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The Deregulation of the Hellenic Financial Sector: Risk and Wealth Effects

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This paper examines wealth effects and changes in the systematic risk associated with the return structure of the Greek commercial chartered banks and investment firms that resulted from the passage of the European Union Banking-Directives over the period 1988 to 1997. The empirical results indicate that the systematic risk for the commercial chartered banks decreased through the tabling of the Free Capital Movement Directive in the Hellenic Parliament. After controlling for systematic risk, the empirical evidence suggests that the Free Capital Movement Directive created wealth effects for the commercial chartered banks but not for the investment firms. Conversely, the statistical results indicate that the Second Banking, the Investment Services and the Capital Adequacy Directives produced wealth effects for the investment firms but not for the commercial chartered banks. **JEL: G21, G24, G28.**

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1. Introduction

The EU's Deregulation of Financial Services Initiative advanced very rapidly in 1988 with the passage of several technical banking directives that aimed to improve the efficiency of all Member States' financial sectors. The banking directives in chronological order were: 1. The Free Capital Movement Directive (effective date: 07/01/1990), 2. The Solvency Ratios Directive (effective date: 01/01/1991), 3. The Own Funds Directive (effective date: 01/01/1991), 4. The Second Banking Directive (effective date: 01/01/1993), 5. The Consolidated Supervision Directive (effective date: 01/01/1993), 6. The Money Laundering Directive (effective date: 01/01/1993), 7. The Investment Services Directive (effective date: 01/01/1994), and finally 8. The Capital Adequacy Directive (effective date: 01/01/1994).[1]

These particular banking directives not only created significant opportunities for all Member States financial services industries but also laid the groundwork for the replacement of Functional with Universal bank based systems within the EU territory.[2] Standard textbook theory on economic regulation indicates that any deregulatory changes aiming to abolish or partially eliminate a Functional with a Universal bank based financial system, would directly affect the shareholders returns and the systematic risk (e.g., market risk) of the various pillars of economic activity.

This study contributes to the regulatory economics and finance literature, since it seeks answers and clues as to: i. how the passage of the EU banking directives affected the systematic risk of the Greek financial institutions and ii. how the returns to the shareholders of the commercial chartered banks and investment firms were affected by the introduction of these EU binding banking directives

Little empirical work exists on how the systematic risk of a financial system for a small open economy like Greece is impacted by any major banking deregulatory changes that incur within a larger trading bloc due to data deficiency.[3] Furthermore, the Greek experience is especially interesting and instructive, for the new EU Member States and other transition economies, since the passage of these banking directives completely transformed and restructured its financial sector from Functional to a Universal bank based in a single policy shift.

The paper is organized as follows. Section 2 examines the workings of the Greek financial system. Section 3 reviews the existing literature. Section 4 highlights the statistical hypotheses and introduces the econometric methodology. Section 5 presents the empirical results. Section 6 concludes the paper.

[1] For more on this issue, see Kollias (1994) and Pantos and Paraskevopoulos (1994).

[2] The following countries were EU's members before the May 1st, 2004 accession: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom. The EU was enlarged on May 1, 2004 by the accession of ten new member states: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia.

[3] For more on this issue, see for instance studies performed by Pantos and Saidi (2005), Tollison (2001), Peltzman (1976) and Stigler (1971).

2. The Greek Financial System

During the 1980s, the Greek banking system operated in a highly regulated environment, imposed by the government through the Bank of Greece.[4] This control was exercised directly through banking regulations, which were often changed to reflect the government's short-term goals of economic and monetary policy, and indirectly through control over the major Greek commercial banks. Government regulations covered reserve requirements, permission for incentives to the banks for the granting of loans to certain types of enterprises, and foreign exchange control measures.

In the beginning of the 1990s, the Greek financial sector compartmentalized itself into a "two-pillar" system. The two pillars were: 1) commercial chartered banks that fulfilled the functions of deposit and lending, fiduciary services and mortgages; and 2) investment firms that underwrote and traded securities. Cross-ownership of commercial chartered banks and investment firms was strictly prohibited. Foreign control of banks and security dealers was also restricted. One of the reasons for the compartmentalization of the Greek financial sector was to limit the ability of deposit-taking institutions to engage in activities that deemed to be "too risky", such as underwriting. A second reason was to guard against conflicts of interest, such as a bank underwriting the equity issue of one of its corporate borrowers.

