

Big Banks In Small Countries: The Case Of Cyprus[†]

Constantinos Stephanou^{*}

World Bank

Abstract

A large banking system has served Cyprus well to date. It has supported the country's outward-oriented, services-driven economic model and has significantly contributed to output and employment. The question going forward is whether banking system growth can continue indefinitely and at what cost. This paper argues that systemic risks are important for Cyprus given its banking system size and structure - in particular, the presence of big domestically-owned banks. It recommends that the authorities take a more macroprudential approach to financial sector oversight, that they engage in an immediate and significant fiscal consolidation effort, and that they introduce a set of prudential measures for systemically important banks that are customized to the needs of Cyprus.

Keywords: financial stability, systemic risk, banking, Cyprus, financial system, systemically important financial institutions, too big to fail.

1. Introduction

The objective of this paper is to review the systemic risks from the presence of big banks in small countries and to identify policy measures to address them, using Cyprus as an example. This topic has acquired prominence recently as a result of the global financial crisis and its impact on banking systems worldwide. Although Cyprus has not been as affected by the crisis as some other European Union (EU) member states, the crisis has provided useful country experiences and policy lessons about the vulnerabilities from having a large banking system in general and big domestic banks in particular.

[†] Prepared by Constantinos Stephanou, Senior Financial Economist at the World Bank, and currently on secondment at the Financial Stability Board.
Email:(cstephanou@worldbank.org).

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The paper is not intended to capture all aspects of this topic or to undertake an in-depth analysis of Cyprus' specific context. The topic is multi-faceted and particularly complex since it involves important policy trade-offs, especially for countries (such as Cyprus) that are heavily reliant on international business services (including finance) as an engine of growth. However, the paper does raise some key issues and provides leads for future research and analysis on this topic.

The paper is structured as follows:

- Section 2 compares the size and structure of Cyprus' banking system to a peer group drawn from EU member states;
- Section 3 describes the systemic risks from having big banks, drawing on the experience of selected countries during the crisis;
- Section 4 outlines policy measures that can mitigate these risks and relevant initiatives at national and international levels;
- Section 5 derives policy implications for Cyprus; and
- Section 6 summarizes the main findings and recommendations.

2. Banking system size and structure

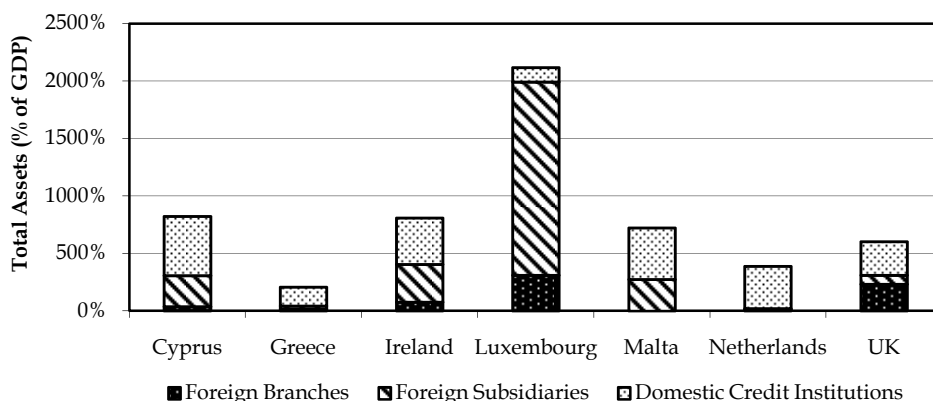
Cyprus has a large banking system compared to its economy (total assets of 896% of Gross Domestic Product or GDP in 2010), relative to the average for the EU and the Eurozone (357% and 334% respectively in 2009). Even if one excludes the overseas operations of domestically-owned banks, the size of the banking system is still large and exceeds 7 times GDP. However, Cyprus is not unique in that respect: several other EU countries have similar or even larger banking systems (Graph 1). For example, Luxembourg's banking system is more than 21 times its GDP, while Ireland's and Malta's systems are similar in size to Cyprus. These systems grew significantly over the past decade (Graph 2) as a result of an accommodating global environment and policy measures by national authorities to promote them as international financial centers. It is only recently that financial crisis-induced deleveraging of internationally active banks and slowdown in cross-border capital flows have halted that trend.

Two factors distinguish Cyprus from some other countries with large banking systems. First, domestically-owned credit institutions - in the form of both cooperatives and commercial banks - play an important role, accounting for 63% of total banking system assets in 2009. The subsidiaries of foreign - mostly Greek - banks have also expanded rapidly in recent years (one-third of total assets in 2009), particularly following the entry of

Cyprus into the EU in 2004 and the Eurozone in 2008. By contrast, domestically-owned institutions account for only 5% of banking system assets in Luxembourg, while 79% of assets belong to subsidiaries of foreign banks. Ireland and Malta also have a relatively large foreign bank presence in the form of subsidiaries (around 40% of system assets), while the UK has a large presence of foreign bank branches (almost 40% of system assets).

