Lessons from the financial crisis and challenges for the Greek banking sector

Yannis Stournaras

Governor, Bank of Greece

International Center for Monetary and Banking Studies

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Ladies and gentlemen,

Introduction

I am honoured to be here today and have the opportunity to share my thoughts on the lessons from the international financial crisis. I would also like to touch upon Greece's experience over the past eight years and the key challenges for achieving a successful turnaround of the Greek economy in general, and the banking sector, in particular. However, before we move on, it is crucial that I stress the importance of financial stability as a necessary condition for achieving prosperity and sustainable growth, common goals for all market participants and central bankers.

I shall begin this lecture by briefly commenting on the lessons from the international financial crisis and the response of monetary and supervisory authorities. I will then outline the unfolding of the Greek sovereign crisis and its impact on the domestic economy and the banking sector. Subsequently, I will present the authorities' response, before proceeding to the core of my intervention and the lessons from the Greek banking crisis.

Lessons from the international financial crisis

The recent financial crisis has been the most severe in seventy-five years. A key question, not only for all of us in this room but also for those who study it or act as policy makers, is "Will it happen again?"

My answer is that − if and when it does happen − it will be different.

First, a valuable lesson is that, while things may work well if left to the invisible hand, during times of stress that hand seems to lose its grip, in the words of Ahamed Liaquat in his Pulitzer - award "Lords of Finance". Policy makers around the world have learned their lessons from the Great Depression: a financial system in distress requires active central bank intervention. Central banks thus acted quickly and forcefully.

They developed their toolkit with a combination of more flexible, effective and innovative measures and enormous firepower. Given the success of these policies, some of these instruments may be permanently included in the new standard-framework, and thus equip policy makers with the tools to engage in proper and timely action.

All in all, there is no strong case for a fundamental change in the monetary policy framework. Central banks are expected to continue to use the asset side of their balance sheets, as well as other tools such as forward guidance, in addition to their standard interest rate policies, as the effective lower bound will likely continue to be a binding constraint on interest rate policy in a low inflation, low interest rate environment. Going forward, central banks are likely to proceed to the downsizing of their balance sheets in gradual and cautious steps. In any case, even taking into account the hazards, sustaining the present high levels of central bank assets creates benefits for the economies and financial markets alike. These benefits relate to the maintenance of accommodative liquidity conditions for banks and the economy, as well as the avoidance of financial turbulence in the event of a sudden rise in interest rates in the markets.

Second, we as central bankers have gained a much better understanding of how the financial system operates and how risks to the stability of the financial system may develop. A lot has been done to make the system much safer than it was 10 years ago and as resilient as possible. Such work has progressed in various directions, including not only more effective regulation but also higher capital and liquidity buffers for banks, early warning systems and the development of macroprudential tools to increase resilience to shocks when they occur. This was evident in the results of the 2018 EU-wide stress tests which show that banks have become more resilient to financial shocks over the past two years.

Third, we have also taken bold steps to strengthen the Eurozone. At the national level, euro area countries have stepped up structural reform efforts in the labour and product markets to boost productivity and in the fiscal sector to make public finances more robust. The Banking Union (with a single supervisor, a Single Resolution Mechanism and – a yet-to-be-established but of utmost importance – common European Deposit Insurance Scheme) has helped create a better integrated, more efficient and well capitalised European banking sector. Coupled with the completion of the

Capital Market Union, it can support the single market and fund investment and growth.

Fourth, many challenges remain and a lot still needs to be done. The financial system continuously innovates and the work of regulators comes with a lag. In fact, certain large financial institutions that conduct activities similar to banks but have no banking license – what we call shadow banks – remain insufficiently monitored and under-regulated. Challenges also remain outside the financial system, with for instance geopolitical risks still elevated, trade disputes or cyber-risks. As central banks, we have to be prepared for all contingencies.

Fifth, an important lesson is the need to safeguard the independence of central banks both with respect to political influence but also with respect to business interests, which sometimes attempt to capture the supervisory as well as other activities of central banks. Central banks have also a duty to speak the truth to the public, to explain the situation of economies as well as to present their forecasts free from any outside influence. After all this should be part of their communication policy.

For someone like me, with deep interest in economic history, it is clear that "those who can't remember the past are condemned to repeat it". We need not only the ability to learn from the mistakes of the past, but also the vision to avert repeat mistakes. At the same time, it is our duty to strengthen our safety net and build the tools to reduce the effects and the length of downturns, should risks materialize.

The Greek sovereign debt crisis and its repercussions on the real economy and the banking sector

Unlike other national crisis-related experiences, the origins of the Greek crisis were not in the banking sector. The Greek crisis was the result of major macroeconomic imbalances, which had accumulated over a long period of time, leading to the outbreak of the sovereign debt crisis in 2010.

