

Towards a sound and effective financial system in Cyprus

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Cyprus: Financing the recovery

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Roadmap

1. A brief history
2. Long-standing issues
3. Bail-in consequences

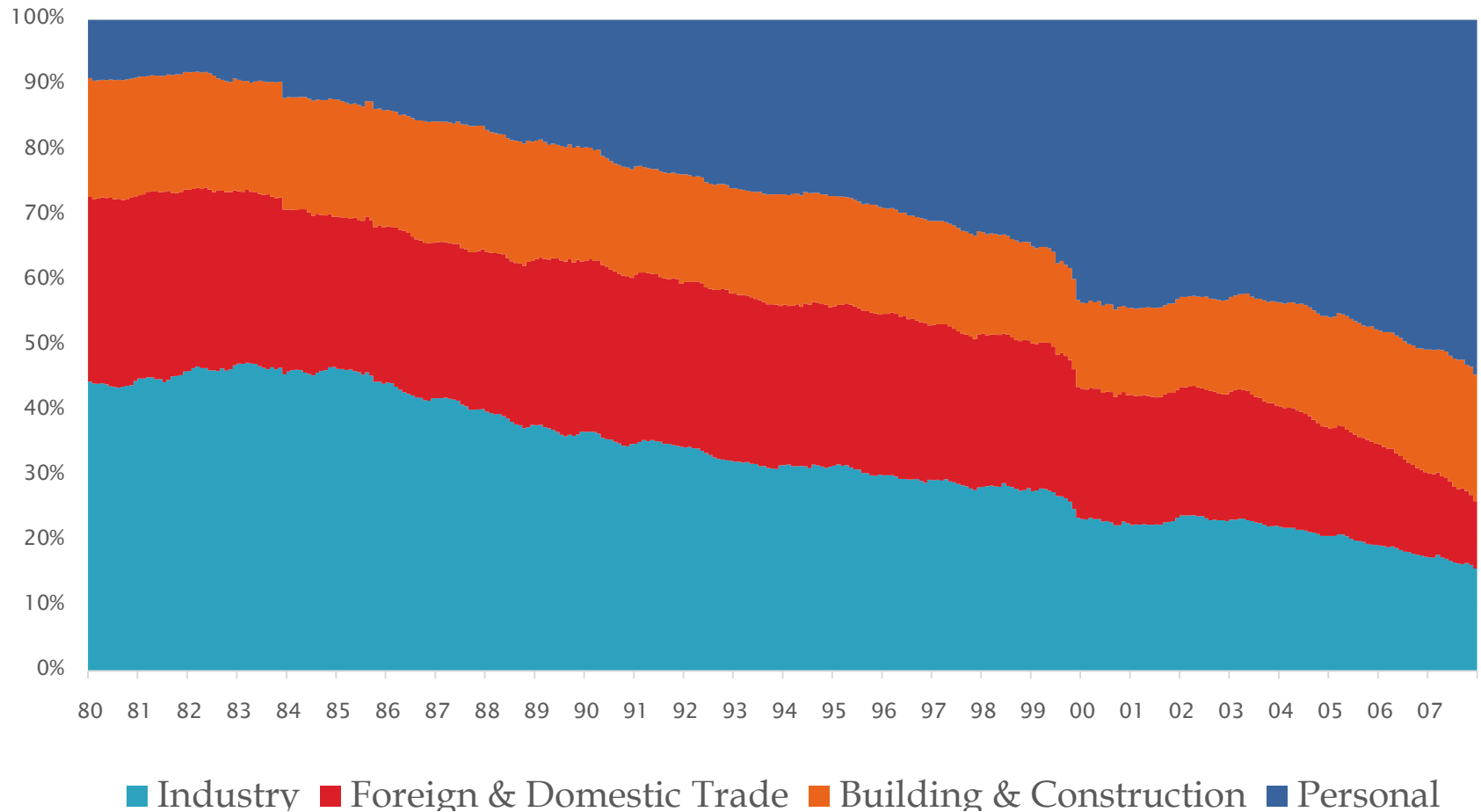
A brief history



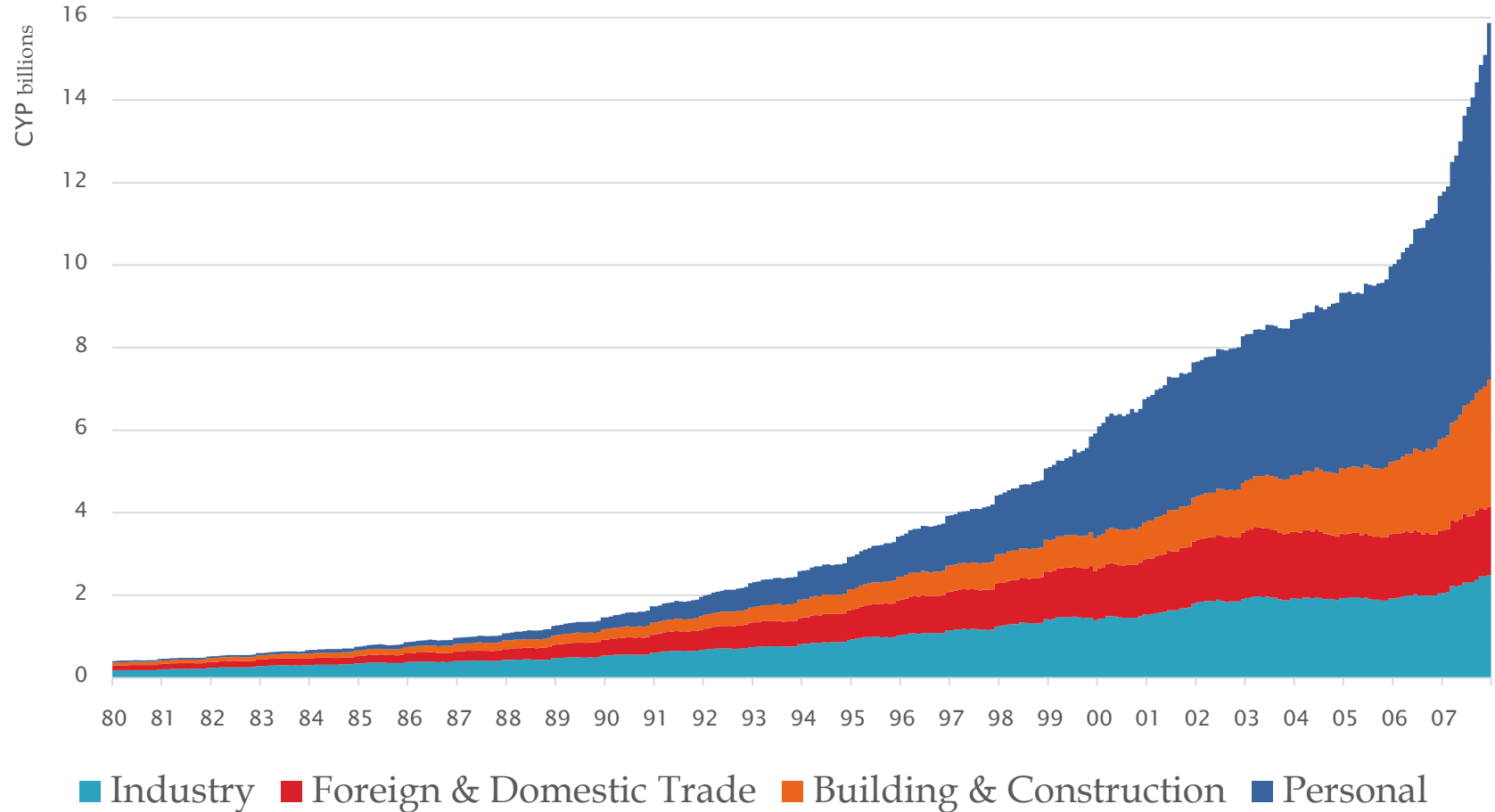
The banking system pre-liberalization

- ▶ Cyprus had a closed and tightly regulated financial sector until end of 2000; capital flows were restricted, interest rates set by law/CB
- ▶ Banking sector grew in terms of assets, branches, employment but was inefficient (overbanking)
- ▶ Credit was plentiful; financial sector depth comparable to developed countries
- ▶ From late 1980s, increasing consumption and construction lending, declining savings rate and investment