FIGURE 1

Size of Banking System for Selected Countries (end-2009)

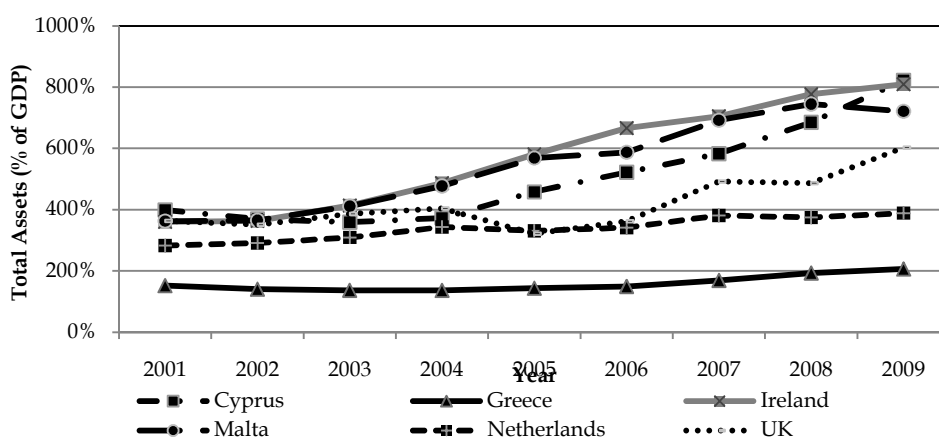


Source: European Central Bank (ECB, September 2010).

Note: These figures include the overseas assets of domestically-owned banks.

FIGURE 2

Evolution of Banking System Size for Selected Countries (2001-09)



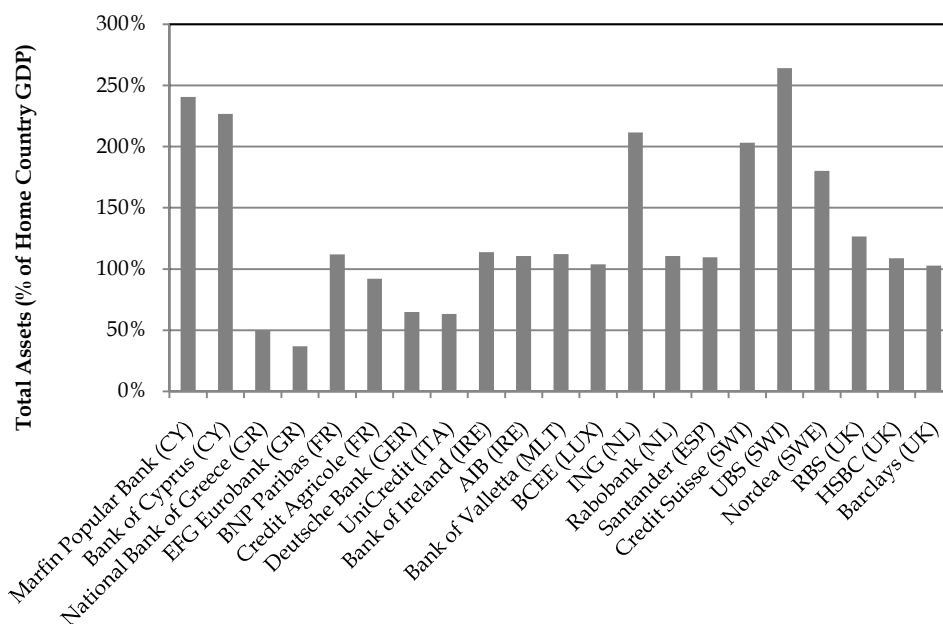
Source: ECB (October 2006 and September 2010).

Note: These figures include the overseas assets of domestically-owned banks. The size of Luxembourg's banking system has remained above 20 times GDP over this period, and it is not shown here in order to more clearly illustrate the evolution of size in other countries.

Second, even though the biggest domestically-owned credit institutions in Cyprus are small in absolute terms, their large size as a proportion of GDP sets them apart from those of other countries (Graph 3). Very few other European countries (Switzerland and Netherlands are exceptions) have domestically-owned banks that are so big compared to the economy. This feature is also reflected in high concentration levels, with the three biggest Cypriot banks - Bank of Cyprus, Marfin Popular Bank, and Hellenic Bank - controlling 55.6% of domestic deposits and 48% of domestic loans as of March 2011. These banks sit at the centre of financial groups that provide a broad range of other financial services. In addition, they have significantly expanded their operations abroad (particularly Greece) in recent years.¹

FIGURE 3

Size of Selected Credit Institutions to GDP (end-2009)



Source: The Banker, World Bank.

