Independent Commission on the Future of the Cyprus Banking Sector

INTERIM REPORT

June 2013

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A. Executive summary

The Independent Commission on the Future of the Cyprus Banking Sector was set up in November 2012 by the Central Bank of Cyprus (CBC) to make recommendations on the long term recovery of the Cypriot banking industry from its present crisis. The Commission's Terms of Reference require it to draw lessons from recent events and put forward proposals to make the Cypriot banking industry stronger and better fitted to meet the country's banking needs. This includes examining the size and structure of the industry, the quality of service, and the supervision of banking. In carrying out its work the Commission was asked to take account of international best practice, and the legal and operational requirements of international agreements and treaties.

This is the Commission's interim report containing its analysis of the causes of the crisis and the recommendations it is minded to make, subject to comment and feedback. It is an independent report in which the views we express and the recommendations we make are entirely our own. Interested parties are invited to submit comments to comments@icfcbs.org by July 31st 2013.

This report is also available on our web site: www.icfcbs.org.

Report outline. The report is in three parts. In the first we examine the recent past to find the causes of the crisis, and identify faults that need fixing. In the second we lay out our recommendations for improvements to the banking sector, and in the third we do the same for financial stability and banking supervision.

Over the last three years the Cyprus banking system has suffered a series of disasters which have transformed what was once a highly regarded and prosperous industry into a national catastrophe. The country's two largest banks are in administration, the co-operative sector, also once held in high regard, is in urgent need of recapitalisation, and Cyprus' once burgeoning international banking business is in doubt.

Urgent work is already underway to contain the damage caused by these events and allow the work of repair to begin, much of it under the terms of the Memorandum of Understanding (MoU) reached by Cyprus with the Troika of the EU, the ECB and the IMF as a condition for a €10bn loan in March 2013. But beyond the next few months, it is hard to predict what might happen with any great certainty.

In order to formulate its recommendations, the Commission examined the crisis in detail to ascertain its causes and draw out the lessons. We found that the Cyprus banks' downfall was caused by the interplay of a number of different factors, some of them outside Cyprus' control, but many of them within it.

1. Setting the scene

A.1 **External causes of the crisis.** The main external causes were two. One was the liberalising effect of Cyprus joining the EU and the euro, which opened up new markets and released large amounts of liquidity into a previously tightly controlled banking system, while simultaneously making it harder for Cyprus to restrain credit growth with traditional monetary levers. The other was the global financial crisis which initially hit the Cyprus banks indirectly through their deep involvement with Greece, but later depressed the Cyprus economy more directly through the shocks to the eurozone and its other markets.

A.2 **Internal causes.** The most significant high level cause was a failure at the national policy level to appreciate that running a big banking industry is about risk as well as reward. The public attitude was that the banks were doing a good job of supporting economic growth and that the international business they brought added to the nation's wealth. Insufficient attention was paid to the fact that the banks were acting imprudently and that the international business was creating serious domestic imbalances, or to how any potential emergency might be handled. There may even have been a (possibly subconscious) desire to ignore these risks in order to avoid "spoiling the party". This set a political tone in which low priority was given to monitoring banking risks, and to supervising the banks themselves.

A.3 **We recommend that Cyprus have a clear policy on the role of banking in its economy given its importance as the major source of credit and its potential to generate foreign earnings. There needs to be a clear understanding of the risks inherent in a high dependence on banks, and of the risks that accompany the rewards from international banking business. This requires a commitment of resources to monitoring these risks and ensuring that banks are equipped to manage them.**

A.4 Also significant were the failures that occurred in the governance of Cyprus' banks and co-operatives, and in Cyprus' supervisory process. During the 2000s, the two major banks used excess liquidity in the Cyprus banking market to embark on aggressive growth strategies which included lending far beyond prudent levels, and making overseas acquisitions which they had difficulty controlling. When domestic sources of funding eventually ran out, they used official liquidity support to fund further expansion, including the fatal step of acquiring €5.7bn of Greek Government Bonds (GGBs), which was to cost them €4.5bn in losses.

