

The Banking System in Cyprus: Time to Rethink the Business Model?†

Constantinos Stephanou*

World Bank

1. Banking System Characteristics

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 (Figure 1). These systems grew significantly over the past decade (Figure 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 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. Second, even though the biggest domestically-owned banks in Cyprus are small in absolute terms, their large size as a proportion of GDP sets them apart from those of other countries (Figure 3). Very few other European countries 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 banks - Bank of Cyprus, Marfin Popular Bank, and Hellenic Bank - controlling 56% of

† Prepared by Constantinos Stephanou, Senior Financial Economist at the World Bank, and currently on secondment at the Financial Stability Board. This note relies heavily on Stephanou (2011).

* Corresponding address: Birmanngasse 14, Basel 4055, Switzerland.
Email: cstephanou@worldbank.org.

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 financial services. They have also significantly expanded their operations abroad (particularly Greece) in recent years⁷.

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 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 (Figure 4).

2. 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 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). 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 and the purpose of the assessment. However, criteria such as size, (lack of) substitutability and interconnectedness are helpful in assessing whether a financial institution is systemically important (SIFI). 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.

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

⁷ 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.

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 on the basis of greater perceived creditworthiness.

The financial crisis has confirmed the risks posed by SIFIs and their support by governments in case of trouble. 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. The crisis hit hard those banks that had invested heavily in U.S. mortgage-backed securities or had lent significantly to finance domestic housing bubbles; 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. 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. The cost was enormous in both cases as economic output and living standards have dropped commensurately. 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. - 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.

3. Policy Implications for Cyprus

In the case of Cyprus, the two big domestically-owned banking groups appear to satisfy the criteria for being systemically important based on the 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. Their sheer size could overwhelm the ability of the government to support them (or to pay out depositors) if needed. Moreover, their dominance of most financial services segments 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 short-term non-resident deposits as well as high exposures to Greece and to the domestic real estate sector.

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; have generally straightforward corporate structures; and do not invest in structured securities or undertake derivatives trading activities. In addition, the banks are regulated and supervised prudently by the CBC. 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.

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 need. 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.

What are the policy implications of international experience for Cyprus? First, the authorities need to take a more macroprudential approach to financial sector oversight⁸ in order to identify and control emerging systemic risks, including those that arise from the presence of big

⁸ Macroprudential 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 system at a given point in time, including its concentration among SIFIs ("cross-sectional dimension").

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 terms of crisis preparedness, the authorities should develop contingency planning protocols and should better clarify responsibilities among them (e.g. with respect to communication and decision-making) in the event of a crisis.

Additional prudential measures should also be adopted to deal specifically with systemically important banks. These include stronger powers and resources for the CBC to enable more intensive and proactive supervision of the two big banks; higher regulatory capital and liquidity requirements, as well as tougher corporate governance standards for these banks; and strengthening the resolution framework and mandating that recovery and resolution planning be undertaken for these banks.

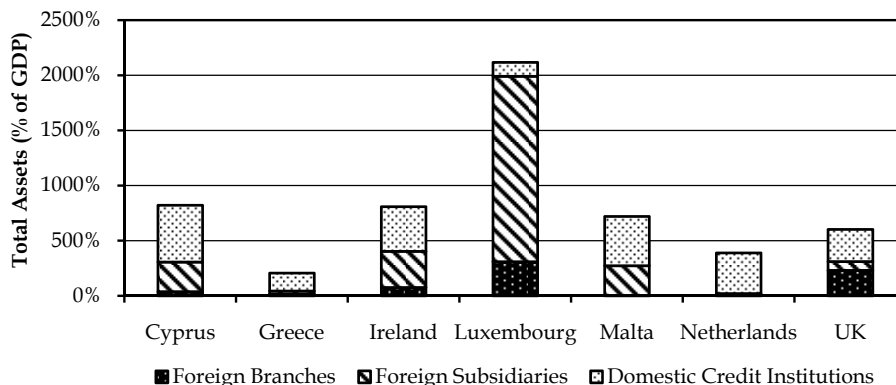
Second, there is a need for an immediate and significant fiscal consolidation effort. This is particularly important for Cyprus since, as a member of the Eurozone, it lacks the ability to resort to monetary expansion in order to counteract the impact of a banking crisis on the economy. While the current level of public debt to GDP is not unduly high compared to other EU member states, 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.

Finally, the authorities should closely monitor relevant international policy initiatives and to consider following the example of other countries with large financial centers - such as the United Kingdom and Switzerland - and convene a Task Force of Experts to report on this topic.⁹ 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 s, would be the Task Force's mandate.

⁹ There are ongoing initiatives at the international level to address the systemic and moral hazard risks associated with SIFIs (FSB, October 2010 and November 2011). In terms of national initiatives, Switzerland recently approved legislative proposals for dealing with the systemic risks of its two big banks based on the recommendations of a report by a Swiss Commission of Experts (September 2010). In the UK, the Independent Commission on Banking has made a number of reform proposals to make the UK banking system safer while maintaining its global competitiveness (September 2011); the authorities are currently following up on these proposals.