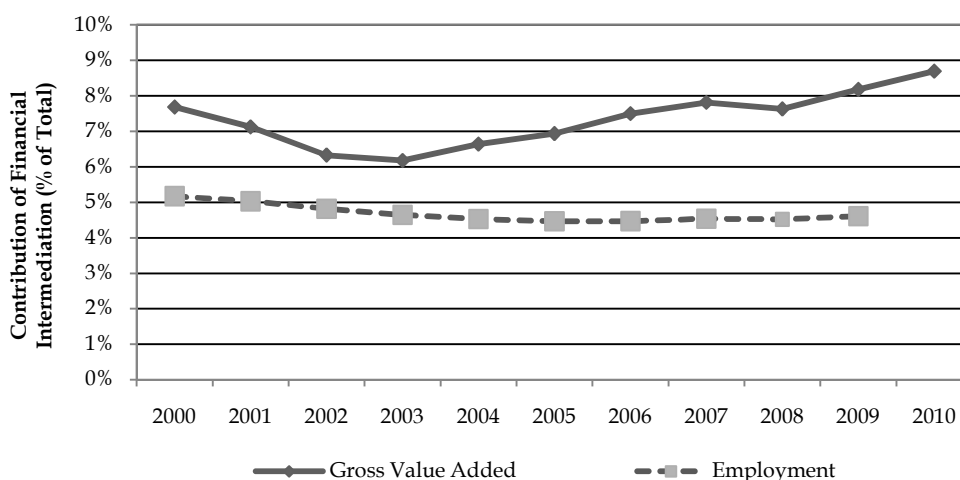
Note: These figures represent a bank's total assets at group level, including from overseas operations. The acronyms in brackets indicate the country where the bank is based: CY=Cyprus, GR=Greece, FR=France, GER=Germany, ITA=Italy, IRE=Ireland, MLT=Malta, LUX=Luxembourg, NL=Netherlands, ESP=Spain, SWI=Switzerland, SWE=Sweden, UK=United Kingdom.

¹ According to the Central Bank of Cyprus (CBC, December 2010), at end-June 2010, the overseas operations of the big 3 domestically-owned banking groups represented around 40% of their total consolidated assets, three-quarters of which were in Greece.

The significant expansion of the Cypriot banking system in general, and of the big domestically-owned banks in particular, has been part of the broader push to promote the island as an international business centre. The Cypriot economy is open and relatively undiversified, traditionally relying on tourism and international business services. The latter type of activity has been driven by various factors², which also help to explain the size of the banking system. The strategy has undoubtedly paid off, and the contribution of the financial services sector - both directly and indirectly - to employment and GDP in Cyprus have been substantial (Graph 4).

FIGURE 4

Contribution of Financial Intermediation in Cyprus (2000-10)



Source: Cystat.

Note: GVA is Gross Value Added. Employment refers to full-time equivalent number of working persons; figures for 2008-09 are provisional.

3. The systemic risks of big banks

The current size of the Cypriot banking system, and particularly of the two biggest banks, raises the issue of whether growth has unequivocally been a good thing that should continue indefinitely. In particular, against the

² These include economic and institutional stability, a favorable tax environment (low corporate tax rate and an extensive network of double taxation treaties), relatively low levels of corruption and bureaucracy, a highly educated and low-cost employee work force, a well-established legal system based on British standards, good geographical location and communications infrastructure, and a relatively sound prudential framework for banks.

benefits previously mentioned are risks that need to be taken into account. The most important of them is systemic risk - namely, the “risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the economy” (IMF, BIS and FSB, October 2009). According to this definition, systemic risk materializes when the collapse of a financial institution causes both a disruption to the flow of financial services (i.e. certain financial services become temporarily unavailable and/or their cost is sharply increased) and significant negative spillovers to the real economy.

Assessing systemic importance is a challenging exercise because it is time-varying and it depends on both the specific context (e.g. economic environment and financial sector conditions) and the purpose of the assessment (e.g. calibration of regulatory framework vs. crisis management). However, three key criteria are helpful in assessing the systemic importance of a financial institution:

- size - the volume, and hence importance, of financial services that it provides relative to the financial system and the economy at-large;
- (lack of) substitutability - the extent to which other financial institutions can provide the same or similar services on a timely basis in the event of its failure; and
- interconnectedness - its direct and indirect linkages with other financial system participants, so that its failure would have broader repercussions and knock-on effects.

