Panayotis Thomopoulos: Supervision of credit and financial institutions – structure of the Greek banking system

Speech by Mr Panayotis Thomopoulos, Deputy Governor of the Bank of Greece, at the Euromoney Conference "Greece's rapidly changing banking sector", Athens, 1-2 November 2006.

*   *   *

First, I would like to thank you for inviting me to this interesting conference.

Before proceeding with issues concerning the structure of the banking system, I would like to say a few words about the Greek economy. Disciplined by the requirements of EMU membership, Greece succeeded in bringing inflation down from around 16%, where it was for most of the first half of the 1990s, to an average just above 3% since 2000. GDP growth, by contrast, rose from an annual rate of less than 1% for about 15 years up to the 1990s to almost 4% over the last ten years. This represents a rate which is twice the euro-zone average. Finally, the fiscal deficit also fell significantly from the double digit figures experienced in the early 1990s. In short, the Greek economy was transformed by euro area entry. Subsequently it was aided by the advantages flowing from the stable macroeconomic environment and low interest rates of the euro area, as well as from the Olympic Games in 2004.

On the supply side, liberalization and privatizations as well as a reinvigorated private entrepreneurial spirit have been the principal driving forces. This spirit has manifested itself in the re-orientation from an inward to an outward looking economy, especially after joining the euro area in 2001. Greece is now fully espousing globalisation, and its overall beneficial effects more than outweigh the severe damage inflicted on a few traditional Greek industries, such as textiles. The financial sector has been the avant-garde of the globalisation process in Greece and has followed, albeit with some delay, the path laid by euro area financial institutions in speeding up consolidation, integration and internationalisation.

Indeed, the Greek banking sector has transformed itself in 15 years from a highly regulated and inward looking one into a competitive and dynamic sector that is now a basic pillar for the successful economic performance. Since its gradual deregulation in the 90s reaching full liberalization in 2003, when the last regulations concerning consumer credit were abolished, it has been transformed to one of the most competitive, outward looking sectors in the Greek economy, with its assets increasing more than fourfold in the last ten years. The release, after the euro area entry, of the high obligatory reserves (12%) held at the Bank of Greece, easier access to the main international financial markets and to the ECB refinancing facilities as well as the sizeable growth in Greek national income increased considerably the lending capacity of the Greek banking sector, underpinning its expansion. The average rate of growth of bank lending to the private sector (corporates and households) has exceeded 20% since 2000, almost three times the annual growth of nominal GDP, with lending to households growing at over 30% on average. Such a high rate of growth, also stimulated by low euro area interest rates, has contributed importantly to the significant rise in the standard of living of the Greek population and to the fast rate of growth of GDP. Indeed, a significant proportion of bank lending has been financing private investment, and has thus contributed to the growth of potential capacity.

Today there are 62 banks operating in Greece, of which 22 are commercial banks, 16 cooperative banks, 23 foreign branches and one special credit institution (the Loans and Consignments Fund which is exempt from the provisions of Banking Law 2075/92). The banking sector plays a dominant role in the financial sector, since it accounts for approximately 85% of total financial sector assets; if we include the financial subsidiaries of the banks as well, that is, insurance companies, mutual funds, brokerage houses etc, the figure is close to 95%. Its importance is also underlined by the fact that banks with their subsidiaries represent about 1/3 of the capitalisation of the Athens Stock Exchange, and the evolution of share prices in the banking sector has a proportionately greater impact on the general index of the stock exchange.

Within the banking sector, commercial banks have a market share of around 85%. Foreign branches account for around 10%, the Loans and Consignment Fund 3.5%, while cooperative banks represent less than 1%. The degree of concentration of the Greek banking sector is somewhat above the euro area average, even if we exclude Germany with its more than 2000 mainly small local banks; it is, however, around the average of countries of a broadly similar size.