A.5 **Weak bank governance.** These reckless ventures were made possible, in the first instance, by the failure of the boards of the banks to place independent checks on the ambitions of strong-willed chief executives and to ensure that their banks had risk strategies and controls that were enforced. Instead, directors lived by a culture of deference which was nurtured in some cases by loans and supply contracts.

There were also severe weaknesses in the governance of the co-operative banks, particularly as regards the independence of directors and the quality of credit and risk controls. It is no exaggeration to say that corporate governance of banks was close to non-existent as the crisis evolved.

A.6 **Business methods.** Two characteristics of Cyprus' banking methods contributed to the bad loan problem at the heart of the crisis. One was the practice of advancing loans against collateral (usually real estate) and personal guarantee, with insufficient attention paid to cash flow and ability to repay. Although this method looks prudent, it only works if the value of the real estate is sustained or, if not, that the banks can seize the collateral in the event of default. The collapse of real estate prices and serious obstacles in Cyprus' legal system both stood in the way of banks recovering their loans. The second was the importance played by personal relationships in Cyprus banking. Familiarity can cut both ways, by giving the lender comfort, but also by making objective credit judgment more difficult. Unfortunately, it often cut the second way.

A.7 **Role of the international financial centre.** Although much has been made of the risks posed by Cyprus' international financial centre business which operates off Cyprus' advantageous tax arrangements, we found little evidence that this was a direct cause of the crisis. The large deposit balances that accumulated in the Cyprus-based accounts of offshore clients, many of them Russian, were remarkably stable well into the crisis period. However the portion of these balances held in Cyprus banks did contribute indirectly to the crisis by supplying these banks with the liquidity they needed to fund their expansion.

A.8 **Poor supervision at all levels.** There was also a failure on the part of Cyprus' authorities to act effectively at all the levels we examined. At the highest, there was little sense in government circles and the supervisory authorities of the risks that Cyprus, as a country, was running by operating a banking system which, at its height, was equivalent to over nine times GDP and included two systemic banks. Nor was there adequate co-ordination between the two main authorities responsible for financial stability: the Ministry of Finance and the Central Bank of Cyprus; in fact relations between the two were openly hostile for much of the crucial period. Within the CBC, the supervision function operated only half-heartedly, querying some of the banks' actions such as the GGB acquisitions but not following this up, or by tightening a key lending rule, only to relax it a year later. We found that Cyprus had all the necessary structures and powers to keep the banks under control, but that these were not effectively used.

A.9 **Culture.** We found that a common cause behind many of Cyprus' problems lay in culture and attitudes. A frequent observation by people we spoke to was that the Cyprus establishment was too closed, that personal and political relationships played too great a role in the management of its business affairs, and that it needed to be more open to different ideas and people. We agree. We find it striking, for example, that there are few non-Cypriots on the boards of banks in a country which operates an international financial centre. This is a theme which permeates the report. **We recommend that there be radical change in the culture of the banking industry and in the politics surrounding it.**

A.10 **Unnecessary delay.** We also conclude that Cyprus made matters worse for itself by failing to agree to the first set of terms drafted by the Troika in July 2012. The delay, caused by political considerations, stretched official support for the banks to the limit, and exasperated Cyprus' potential lenders. The consequence was a much tougher set of terms in the March 2013 MoU which included an unprecedented haircut on deposits in the country's two biggest banks, and the imposition of capital controls and restrictions on domestic banking transactions. We believe that many of the terms in the loan agreement will cause unnecessary damage to the Cyprus economy and its banking system, and possibly create longer term structural problems for which no provision is made. The MoU is now part of history, but it sets unpromising conditions for the task ahead.