An assessment based on these criteria needs to be complemented with an analysis of other contributing factors, such as institution-specific financial vulnerabilities (e.g. leverage, liquidity and maturity mismatches etc.) and other characteristics (e.g. complexity in organizational and legal structure), as well as the robustness of the institutional framework to deal with systemic risk (e.g. effectiveness of failure resolution arrangements).

Based on these criteria, some financial institutions can be labeled as systemically important (SIFIs). Systemic risk created by SIFIs is a negative externality that may lead to significant contagion effects for the broader financial system and spillovers on the overall economy. The absence of policy measures to adequately monitor and control such risk contributes to the expectation by market participants of government support in case of SIFI trouble - the so-called ‘too-big-to-fail’ problem. As a result of the lack of market and supervisory discipline, SIFIs are therefore able to borrow at preferential rates, operate with higher levels of leverage, and engage in excessively risky activities. This type of behavior has adverse implications

for competition (unfair advantage) and for financial stability (increased risk-taking beyond a socially optimal level).

The financial crisis has illustrated that big and highly interconnected financial institutions, most notably banks, are significant sources of systemic risk and that their failure can have wider fiscal, economic and social costs from the damage to the economy at-large. While the costs of the crisis cannot be attributed solely to systemically important banks, these banks have contributed greatly to the scale of the crisis and have been disproportionate beneficiaries of rescue packages.³ The crisis has therefore not only confirmed the risks posed by SIFIs and their support by governments in case of trouble, but also significantly expanded the subsidies that such institutions receive.⁴

The implicit support provided by the authorities to the banking sector is also reflected in the ratings that are assigned by credit rating agencies to banks. A credit rating of a bank, which is meant to capture its safety and soundness, encompasses both an assessment of the bank's stand-alone default risk as well as a judgment on the expected government support. Credit rating agencies often notch up the ratings of big banks to account for the probability of sovereign support that such banks would receive in case of financial distress. This ratings uplift represents an implicit subsidy from the government to the banks, since it allows them to borrow at a lower cost and to attract clients on the basis of greater perceived creditworthiness.⁵

Prior to the crisis, the balance sheets of banking systems in some international financial centers - such as Iceland, Ireland, Switzerland, and the UK - expanded rapidly. This can be attributed primarily to the growth of their biggest banks as a result of a variety of domestic and cross-border strategies that they pursued (IMF, April 2010). Their growth was supported by an accommodating macroeconomic environment and by the

³ In addition to industry-wide support measures, several countries adopted rescue packages for certain troubled SIFIs (e.g. Citigroup and Bank of America for the US, RBS and Lloyds for the UK, Hypo for Germany, ING for the Netherlands, and UBS for Switzerland).

⁴ See, for example, IMF (May 2011b) and chart 5.9 on page 51 in the Bank of England's Financial Stability Report (December 2010) on the estimated implicit funding subsidy to UK credit institutions by size of institution.

⁵ See chart 3.41 on page 43 of the Bank of England's Financial Stability Report (June 2010), which shows the extent of government support embedded in the ratings of different countries' banking systems. It is possible to convert the ratings uplift into a monetary measure of support by mapping the different ratings to yields paid on bank bonds, and by then scaling the yield difference by the value of each bank's ratings-sensitive liabilities; see Haldane (March 2010) for an example.

so-called “light-touch” regulation and supervision that did not properly monitor or prevent the accumulation of risks.⁶ The crisis hit hard those banks that had invested heavily in U.S. mortgage-backed securities or had lent significantly to finance domestic bubbles (primarily related to housing and construction); that were highly leveraged and operating with low capital and liquidity buffers; that were particularly exposed to external wholesale funding; and that were reliant on volatile sources of income.

As a result of the crisis, Iceland suffered the collapse of its three major commercial banks, which had become too big to save, and endured a major economic crisis (IMF, October 2010). Ireland avoided a similar fate, but at the cost of nationalizing its banking system (which is now being deleveraged and restructured) and resorting to an IMF-EU rescue program (IMF, May 2011a). The cost was enormous in both cases as economic output and living standards have dropped commensurately. Moreover, according to the IMF, the gross general government debt/GDP ratio for Iceland and Ireland increased from 28% and 25% respectively in 2007 to 96% in both cases in 2010, and that ratio will continue to rise for the next few years.⁷ Switzerland intervened rapidly by setting up a “bad bank” vehicle to hold some of the toxic assets of one of its two major banks (UBS) and by injecting capital into it, albeit with ultimately minor fiscal consequences. The UK provided significant support to its banking system in various forms – liquidity provision, debt guarantees, asset protection scheme etc. (IMF, November 2010) – including by taking large equity stakes in two of its biggest banks (RBS and Lloyds).

