

Greek financial institutions operate in an intensely competitive international environment as spreads decline and the MiFID is about to unleash further competitive pressures. Yet banks are well organized and healthy, enjoying high profitability.

The Greek financial system in 2008

The Greek financial sector is one of most dynamic and profitable areas of the Greek economy. Since the late 1980s its performance has been boosted by a gradual process of liberalization and a subsequent wave of mergers and acquisitions, which totaled 37 over the period 1995 to 2006. Greek banks became fewer and larger and, in the last decade, expanded aggressively into the neighboring region. Today, Greek financial institutions face a number of challenges regarding their growth and profitability strategy. Some of the open questions are:

- Will there be a new cycle of mergers and acquisitions in the Greek financial sector, which would lead to larger financial groups that are able to compete more effectively in the region of New Europe?
- What are the consequences of the crisis in the subprime market abroad on the domestic financial market and the cost of money?
- Are there substantial risks involved in the expansion in New Europe?
- Will the Greek insurance companies continue their restructuring and consolidation in order to take advantage of the enormous growth opportunities in the life insurance sector?
- Will the domestic stock market strengthen its position in the international financial system and respond adequately to the pressures of the Markets in Financial Instruments Directive (MiFID)?
- How can the Greek mutual funds regain the trust of individual investors?

Banking sector

Greek bank groups are the key players in the domestic financial system, providing a complete spectrum of financial services. Commercial banks' assets at end-2006 amounted to 352 billion euros or 164 percent of GDP. The degree of concentration in the Greek banking system remains among the highest in the eurozone. The five largest banks in Greece held 66.3 percent of total bank assets at the end of 2006, compared to a corresponding 42.8 percent in the EU-12.

No major events occurred in the domestic financial market during 2007, while 2008 is expected to bring new developments concerning the future of Attica Bank and the Greek Postal Savings Bank. The challenges and risks that Greek banks face come mainly from the international market. The spread of the credit crisis which began in the USA subprime mortgage market and the growth prospects of New Europe constitute the main sources of risk as well as opportunity in the short run.

Aftermath of the subprime crisis

The credit crisis, which spread from the subprime mortgage markets in the US to all international credit

markets, is expected to lead to direct financial institution losses of approximately \$200-\$400 billion internationally. With the exception of the Greek Postal Savings Bank, the country's banks have no direct exposure to securitized products that are based on subprime mortgages or other subprime bank loans and, hence, are not expected to face any direct losses. The costs for Greek banks stem indirectly from the higher cost of capital in the interbank market (Chart 1). Since the outbreak of the crisis in August, liquidity has dried up in the interbank market. There is a reluctance to lend funds for longer periods than overnight, as the lack of information on the exposure of each international financial institution to derivative securities of low quality makes banks suspicious of each other. This higher marginal cost of bank liquidity, coupled with the reluctance of the European Central Bank (ECB) to cut its intervention rate, will translate into higher lending rates for both households and businesses in 2008, adding roughly one percentage point to lending rates throughout the eurozone. Banks will no longer offer floating rate loans based on the ECB's intervention rate or on other government short-term bills, but on the higher interbank rates, which better reflect the credit risk and the real short-term cost of money. The higher interest rates will naturally lead to a lower overall expansion of credit.

In addition, some of the higher cost of liquidity is bound to be absorbed by the banks themselves. Both factors would ceteris paribus lead to slightly lower profitability.



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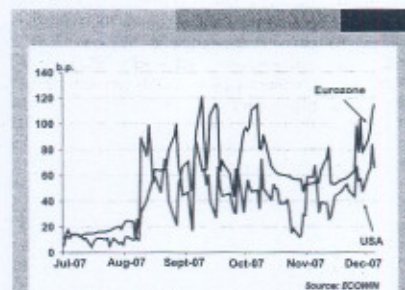


Chart 1.
The subprime effect on the interbank market
Eurozone: 3-month EURIBOR minus the EONIA overnight rate
USA: 3-month LIBOR minus the Effective Fed Funds rate
Source: ECOMW

Greek banks do not face any short-term liquidity problems, as is the case with many banks in other



countries. The average loans-to-deposits ratio in Greece is not very high, close to 100 percent, suggesting that the Greek financial system is liquidity-neutral. Furthermore, those banks with a loans-to-deposits ratio above 100 percent have already secured the required liquidity at least until the end of the first quarter of 2008. Presently, Greek banks also have the ability to secure liquidity through the ECB in the repo market using covered bonds at a lower cost than in the interbank market. This is because the Bank of Greece (BoG) recently allowed the issuing of covered bonds by banks under a strict legal framework and a set of rules offering extra protection to investors. Covered bonds use bank assets, such as mortgages, government bonds etc, as collateral and if a loan in the collateral pool defaults, the bank is obligated to replace it with another healthy loan.