2. The banks

A.11 **Immediate steps.** We consider it essential that normality be restored to the Cyprus banking system as rapidly as possible to provide continuity and confidence. A clear schedule of steps needs to be laid out to reconstitute Bank of Cyprus and the co-operative sector so that capital controls can be lifted and uncertainty removed. The complexities of the exceptional merger of Bank of Cyprus and Cyprus Popular Bank should not be underestimated. The resulting bank needs to be sufficiently well capitalised to dispel all concerns about the need for further action. The governance and management should be strong and independent, and have experience of managing difficult mergers. **The longer exceptional conditions last, the harder it will be to rebuild confidence.**

A.12 **Size of the banking system.** The MoU requires Cyprus to get its banking system down to 3.5 times GDP, mainly by disposing of its foreign operations. Shrinkage is a step we support because the Cyprus banks' foreign acquisitions did not fit a sensible or prudent growth strategy. However this target is an arbitrary figure set by the average of the EU's very different banking systems. **We believe that there are acceptable reasons why, in the longer run, Cyprus could aspire to have a banking system of above average size. One is that it has virtually no alternatives to banks to supply finance to the economy. Another is that we believe Cyprus can still maintain banking as an industry servicing the needs of non-resident customers.** We examine this possibility further below.

A.13 **Structure of the banking system.** The current restructuring will result in Cyprus ending up with one large bank (Bank of Cyprus) with nearly half the market, a much smaller bank (Hellenic Bank), and a co-operative sector. There will also be branches of domestically active foreign banks. **This is an unsatisfactory structure because the existence of a dominant bank raises competition and stability concerns which will have to be reviewed.**

We also recommend that the co-operative sector undergo a major transformation to rid it of its weak business culture and turn it into a competitive commercial force. Specifically, we recommend that the co-ops be combined into a single institution with a joint stock structure and a commercial culture, and that this institution be placed under the direct supervision of the Central Bank of Cyprus.

A.14 **The international financial centre.** Cyprus' international financial centre business, a major source of earnings for banks and professional firms, is at risk because of the measures emanating from the crisis. We do not find fault with the concept of an international financial centre: if well managed, this can be a legitimate business which serves a genuine financial and tax planning need and contributes to economic growth. The problem in Cyprus is that it was poorly managed: it grew too fast, it was inadequately supervised, it was insufficiently diversified geographically, and its distorting effect on the local economy went uncorrected for too long. As a business, it relied too much on tax appeal and poorly managed supervision, and not enough on financial soundness and quality. Cyprus also allowed it to become reputationally associated with tax evasion and money of doubtful origin.

We believe this business could have a future in a more focused and upgraded form which attracts clients not just for its tax breaks but because of the quality of skills and services on offer. Cyprus should also make more of its strategic location as a "safe haven" in a politically troubled region.

As a first step, we recommend that Cyprus seek to raise the quality and scope of the international financial centre's skill base so that customers choose to use it for its breadth and sophistication, not just the tax breaks, and that the banks develop their product range to include wealth management and off-balance sheet services, and later custodian and fund administration services.

Supervision will also need to be improved by drawing on outside assistance to give confidence to users of these services, and anti-money laundering controls will have to be strictly and visibly enforced. If concerns persist about the risks that the foreign banking business poses to the domestic economy, it may be desirable to ring fence it in separate legal entities.

A.15 **Banking competition and service quality.** In the current unsettled conditions, it is hard to make firm judgments about the future of banking service in Cyprus, and we have decided to postpone our recommendations until our final report. However, we identify the following issues as important in this area.

A.15.1 **Quality of service:** Cyprus banks have a very high level of personal contact with their customers: they have the densest branch network in the EU, and personal relationships play a big role in banking transactions. Until the crisis, market research showed a high level of customer satisfaction. We expect this to change. In order to make themselves more efficient, the banks will have to close a large number of branches and reduce personnel, with a loss of personal touch. On the other hand, new forms of service delivery will accelerate, such as internet and telephone banking, and cash machines. This makes sense but it does mean that Cypriot bank customers will have to prepare for a major shift in the way they do their banking, and that the economics of banking itself will change.

