Eleni D Dendrinou-Louri: Assessing the performance and regulation of the Greek banking system

Speech by Ms Eleni D Dendrinou-Louri, Deputy Governor of the Bank of Greece, at the conference: "The future of banking in Greece: redefining the business of financial services to drive growth and expansion in 2009 and beyond", Athens, 21 January 2010.

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Ladies and Gentlemen,

I would like to thank "The Banker" and "Financial Times Global Events" for inviting me to participate in this conference and giving me the opportunity to address such a distinguished audience.

In this intervention, I will present an overview of the Greek banking sector and outline the major challenges and opportunities that Greek banks face. I will finish by providing a perspective about the new regulatory framework changes proposed by the Basel Committee.

During the current decade, the Greek banking system has enjoyed a favourable macroeconomic environment, in both Greece and in South Eastern Europe (SEE). This situation has contributed to healthy profitability, underpinned by rapid loan-portfolio growth, relatively wide net interest margins, high-yield lending to SEE borrowers and broadly resilient fee-income generation. These factors, in conjunction with the negligible exposure of Greek banks to US subprime assets and other complex structured products, considerably mitigated the financial fallout from the first wave of the recent global financial crisis, the worst since the Great Depression in the 1930s.

However, the Greek economy and other markets where Greek banks operate, notably SEE, have not been spared by the second round effects of the crisis. The liquidity squeeze and the asset-quality deterioration tested the Greek banking system, which fared rather well in the course of the previous year (9months to be exact). More precisely:

- Greek banks' capital adequacy remained at satisfactory levels and was gradually strengthened;
- Profitability declined but remained at overall satisfactory levels;
- Credit risk increased and so did loan loss charges, with signs of moderation in the 3rd quarter of the year;
- Enhanced by ECB funding, the Greek Government's liquidity support package, and the increase in deposit base, the liquidity position of Greek banks remained satisfactory.

In more detail:

Capital

In the first 9 months of 2009, the capital adequacy of Greek commercial banks and their groups was substantially enhanced. This development was attributed mainly to a considerable increase in prudential own funds, while a marginal rise was recorded in risk-weighted assets. In addition to the quantitative increase of equity capital, its qualitative enhancement via the increased share of Tier 1 capital in prudential own funds played a dominant role in the banking system's overall stability. The main factors behind the increase in prudential own funds of banks and their groups were the:

- Issuance of preference stocks acquired by the Greek government as part of the liquidity enhancement plan (Law 3723/2008)
- Completion of capital increases funded by the market
- Internal financing stemming from non-distributed profits
- Appreciation in the prices of stocks held by banks.

As a result, Greek banks' capital levels are at a par with the EU average (11.7 percent), with a Tier 1 ratio of 10.6 percent (Q3 2009) from 7.9 percent at end 2008. The leverage ratio stands at 13.4 and is significantly lower than the European average.

Profitability

Greek banks have remained profitable. Net interest margin stood at 2.6 percent during the first 9 months of 2009, twice the EU average. However, profitability declined y-o-y by around 42%. This outcome was the unavoidable result of the crisis that hit Greece with a time lag and was aggravated by the structural and fiscal imbalances that characterise the Greek economy. Impairment charges have been the key drag on profits. ROE and ROA after taxes (7.5 percent and 0.5 percent, respectively, during the first 9 months of 2009) also declined but remain above the EU average. The cost-to-income ratio, at 51.9 percent, has decreased thanks to cost containment and is lower than the Large and Complex Banking Groups' euro-area weighted average (60.7% for the first half of 2009).

However, it is of some concern that trading income, notable for its high volatility, represented a considerably large chunk of profits before taxes. The increase of trading income during the first 9 months of 2009 compared with the same period a year earlier, was attributable mainly to the increase in the price of Greek government bonds and stock prices in the second and third quarters of 2009. These trends have currently been reversed, rendering any gains from trading and financial transactions during the last quarter of 2009 and the first part of 2010 highly unlikely.

Asset quality

In the course of 2009, the quality of the loan portfolio declined, resulting in an increase of the NPL ratio (on a solo basis) to 7.2 percent in September 2009 (from 5.0 percent in December 2008), albeit at a decelerating rate. The NPL ratio increased for all types of loans, but the increase was more pronounced for consumer loans (September 2009: 11.7%, December 2008: 8.2%). The NPL ratio for mortgages reached 6.9% (from 5.3% at the end of 2008) and for corporate loans reached 6.4% (from 4.3% at the end of 2008).