The five largest banks control 66% of the banking system assets, which is lower than the 85% of the Netherlands and Belgium, close to the 69% of Portugal, but above the 45% of Austria. Financial liberalization, the facility with which capital was raised in the Athens Stock Exchange until 2000, and favourable prospects for continuing high profit rates encouraged the creation of numerous private banks especially in the period up to 2001 and was followed by a scramble for market shares both by new and old private banks. This resulted in a major card reshuffling of the financial system. Whereas until the mid-1990s one state controlled bank – the NBG – (including its subsidiary the National Mortgage Bank) had a market share of almost 50% and, as such, was effectively the market maker, to-day its domestic market share is 23%, closely followed by two private banks with a market share of 18% each and two others with 10% each. If we include subsidiaries and branches abroad the largest bank's share – the NBG – is higher but it is still far below that of 10-12 years ago. The more even distribution of market shares does not leave much room for anti-competitive practices. I would like to note that not only there is a better distribution of market shares today but also, reflecting strong competition, the ranking has significantly changed: banks with a market share of 18% today had less than 10% in 1995 and a couple with double-digit markets shares in 1995 have now a single-digit market share. Foreign financial institutions are also present, especially in the wholesale banking sector, and they constitute a challenge for the better. As in most European countries, the Greek banking landscape can now be characterized as highly competitive. This is also underlined by the sometimes aggressive advertisements by individual banks trying to take away other banks' customers, by offering very advantageous loan terms, especially to those who regroup their dispersed accounts among different banks in one bank.

In the very competitive international environment, and especially after joining the euro area with its unified money market, the small size of Greek banks was an important handicap that banks themselves perceived as being a serious threat to their longer-run existence. Effectively they thought that either they would be an easy prey for larger foreign banks or they would be unable to compete with the larger European banks, which had much lower operating costs. In 1998, among the first 100 EU banks, there was only one Greek bank and it occupied the 78th place. A wave of Mergers and Acquisitions (M&As) started towards the end of the 1990s and is still continuing, and which was also aided by the privatization process. Today, the Greek banking system occupies a place in Europe that corresponds to the size of the country with three Greek banks being among the 100 largest EU banks; furthermore the first Greek bank moved from its 78th place before 2000 up to the 63rd place.

The Bank of Greece, for its part, has been continuously encouraging both the creation of larger and more efficient financial institutions through M&As as well as greater foreign presence in the Greek financial market. Its aim is to strengthen competitive forces, encouraging banks to adopt best practices and modern management techniques, introduce new bank products and lower the cost of borrowing. This, together with the rapid expansion of the Greek banking sector abroad, should help to gradually establish Athens as a regional financial hub. This is, I think, a realistic goal but it does have some prerequisites: Greek banks for their part need to accelerate their process of modernization, especially by rapidly expanding the use of low cost electronic means of payments, and increasing the offer of sophisticated bank products, while improving their risk management techniques in line with Basel II.

In the course of 2006 the key driver of structural developments has been the full or partial privatization of state-controlled institutions. Emporiki Bank was acquired by Credit Agricole, while the Postal Savings Bank was granted a banking license in conjunction with an Initial Public Offering (IPO) on the Athens Stock Exchange. In the last 10 years, the National Bank of Greece has been gradually cutting loose from state control. To this end, the appointment of professional managers and the last capital increase, which led to a dilution of the state's shareholding, have been decisive factors. As a result, the share of directly state-controlled institutions declined further to about 13% of total banking system assets from about 80% some 10-12 years ago. These developments are expected to further enhance competition to the benefit of the Greek consumer.

Concurrently, the consolidation among private medium-sized banks continued. Marfin Popular Bank is emerging as an important player, after the participation of Dubai Financial in its share capital and the planned triple merger between Marfin Bank, Egnatia Bank and Laiki Bank (Cyprus). Proton, which is focused on investment banking, is also acquiring a retail bank to expand into retail banking activities. Greece, at present, is primarily a retail banking market; but, gradually, as Greek banks' networks abroad increase, Greek banks will also serve the growing number of Greek multinational firms both in their domestic activities and abroad. Thus the shift towards wholesale and investment banking is expected to gather strength.