In an unfavourable international economic and financial landscape, the macroeconomic and fiscal deterioration, coupled with increased investor uncertainty, led to a loss of confidence and capital market access for the Greek sovereign. As a consequence, recourse to external financial assistance was necessary. To tackle the ensuing sovereign crisis, three Memoranda of Economic and Financial Policies (MEFP) including, inter alia, substantial sovereign debt restructuring (the so-called Private Sector Involvement – PSI in 2012) were required.

The unprecedented fiscal consolidation that followed, contributed to the magnification of the initial economic shocks, resulting in a cumulative real GDP decline of over 25%, historic high (post-war) unemployment levels and a substantial drop in gross disposable income. In a nutshell, one could say that, at a national level, the Greek crisis has been more severe than the Great Depression.

As anticipated, the banking sector took a heavy toll. A large-scale deterioration of Greek banks' fundamentals, in general, and asset quality ratios, in particular, took place. The domestic sector recorded an NPE ratio of approximately 45% in 2016, severely limiting banks' capacity to internally generate capital.

Due to a liquidity squeeze, the intermediary role of banks has been undermined and the channels for financing the real economy have been impaired. In addition, deposits fell substantially by some €117 billion (a 49% decline), between September 2009 and December 2015, in part because of depositors' uncertainty about the macroeconomic environment and the prospects of Greece within the euro area. In this context, it is worth mentioning that the ability of financial institutions to provide liquidity to the real economy was further constrained by procyclicality. During prolonged recessions the capital base is used as a safety margin to deal with unexpected risks. As a consequence, even higher capital adequacy levels have to be met, thus 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 impairments, thus undermining profitability. The banking system began experiencing losses in the first quarter of 2010, and the capital base started to be eroded. Despite efforts to support operating profitability, the high level of loan loss provisions resulted in a series of loss-making results at least up until the end of 2015.

Moreover, due to the unfavourable macroeconomic environment, there has been a significant credit contraction since the end of 2010, with an accumulated decrease of the outstanding credit to the private sector of about €54bn (or a decline of more than 20%) for the period December 2010 to December 2015. Demand for credit by enterprises has been dropping as business risk increased; households also reduced their demand due to uncertainty about their future economic situation and debt servicing capacity. In addition, the imposition of capital controls at end-June 2015 hampered economic activity. The effects appear to have been less severe than initially expected, due to the positive contribution of net exports and lower-than-expected decline in consumer spending; however, adverse effects were observed in the business environment and particular sub-sectors such as shipping and financial services.

The authorities' response

Over the past eight years, the economic adjustment programmes that have been implemented in Greece aimed at addressing the twin deficits (i.e. fiscal and current account) and structural weaknesses from which the economy has suffered for decades. The achievements so far have been remarkable:

- Unprecedented fiscal consolidation: Over the period 2013-2017, the primary deficit of the general government was eliminated and, for the first time since 2001, general government primary surpluses were recorded for five consecutive years.

- Gains in external competitiveness: The current account deficit, which exceeded 15% of GDP in 2008, was all but eliminated, underpinned by a recouping of the sizeable cumulative loss in labour cost competitiveness vis-à-vis our trading partners and an increase in the share of exports to 33.2% of GDP from 19% of GDP in 2009. As a consequence, openness has improved substantially and the economy has started to rebalance towards tradable, export-oriented sectors.

- Structural reforms, notably in the labour market, but also in product and services markets, as well as in public administration, have been undertaken. Important reforms of the tax system, tax administration as well as in the social security system, have been also implemented.

In a similar vein, the Bank of Greece has taken prompt and effective action to safeguard financial stability. The banking system has been restructured, consolidated and recapitalized, following stringent stress tests along with in-depth asset quality reviews. This, enabled the banking sector to withstand the crisis and the flight of deposits.

In particular, the authorities' response to tackle the issue of non-performing loans comprised of three pillars:

- *Enhancement of the supervisory framework for the management of non-performing exposures (NPEs)*. The Bank of Greece, in cooperation with the ECB Banking Supervision (the SSM), has issued supervisory guidelines for the internal management of NPEs and has recently agreed NPE operational targets with banks for the period June 2017 – December 2019, entailing a reduction of NPEs by 37%. The Bank of Greece monitors the implementation of NPE targets and related key performance indicators through an enhanced prudential reporting framework. This framework is currently being revised to take banks up until end-2021 and fully align Greek banks with the NPE guidance provided by the SSM.

- *Removal of legal, judicial and administrative impediments to Non-Performing Loan (NPL) management*. The household insolvency framework has been improved, legal proceedings have been simplified and accelerated, secured creditor rights have been enhanced, legal protection of bank and public sector employees has been established, the tax treatment of provisions and write-offs is favourable, out-of-court workout and electronic auction platforms have been introduced.