With Greece experiencing the first domestic recession since the early 1990s and with a rather subdued private sector credit expansion and a public sector trying to address chronic fiscal imbalances, the medium-term outlook regarding asset quality is challenging. A further decline in loan quality and increases in impairment charges are likely both domestically and abroad; economic conditions in SEE have improved but significant challenges still remain, observed and expected increases in unemployment being a key concern. Additionally, a high percentage of loans in SEE is FX-denominated and unhedged from the borrowers, which should further strain the balance sheets of households and corporates. So Greek banks should be particularly vigilant and pro-active in the management of their loan portfolio and overall balance-sheet.

Liquidity

The global financial crisis and the freezing of liquidity in international markets have affected funding operations, a situation that, has in turn affected the liquidity buffers. As in other

European economies, given the difficulties in wholesale financial markets, ECB lending facilities have become a major source of funding, alongside the increase of the banks' deposit base and the Greek Government liquidity support package. All of these sources of funds helped the Greek banking system to increase its liquidity position during 2009. At the end of September 2009, the loan-to-deposit ratio stood at 113%, one of the lowest in EU, and the financing gap (i.e., the difference between deposits and loans) shrank. The total borrowing of Greek credit institutions from the Eurosystem/Bank of Greece, at the end of November 2009 amounted to 8.5% of total assets. At the same time, the liquidity allotted to Greek banks in the ECB's open-market operations represented 6.3% of the total liquidity provided at the Eurozone level. In the December one-year Eurosystem financing operation this percentage dropped to 6.0% and is expected to fall again this month.

During the course of 2009 Greek banks issued €4.3 bn of unsecured debt with a 2–3 years maturity in the capital markets. They also issued €1.5 bn of covered bonds. Banks' funding plans for 2010 take into account that the liquidity to be provided by the ECB will eventually return to its pre-crisis level. Thus, banks are now re-oriented to the capital markets. The extent to which their funding plans will be realised depends on the degree of normalization of international financial markets.

Exposure to SEE – challenges and opportunities

During the last 15 years, Greek Banks expanded in SEE, while in the last few years they also expanded in Turkey, Poland and Ukraine. The assets of their braches and subsidiaries in those countries represent 10 percent of the total of the Greek banking system's assets. Before the crisis, Greek banks benefited greatly from the high lending growth (especially in housing and consumer loans) in these countries, the strong economic performance of these countries, and their accessibility to money markets because of Greece's participation in the Eurosystem.

With the recent crisis and in response to deteriorating macroeconomic conditions, most banks in the region revised their business plans and curtailed their short-term activities. In recent months the scale of external support to the region has become clear. In a repetition of the banking crises of the '90s, the financial-rescue packages funded by the International Monetary Fund, the European Union and other IFIs, were very important for the viability of the domestic banking systems. Greek banks have been strong supporters of the so-called "Vienna Initiative" and have maintained their overall exposure to the area despite falling demand for loans. At the current juncture, the main challenge for the banks in the region is to sustain capital adequacy in the face of falling loan quality, coupled with a still adverse macroeconomic environment eroding banks' profitability. Another major challenge is to preserve adequate liquidity.

The key factors that will determine the extent of the successful operation of Greek banks in SEE will be efficient risk-management practices and internal control systems, adequate deposit and liquidity provisions and efficient administration strategy and operation. At the same time, Greek banks, as already agreed under the IMF support schemes, will at least maintain their current exposure levels and continue to provide financing to the real economy.

Ladies and Gentlemen,

Despite the perceived easing in international money and capital market conditions, serious challenges persist for the banking sector and Greek banks in particular. They mostly have to do with the domestic macroeconomic environment, the country's fiscal imbalances and recent downgrades of sovereign ratings and the markets' rating of Greek state debt.

It is hence of critical importance that Greek banks take great caution in planning their medium-term strategy with respect to their capital base and fund utilization. They need to maintain considerable capital margins over and above the required minimum levels, as well as ample liquidity buffers. One way to achieve this objective is by promoting internal financing. Furthermore, in the context of the present situation, banks should give priority to the strengthening of their ability to absorb any unforeseen losses. The prudent management of their payout and remuneration strategies is, hence, strongly advised.

