Yannis Stournaras: Prospects of the Greek economy and the role of supervisors in regulating the banking system

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the International Forum of Independent Audit Regulators (IFIAR) Inspection Workshop, Athens, 8 February 2017.

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Ladies and gentlemen,

I am deeply honoured to be here today and have the opportunity to share with you my thoughts on the impact of ongoing developments in the Greek economy in general and the domestic banking sector in particular. Before I move on, please allow me to highlight the importance of financial stability as a necessary condition for achieving the goals of prosperity and sustainable growth; these are common goals between market participants and central bankers. This pre-condition becomes really important, as our macro-prudential environment becomes stricter with the passing of each year. Regardless of any single initiative or project, the general macroeconomic framework and key financial stability conditions are absolutely necessary in order to achieve overall positive performance. These simple facts have become abundantly clear over the past few weeks in Greece, as we all look forward to reaching an agreement between the Greek Government and the institutions as soon as possible and bringing the second review of the current economic adjustment programme to a successful conclusion.

I will briefly outline some of the most significant developments that have been made in the domestic economy. These developments were accompanied by positive changes in the Greek banking sector and, in particular, by a series of ongoing initiatives to achieve higher asset quality. In this context, it is worth adding some thoughts to the ongoing discussion between banks and supervisors, in terms of the medium-term impact of IFRS 9 implementation. Finally, a few remarks about cooperation between banking and audit regulation as well as the issue of mandatory auditor rotation are quite relevant for our discussion.

Following a deep and prolonged recession, Greece is currently on the road to recovery. The rebound of economic activity in the second and third quarters of 2016 supports an expectation of positive growth rate for the year as a whole, for the first time since 2014, and much stronger growth in 2017.

As you are aware, the economic adjustment programmes that have been implemented in Greece since 2010 aimed to address the large twin deficits (i.e. fiscal and current account) and structural weaknesses from which the economy had suffered for decades. So far there have been remarkable achievements:

- Unprecedented fiscal consolidation: Over the period 2013–16, the primary deficit was eliminated and, for the first time since 2001, substantial general government primary surpluses were recorded.
- Gains in external competitiveness: The external deficit, which exceeded 15% of GDP in 2008, was eliminated, underpinned by a substantial increase in labour cost competitiveness vis-à-vis our trading partners and an increase in the share of exports to 32% of GDP today from 19% in 2009.
- Structural reforms, notably in the labour market, but also in the goods and services markets and in public administration.

Unlike in other Member States that also experienced similar crises, the Greek crisis did not come from the banking sector. In an adverse international economic and financial environment, Greece was hit by a serious sovereign debt crisis that required three economic adjustment programmes that included, inter alia, substantial structural reforms and severe austerity measures. The sharp

deterioration of the macroeconomic environment that led to a loss of more than 25% of GDP over these years bears testimony to the fact that the Greek crisis is more far-reaching and lasted longer than initially foreseen. In this adverse macroeconomic environment, unemployment increased to historic high (post-war) levels, and disposable income dropped substantially.

At the outset of the crisis, deteriorating macroeconomic conditions and sovereign downgrades blocked access to international capital and money markets, thus creating very tight liquidity conditions and pressures to the financial sector.

As a consequence, banking sector developments were unprecedented including a large-scale deterioration of Greek banks fundamentals and of asset quality. The extent of the deterioration can be described in terms of losses due to the restructuring of Greek government bonds held by the private sector (Private Sector Involvement – PSI): Greek banks suffered losses of about €38 billion in 2011, which was close to 170% of their total Core Tier I (CT1) capital at that time.

Due to the liquidity squeeze, the role of banks as intermediaries was undermined, and the channels for financing the real economy were severely disrupted. In addition, substantial deposit outflows took place from September 2009 to July 2015, primarily relating to the uncertainty of depositors regarding economic and financial developments. It is worth mentioning that the difficulties of credit institutions to provide liquidity to the real economy were further exacerbated by procyclicality, as their capital base had to be used as a buffer against unexpected risks. As a consequence, even higher capital adequacy ratios had to be met, rendering it even more difficult for banks to finance the real economy.

The protracted recession, coupled with austerity measures, resulted in a significant increase of non-performing loans and impairment, thus undermining profitability. As a result, the banking system began to experience losses from the first quarter of 2010, and their capital base started to erode. Despite efforts to support operating profitability, the high level of loan-loss provisions resulted in successive negative results until the end of 2015.