- *Establishment of a secondary market for NPL servicing and sales*. The Bank of Greece has already authorized 14 non-bank NPL servicers, with some portfolios being transferred for servicing either by banks or by purchasers of NPLs. The sale of loans has also been largely liberalized and €12 billion of NPE balances (nominal value) have been sold to third party investors.

These developments make it clear that the domestic banking sector has experienced a sea change 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 was never going to be pleasant; neither were three rounds of recapitalization, with substantial effects upon private and public equity holdings.

However, these initiatives helped both systemic banks and less significant institutions in Greece to build significant capital adequacy reserves and buffers. Moreover, one of the effects of the crisis in the Greek banking sector has been the fact that it has been subjected to a series of tests. In fact, since 2010, Greek banks have been subjected to stress tests six times, four of them accompanied by full blown asset quality reviews. These exercises have been cumbersome and substantial amounts of time and resources have been consumed.

These exercises have nonetheless had a few major advantages: First, credit losses have been calculated and recalculated and the possibility of having unanticipated losses is now smaller than ever. Secondly, as a result of a mandatory adverse scenario, buffers for potential additional loan losses have been specified and banks have raised high-quality regulatory capital to support these buffers. Moreover, it is not surprising that Greek banks' provisioning policies have been radically changed since the Asset Quality Review

(AQR) methodology was implemented and total losses were recalculated according to anticipated loss drivers.

Lessons learned from the Greek banking crisis

Thucydides, the great ancient Greek historian, considered his writings as “a possession for all time” for as long as human nature remains the same. In this vein, we ought to carefully consider what we have learned from the deep and prolonged Greek banking crisis.

The first lesson is that a *well-designed and decisive policy response* can mitigate the impact of shocks. The Bank of Greece along with other Greek authorities and the European Institutions was involved in the establishment of the Hellenic Financial Stability Fund (HFSF) and in securing the appropriate financial envelope (initially €10 billion and subsequently €50 billion in total) for the recapitalisation and restructuring of the Greek banking sector. The Bank of Greece also conducted in-depth diagnostic studies of the banks’ asset quality as well as stress tests, engaging international consultants with the objective of estimating the impact of the crisis on Greek banks. Moreover, the Bank of Greece developed a comprehensive strategy to implement efficiently the newly established resolution framework for banks and conducted a viability assessment, enabling the smooth resolution of non-viable banks without any depositor losing his/her money. Lastly, the Bank of Greece developed an enhanced supervisory framework for the management of non-performing exposures, including an NPE operational targets framework, acknowledging asset quality as the key driver for banking sector performance. In a nutshell, financial stability was preserved thanks to policies that were commensurate to the underlying risks and that were enacted promptly.

The second lesson is the importance of *rigorous implementation*. For example, the Bank of Greece did not hesitate to resolve non-viable banks, both commercial and cooperative, thus contributing to the consolidation and restructuring of the Greek banking sector. The four systemic banks, managed to attract private capital in three consecutive recapitalisation rounds. This allowed the downsizing of the Greek banking sector via personnel, network and cost rationalisation commensurate to the reduction of domestic economic activity. Furthermore, the Bank of Greece set up a comprehensive reporting mechanism and conducted troubled asset reviews and on-site examinations to closely monitor the implementation of the enhanced supervisory framework for non-performing exposures, thus ensuring that balance sheet repair is the top priority for the management of all Greek banks. Concurrently, the Bank of Greece contributed to the effort of establishing a secondary NPL market via the licensing of NPL servicers and the monitoring of NPL sales and securitisations. We should bear in mind that reforms and initiatives bring about tangible results only if implemented appropriately.

Throughout the crisis, the Bank of Greece has been the guardian of financial stability, protecting fully all deposits (regardless of type and size) and supporting the economy and the public interest. Our response was focused upon two major fronts: ensuring adequate provision of liquidity and managing and assisting recapitalization, resolution and restructuring of the banking sector.

With respect to liquidity provision, the intervention of the Bank of Greece has been critical in ensuring continuous liquidity provision to banks using one of the oldest tools available, that of the lender of last resort. On various occasions, the Bank of Greece has provided Emergency Liquidity Assistance (ELA) to the banking system. This has helped preserve financial stability and contributed to the avoidance of a banking crisis.

With respect to managing and assisting recapitalization, resolution and restructuring, the Bank, 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.

Following an assessment by the Bank of Greece of each bank on the basis of specific regulatory and business criteria, those banks deemed non-viable were resolved and eventually 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, as a rule, deposits from resolved banks were transferred to systemic banks. This process also ensured a minimum of disruption for customers of resolved banks. 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.

Those banks deemed viable were recapitalized. The first round of recapitalization, following, *inter alia*, the impact incurred from the Private Sector Involvement (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. 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 result of this exercise was the 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, including the Bank of Greece, successful rights issues resulted in the full coverage of the shortfall by December 2015, with private investors subscribing €9 billion. These efforts minimized HFSF participation and helped to restore confidence in the longer-term viability of Greek banks.