FIGURE 1

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

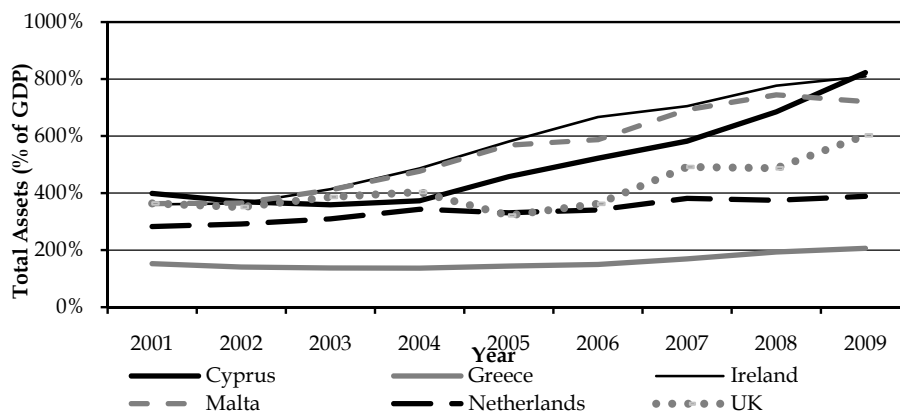


Source: European Central Bank (ECB, September 2010).

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

FIGURE 2

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

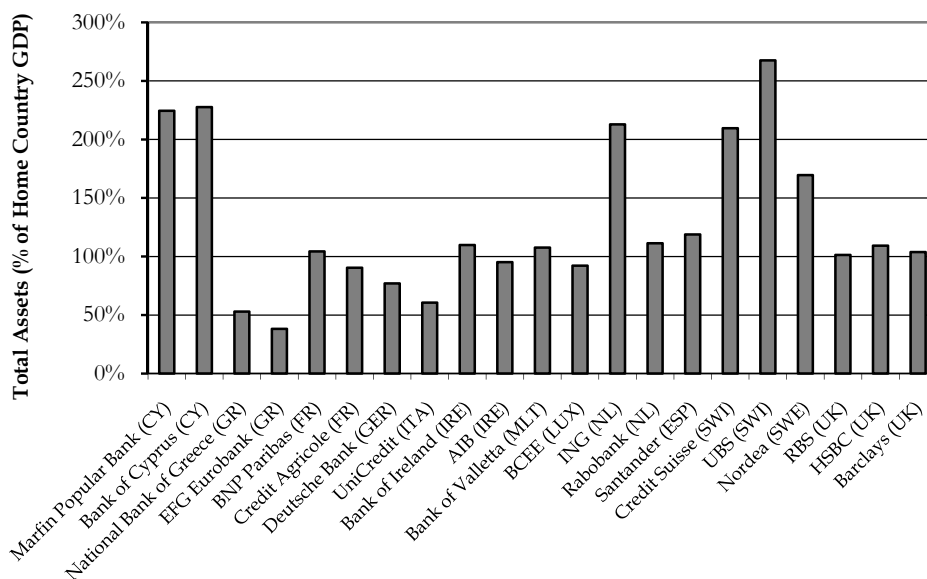


Source: ECB (October 2006 and September 2010).

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.

FIGURE 3

Size of Selected Credit Institutions to GDP (end-2010)

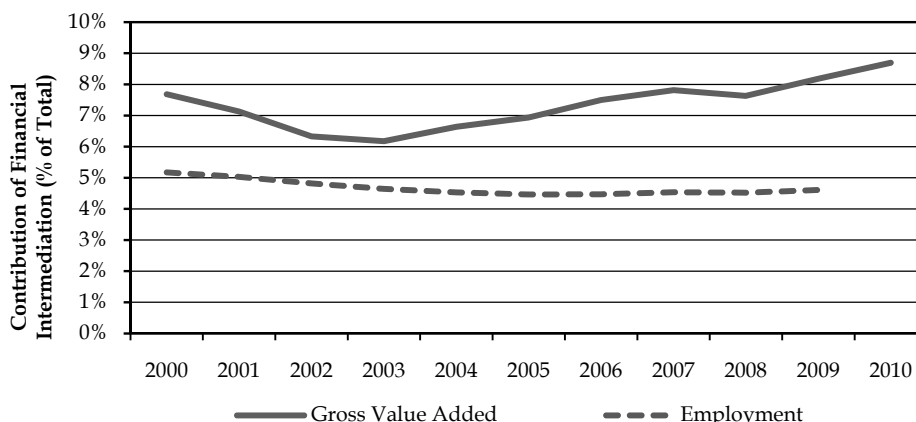


Source: The Banker, World Bank.

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.

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.

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