Expansion into New Europe

The presence of Greek banks in the countries of New Europe has intensified in recent years. They have strengthened their networks in the region either through direct acquisitions of banks in countries including Turkey, Bulgaria, Serbia, Ukraine, Albania and the Former Yugoslav Republic of Macedonia (FYROM) or through organic growth in countries such as Poland (EFG Eurobank) (charts 2 & 3). There is also active interest in the markets of the Middle East and North Africa, with Piraeus Bank already having acquired a small bank in Egypt. The profit targets in those countries are ambitious but attainable. In the case of EFG Eurobank, profitability from the international network appears low compared to the other Greek banks (see Chart 3), but this is a healthy sign. It is due to the

financing of an aggressive organic growth schedule, which absorbs most of the gross profitability of the international network itself.

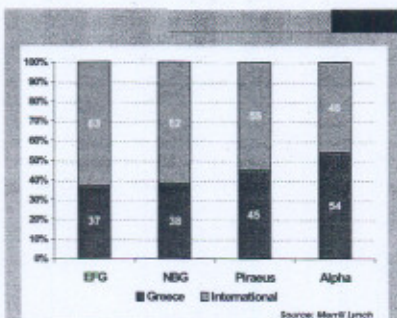


Chart 2.
The distribution of the branch network of the 4 largest Greek banks
(3rd quarter 2007)

The increasing dependence on bank profits coming from abroad suggests that the macroeconomic and financial risks in New Europe are gaining importance. Yet 2008 is expected to be a year of high growth in the region with all countries growing above 5 percent and with their financial sectors expanding at even faster rates.

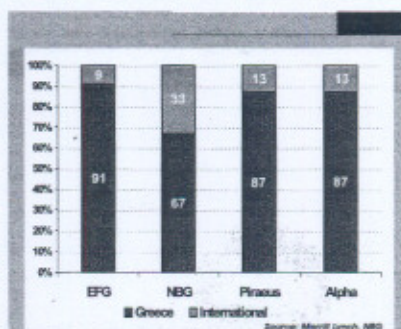


Chart 3.
The contribution to profits according to domestic and international activities for the 4 largest Greek banks
(3rd quarter 2007)

Developments in the domestic market

Despite its small size, the domestic market is the one that presently supports the profitability of Greek banks (Chart 3). Credit expansion to households and businesses continues to be strong and outperforms the corresponding expansion in the eurozone. In September 2007, housing loans in Greece increased by twice the corresponding rate in the eurozone (22.3 percent against 7.8 percent on an annual basis). Consumer loans increased by 20.8 percent (4.1 percent in the



eurozone) while business loans increased by 12.1 percent (13.4 percent in the eurozone). In the last two years, there has been an increase in the growth of business loans with a simultaneous decrease in the growth of loans to households (Chart 4). Total loans are expected to continue increasing in 2008, since the Greek banking system is mature, although not as much as in the EU-13. The private sector credit-to-GDP ratio stood at 87 percent in Greece and 176 percent in EU-13 in the third quarter of 2007 (not including securitized loans).

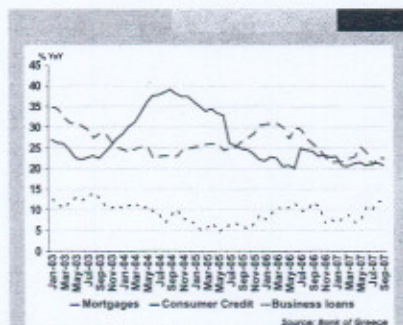


Chart 4.
Loan growth in Greece

Competition in the Greek domestic market has intensified significantly, leading to a substantial decrease in the spreads between lending and deposit rates. Those spreads are now very close to the eurozone averages (Chart 5). The rapid credit expansion means that it is crucial to be vigilant on credit risk. The non-performing loans to total loans ratio remains higher than in the eurozone, albeit much improved (2003: 7 percent, 7/2007: 5.1 percent) (see Monetary Policy Interim Report, Bank of Greece, October 2007).

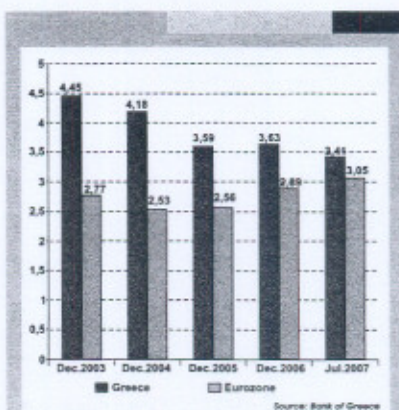


Chart 5.
The spread between lending and deposit rates (percent)

Insurance companies

The Greek insurance market is still underdeveloped and has great prospects for future growth. Despite an important increase in premium production in 2006 — 10.5 percent against 6.7 percent in the eurozone, overall premium production ranks very low in Europe: As a percent of GDP, premium production amounted to 2.03 percent in 2006 compared to 8.16 percent in the eurozone. The comparative shortfall in the investments component of the balance sheet is even larger, despite its important increase of 11.7 percent in 2006 against 5.8 percent in the eurozone. Insurance company investments in Greece, as a percentage of GDP, hardly amount to 1/10 of the corresponding investments in the eurozone (4.9 percent of GDP in Greece against 49 percent of GDP in the eurozone), raising questions about the efficiency of

management of insurance company assets in the past (Chart 6).