Following three rounds of recapitalization, Greek banks now have relatively high capital ratios and maintain buffers sufficient to absorb additional credit losses, as the 2018 pan-European stress test indicated. They have also markedly improved their liquidity position, reducing their reliance on central bank funding, regaining access to the interbank market and issuing securitizations and covered bonds, three of which have already been assigned with an investment grade rating. Concurrently, customer deposits have been gradually increasing.

Challenges for the banking sector going forward

Towards the road to recovery the Greek banking sector faces the following closely interlinked challenges:

- *Reducing the elevated stock of non-performing loans*.
- *Restoring the intermediation role of banks*.
- *Developing a sustainable business model*.

The efficient management of NPEs is of utmost importance for banking sector stability, economic growth and social cohesion. As of June 2018, the NPE stock stood at €88.6 billion, reduced by 6.1% since December 2017 and by 17.3% from its peak (March 2016). So far, NPE reduction has been mainly driven by write-offs and to a lesser extent by loan sales. This partly explains the stickiness of the domestic NPE ratio at 47.6%, which remains one of the highest in the euro area. Despite the progress so far, we still have a long way to go. Greek banks have already submitted revised NPE operational targets covering the period up to 2021. Loan sales, collections, collateral liquidation and curing are anticipated to contribute more extensively towards NPE reduction, at ratios around or lower than 20% of total non-performing exposures.

Balance sheet repair will bring many benefits to banks. Firstly, it will reduce credit risk cost, which remains far higher than pre-crisis levels and consumes most of banks' pre-provision income. The prohibitively high credit risk cost feeds into lending spreads, increasing the funding cost of non-financial corporates and households and thus reducing loan demand and competitiveness. Secondly, it will underpin banks' net interest income, since impaired assets are typically not interest bearing. Thirdly, it may reduce the funding cost of banks alleviating concerns regarding their asset quality and long-term resilience. Fourthly, it will reduce the administrative burden and operating cost for handling non-performing assets. Last but not least, the elevated stock of NPLs diverts management attention from the pursuit of profitable growth opportunities. After all, banks are not supposed to be distressed-assets managers.

Moreover, one of the main channels through which high NPLs can have a feedback effect on the macroeconomic environment is through their impact on bank lending capacity to the economy. NPLs can weigh negatively on the supply of credit by locking in bank capital and funding in the financing of non-productive assets. In addition, high NPLs distort credit allocation, as non-viable firms are kept artificially alive in an attempt by banks to avoid or delay loss recognition on these loans at the expense of firms that are competitive and have better growth prospects. This brings us to the necessity of restoring the intermediation role of banks in an economy that is suffering from a significant savings – desirable investment gap as well as continuous deleveraging. It is well documented that a credit-less recovery is weaker, mainly because the lack of bank credit affects investment. Yet such a recovery can hardly be tolerated given other drags on potential output growth, such as the high public debt ratio and the negative demographic trends. The improvement in the liquidity position of banks on the back of gradually increasing deposits, enhanced access to the secured interbank market and a handful of covered bond and securitization transactions is encouraging. Crucially, the elimination of the recourse to ELA will allow banks to design and implement credible medium-term credit expansion plans. Against this backdrop, financing of non-financial corporates for working capital or investment projects would be given priority. That said it is also important to restore the access of the household sector to credit after a protracted period of almost a complete standstill.

That brings us to the challenge for bank managers to come up with a sustainable business model for Greek banks. In the midst of the crisis, Greek banks were obliged to reduce substantially their international operations as well as non-core domestic activities, as part of their restructuring plans agreed with DG Competition in the context of State aid support approval. As a result, domestic traditional banking activities contribute the bulk of their operating profitability and will continue to do so in the foreseeable future. Undoubtedly, banks face a challenging, to say the least, operating environment in Greece, while some of their best customers, i.e. large extrovert non-financial corporates, can tap the international bond markets directly at relatively favorable terms. Against this backdrop, a digitalization drive coupled with other cost containment efforts can further improve banks' efficiency, which already compares favourably with their European peers. The development of fee-based businesses (e.g. asset management, bankassurance etc.) could also contribute to the diversification of their revenue sources. Needless to say, restoring credit intermediation is a "sine qua non" for long-term sustainability.

Concluding remarks

Ladies and Gentlemen,

I feel we have gone a long way towards facing a series of challenges and tasks. For us, the ultimate goal in meeting these challenges is to shape a competitive economy, attractive to foreign direct investment, with its income per head gradually converging to the rest of the Eurozone, fully sustainable public finances not only in the short run, but also in the medium and long term, full access to international financial markets under sustainable terms, and a banking sector which will be in a position to undertake efficiently its main task, namely the financing of the real economy. I will 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.