The introduction of the EU banking directives brought increased competition in the Greek financial sector as European financial institutions received the right to expand within the EU market. Cross-ownership of commercial banks and investment banks was finally allowed. Increased international competition, especially in investment banking and corporate lending, compelled financial institutions to seek greater efficiencies by expanding into each other's line of business in order to obtain scale and scope economies.

The Greek financial system changed rapidly, conforming to EU's market forces, altering the organization of the Greek financial sector. The preoccupation of every Greek government since the passage of these directives is to conform to the new global regulatory environment, and ensure that the commercial chartered banks ran prudently, in order to avoid any major upheavals in investor confidence, movement of funds and concentration of powers.

3. Literature Review

The academic studies of Stigler (1971) and Peltzman (1976) constitute the framework for analyzing the impact on the financial institutions after various regulatory changes are introduced.

[4]The Bank of Greece during the 1980s and the beginning of 1990s did not enjoy a substantial degree of independence or near autonomy from the Greek government. The socialist government of Andreas Papandreou and the PASOK political party applied a great deal of pressure to the Central Bank with respect to the conduct of monetary policy in order to achieve their "myopic" short run goals. Furthermore, the political pressures that were imposed on the Prime Minister Papandreou after the exposition of the "Bank of Crete" economic scandal and the political unrest of the Greek labor movement (e.g., labor organizations such as ΓΣΕΕ and ΑΔΕΔΥ) have circumvented even more the autonomy of the Central Bank of Greece, since the socialist government ordered the largest expansion of the money supply in order to satisfy its unreasonable demands.

Stigler (1971) develops an economic theory of regulation and explains that economic interests among various market participants are affected based on the regulatory framework and the political power that each lobby group possesses. The chief regulator sets the rules in such a way to benefit the party with the greatest political power at the expense of everybody else in the system. Regulation essentially imposes a tax on the wealth of economic agents and the per capita gains accrue to the party with the greatest association with the regulators.

Peltzman (1976) suggests that the introduction of various regulatory reforms may affect the systematic risk of the banks. He argues that reduction of economic regulation and movement from segmented markets to universal ones will increase the risk of equity ownership. This is due to the increase in competition and the resultant increased variability of banking earnings.

In the last two decades, various researchers have examined deregulatory changes produced by the introduction of the Glass-Steagall Act that separated banking from underwriting/investment business in the U.S. Litan (1985) discusses how systematic risk may rise when banks diversify into riskier non-banking ventures because of the existence of moral hazard associated with government deposit insurance. Joskow and MacAvoy (1975) on the other hand, suggest that the introduction of various regulatory reforms and barriers results in lower risk. Brewer (1990) claims that regulatory reforms leading to geographical diversification also decrease systematic risk.

Fraser and Kannan (1990) find that the introduction of regulatory reforms increases the risk of equity for banks. Similar results were obtained by (Pettway, Tapley and Yamada (1988)). They examine Japanese and American financial institutions that underwrote and managed Eurobond offerings and find that the systematic risk for these firms increases. Aharony Saunders and Swary (1988) examine the Depository Institutions Deregulation Monetary Control Act enacted in the U.S. in 1980 and find that its introduction decreases the systematic risk for financial institutions, while Allen and Wilhelm (1988) find no relationship associated with this Act and the risk of banks. Wall (1987) and Brewer (1990) respectively, find that deregulation does not lead to greater risk as banks enter into investment firms' business.

Thus, from the above-mentioned literature review one clearly understands that there exists no consensus among academics on how changes in economic regulation will affect a financial institution's risk or its shareholder value.

4. Hypotheses, Data and Econometric Methodology

I test the separate effects of each of the eight banking directives on the commercial chartered banks and the investment firms in my sample. These tests will indicate whether or not was an increase in the systematic risk of these firms at the time of the introduction of these eight EU deregulatory events. In addition, I separately test whether or not any change in the shareholders' wealth for these two-pillars of economic activity was attributable to the passage of each individual deregulatory event.