Competition is rather intense and a variety of new products are entering the market across the whole gambit of the banking portfolio. However, financial innovation is more pronounced in mortgage loans, where demand for credit has been particularly strong: mortgage loans continued to grow at over 30% per annum in the first half of 2006. Many banks, many more than in most EU countries, offer mortgage loans "à la carte" according to the possibility of repayment by the borrower. Initially, interest-only mortgage loans were introduced where the borrower pays, typically for a period up to 1/3 of the total duration of the loan, only interest. Then, mortgages with an initial grace period, during which no capital payments are made, appeared. Later, came mortgage loans with embedded flexibility in repayment, where monthly installments can be increased, reduced or skipped and the duration of the loan can be adjusted. Finally, foreign currency mortgage loans are being offered (initially in Yen, recently in Swiss franc), while many banks have securitized a significant part of their mortgage loans. The increasing wealth of the upper income categories has also led to the establishment of private banking departments which offer very sophisticated structured products to their wealthy clients.

The Greek banking system is in good health, and this was verified by the detailed examination it underwent during the Financial Sector Assessment Program which we undertook last year (2005) under the auspices of the International Monetary Fund. In the context of this exercise, a stress test was conducted which showed that in general the Greek banking system can withstand various adverse economic situations contemplated by the scenarios. Even in the worst case scenario, where it was assumed that the probability of default increased by 60%, the resulting fall in the Capital Adequacy Ratio (CAR) was just over 1 percentage point. As the overall CAR is around 13%, even a 1 percentage point reduction, or slightly more, leaves it at quite satisfactory levels.

Profitability in the Greek banking sector is above EU averages, something which is partly explained by cyclical factors (in 2005 the return on equity in Greece was 17% compared to 12% for medium sized banks in the EU). The non-Performing Loans ratio (NPLs), although still higher than European averages, has declined to 6.3% in 2005 from 7.1% in 2004 due to increased write-offs. We have to note that this relatively high ratio is partly accounted for by a couple of medium sized banks, which are, however, in the process of cleaning up their bad loan portfolio. The Bank of Greece also encourages the banks to write-off doubtful loans timely and we are, therefore, confident that the NPL ratio would converge to the EU average sometime in the next few years. In addition, it should be noted that the provision coverage ratio, which stood at 61.5% in 2005, is quite satisfactory, and given the long tradition of collateralized lending, as banks ask for real estate security, the loss-given-default rate is relatively low. However, even if the relatively high ratio of NPL does not represent a short-term risk, the Bank of Greece closely monitors the fast rate of growth of credit of individual banks and their progress in reducing their NPLs.

Even if there is no immediate risk and though the household debt to GDP ratio at 38% is much below the euro area average of close to 60%, a Central bank has to err on the side of caution and address all longer term issues that might undermine the soundness of the banking system. To this end, the Bank of Greece has lately introduced a series of measures: some of them have resulted in higher capital adequacy ratios by imposing on certain banks a minimum CAR above the 8%, in higher provisioning coefficients, especially for consumer loans, in speeding up write offs of NPLs, and we have explicitly limited annual debt repayment to 30-40% of household income. At the same time and in line with the new philosophy of Basel II, in April 2006 the Bank addressed more fundamental problems by imposing new and more efficient rules pertaining to internal control systems, and all associated functions: internal audit, risk management, flow of information to the top echelons, compliance functions, governance as well as measures aimed at improving decision making and procedures in credit disbursements.

The growth outlook of the Greek banking sector remains favourable, first as profits continue to increase, and second the Greek economy is underbanked by any measure used. This underlines the still great potential for further growth. Population per branch, at 3.100, is 20% more than the euro area average; population per employee is 181, 25% above the euro area average; and assets per employee amount to €4.600, 65% below the euro area average. Moreover, Greek banks are still far from reaping all the economies of scale and scope that modern banking systems provide. Banks are largely dependent on cash and make very little use of electronic means of payments – the use of electronic fund transfers and direct debits is about 90% below the euro area average. In addition, because of the reluctance to use electronic fund transfer services, Greeks are obliged to keep a great number of accounts with different banks, e.g. an average Greek has 2.6 overnight deposits, by far the highest number of bank accounts per inhabitant in the euro area, and twice the euro area average. This results in a high cost both to the individual and to the bank. However, as from 2008 this situation

will have to change with the introduction of the Single European Payments Area (SEPA). Indeed, Greek banks and DIAS –the electronic retail payment system– are working together to be ready to exploit the advantages of SEPA by 2008 and thus reduce considerably the high cost of a cash based banking system while providing more upgraded electronic fund transfer and direct debit services to their clients.