Over the last few years, there were significant efforts aiming at higher transparency and reliability in the Greek insurance sector. The establishment of a new public authority at the Ministry of National Economy for monitoring the insurance market constitutes an important first step. There is significant consolidation in the sector as well with the weaker companies being forced to cease operations or be taken over. The number of insurance companies operating in the Greek market at the end of 2006 decreased to 90 from 110 in the year 2000. From the official number of 90, only 77 were in actual operation (63 Greek and 14 foreign companies) at end-2006, with most of them operating in casualty insurance.

The Athens Stock Exchange

Following the price and trading volume boom of the late 1990s and the crash of 2000, the Greek stock market has subsequently recovered, follow-

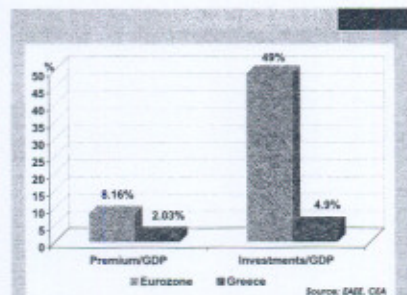


Chart 6.
Insurance sector asset investments and revenues from insurance premiums (percent GDP)



ing the rise of the international markets from 2003 onward. The entry of foreign institutional investors and the increasing profitability of enterprises were the main driving forces behind the renewed interest in the market. Since the beginning of 2003, the general index of the Athens Stock Exchange (ATHEX) has gone up by 193 percent, and as of December 12, the year-to-date increase in 2007 is 16.8 percent, outperforming most international stock markets.

The ATHEX's aggregate price index reached an all-time high on October 31, 2007, corresponding to a capitalization of approximately 202 billion euros (Greek GDP in 2006 was 214 billion), while at the beginning of December 2007 it was 196 billion. A main feature of this period is the continuously rising share in the participation of foreign investors. In October 2007, the share of foreign investors amounted to 57.2 percent of total capitalization and was concentrated mainly in large and medium-size companies, against a share of only 36.4 percent in December 2004. The rise in prices and the influx of foreign investors revived interest in raising new company capital through the ATHEX as well. In the first nine months of 2007, 9.1 billion euros were raised through IPOs and SPOs, a six-year high (2006: 4.1 billion, 2005: 4 billion).

Today, the Greek stock exchange and all Greek brokerage firms and other related intermediaries are called upon to adapt successfully to the new environment to be shaped by the creation of a single European market for financial services (MiFID). The transposition of European directives concerning financial service markets into Greek law opens the way for investors to gain access to all member states' markets under a common institutional framework, thus increasing competition and reducing transactions costs.

Mutual funds

Greek mutual funds are bleeding. In 2007, just as in 2006 and earlier, both open-end and closed-end funds failed to keep pace with the rising stock market. Open-end fund assets in the first six months of 2007 decreased to 23.6 billion euros, from 23.9 billion at the end of 2006 and 35 billion at the end of 1999. Greek mutual funds represent an aberration to a positive international environment for funds (Chart 7). Something is definitely not right. Perhaps the funds market would reverse course with the application of long-awaited essential reforms (tax regime, legal framework for operation of hedge funds etc.).

The same dismal picture holds true for the assets of closed-end funds, which peaked in 1999 at 4.2 billion euros, but at the beginning of December 2007 were approximately 0.25 billion. Part of the drop in size is also due to the fact that a number of active closed-end funds were absorbed by their parent banks.

Conclusions

Greek financial institutions operate in an intensely competitive international environment as spreads between bank lending and deposit rates are declining and MiFID is about to unleash further competitive pressures. Yet banks are well organized and healthy, enjoying high profitability. This is also evidenced by the fact that the current international banking crisis, which originated in the US subprime mortgage market, has not affected them. The cost of the crisis is only indirect and minor, as it works through the higher cost of attracting funds in the interbank market.

The future of Greek banks depends critically not only on their success in competing effectively in the domestic market, but also on the success of their international expansion, mainly in the coun-

tries of New Europe. These countries are growing fast and their financial sectors even faster. Thus Greek banks are posed to do well. Of course, international expansion requires a careful strategy and an active monitoring of associated risks.

Other sectors of the Greek financial system, such as insurance companies or the mutual funds industry, must resolve a series of deep-rooted problems and weaknesses, before achieving sustainable and dynamic growth.

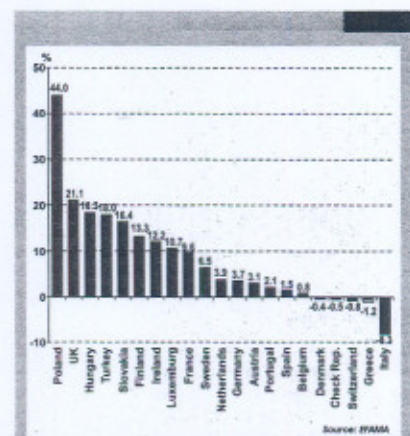


Chart 7.
The increase in mutual fund assets during the 1st quarter of 2007 (percent)