The two hypotheses to be tested in this research are: 1. Whether there was a significant shift in the systematic risk of the commercial chartered banks and investment firms resulting from the

initial proposals that commenced with the passage of the various deregulatory banking directives, and 2. Whether the announcement of each banking directive had a significant impact on shareholder wealth of each portfolio of banks and investment firms respectively.

The data is comprised of monthly stock returns from the Emerging Markets Data Base (hereafter, EMDB) compiled by the International Finance Corporation (hereafter, IFC) for the period January 1988 to December 1997 and encompasses two portfolios: (a) an equally weighted banking index made up of 5 major banks and (b) an equally weighted investment company index, which included 3 investment firms. In addition, I use monthly returns for the Morgan Stanley World Index (hereafter, MSWI) as my proxy for the market portfolio. The indices were converted to returns using the log difference method.

Following the work of Binder (1985), Allen and Wilhelm (1988), Cornett and Tehranian (1989, 1990), the seemingly unrelated regressions econometric methodology (hereafter, SUR) of Zellner (1962) is used. This methodology has the advantage of providing a framework for testing a wide range of regulatory change announcements. Moreover, with common calendar day announcements for all stocks, the error term is not independent across equations. The lack of independence of the regression residuals reduces the efficiency of the estimated coefficients and renders the t-statistics unreliable if each equation is estimated separately as it is often done with the standard residual analysis.

The SUR methodology is more suitable in testing for abnormal returns when the event involves a common calendar date.[5] Equations (1) and (2) model the return generating process and constitute a system of simultaneous equations to be jointly estimated using the SUR econometric methodology.

Chartered Banks:

$$R_{1t}=\delta_1+\delta_1^{'}D_s+\beta_1 R_M+\beta_1^{'}D_s R_M+\sum_{j=1}^{4}\gamma_{1j}D_{jt}+\varepsilon_{1t} \quad (1)$$

Investment Firms:

$$R_{2t}=\delta_2+\delta_2^{'}D_s+\beta_2 R_{Mt}+\beta_2^{'}D_s R_{Mt}+\sum_{j=1}^{4}\gamma_{2j}D_{jt}+\varepsilon_{2t} \quad (2)$$

where, R_{it} denotes the time series of portfolio returns for the chartered banks and the investment firms respectively with (i=1,2), R_{Mt} denotes the time series of market portfolio returns, δ_i denotes the intercept coefficient of portfolio i before July 1990 regulatory changes, β_i denotes the systematic risk coefficient of portfolio i before July, 1990 regulatory changes, $\beta_i^{'}$ denotes the shift in the systematic risk

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[5] I would like to express my gratitude to the anonymous referee for providing me with the following intuitive econometric statement: "Since the error term of one equation is correlated to the error term of the other, ε_{it} (i=1, 2) will not have an expected value zero. Failure to use SUR results in inefficient estimates of beta coefficients (e.g., the coefficients will not exhibit minimum variance) and the corresponding t ratios are drawn into question. The practical consequence of this, of course, is the possibility of erroneously not rejecting the null hypotheses relating to these coefficients". Thus the SUR model is the most appropriate in testing for abnormal returns when the event involves a common calendar date.

coefficient due to the post July 1990 regulatory changes, D_s denotes the shift dummy variable that takes values of zero before July 1990 and one after July 1990 regulatory changes, D_{jt} denotes the regulatory event dummy variable j that takes the value of one if t is the month of the announcement and zero otherwise. Finally γ_{ij} denotes the marginal effect of each regulatory event j on the portfolio i with (j=1, 2, 3, 4) for the 4 distinct months of regulatory changes in Table 1 and portfolio i with (i=1, 2).

Equations (1) and (2) constitute a system of simultaneous equations to be jointly estimated using the SUR model. Our primary interest is to evaluate whether there is a significant shift in the systematic risk of each financial institution as a result of the introduction of the proposals for regulatory reforms (e.g., $\beta_i^{'} \geq 0$ or $\beta_i^{'} \leq 0$). This is tested in equations (1) and (2) with the beta shift dummy that appears in the term $\beta_i^{'} D_s R_{Mt}$.