Sectoral allocation of credit, 1980–2007



Sectoral allocation of credit, 1980–2007



After liberalization

- ▶ Liberalization led to increased capital inflows, massively so after EU entry in 2004
- ▶ Mostly financial capital that ended up on bank balance sheets, leading to excessive lending and risk-taking
- ▶ Pre-existing trends towards consumption and real estate lending accelerated
- ▶ **Financial resource curse:** cheap foreign capital shifts productive resources toward non-tradable sectors like construction, leading to low productivity growth

A disastrous outcome

- ▶ Led to bubble in real estate and construction, heavily indebted households and business
- ▶ Overseas expansion of banks, investment in risky government bonds
- ▶ Revenue generated from rapid growth was happily spent by governments; transient nature of revenue not recognized
- ▶ The onset of the global crisis burst the bubble
- ▶ Policy blackout led to a catastrophic outcome

What went wrong?

- ▶ **Large capital inflows**
- ▶ System was unable to manage (unsurprising; it has happened over and over again)
- ▶ Associated risks not understood at all; in fact policy was directed at attracting ever more cash
- ▶ Cash in the bank was mistakenly equated with investment; a misperception that persists today

Bank follies and sins

- ▶ Contributed to stock market bubble of 1999–2000
- ▶ Collateral-based lending led to a vicious cycle of ever-increasing real estate prices and more lending ⇒ real estate bubble
- ▶ Lax definition of non-performing loans covered up problems
- ▶ Fierce competition for deposits drove up interest rates; credit was easy, but not cheap

Bank follies and sins

- ▶ Overseas expansion, including questionable acquisitions
- ▶ Aggressive lending for consumption
- ▶ Foreign currency lending (Swiss franc)
- ▶ Greek government bonds
- ▶ Questionable practices:
 - Aggressive marketing of securities to non-investors
 - Increase of interest margins on existing variable-rate loans
 - Information manipulation
 - Anti-competitive practices

Long-standing issues



All systems down

Systemic failure highlights need for drastic change in several areas:

1. Operational framework
2. Bank operation and performance
3. Supervision
4. Consumer protection
5. Government policy

1. Operational framework

- ▶ Many improvements made or are in the works:
 - Corporate governance
 - Foreclosure framework
 - Insolvency framework
 - Loan securitization
 - Financial leasing
 - Credit registry

2. Bank operation and performance

- ▶ Some improvements have been made (e.g. board composition) but more to be done
- ▶ Must change lending culture and develop expertise in assessing repayment ability
- ▶ Banks are bureaucratic and inefficient; they look more like the public sector than private companies
- ▶ Powerful union (ETYK) is a hindrance to change
- ▶ Lack of competitive pressure to effect change

3. Supervision

- ▶ CB complacency facilitated banking excesses
- ▶ Classic example of regulatory capture: regulator becomes protector/facilitator
- ▶ SSM supervision of big banks should (?) help, but local oversight still important
- ▶ CB and CySEC need to be vigilant, especially with new types of financial activity
- ▶ Good reputations hard to build, easy to destroy

Central Bank

- ▶ One of the biggest casualties of the crisis; beleaguered by governance problems, politicization, conflict with the political system, lost credibility, infighting, low morale
- ▶ Needs an overhaul, to be overseen by independent body – many good recommendations by Lascelles committee
- ▶ Specific issues:
 - Governance structure
 - Lack of transparency
 - Revolving door between CB and commercial banks
 - CB employee representation by ETYK

Institutions

- ▶ Strong, **independent** institutions are vital
- ▶ Independence means freedom to exercise the powers granted to them by the state *without political interference*
- ▶ Institutions should be accountable for their actions
- ▶ Politicians give a mandate, *appoint the right people*, and let them do their job
- ▶ Building strong institutions takes time and money; but it's a worthwhile investment

4. Consumer protection

- ▶ Banks have repeatedly abused their power
- ▶ Consumers have very limited recourse against bank abuse
- ▶ Competitive pressure will probably never be sufficiently strong to protect consumers
- ▶ Need an independent office like the UK's Financial Conduct Authority
- ▶ Newly created Financial Ombudsman's office could evolve into that but a long way from it

