George A Provopoulos: The SRM, financing the real economy and related European initiatives

Opening speech by Mr George A Provopoulos, Governor of the Bank of Greece, at the EUROFI, Athens, 31 March 2014.

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It is a pleasure to welcome you to Athens for this high-level seminar, co-organized by EUROFI, the Greek Presidency, and the Bank of Greece.

My remarks will focus on two issues.

First, I will make a short comment on the agreement reached on the Single Resolution Mechanism (SRM).

Second, I will provide reflections on another important issue – the financing of the real economy and European initiatives related to that financing.

Resolution in the context of a banking union

A prominent feature of the crisis was the existence of negative feedback loops between the fiscal and banking sectors. From that followed the major lesson, that an effective economic and monetary union must include a banking union.

A key pillar of the euro-area's banking union will be the Single Resolution Mechanism (SRM).

I believe that the outcome of the recent negotiations on the SRM is satisfactory.

First, it ensures the creation of a viable banking system for the euro area through the resolution of failing banks in an orderly fashion that protects financial stability.

Second, the responsibility for deciding the time that resolution of a credit institution is warranted remains primarily a task for supervisors, while the Supervisory Board also retains the right to declare a credit institution "failing or likely-to-fail" in some cases.

Third, resolution mechanisms need efficient decision-making procedures that allow resolutions to take place quickly and efficiently. In Greece, we resolved 12 banks in the last couple of years. All resolutions were carried out unannounced – typically over a single weekend – thus allowing a smooth, uninterrupted transition for depositors of the affected institutions. The resolution process under the agreement satisfies this condition.

Finally, the mechanism needs a credible back-stop. In the Greek case, funds from the Economic Adjustment Programme were earmarked specifically for resolution and recapitalization. As a result, there was never any doubt about our ability to resolve and recapitalize banks.

In this connection it has been agreed that the Single Resolution Fund is to be composed of contributions from banks over an eight-year period, while the pace of mutualisation envisaged is frontloaded. At the same time an enabling clause has been approved by the Council, so that the Fund can seek public bridge financing.

Overall, I welcome the agreement as a step forward toward eliminating the negative-feedback loops between banks and sovereigns.

Financing of the real economy

Let me turn to the second issue.

A key characteristic of the euro area economic recovery is the decline in loans to the private sector. This situation applies at both the euro-area and, in many cases, the individual-country levels.

Because the euro-area economy is bank-based, bank lending is especially significant for SMEs, which produce the bulk of goods and services.

Consequently, a credit contraction raises the question: Can the recovery be sustained in the presence of negative loan growth?

A number of actions and initiatives are addressing this issue. I will confine my remarks to two areas.

The first concerns monetary policy. Throughout the crisis, the ECB has put in place both conventional and unconventional policy measures with the objective of increasing confidence and restoring the smooth operation of the monetary transmission mechanism.

The volume of credit would have contracted significantly more had it not been for the ample provision of liquidity to European banks by the Eurosystem.

The declining path for real interest rates, suggested by the fact that inflation expectations are anchored close to 2% in combination with the ECB's commitment to keep an accommodative monetary policy stance, will lead to a substantial increase of the demand for credit along the way.

There is, however, still work to be done on the supply side of financial markets. This circumstance brings me to the second area that deserves attention, i.e. the need to restore confidence in the banking sector.

Confidence has been undermined by the perception that some banks have been holding assets of questionable quality on their balance sheets.

The resulting credit and counterparty risk has contributed to a rise in funding costs, preventing some banks from on-lending to the private sector.

Supervisors, at both the European and individual country levels, are using tools – including stress tests, asset quality reviews and transparency exercises – to assess the resilience of banks and to request injections of capital, so that confidence in the quality of bank balance sheets can be restored.

In this context, the establishment of the SSM and the comprehensive assessment taking place will provide a catalyst for the cleaning-up of balance sheets to take place more quickly and more comprehensively than would otherwise have been the case.

The repair of banks' balance sheets is unavoidable and will, of necessity, involve some deleveraging. However, deleveraging does not necessarily lead to credit contraction.

The "positive" deleveraging policymakers seek is a procedure in which the growth of equity allows banks to recognize bad loans and refrain from rolling them over, in turn, freeing resources and allowing banks to provide loans to firms that can use them productively.

Again Greece is a prime example of this scenario in action. Following the first recapitalization of our banks in 2012, we began to reform and consolidate the banking system. Banks sharply reduced reliance on central-bank funding while making provisions for bad loans. As a result, they have been able to attract private investors.

Recently, we concluded follow-up stress tests that were exceptionally well received by the markets. Following the release of the results, two core banks have completed much larger than requested capital increases of approximately €3 billion, with significant oversubscription. One of them has issued an additional unsecured bank note for €500 million with a maturity of three years.

These are the first signs of markets' opening up to Greece again. I am therefore confident that the second stage of recapitalization will play an important role in restoring confidence in Greece and a healthy financing of the economy.

As a longer-term strategy, it would be desirable at the European level to develop market standards to allow equity and bond markets to gain ground as a source of funding.

Doing so would increase the volume of funds available for long-term investment, contribute to long-term sustainable growth, and increase the resilience of the corporate sector during periods of banking-sector stress.

The development of a deep EU securitization market for corporate loans would provide capital relief to banks, improve risk sharing, and increase banks' lending capacity.

To sum up, it has to be accepted that the crisis exposed weaknesses in EMU's original architecture. However, European institutions have responded to the crisis with decisive policies and significant reforms to the original architecture. Those responses will help create a more-effective, crisis-resilient, economic and monetary union in the future.

The benefits of the efforts are already evident at the euro-area level, especially in the sovereign-bond markets, where conditions have normalized to a considerable extent. The benefits are also evident in individual countries such as Greece, where the crisis, deep though it was, gave us the impetus to consolidate and recapitalize the banking sector, while simultaneously undertaking reforms that will allow us to reap substantial benefits in the future.

I thank you for your attention.