The ability of the authorities to support the banking system in these countries ultimately depended both on the scale of the problem and on macroeconomic conditions - namely, the “fiscal space” available to address the problem (which depended on the size of the public debt), the dependence on foreign financing sources, and the ability of the economy to recover by relying on other sources of growth. Two of the main lessons from the financial crisis are therefore the importance of containing the contingent liabilities to the government arising from a large banking system, and the need for strong macroeconomic fundamentals to act as a shock absorber in case related risks materialize.

In the case of Cyprus, the two big domestically-owned banking groups appear to satisfy the criteria for being systemically important based on the

⁶ See, for example, the Report of the Commission of Investigation into the Banking Sector in Ireland (March 2011) on the causes of the systemic banking crisis in Ireland.

⁷ Part of the increase in public debt for those countries can be attributed to the fallout from the global recession as a result of the financial crisis (i.e. automatic stabilizers, fiscal stimulus, collapse in revenues) as opposed to financial sector support per se.

aforementioned definition. Their role as intermediaries of foreign financial flows and as providers of domestic financial services means that the collapse of either of them would have significant negative repercussions on the real economy and deleterious reputational effects on Cyprus as an international business centre.⁸ Their sheer size could overwhelm the ability of the government to support them (or to pay out depositors⁹) if needed. Moreover, their dominance of most financial services segments (payments, deposit taking, lending, international business, asset management, money market, government debt, securities brokerage, insurance, leasing etc.) would likely impair the provision of key financial services in the event of failure and could lead to knock-on effects on other financial institutions. In addition, these banks are exposed to conjunctural vulnerabilities such as a significant amount of non-resident deposits¹⁰ and high exposures to the troubled domestic real estate and construction sectors. However, the most important current source of vulnerability is the exposure of these banks, and of the Cypriot banking system in general, to Greece (IMF, September 2010a; Moody's, October 2010).

Several structural and policy factors mitigate these risks. The big banks have strong and profitable domestic franchises; operate a traditional business model with low loan/deposit ratios compared to most large European banks (even when one excludes non-resident deposits); have generally straightforward corporate structures (albeit increasingly large as a result of conglomeration and foreign expansion); and do not invest in structured securities or undertake derivatives trading activities. These factors have allowed them to weather the financial crisis relatively well without the need for any capital support by the authorities, and to remain profitable and continue to attract non-resident deposit inflows. In addition, the banks are regulated and supervised prudently by the CBC¹¹, and recent

⁸ See Moody's (June 2009 and August 2010) and Fitch Ratings (December 2009 and March 2010) for profiles of these two banking groups.

⁹ According to the IMF (September 2010a), total deposits insured by the CBC's Deposit Protection Scheme as of March 2010 were €21.7 billion (125% of GDP); cooperatives are covered by a separate scheme administered by the Authority for the Supervision and Development of Cooperative Societies (ASDCS). According to the European Commission (2011), around 66% of Cypriot banking system deposits (excluding cooperatives) that were eligible for deposit insurance coverage as of 2008 were held by the 2 biggest banks.

¹⁰ Around 37% of the banking system's deposits currently belong to non-residents, primarily from Russia and Eastern Europe. According to Moody's (December 2010), "most offshore deposits (70%-75%) come to the island for tax purposes, are short-term and have certain transactional characteristics, as they represent money that will eventually be reinvested abroad".

¹¹ For example, the CBC applies strict loan-to-value criteria for mortgage lending. It also requires commercial banks to hold 70% of their foreign currency deposits, as well as 20% of

stress tests indicate that they would be able to withstand a significant deterioration in market conditions.¹² However, these mitigating factors do not erase the fact that the collapse of one of these banks (however unlikely) could disrupt the flow of financial services and have significant negative spillover effects on Cypriot taxpayers and the real economy.

Finally, it should be noted that (as in other countries) the two big Cypriot banks are operating under the presumption by the credit rating agencies and many market participants of government support in case of need¹³. The recent rating downgrades of Cypriot government debt, which prompted the rating agencies to lower their assessment of the government's capacity to support the banking system and thereby led to the downgrade of the bank ratings as well, highlights the close links between the sovereign and the banking system.¹⁴

4. Risk mitigation measures

As the preceding section notes, there are two main sets of policies to address the systemic risks arising from the presence of big banks in small countries: effective prudential regulation and supervision, and strong macroeconomic fundamentals (including significant fiscal buffers).

Appropriate prudential policies to strengthen the resilience of the domestic banking system can take different forms that address distinct dimensions and stages of the problem (IMF, May 2011b):

all Euro-denominated deposits and all liabilities with maturities of less than one year, in liquid assets (essentially by re-depositing them with highly-rated international banks). This requirement limits the ability of banks to deploy them for lending purposes and hence their funding and foreign exchange risks; see IMF (October 2009 and September 2010a).