The Greek banking sector also faces a number of additional challenges; it has to apply all new regulations, mechanisms and the risk based methods required by the new capital adequacy framework known as Basel II, while expanding rapidly both in Greece and abroad. At the same time, it has to integrate as quickly as possible its subsidiaries and branches in South Eastern European countries, where the environment still differs considerably from that of the average euro area country.

The implementation of the new framework requires substantial effort from both credit institutions and supervisory authorities. This is especially true for internationally-active banking groups, irrespective of the approach they are planning to implement. However, one should keep in mind that the Basel II framework is effectively accelerating a process that had or should have started earlier and would be necessary even if the new framework had not been introduced. The new framework was designed by the Basel Committee of Banking Supervisors for "internationally-active" banks. It provides a number of options in terms of the methods used for the estimation of capital requirements under Pillar I. It is worth noting that even the simpler ones, especially the standardized approach for the estimation of capital requirements for credit risk, requires a degree of sophistication in terms of systems and data that very small banks may find it difficult to fully fulfill at short notice.

Basel II rather than being a new framework for the estimation of capital requirements is a new framework for the organization and corporate governance of risk management as well as, and this is even more important for the Bank of Greece, for the streamlining of banking supervision. It is essential that supervision, without overlooking the legal responsibilities of supervisors and their particular concerns, follows or rather adjusts its methods to some extent to the management methods of banking groups. Past are the days that a supervisory authority monitored a few simplistic types of credit. Nowadays, banks provide different forms of credit with many more risks than before and invest in complex products which required very strong internal control mechanisms that previously did not exist. In addition, Basel II highlighted the need for the enhancement of cooperation between home and host supervisors. The Bank of Greece, as a supervisor involved in the supervision of consolidated banking groups, has already organized a "college of supervisors" among the supervisors of the neighboring countries in order to accommodate their particular interests in the Basel II implementation process and we exchange views regularly on the situation of banks with cross-border business. Gradually a common supervisory culture will have to be established.

I have already mentioned the expansion of Greek banks in the neighboring countries since the early 90s with the result that that Greek banks' share in the banking sector of our neighbors is now around 20%. Although the presence of Greek banks is not limited to the wider region, it is in this area that it is most important in terms of both size and local market share. They have some 1200 branches with a total number of employees over 16000 in South East Europe and, if we include some other countries, primarily Cyprus and Turkey, the number is close to 27000; these are significant numbers for a region which is underbanked. In around 8 years time, may be up to one-half of the profits of certain large Greek banks will be derived from their operations abroad and the rank of the Greek banks in the list of the European banks will continue to improve.

All four major private Greek banking groups have been engaged in recent acquisitions abroad. EFG Eurobank Ergasias SA acquired Turkey's Tekfenbank AS in May and bought a Ukrainian lender in July. It is also opening branches in Poland. Alpha Bank SA is also looking at countries of the wider region where it has not yet a presence. Piraeus Bank SA bought the Egyptian Commercial Bank last year, the first Greek banking purchase in the Arab world's most-populous nation. But the most significant acquisition is that of the National Bank of Greece which bought a controlling stake in Turkey's Finansbank AS. That is the biggest takeover ever by a Greek company outside its home market. Furthermore, the NBG also expanded its presence in Serbia acquiring a medium-sized local bank.

As I have already said, the contribution of South East Europe, including Turkey and Romania, to the profitability of Greek banks is expected to increase in the future. However, in order to achieve this they have to integrate their new acquisitions smoothly into their systems and culture; this is by no means an easy task. We at the Bank of Greece make sure that banks that expand their activities abroad not only have enough capital but also have the organizational structure to support such an expansion. As many

of you probably know any acquisition of a credit or financial institution abroad and any expansion of branch network has to be approved by the Bank of Greece after a thorough assessment of its capital base and its internal control and risk management system. This is not only a regulatory requirement but also a business necessity in order to accurately monitor risks and thus maintain their competitive position in what is a very sought after market.