Moreover, due to the unfavourable macroeconomic environment, there has been a significant credit contraction since the end of 2010. The cumulative reduction of the outstanding credit to the private sector was about €54bn (or more than 20%) during the period December 2010 – December 2015. The demand for credit by both enterprises and households has dropped, due to the increased business risk and households' uncertainty about their future finances and debt servicing capacity. In addition, the imposition of capital controls in late June 2015 has hampered economic activity. The effects seem to have been less severe than initially anticipated, due to a positive contribution of net exports and a lower-than-expected decline in consumer spending. However, substantial adverse effects have been observed in the business environment.

Against this backdrop, the Bank of Greece has taken prompt and effective action to safeguard financial stability. The banking sector has undergone a profound restructuring through consolidation and recapitalisation, enabling it to withstand the crisis and the flight of deposits. As a result, it now has adequate capital, loan loss provisions and collateral. Hence, the necessary (though not sufficient) conditions are in place for the banking sector to address the major challenge posed by the high stock of non-performing loans.

The authorities' response to tackling non-performing loans is based on three pillars:

- First, enhancement of the supervisory framework for the management of non-performing loans (NPLs). The Bank of Greece, in cooperation with the ECB's Banking Supervision (SSM), has issued supervisory guidelines for the internal management of NPLs and has recently agreed on NPE operational targets with banks for the period Q3 2016 – December 2019, entailing a reduction of NPEs by 38%. The Bank of Greece monitors on a quarterly basis the implementation of NPE targets and related key performance indicators through an enhanced prudential reporting framework. Moreover, the Bank of Greece has issued a Code

of Conduct governing the relations between credit institutions and borrowers in arrears.

- Second, establishment of a secondary market for NPL servicing and sales. The licensing and supervisory framework for independent credit servicing firms has been established, thus allowing the Bank of Greece to issue the first license at the end of 2016, while there are many more in the pipeline. The sale of loans has also been largely liberalised and a current assessment initiative could lead to further relaxation of requirements and documentation for NPL credit servicing firms
- Third, removal of legal, judicial and administrative impediments to NPL management. In this respect, the household insolvency framework has been improved, the legal proceedings have been simplified and accelerated, and secured creditor rights have been enhanced. That said, some impediments remain, such as the legal protection of bank and public sector employees involved in the restructuring of NPLs; the design of an efficient out-of-court settlement framework; and the tax treatment of provisions and write-offs.

As a result of these actions, the stock of non-performing loans gradually decreased in the second and the third quarters of 2016, reflecting among others, a shift of banks towards the offering of long-term loan restructuring. Looking forward, banks are expected to accelerate the restructuring of viable underlying business and resume their intermediation role in financing investment.

The improvement in their operating environment and in their asset quality marked the return of banks to operating profitability in the course of 2016. At the same time banks proceeded with the implementation of their restructuring plans, which entailed the divestment of foreign subsidiaries and the shedding of non-core activities.

Moreover, banks have reduced substantially their dependence on ELA funding by the reinstatement of the waiver for Greek bonds, the regaining of access to secured interbank funding, the slight increase of deposits and gradual deleveraging. In tandem, the capital controls framework has been gradually relaxed with an emphasis on facilitating the conduct of business activities. Further improvement in liquidity crucially hinges upon economic developments and the restoration of depositors' confidence.

It is now quite obvious that the domestic banking sector has experienced profound changes in the way it is structured, monitored and supervised. Some of these changes were costly and painful: for instance, resolving more than a dozen banks, or the completion of three rounds of recapitalisation, with substantial dilution of private and public equity shareholders.

On the other hand, these initiatives helped both systemic banks and less significant institutions in Greece to build significant capital reserves and buffers. Moreover, on account of the ongoing crisis the Greek banking sector has undergone a series of stress tests. In fact, since the beginning of the current decade, Greek banks have undergone six stress tests, four of them accompanied by full-blown asset quality reviews. These exercises have been cumbersome to say the least: precious resources have been spent.

However, this has had some major advantages: First, credit losses have been calculated repeatedly and the possibility of having unanticipated losses is now smaller than ever. Second, accountability of bank executives is now linked to specific quantitative and qualitative drivers and a comprehensive monitoring framework is being implemented. Finally, buffers against potential additional loan losses were specified as a result of a mandatory adverse scenario, and banks have raised high-quality regulatory capital to support these buffers.

As we all know, eleven months from today, a new accounting standard, IFRS 9, will change the way banks deal with credit losses, as well as their daily routine in terms of loss calculation in a number of assets. We welcome this development; as we have repeatedly stated, it will bring accounting losses closer to loss calculation according to supervisory methodology.