¹² The Bank of Cyprus and Marfin Popular Bank participated in the 2010 EU-wide stress testing exercise and passed the 6% Tier 1 capital ratio hurdle (see http://www.centralbank.gov.cy/nqcontent.cfm?a_id=7623&lang=en).

¹³ Moody's (December 2010) states that "Moody's considers Cyprus to be a high support country. This is based on the willingness of the state to support the banking sector, the high importance of the banking system to the country's economy, as well as the country's proven support track-record." As a result, Moody's currently gives a 2- and a 3-notch rating uplift to the deposit and senior debt ratings of the Bank of Cyprus and Marfin Popular Bank respectively (compared to their stand-alone ratings) on systemic support considerations.

¹⁴ In its 16 May 2011 announcement to review the government's debt for a possible (additional) downgrade, Moody's states that "today's rating action reflects Moody's concerns over heightened risk of crystallisation of the Cypriot banking sector contingent liabilities on the government's balance sheet due to the banking sector's large size relative to the size of the economy [...] Should the government need to use its own balance sheet to support the Cypriot banking system, this could cause a material deterioration in the government's financial strength".

- enable the early identification of risks before they threaten the solvency and liquidity of a SIFI (e.g. via more intensive supervisory oversight and an effective and credible early intervention regime);
- reduce the probability of failure by a SIFI (e.g. via higher capital and liquidity requirements, tighter large exposure restrictions, as well as levies and structural measures to reduce the involvement of SIFIs in systemically risky activities);
- reduce the cost to the public sector should a decision be made to rescue a failing SIFI (e.g. via an effective resolution framework that imposes burden sharing on certain categories of the institution's investors before any public funds are used);
- reduce the extent or impact of failure, assuming that the SIFI is not rescued by the authorities (e.g. via more robust core financial market infrastructures and a stronger deposit insurance scheme); and
- level the playing field by reducing too-big-to-fail competitive advantages that SIFIs may have in funding markets as a result of their perceived government support (e.g. via a credible resolution regime that reduces market participants' expectations of government support, and via a suitably designed bank levy that penalizes systemically risky activities).

There are ongoing initiatives at both national and international levels to address the systemic and moral hazard risks associated with SIFIs. The Financial Stability Board (FSB, October 2010) has recommended a comprehensive policy framework for SIFIs that includes an effective resolution regime, higher loss absorbency capacity (e.g. via higher minimum capital requirements than those in the Basel III Framework), more intensive supervisory oversight¹⁵, and robust core financial market infrastructures. Work is currently underway in these areas, including in the development of a methodology to assist the FSB and national authorities in assessing the systemic importance of financial institutions at a global level (FSB, April 2011). The policy framework for SIFIs complements the recently-approved Basel III Framework for internationally active banks, whose aim is to strengthen the overall resilience of banks and of the global banking system.

In terms of national initiatives, Switzerland recently prepared a set of legislative proposals for dealing with the systemic risks of its two big

¹⁵ See FSB (November 2010) for recommendations to make the supervision of financial institutions more intense, effective and reliable, which are primarily aimed at making SIFIs less susceptible to failure.

banks. Based on the recommendations of a report by a Swiss Commission of Experts (September 2010), the proposals include significantly higher capital and more stringent liquidity requirements for these banks, as well as the adoption of organizational measures to ensure the maintenance of their systemically important functions (e.g. payment transactions) in the case of threatened insolvency. In the UK, the Independent Commission on Banking is currently in the process of identifying reform proposals that would make the UK banking system safer while maintaining its global competitiveness. In its consultation paper (April 2011), it has proposed ring-fencing (e.g. via separate subsidiaries) the domestic retail operations of UK banking groups that provide vital and irreplaceable financial services, and imposing higher capital requirements on them. Sweden, home to four of the Nordic region's six biggest lenders, has established a stabilization fund to finance the cost of any future banking crisis, and it recently announced that it intends to introduce higher capital requirements than Basel III for its systemically important banks.

More broadly, the effective identification, monitoring and containment of system-wide financial risk is the key objective of macroprudential policies. These policies aim to address two dimensions of system-wide risk: first, the build-up of such risk over time as a result of the procyclical behavior by financial system participants ("time dimension"); and second, the distribution of risk in the financial system at a given point in time, including its concentration among SIFIs ("cross-sectional dimension"). The institutional framework, data requirements, and tools for implementing such policies are still work-in-progress, and there is currently a lot of relevant work being undertaken at both national and international levels.¹⁶

As the crisis experience has shown, prudential policies need to be complemented with a strong macroeconomic framework to absorb any banking system shocks. Such a framework should include the maintenance of low levels of public debt to allow fiscal policy to be used as a buffer, especially in the case of countries (such as those in the Eurozone) that do not have monetary sovereignty; a public debt management strategy that does not rely excessively on domestic SIFIs as investors (to avoid contagion); access to international liquidity support for countries with their own currencies, particularly if the banking system has a high concentration of foreign funding (to ensure continued financing of external obligations); and sufficient diversification of the domestic economy (to enable the resumption of economic growth even without a strong banking system). However, as the cases of Ireland and Iceland indicate, even

¹⁶ See Committee on the Global Financial System (May 2010), FSB et al (February 2011), and IMF (March 2011) for efforts to develop effective macroprudential policies and frameworks.

macroeconomic buffers may not be sufficient to address banking sector problems, particularly if prudential regulation and supervision are weak.