Banks must also persevere in their efforts to further strengthen the risk management culture, methodologies, processes and controls and improve governance. As managing risk is not always straightforward, qualitative analyses are needed to complement quantitative analyses. We can see good steps taken in this direction. In a challenging economic environment, Greek banks need to find the appropriate balance between improving asset quality, harnessing the cost of risk and providing the necessary liquidity to the economy. Financial institutions need to have a clear view of the risk they undertake relative to available capital and liquidity buffers.

When planning their future strategy, banks should also take into consideration proposed changes in the supervisory and regulatory framework, aiming at strengthening the resilience and enhancing the stability of the banking system. One should bear in mind that the cornerstone of sustainable economic growth is the ability of banks to facilitate credit intermediation between savers and investors and to provide the critical services consumers and enterprises obtain from banks to run their daily lives and business. One cannot forget that some of the reasons behind the recent financial crisis were the build up of excessive leverage, insufficient capital and liquidity buffers and the pro-cyclical amplification of risks. International regulatory bodies promptly reacted to address the identified deficiencies of the current framework.

The Basel Committee recently published proposals on ways to redesign the existing regulatory capital and liquidity framework. The target date for the implementation of these proposals is end-2012, with "appropriate phase-in measures and grandfathering arrangements for a sufficiently long period to ensure a smooth transition to the new standards". Increased capital requirements for trading books and securitizations, proposed at the beginning of 2009, are expected to be effective as of December 2010. These "Basel III" draft proposals:

1. ***Re-define eligible capital.*** All regulatory adjustments are to be applied to the more-strictly defined and more internationally harmonized common equity component of Tier 1. Tier 2 capital instruments will be standardized, and Tier 3 capital will be phased-out. Explicit minima for common equity, Tier 1 and Total Capital as percentages of Risk Weighted Assets will be determined after the comprehensive impact assessment, that will take place in the first half of 2010, is concluded.

2. ***Tighten risk coverage*** by better addressing the counterparty credit risk (CCR) arising primarily from derivatives, repos and securities-financing activities. This change is motivated by the fact that "two-thirds of the Counterparty Credit Risk losses were due to credit valuation adjustments and only about one-third were due to actual defaults".

3. ***Limit the inherent procyclicality*** of the existing framework with the introduction of (a) capital buffers beyond the regulatory minimum, which will be built-up in good times so that they can be drawn upon during stress periods and (b) "forward-looking" provisioning based on expected losses to substitute for the current "incurred loss" provisioning model.

4. ***Introduce a non-risk metric,*** the leverage ratio, to supplement existing Pillar 1 risk metrics.

5. ***Propose a short-term Liquidity Coverage Ratio*** in order to ensure that financial institutions have sufficient high quality liquid resources to survive an acute stress scenario calculated for 30 calendar days into the future and a longer-term Net-Stable-Funding Ratio which promotes an institution's resiliency by creating incentives for more-stable funding choices.

Ladies and gentlemen,

Before closing, I would like to say a few words about an important lesson of the recent crisis which can be summarized in the following sentence: “Regulatory reform is a necessary, but not a sufficient condition for a safer financial system”.

Broadening the focus from the supervision of individual institutions by taking into account system-wide risks is an urgent priority. We need to understand the ways the components of the financial system interact; we need to realize that because of these interactions, system-wide risk can be much larger than the sum of the risks posed by individual institutions.

Developing a system-wide view of financial risks, of the way they are distributed within the financial system and of the systemic importance and contribution to systemic risk of each individual institution are some of the key tasks of the macro-prudential dimension of regulation. This is the mandate of the Financial Stability Department of the BoG, created as a separate entity during the fourth quarter of 2008. At the level of the EU, this analysis of risk is in the hands of the newly-established European Systemic Risk Board (ESRB). The credibility and effectiveness of both critically depend on not only the quality of the risk assessments but also on the timely and efficient translation of those assessments into concrete policy recommendations.

I would like to leave you with these last thoughts:

Despite the significant progress of this past year, the reform program is far from complete. Sustaining the reform impetus is crucial, especially now that the recovery of the banking sector from this unprecedented credit crisis, across the world and in Greece, appears under way.

For the financial industry and us regulators, this situation simply means that good plans have to be carried to fruition, changes need to be institutionalized, and adjustments to the business models need to continue and not be forgotten. Reform is a continuous process, not merely a reaction to a shock.

Thank you for your attention.