, there is no room for complacency. The system still faces challenges.

The SSM has identified banks' business model and profitability as a top priority for its supervisory action plan for 2016. Yet the background against which this priority takes place is a challenging one. The macroeconomic environment is still fragile, market sentiment is volatile and capital controls are still in force.

A large part of the challenge in addressing a new business model relates to the increasing stock of Non-Performing Exposures (NPEs) and their management. These exposures are acting as a significant impediment to banks' reorienting their business model as well as, more broadly, to growth and financial stability, particularly in the countries of the European South. It should be highlighted, however, that we are in a good position to deal with this challenging issue. Thanks to the work that has been done over the past few years, we are fully aware of problems' analytics and important knowledge has been accumulated both for the monitoring and managing of troubled assets. Moreover, as a recent Bank of Greece study indicates, domestic NPEs are primarily driven by recession. This finding leads us to the inevitable conclusion that pro-active loan restructuring and immediate involvement of loan servicers and private equity funds (gaining from the upside in the EBITDA) may add value.

The Bank of Greece's key priority at present is to contribute towards a sustainable solution for the management of NPEs. A number of initiatives are underway with the goal of setting up an accelerated and efficient framework of private debt resolution. These elements,

amongst others, include: (a) the recently voted amendment of Law 4354/2015 which paved the way for the development of a secondary market for non-performing loans; (b) the establishment of an enhanced framework for out-of-court workouts and the pre-bankruptcy process; (c) the elimination of a series of taxation driven obstacles both for borrowers and lenders; (d) the re-drafting of the Code of Conduct to address issues identified in the early implementation phase; (e) amendments in legislation, which would ensure the cooperation of old shareholders in the restructuring of the underlying businesses; and, finally, (f) the launch of a comprehensive monitoring framework in relation to banks' non-performing exposure resolution activities.

The ultimate aim in meeting these challenges is to shape a banking system which will be in a position to undertake efficiently its main task, namely the financing of the real economy. To this end, the Bank of Greece and the SSM have to ensure an appropriate policy mix. Central banks today undertake monetary policy, macro-prudential policy and micro-prudential supervision. Macro-prudential policy bridges the gap between the micro-prudential supervision of individual banks and monetary policy. It is imperative that all these different policy areas are adequately coordinated. In the same context, it is important that the macro-prudential toolbox be further enhanced with innovative tools beyond those focused on capital requirements. For instance, cyclical systemic risk can arise not only as a result of excessive credit expansion (an issue that can be addressed with the countercyclical capital buffer) but also due to inadequate channeling of credit that keeps the real economy under-financed for significant periods.

I have focused in my remarks today on the banking system and the policy role of central banks. Other policy-makers, however, also have to recognize their responsibilities. I could refer to the completion of the banking union, the proposal for shared fiscal responsibility outlined in the Five Presidents' Report and the continued implementation of structural reforms to enhance product market competition, improve educational systems, raise the efficiency of the judicial system, promote financial literacy and so on.

The objective to restore confidence and enhance the resilience of credit institutions to withstand shocks in an uncertain economic environment has always been a challenging task. Yet we should not forget that this is a prerequisite to fulfill the ultimate objective of financing the real economy to promote sustainable economic growth, create jobs and ensure better standards of living for all citizens. Financial stability is a prerequisite for sustainable growth; it is also true, however, that financial stability on a sustainable basis cannot be achieved without growth. Failure to maintain strong growth has been the biggest threat to long-term stability in the EU. The appropriate balance between managing risk and enabling investment needs to be struck and it is crucial that the regulatory framework does not impede growth. The key to a sustainable recovery is higher investment, yet a significant investment gap exists. The financial system and its stability have a crucial role to play in closing this gap, and central bankers and supervisory authorities have a catalytic responsibility in shaping a system that can deliver future prosperity.

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