For example, if the regulatory proposals allow the banks to diversify into the underwriting industry by acquiring some securities dealers and such news significantly affect the systematic risk of the banks we should expect $\beta^{'}$ to be statistically different from zero. The choice of July 1990 as the test date for the beta shift is made on the basis that it was the month of the first proposal of reform and thus is expected to be the event that would initially shift the systematic risk.

The regulatory impact is measured by the statistical significance of the coefficient γ_{ij} for each specific event. If the effect on portfolio i of each financial institution results in an increase in shareholder wealth, the coefficient will be greater than zero, $\gamma_{ij} > 0$. Conversely, a coefficient, which is less than zero, $\gamma_{ij} < 0$, implies a decrease in the shareholder wealth.

5. Analysis of Empirical Results

A. Descriptive Statistics

In Table 2 the results of the summary statistics and the univariate t-tests conducted in the presence of the four major deregulatory EU banking directives over the period 1988 to 1997 are reported and fully described in Panels A to D respectively. The empirical results indicate that the returns of the commercial chartered banks and the market returns declined with the passage of the Free Capital Movement Directive. In addition, the empirical results obtained suggest that the investment firms' returns were not affected by the passage of these particular directives. The rendered t-statistics indicate that the four deregulatory directives did not significantly affect the monthly returns of the Greek "two-pillar" system at the 1% and 5% level of significance respectively.

One possible explanation is that the passage of these banking directives removed all barriers to entry and exit and all other impediments to foreign capital flows and hence create an allocative efficient and competitive Greek Capital Market allocation that reduced the previously buffered from competition domestic market returns. A second explanation is that Greek institutional investors fully expected that the passage of these EU deregulatory proposals would create "self-fulfilling"

equilibria and fully anticipated the diminished domestic market returns.[6]

B. Regression Analysis

Table 3 presents the SUR regression estimation results. I find significant beta coefficients for both banks and investment firms. The magnitude of banks' beta coefficient is greater than this of the investment firms. This implies that the commercial banks became riskier in comparison to the investment firms during the passage of these binding banking directives.

Examining the impact of the dummy variable for the structural shift in beta, I find that the beta for banks after the passage of the Free Capital Movement Directive was structurally reduced. On the other hand, I do not find a structural shift in the investment firms' beta with the introduction of the Free Capital Movement Directive. This empirical finding is consistent with the risk return "trade-off" theory. Thus, the Free Capital Movement Directive reduced the banks' risk but also produced diminished banks' returns.

After controlling for the systematic risk I find that the passage of the Free Capital Movement Directive that was enacted in 1990, the Investment Services Directive, and the Capital Adequacy Directives that were enacted in 1994 have increased the commercial chartered banks' return. One possible explanation is that with the passage of the banking directives the commercial banks' obtained scale and scope economies because of the fierce competition and the various "cross-ownership" relations that were existed in the well-protected and buffered from global competition Hellenic financial services industry. The overall analysis of the Seemingly Unrelated Regressions results indicates that the correlation of errors between the commercial banks' and investment firms' returns was 0.48 and it was statistically significant.

6. Conclusions

The deregulatory changes in the EU have transformed the Greek Functional financial system to Universal. The statistical results indicate that the Free Capital Movement Directive significantly reduced the overall Greek market returns and increased the returns of the commercial chartered banks. The result was expected and is in line with Stigler's view of economic regulation. Stigler (1971) has clearly shown that any liberalization of capital flows reduces the domestic market returns but enhances the scale and scope economies of the commercial chartered banks.

In addition, the statistical results have shown that the banking directives decrease the market risk of the commercial chartered banks. The empirical results do not support Peltzman's (1976) argument that deregulation of an industry increases the market risk of those firms previously buffered from outside competition. After controlling for systematic risk, the statistical evidence suggests that the commercial chartered banks' return was

[6] For more on this issue, see Pantos and Saidi (2005). In their study the authors have shown, how the tabling of the EU banking directives in the Hellenic Parliament has momentarily changed the Functional Greek financial sector to Universal. In addition to this, the authors claim that the establishment of the Universal bank based regime produced lower domestic returns in comparison to higher returns of the past that were earned from the buffered and well protected by the Greek government old Functional or Segmented financial sector.

significantly increased with the passage of the Free Capital Movement Directive.