IFRS 9 represents a breakthrough in the way banks manage and report the asset side of their balance sheet, and could also have a material impact on regulatory capital requirements as well as their pricing methodology. It can also serve as a catalyst in the ongoing debate about hidden losses in European bank books vis-à-vis banking systems in other countries.

However, it is important to keep in mind here that the IFRS represent a remarkable case of EU global leadership. In fact, it is arguably the single most prominent example of the EU successfully leading the way in international financial reform in the past two decades, with its initial adoption of IFRS in 2005 followed by an increasing number of jurisdictions in the ensuing years. There is little doubt that the delays associated with these reforms would have been significant without the initial impetus from the EU, with a relevant decision taken at the political level in 2000 and enshrined in EU legislation in 2002. Against this background, the EU has a stake in the continued success of the IFRS project.

It is not surprising that Greek banks' provisioning policies have radically changed since the AQR methodology was implemented and total losses were recalculated according to anticipated loss drivers. Let us recall that the Bank of Greece was heavily criticised back then simply for frontloading three-year or lifetime losses in domestic and foreign banking books. Ex-post performance apparently indicated our projected losses did not differ much from actual reported credit losses in subsequent years.

European banks in general and Greek banks in particular, are currently preparing for their transition to the new framework. There are no grounds for anticipating any delays in these preparations. Domestic banks in particular have accumulated significant experience towards these goals. Moreover, it is worth noting that the largest part of their credit exposures has been tested according to IFRS 9-equivalent methodology. This can be seen as one of the benefits of having an Asset Quality Review exclusively designed for Greek banks like the one completed in 2015. In any case, we should all be in a better position to evaluate the medium-term impact of IFRS 9 implementation soon, as the SSM will complete a full review on that matter, ahead of the 2018 stress tests and the methodology supporting that exercise.

Finally, allow me to add a few remarks about issues associated with the cooperation between banking and audit regulation, as well as the issue of mandatory auditor rotation.

I believe that, so far, the debate over mandatory auditor rotation has mainly consisted of two competing arguments. On the one hand, proponents of mandatory rotation are concerned about the risks that long-term auditor-client relationships pose to the auditor's mindset. By limiting that relationship, rotation would improve audit quality by helping ensure that auditors remain professionally skeptical and do not become overly trusting of their clients' assertions. That is more or less the key idea behind requirements stated in the Memorandum of Understanding (MoU), as agreed last year, and it is incorporated within a number of changes in the corporate governance structure of Greek banks.

On the other hand, it is more or less obvious that the know-how acquired by an auditor concerning the specific business, financial and operational aspects of a company would be lost with each rotation. Banks should hence support external auditors in understanding all key issues as soon as possible.

European banks in general, and Greek banks in particular, are increasingly reflecting upon a series of key challenges for banking and audit regulators alike. The growth and diversity of non-performing exposures across Europe, the width and complexity of derivative products and the rapid differentiation of shadow banking instruments and markets, present key risks for regulators in view of major changes in banks' business models.

The recent financial crisis not only exposed weaknesses in banks' risk management, control and governance processes, but also highlighted the need to improve the quality of external audits of

banks. External auditors can contribute to financial stability by delivering quality bank audits, thereby increasing market confidence in banks' financial statements. Quality bank audits are also a valuable input in the supervisory process as our recent experience with the Asset Quality Review has demonstrated.

We strongly believe that building effective relationships between prudential supervisors and external auditors, and between prudential supervisors and audit oversight bodies, can enhance banking supervision. It is also important to maintain effective communication between prudential supervisors and external auditors, as this provides significant insights and valuable market perspective. These are forms of cooperation we have repeatedly relied upon over the past few years for a number of issues and I must admit that they have enhanced our understanding of the strengths and weaknesses of each institution we supervise.

Ladies and Gentlemen,

I believe that we have come a long way towards addressing a number of challenges and tasks. For us, the ultimate goal in meeting these challenges is to shape the banking system into a position where it can undertake effectively its main task, namely the financing of the real economy. Let me conclude by saying that the improvement of the Greek banking sector landscape, the restoration of confidence and the elimination of certain risk factors are positive elements that are expected to be a prime driver for growth of the Greek economy. Moreover, all the changes to the institutional framework that we just discussed are key to ensuring that the growth potential of the Greek economy will be sustainable and will not be threatened by any form of structural weakness.