5. Government policy

- ▶ Policies focused on attracting financial capital and real estate investment contributed to the crisis
- ▶ This is not widely recognized and powerful lobbies continue to push policy in that direction
- ▶ Selling visas is not a sustainable growth model
- ▶ Must focus on reducing red tape and attracting entrepreneurs and productivity-enhancing investments that will create high quality jobs

Consequences of the bail-in



Bank ownership

- ▶ New ownership structure of banks:
 - Ex-depositors – accidental owners with no interest or expertise in owning a bank
 - Investors with short horizon
 - Investors with no previous presence in banking
 - The state
 - Institutional investors with a long horizon
- Not ideal
- ▶ Link between banks and sovereign stronger than before; political meddling is all too obvious

Market structure

- ▶ Merger of two dominant banks increased market concentration and reduced consumer choice
- ▶ Competition can be encouraged by lowering entry barriers and switching costs, combating anti-competitive practices
- ▶ Sector-wide collective bargaining is an entry barrier
- ▶ Competition in banking works in strange ways; competitive pressure can help improve sector's efficiency but must be coupled with tight regulation to avoid race to the bottom

Saving

- ▶ Bail-in was a massive, probably unprecedented destruction of wealth
- ▶ Savings lost, while others are being depleted as many households use them to sustain consumption; could cause problems at retirement
- ▶ Will bail-in affect people's future saving behavior?
- ▶ Need to think about providing:
 - Incentives for saving (lowering tax rate for starters)
 - New saving vehicles (other than banks and land)

Financing

- ▶ How will growth be financed? “Creditless recovery”?
- ▶ Not just a supply problem; debt overhang severely restricts demand for credit
- ▶ So far the constraining factor seems to have been demand rather than supply, but this could change soon
- ▶ Problem might be particularly severe for households and small businesses with limited options
- ▶ Opportunity for new, unburdened banks to establish themselves; should be encouraged

Summary



Concluding remarks

- ▶ Financial sector remains weak point of Cyprus' recovery
- ▶ Key challenges:
 - Increase competition, efficiency, governance of banking sector
 - Build strong, independent regulators
 - Provide consumer protection
 - Restore savings culture and provide for SME financing
 - Monitor capital inflows and design policies to attract FDI, not cash

Domestic credit to private sector by banks (% of GDP)

	1975 – 1979	1980 – 1984	1985 – 1989	1990 – 1994	1995 – 1999	2000 – 2004	2005 – 2009	2010 – 2013
Cyprus	70	60	73	112	141	164	213	296
High income: OECD	48	57	64	69	73	91	120	126
High income: non-OECD	31	38	45	50	53	56	66	76
Upper middle income	28	31	36	37	36	36	44	49
Lower middle income	19	21	20	19	20	21	27	33
Low income	12	12	11	10	11	12	14	20

Gross domestic savings (% of GDP)

	1975 – 1979	1980 – 1984	1985 – 1989	1990 – 1994	1995 – 1999	2000 – 2004	2005 – 2009	2010 – 2013
Cyprus	13.2	19.4	22.0	20.7	19.0	17.7	15.2	12.0
High income: OECD	23.0	22.0	24.0	23.3	24.1	24.6	25.3	24.0
High income: non-OECD	27.5	27.5	26.6	24.6	24.6	31.7	36.4	37.2
Upper middle income	21.2	19.6	21.1	17.8	18.5	18.3	21.0	21.0
Lower middle income	13.3	9.0	9.7	12.0	11.8	10.1	10.8	12.5
Low income	7.8	3.3	6.6	5.0	5.1	4.2	1.1	2.7

Foreign direct investment, net inflows (% of GDP)

	1975 – 1979	1980 – 1984	1985 – 1989	1990 – 1994	1995 – 1999	2000 – 2004	2005 – 2009	2010 – 2013
Cyprus	27.7	30.8	25.4	23.6	18.6	17.7	21.1	18.4
High income: OECD	24.7	23.1	22.6	22.0	22.5	22.1	22.5	19.7
High income: non-OECD	23.3	29.6	25.9	25.9	30.3	24.5	26.4	23.5
Upper middle income	26.4	25.8	23.0	22.3	23.4	20.7	23.7	24.4
Lower middle income	21.8	24.7	22.6	22.1	21.5	21.7	24.4	25.5
Low income	15.1	16.6	16.4	16.2	15.6	16.2	18.9	22.5