5. Policy implications for Cyprus

What are the policy implications of international experience for Cyprus? First, the authorities need to take a more macroprudential approach to financial sector oversight in order to identify and control emerging systemic risks, including those that arise from the presence of big domestically-owned banks. The responsibility for financial stability does not reside solely with the monetary and supervisory authorities; as seen in other countries, national governments may have to intervene by using taxpayers' funds to support the banking system.

In that context, the role of the National Financial Stability Committee (NFSC)¹⁷ should be significantly strengthened. The NFSC participants need to engage in closer coordination and more frequent information exchange, and they should review and discuss the adoption of suitable prudential and fiscal measures to promote financial stability. In terms of crisis preparedness, they should develop contingency planning protocols and test them via crisis simulation exercises, and they should better clarify responsibilities among them (e.g. with respect to communication and decision-making) in the event of a crisis.

Second, prudential measures that could be considered by the Cypriot authorities to deal specifically with systemically important banks include¹⁸:

- ensuring that the CBC has the necessary powers and resources for more intensive and proactive supervisory oversight (e.g. by granting it explicit authority to restrict bank dividends);
- further strengthening cross-border supervisory cooperation - for example, by formally agreeing with other jurisdictions in which those banks have a major presence on the respective responsibilities and burden sharing in a crisis situation;
- introducing higher regulatory capital and liquidity requirements, as well as tougher corporate governance standards (e.g. with respect to Board composition, the functioning of the audit and risk committees, and the use of external auditors), for those banks;

¹⁷ The NFSC was set up in accordance with the provisions of the 2007 Memorandum of Understanding between the CBC (chair), the ASDCS, the Cyprus Securities and Exchange Commission, the Insurance Companies Control Service, and the Ministry of Finance. The task of the Committee is to discuss financial stability issues, including crisis management.

¹⁸ See IMF (October 2009 and September 2010a) for details on some recommendations.

- undertaking targeted stress tests focused on SIFI-specific (as well as sector-wide) identified vulnerabilities and on wider contagion effects;
- applying a levy on the banking industry, designed so as to discourage systemically riskier activities (e.g. short-term offshore deposits, intermediation of non-resident financial flows etc.), to finance the ex ante build-up of a Financial Stability Fund that can be used in a crisis situation;
- strengthening the resolution framework by ensuring that the CBC is able to intervene early (based on explicit criteria) and by mandating that recovery and resolution planning be undertaken for such banks;
- minimizing the operational reliance of core domestic financial market infrastructures (e.g. payments, clearing and settlement, custodial services, credit bureau etc.) on these banks; and
- bolstering the size of the deposit insurance fund, by charging higher (but risk-adjusted) premiums on the banking industry, to enable it to handle bigger payouts.¹⁹

As an EU member state, Cyprus will need to adopt relevant European Commission initiatives, including a possible EU framework for bank resolution and recovery (European Commission, October 2010). The authorities should also monitor and be ready to consider other policy measures for SIFIs that are agreed at international level. Given the sheer size and critical importance of its banking system, the authorities should adopt prudential measures that go beyond any minimum EU-wide requirements - the stakes are simply much higher for Cyprus than for other EU member states, and its financial stability concerns should not be compromised in the interest of promoting a more level playing field.

Second, there is a need for an immediate and significant fiscal consolidation effort, as has already been pointed out by international organisations (IMF, September 2010) and credit rating agencies. This is particularly important for Cyprus since, as a member of the Eurozone, it lacks the ability to resort to monetary expansion in order to counteract the impact of a banking crisis on the economy.