Conversely, the empirical results indicate that the introduction of the Free Capital Movement Directive was not associated with any creation of wealth effects and had no significant material impact on the return structure of the Greek investment firms. Consequently, unlike the findings of Cornett and Tehranian (1990), I have found no significant wealth creation in my study with respect to investment firms.

Table 1: Descriptive Statistics

The table presents the averages of monthly returns to shareholders for the commercial chartered banks, investment firms and the Greek stock market index during the 1988 to 1997 period. Four main EU deregulatory changes are examined. The Free Capital Movement Directive enacted in July 1, 1990, the Solvency Ratios Directive and the Capital Funds Directive, enacted in January 1, 1991, the Second Banking Directive, the Consolidated Supervision Directive, the Money Laundering Directive, enacted in January 1, 1993 and finally the Consolidation in the Investment Firm Services and the Capital Adequacy Directives enacted in January 1, 1994. The t-tests of the two means of returns before and after these EU deregulatory changes are reported in the four panels below.

Panel A.
The Free Capital Movement (July 1, 1990)

	before	after	t-ratio
Commercial bank returns	0.0656	0.0049	2.42**
Investment firm returns	0.0371	-0.0061	1.46
Market index returns	0.0576	0.0003	2.98***
Number of observations	30	90	

Panel B.
The Solvency and Funds (January 1, 1991)

	before	after	t-ratio
Commercial bank returns	0.0395	0.0011	1.39
Investment firm returns	0.0167	-0.0005	0.63
Market index returns	0.0336	0.0065	1.45
Number of observations	36	84	

Panel C.
Second Banking Directive (January 1, 1993)

	before	after	t-ratio
Commercial bank returns	0.0145	0.0011	1.39
Investment firm returns	-0.011	0.0204	-1.36
Market index returns	0.0132	0.0159	-0.16
Number of observations	48	72	

Panel D.
Investment Services and Capital Adequacy (January 1, 1994)

	before	after	t-ratio
Commercial bank returns	0.0132	0.0118	0.07
Investment firm returns	-0.0066	0.0215	-1.27
Market index returns	0.0172	0.0105	0.38
Number of observations	60	60	

Notes: The **, *** denote levels of significance at 0.05 and 0.01 respectively.

Table 2: The Seemingly Unrelated Regressions Estimation

The table presents the results from the Seemingly Unrelated Regressions Estimation (hereafter, SURE) between the monthly returns for the commercial banks and investment firms respectively. In Panel A, the dependent variable is the monthly returns for the commercial chartered banks. In Panel B, the dependent variable is the monthly returns for the investment firms. Note that the term MKT-RETURNS denotes the monthly returns for the Greek Stock Market Index. The variable D 1990 denotes the dummy variable that takes a value of one after July 1990 and zero otherwise. The term D1990*MKT-RETURNS denotes the interaction between the dummy variable D1990 and the MKT-RETURNS for the Greek Stock Market Index respectively. Similarly, D1991 denotes the dummy variable that takes a value of one after January 1991 and zero otherwise, D1993 denotes the dummy variable that takes a value of one after January 1993 and zero otherwise, and finally D1994 denotes the dummy variable that takes a value of one after January 1994 and zero otherwise. I have conducted all tests by using the SURE econometric methodology but I have also employed the econometric methodology suggested by Scholes-Williams (1977) in order to obtain robust and reliable statistical results in the presence of non-synchronous trading. The non-synchronous beta estimation results are not presented here. However, these results are qualitatively the same with the results presented in this table. The SURE regression results are of course corrected for the element of heteroskedasticity.

Variables	**Panel A**	**Panel B**
MKT-RETURNS	1.2065	1.0829
	(16.58)***	(10.55)***
D1990*MKT-RETURNS	-0.1700	0.0700
	(-1.79)*	(0.52)
D1990: (γ_1)	0.0956	0.0372
	(1.99)**	(0.55)
D1991: (γ_2)	0.0142	0.0035
	(0.30)	(0.05)
D1993: (γ_3)	0.0294	0.1051
	(0.61)	(1.54)
D1994: (γ_4)	0.0819	0.0454
	(1.70)*	(0.67)
Intercept	-0.0067	-0.0127
	(-1.48)	(-1.98)**
R-square	0.8285	0.7165
Contemporaneous		
Correlation of errors	0.48***	
Chi-square	27.35***	
Number of observations	120	120

Notes: The ***, **, and * denote levels of significance at 0.01, 0.05 and 0.10 respectively.