A.15.2 **Interest rates.** Cyprus has a high interest rate structure due to the intensity of competition for deposits and, more recently, crisis conditions in the markets. These will have to come down to reduce borrowing costs and support economic recovery. However it will take a difficult balancing act to keep deposit rates high enough to attract funds and low enough to make borrowing affordable, while also leaving the banks with a sufficient margin in between to service their capital. Initially, this may require administrative measures, but Cyprus should move as soon as possible to a position where interest rates find a natural healthy level through the interplay of market forces.

A.15.3 **Cost and availability of lending.** As just observed, the cost of borrowing will need to come down, but there is also a concern about availability of credit for a number of reasons. One is that a more concentrated and heavily regulated banking system will have too little, rather than too much, capacity to lend. It will also, very likely, be risk-averse. Another is that Cypriot banks will need to move away from the collateral-based lending methods which contributed heavily to the crisis. The alternative "ability to pay" method requires superior credit judgment skills which the banks may not possess in sufficient quantity, and will have to develop.

A.15.4 **Competition.** The Cyprus banking market has historically been heavily overbanked, so a shake-out will be healthy. However we have concerns about the narrow structure which is likely to emerge from present changes, with a dominant bank, a reconstituted co-op sector and a much smaller No. 3. We favour a more balanced scenario. It is possible that both Bank of Cyprus and the co-ops will shrink as they consolidate and write off bad debts. Hellenic Bank might seek a merger with another domestic bank or a foreign bank and become a stronger No. 3. Also, foreign banks might see an opportunity to enter or expand in a market where the domestic players are preoccupied with reorganisation. This is speculation. But we see the need for further restructuring of the Cyprus banking sector to achieve a healthier balance.

A.15.5 **Alternative sources of finance.** Much of Cyprus' crisis arises from the fact that banks dominate the financial scene. Although Cyprus has a stock exchange, it has never become an important source of business capital. Although banks are a flexible source of short-term funds, Cyprus needs to develop alternative forms of market-based finance (mutual funds, private equity) to raise long term capital and reduce its bank dependence. This may require initiatives from both the public and private sectors.

A.16 Corporate governance

The failure of corporate governance was one of the most important reasons why Cyprus' biggest banks brought disaster upon themselves. Strong corporate governance is essential to a healthy business, particularly one like banking which relies heavily on public confidence.

We make a number of recommendations to raise the standard of corporate governance in Cyprus' banks, and in the co-operative banks where there were also severe weaknesses. In particular, we see the need to

A.16.1 **instil a new culture of independence in the boardroom, and raise the status of boards,**

A.16.2 **improve the quality of directors, and to appoint at least two non-Cypriots to the boards of the major banks,**

A.16.3 **increase the non-executive component of boards to counter-balance the executive,**

A.16.4 **strengthen board procedures to ensure that board members are fully informed of the bank's affairs,**

A.16.5 **strengthen board committees, particularly in the areas of audit and risk,**

A.16.6 **devise incentive schemes which commit executives to long term objectives, and**

A.16.7 **strengthen the risk management and internal audit functions to provide additional independent checks and controls.**

A.17 **Responsibility for financial reporting**

The board plays a key role in ensuring that financial information about the bank is collected and accurately reported. The fact that the losses suffered by Cyprus' largest banks came as a surprise to many people, including bank directors, is evidence of serious failures in this area. We make recommendations both about the banks' auditing responsibilities, and about the quality of auditing and financial reporting.

We recommend that

A.17.1 **accounting treatments be brought in line with the best international standards,**

A.17.2 **Cyprus's auditor oversight function be strengthened as soon as possible, that it be financed by the profession and/or listed companies, and that the results of its inspections be published,**

A.17.3 **the Cyprus Securities and Exchange Commission raise the quality of financial reporting by listed companies,**

A.17.4 **trilateral meetings between banks, the external auditors and the supervisors be re-established on a firm basis,**

A.17.5 **auditors be genuinely rotated on a regular basis, and**

A.17.6 **that shareholders play a more active role in holding the banks to account.**

3. Financial stability

A.16 We found that there were critical shortcomings in the supervision of the banking system, from high level failure to recognise the "big picture" risks to banks that were building up in foreign and domestic markets, down to inertia in the discharge of key supervisory functions.

