

Discussion on Banking System in Cyprus: Time to Rethink the Business Model?

Marios Clerides*

Hellenic Bank

It is a great pleasure to be invited to this first University Economics Symposium and an extra pleasure to be asked to discuss the paper by Costas Stephanou, on a topic very close to my heart, entitled "Improving the Stability of the Cyprus Banking System".

The collapse of the Icelandic and Irish banking systems early in the crisis and the subsequent collapse of their economies, as well as the almost-collapse of the Swiss banking system, should have alerted us in Cyprus to start building our defences against a similar unthinkable event.

Cyprus, as his paper shows, is one of those countries that are characterised by a large banking system in relation to the size of the economy. This implies that if ever the government is asked to bail out its banks, the economic hardship of doing so will be immense. Hence, the question on how to reduce the chances of such an eventuality. The paper presents all the classic economic solutions to such a problem - increased capital and liquidity requirements, better governance and supervision, taxation of high-risk banking activities, deposit insurance, creation of a robust resolution regime, and, as a final buck-stop, fiscal discipline to strengthen government borrowing ability in case of need. All of these I fully endorse and amplify.

In order, though, to contribute to this discussion, I will try to bring into the picture the idiosyncratic features of the Cyprus "banking size issue" since these have to be borne in mind in any policy design.

The aspects I want to bring to your attention are the following:

* Corresponding Address: c/o Hellenic Bank, Corner Limassol & Athalassa Avenue 200, P.O. Box 24747, Nicosia 1394. Email: m.clerides@hotmail.com.

- (a) The first reason that leads to the burgeoning of the Cyprus banking system is the success Cyprus had in establishing itself as an offshore centre through the existence of double tax treaties that are especially beneficial to the Eastern Bloc countries. The stability of the banking system seen from this angle depends on our ability to maintain the double tax treaties with these countries (something that is more in the sphere of politics than economics), our ability to defend our low corporate tax rates in light of a European Union drive towards corporate tax harmonisation, and to protect our reputation as a financial centre from money laundering accusations.
- (b) The second driver of the banking size is the overseas expansion of Cypriot banks, - to Greece, Russia, ex-Eastern Bloc countries, United Kingdom, Australia etc. This in turn creates different policy issues on how to “manage” such expansion, which can bring diversification on one hand but also create new contagion channels to Cyprus, as the recent case of Greece graphically demonstrates.
- (c) A different aspect of the size issue is that the Cypriot banking sector (as his paper also highlights) is highly concentrated, with the existence of a small number of large banks. This means that there is no built-in diversification in the system - the risk profile of the Cyprus banking system is not the risk profile of a big banking system consisting of a large number of small, “easy-to-handle-in-case-of-crisis” banks. In addition to this, the few banks that make the bulk of the system are all active in broadly the same areas - Cyprus, Greece, ex-Eastern Bloc, and in construction, tourism and housing loans - further reducing any diversification.
- (d) A fourth aspect of the size issue that a well-designed policy should cover is the existence of the cooperative banking (or co-ops) sector consisting of a large number of locally active “mini” banks all brought together under a mutual cross guarantee system under the Co-Operative Central Bank. This sector, with its close ties with the government, presents an altogether different stability issue.
- (e) A fifth aspect of the banking sector size issue is the establishment in Cyprus of a number of foreign bank subsidiaries that were established in Cyprus to take advantage of the low corporate tax rates and the existence of the double tax treaties. This sector presents again its own risk issues - the incentive that these banks have to “book” profits (and hence risk assets) in their Cypriot subsidiaries to benefit from the

favourable tax treatment, but also the existence of their “parent” banks that, on one hand, can act as a risk buffer before Cypriot tax payers are called on for support in case of distress, but can also open another risk contagion channel where the problems of the “parent” bank can find their way to Cyprus.

- (f) Finally, any solution to the size issue should take into account the difficult access that both Cypriot banks and the Cyprus government have in accessing the world financial markets due to the relatively small sizes (compared to the global sizes) involved.