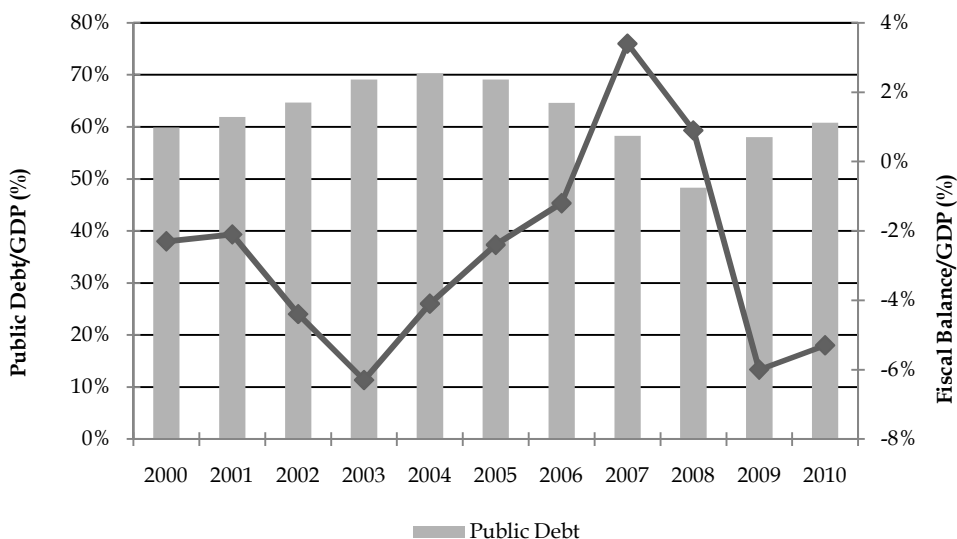
Following a relatively brief period in the mid-2000s, the public debt-to-GDP ratio resumed its long-term upward path and reached 60.8% in 2010

¹⁹ The total funds held by the Deposit Protection Fund at end-2010 were only €65 million and, although they will eventually reach €100 million, they correspond to only around 0.5% of insured deposits. The current funding model therefore relies heavily on banks to collectively cover the cost to the depositors of a failed bank by raising their contributions on an ex post basis.

(Graph 5). The current trajectory - an increase of 12.5 percentage points in only 3 years - limits the government's fiscal space and therefore its options to undertake remedial measures in case of banking system problems. While the current level is not unduly high by Eurozone standards, the size and structure of the banking system means that Cyprus should aim to bring public debt to a much lower level as a proportion of GDP over the medium term.

FIGURE 5

Evolution of Public Debt and Fiscal Deficit (2000-10)



Source: CBC, IMF.

Note: Public debt figures exclude intra-governmental debt.

Finally, fiscal consolidation should be complemented by a public debt management strategy that does not rely excessively on the big domestically-owned banking groups as investors in government debt, since this would further link the fortunes of the sovereign with those of the banking system. In that respect, additional efforts to develop the domestic investor base for government debt - for example, by reaching out to households and non-bank institutions - are warranted.

6. Conclusions and recommendations

A large banking system has served Cyprus well to date. It has supported the country's outward-oriented, services-driven economic model and has significantly contributed to output and employment. The question going

forward is whether banking system growth can continue indefinitely and at what cost - particularly in terms of the build-up of systemic risk whose materialization may not only disrupt the provision of financial services but could also have serious negative consequences for Cypriot taxpayers and for the overall economy.

This paper argues that systemic risks are important for Cyprus given its banking system size and structure (in particular, the presence of big domestically-owned banks²⁰). It recommends that the authorities take a more macroprudential approach to financial sector oversight, and that they engage in an immediate and significant fiscal consolidation effort.

The paper also provides examples of policy initiatives at both national and international levels to address systemic risk. A specific set of macroeconomic and prudential measures customized to the needs of Cyprus is beyond the scope of this paper, although it should be a priority given the experience of other countries with large banking systems. The introduction of any package of measures will need to be carefully planned so as to be effective and credible to market participants, particularly given the current situation in Greece.

In that respect, the authorities may wish to consider following the example of Switzerland and convene a Task Force of Experts to report on this topic (Swiss Federal Council, December 2009; Swiss Commission of Experts, September 2010).²¹ The reason for undertaking this approach is that the topic involves difficult policy trade-offs and any proposed solutions to control the build-up of systemic risk may carry implications on the business model pursued by Cyprus in recent years, which relies to a large extent on the intermediation of non-resident financial flows. Involving all relevant stakeholders to fine-tune this model, while maintaining an internationally competitive financial sector, would be the Task Force's mandate.

²⁰ Having big foreign institutions instead in the domestic banking system is no panacea and raises other important prudential issues, such as the ability of domestic (host) supervisors to rely on home authorities for support and to establish mechanisms for cross-border supervisory cooperation, crisis management, resolution and burden sharing with them. These factors are particularly important, for example, in the case of Luxembourg given the prevalence of foreign-owned subsidiaries in its banking system - see IMF (June 2010).

²¹ The commission of experts was mandated by the Swiss Federal Council in November 2009 to examine the economic risks caused by large companies and propose solutions for containing the too-big-to-fail problem. The commission included representatives from the authorities, the academic world, and private industry.

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