In particular we identify

A.16.1 The absence of a clear national policy which recognised that the benefits of a large banking industry also brought risks which the government needed to recognise and for which it needed to be prepared;

A.16.2 the disjointed structure of financial supervision in Cyprus, and the lack of co-ordination between the various public authorities which had responsibility for financial stability

A.16.3 the politicisation of relations between the CBC and government;

A.16.4 the governance of the CBC itself, where weaknesses contributed to the ineffectiveness of banking supervision;

A.16.5 failings in macro-prudential oversight; and

A.16.6 the poor performance of line supervision.

A.17 **Structure.** Cyprus has a fragmented system of financial supervision with five separate authorities, two of them placed in ministries. This leads to confusion and the risk of political interference. **We recommend that the system of regulation be streamlined to increase its effectiveness and give it greater independence. Specifically, we recommend that Cyprus consolidate these functions into a single regulator located within the CBC which has the legal and financial independence to handle this role, and whose supervisory competence is in the process of being strengthened.**

A.18 **Independence and accountability of the CBC.** The highly charged political atmosphere surrounding Cyprus' banking system has led to tension between the government and the CBC which could be harmful. It is important, for the effective discharge of the CBC's supervisory duties, that its independence be recognised and respected, but that this also be balanced by clear CBC accountability in the supervisory area.

A.19 **We recommend that the CBC's accountability for financial stability and banking supervision be made more explicit in the relevant laws. We also recommend that the existing Memorandum of Understanding governing relations between the CBC and the Ministry of Finance be reviewed to ensure that it addresses the failures which contributed to the crisis, particularly by requiring regular contact between the Minister of Finance and the Governor of the CBC.**

A.20 **Governance of the CBC.** Poor governance arrangements of the Central Bank of Cyprus unquestionably contributed – over a number of years - to the 2012 crisis by concentrating too much power in the hands of the Governor, and by tolerating an ineffective internal audit function which, in turn, led to lax supervision. We share the view that there needs to be greater pluralism at the CBC. However the options for change are limited by EU law which requires that the independence of the Governor be protected, which we also believe to be important. The solution lies in having a stronger non-executive structure and clearly defined board responsibilities.

A.21 **We recommend that the CBC have a policy-setting board chaired by the Governor, with two executive directors and four non-executive directors with clear decision-making powers in specified areas. The checks and balances on the executive would be provided by appropriately qualified, independent non-executive directors and effective board committees with the power to monitor the executive's performance and take corrective action if needed.**

A.22 **We recommend the establishment of a nominations committee to oversee a transparent process of board member selection and to propose suitable candidates for Council of Ministers approval. We also recommend that the qualifications for non-executive directors be widened to allow at least one non-Cypriot to sit on the board.**

A.23 **Macro-prudential supervision.** The lack of an effective macro-prudential analytical function to keep track of "big picture" risks, such as a build-up of debt and threats in the international markets was an important reason why Cyprus lost control of its banks. Had this function worked properly, it would have enabled Cyprus to take early corrective action and avoid the need for government support of the banks. There are plans to designate the CBC as Cyprus' macro-prudential authority and to create a macro-prudential oversight section within the CBC, which are welcome initial steps in this direction.

A.24 **We recommend that the macro-prudential oversight function have rigorous procedures for identifying risks, and taking action. In addition we recommend that the existing Financial Stability Committee be reinvigorated to improve the CBC's working relationship with other areas of government, and provide a top level forum for policy discussion on supervisory issues in each of the financial sectors.**

A.25 **Supervision.** The CBC's supervision function is being improved to correct the failings exposed by the crisis. We make a number of detailed recommendations to advance this programme which we consider to be essential to the recovery of the banking industry.