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Book Review:

The Principle of Mutual Recognition in the European Integration Process. **Editor: Fiorella Kostoris Padoa Schioppa.** New York: Palgrave Macmillan, 2005. ISBN 10: 1-4039-3489-4.

The stated objective of this book is to describe the Principle of Mutual Recognition, its evolution, implementation in European markets to date and finally its potential for utilization in an enlarged EU of the future. As is well known, 'mutual recognition' first came to the fore, with the 1979 European Court of Justice (EJC) ruling surrounding *Casis de Dijon.* Ever since that landmark ruling, a new approach based on respect for different national regulations is fast emerging. Goods and services produced by the various member states under different regulations, can and must have access to all Union countries provided that they do not damage the health or the natural and artistic environment of the destination markets. In other words, harmonization is not always essential for European construction and that in turn fulfills two important objectives: (a) acceptance of the sovereignty of European Member States to choose their own regulatory regimes; and (b) the elimination of barriers to entry, thereby creating a union truly without frontiers between and within Western and Central-Eastern Europe.

In keeping with the book's objectives, the historical foundations of mutual recognition are described by Materra in Chapter 1 and to some degree by the editor (Schioppa) in Chapter 6. Materra argues very effectively that the importance of mutual recognition can hardly be overemphasized, specially if one wishes to safeguard Europe's national, regional and local identities and traditions. In fact he proposes conformity with the ancient Roman tradition of imposing "unity over uniformity", as a way to facilitating mutual recognition in Europe.

Chapter 2 (Weiler) provides an interesting critique of the recognition procedure, attempted to date. Professor Weiler's review of EJC cases from the mid-60s to the late 90s leads him to conclude that "mutual recognition….. was perhaps an intellectual breakthrough but a colossal market failure…. Goods which do not meet the

technical standards of the importing country may not be marketed….In this case harmonization is simply required". This is why he prefers another lexicon, where the formula of "functional equivalence" is a substitute for the traditional wording of ' mutual recognition'.

Chapter 3 (Pelkman) examines the costs and benefits of mutual recognition to European commodity and service markets. This analysis shows that the adoption of mutual recognition is almost rare in the service sector. In the goods sector, 'mutual recognition covers about half of intra-EC industrial trade, but it only matters for the 30 percent of intra-EC trade for which national regulations exist'.

Chapter 4 (by Nicolaidis) reveals yet another paradox – while capital is allowed free reign to traverse all of the European continent, the cross-country flow of people appears to be controlled and managed. Even white collar professionals such as doctors, engineers, accountants etc., face binding constraints, even in situations where the destination member state would benefit from these professional service providers. This is surprising considering that the first step in this direction had been taken decades ago – the 1957 Directive on the mutual recognition of diplomas, certificates etc. It is clear that despite all the rhetorics, the European Union still has much to do to fully accomplish a managed, mutual recognition of the professional self-employed in Europe.

The final chapter (Chapter 5) extends the discussion even further, exploring employment related issues in even greater details. It points out that in the case of migrant workers, host and not home country principles is always enforced. The evidence also suggests that despite the pledge of non-discrimination and equal treatment in European labour markets, current legislation is geared to protect national workers from other (European) worker's potential competition. If mutual recognition were truly implemented, mobility would increase and unemployment would decline in the EU, thereby increasing the level of equity and efficiency of all European societies.

The contributors to this edited volume appear to suggest that despite the universal support of MR (mutual recognition) by the EU member states, actual adoption and implementation has not been an unambiguous success story. Even if one does not wholly accept this view, there is still much to like in this book. This book is worthwhile reading for anyone interested in the intricacies of bloc formation, in general; and the nature, scope and the wide variety of problems encountered when implementing MR, in particular.

Saud Choudhry

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