In addition to all the above, a well-designed policy response should examine the intra-Cyprus contagion channels whereby problems from one area can pass onto the other. These are:

- i. From banks to government. This includes the classic problem that a bank bail-out can create for the government whereby any bail-out suddenly increases government debt, but also includes the Cypriot-centric issue whereby problems in a bank can lead to difficulties in government financing because of the dependence of the government on borrowing from local banks. This is especially so for the co-op sector where, for example, problems in that sector can deny the government a significant source of funding.
- ii. From government to banks. This is the “Greece” effect whereby problems of the government and the ensuing haircuts badly affected Greek banks through their holding of Greek bonds. Government problems can soon transmit themselves to Cypriot banks and co-ops through the large holding that the banks and co-ops have of Cypriot sovereign debt.
- iii. The existence of other hidden contagion channels have also to be factored in. These include deposit insurance funds investing in Cyprus government bonds but also not being fully-funded but relying on funding from the banks in case of need, the co-op cross-guarantees, the variety of semi-public sector provident and pension funds holding both government bonds and local bank deposits where moral pressure from the government to invest in its bonds can lead to deposit outflows for banks.

Examining these issues some ideas on how to improve the stability of the banking system come to mind and are put forward to stimulate discussion.

- Should we have accountants and lawyers, who directly benefit from Cyprus having a stable banking system, contribute to the soon-to-be-created stability fund?
- Should we pay bank staff partly with shares that cannot be sold for long periods, thus building equity but also creating a group of insiders with an interest in the stability of the banks?
- Why don't we change the current tax system, at least in the way it applies to banks, to one that favours retention, compared to the existing one that favours distribution?
- Should we insist that subsidiaries of foreign banks are capitalised to such an extent as to achieve a target stand-alone credit rating (e.g., AAA) as Luxemburg does?
- Should we prohibit too-big-to-fail banks from taking big risks? This is an idea put forward by J. Stiglitz who argues that only small banks that are not too big to fail should be allowed to take big risks because this risk taking doesn't involve / require state support if things turn bad.
- Should we consider inducing big banks to move their incorporation base? This basically moves the problem to bigger economies that can support potential collapse.
- Should we try to get an EU role in financial centres whereby the financial centre contributes to EU state funds some of the revenue it has from being a financial centre, in exchange for bail-out money in case of need? This is the classic case of buying insurance.
- Should we have the stabilisation fund buy CDS (credit default swaps) for each bank and pass this cost to each bank, thus forcing it to internalise the costs that its risk profile can potentially have on the country's tax payers, hence creating incentives for more prudence?
- Should we break up big banks? Absurd as it first sounds it stems from Mervin King who claims that a too-big-to-fail bank is simply too big.

- Should we restrict Cypriot banks from holding Cyprus government bonds, thus reducing the “Greece” contagion channel? More generally, given that within the euro area there is no exchange rate risk, banks and other financial institutions ought to diversify their bond holding adequately across different government bonds; Cyprus government bonds should be a small part of their portfolio, which also means that the government must rely more on international lending to cover its financing needs, a move that will exert pressure also on fiscal authorities to behave more prudently.
- Should we mandate that banks ring-fence their offshore units? That they also separately incorporate and capitalise their foreign and domestic operations so that problems in one area – say Greece – do not transmit themselves to other business lines – offshore operations, for example?
- Should we restrict any systemic contagion-transmitting banking links? (e.g., deposit insurance guarantees, bank cross share holdings, interbank deposits among Cypriot banks, the Co-Operative Central Bank-Central Body, deposit insurance/stabilisation fund, holding Cyprus government bonds, etc.)

All these have both plusses and minuses. In some cases they also create perverse incentives; for example a supervisor that feels it has a well protected system might become too relaxed in its supervision, the existence of a stability fund might aggravate moral hazard etc. All these need to be factored in and be brought to the open in order to reach a balanced policy response.