A.25.1 **We recommend that the supervisory function have a rigorous risk framework in which risks are clearly identified and prioritised, and that it be measured against international benchmarks such as those laid down by the Basel Committee on Banking Supervision.**

A.25.2 **We recommend the creation of stricter frameworks for systemically important banks, such as more intensive supervision, higher loss absorbency capacity, and higher standards of corporate governance. In particular, the capital base of the banks needs to be maintained at**

a high level. The CBC's enforcement function also needs to be more rigorously applied, and details of enforcement actions made public.

A.25.3 **The resourcing of the department should be increased to support its enlarged role, and we also recommend that it seek long-term technical assistance from a body such as the IMF to raise the level of expertise and ensure that it meets the highest international standards.**

A.25.4 However we also believe it important that the supervision function itself be subjected to closer oversight. For this reason, **we recommend that the supervision department be included in the Bank's internal audit process to provide an independent check on its work, and that the assessments made be reported to an audit committee of the CBC's main board.**

A.26 **Consumer protection.** The recovery of the Cypriot banking system will have to include a return of popular confidence in banks, with stronger conduct of business regulation to ensure that banks deal honestly and fairly with their customers. The CoCos affair, in which bank customers were not sufficiently apprised by the banks of the risks in unfamiliar savings instruments and had difficulty obtaining compensation when they lost money, highlights the deficiencies.

We recommend that conduct of business regulation be strengthened by clarifying the CBC's responsibility for regulating the conduct of banks' investment business, as well as areas such as savings, mortgages, pensions, insurance and loans. We also recommend that the part played in these areas by the Financial Ombudsman and the Banking Codes be expanded, and that a more concerted effort be put into financial education to raise consumer awareness of financial risk.

Although this is a daunting list of challenges, it lies within Cyprus' power to address all of them, and we firmly believe that they will produce the strong and healthy banking system that Cyprus needs.

Acknowledgements

We are grateful to the many institutions and individuals who provided information and advice to the Commission. They are listed at the end of the report. We would also like to acknowledge, with thanks, the support received from George M. Georgiou, Head of the Office of the Governor at the Central Bank of Cyprus, Roula Avraamidou who heads our secretariat, and Anna Markidou, our researcher.

The Commission

The Independent Commission on the Future of the Cyprus Banking Sector was set up in November 2012 by the Central Bank of Cyprus (CBC) to make recommendations on the long term recovery of the Cypriot banking industry. Its Terms of Reference require it to draw lessons from the current crisis and put forward proposals to make the Cypriot banking industry stronger and better fitted to meet the country's banking needs. This includes examining the size and structure of the industry, the quality of service, and the supervision of banking. In carrying out its work the Commission was asked to take account of international best practice, and the legal and operational requirements of international agreements and treaties.

Under the terms of the financial facility granted to Cyprus by the European Union, the European Central Bank and the International Monetary Fund (the "Troika") in March 2013, urgent changes are already being made to the structure of the banking industry and to supervision. In April 2013, the Commission's Terms of Reference were revised to take this into account. The Revised Terms of Reference are on page 96.

The members of the commission are:

David Lascelles, chairman. David Lascelles has been analysing the banking industry for more than 30 years as Banking Editor of the Financial Times and more recently as Senior Fellow of the Centre for the Study of Financial Innovation, an independent London think tank. David has also been a university lecturer in banking and a bank non-executive director.

George Charalambous has been a key figure in the Cypriot financial sector for many years, as senior general manager of the Bank of Cyprus and more recently as chairman of the Cyprus Securities and Exchange Commission. A graduate of the London School of Economics and the Athens School of Economics, he has also held senior positions at several other institutions including the Central Bank of Cyprus and the Cyprus Development Bank.

David Green is a leading international expert on financial stability matters with over 40 years as a central banker and financial regulator. During his career he has worked in the Bank of England and the Financial Services Authority, and more recently in the UK's integrated regulator for corporate reporting, the Financial Reporting Council. He has also been advising the Central Bank of Ireland.

Pierre de Weck is a senior Swiss banker with more than 35 years experience of banking at the international level. During his career he has held senior positions at Citibank, UBS and Deutsche Bank, working in Europe, North America and with the Middle East. Most recently he was a member of the Group Executive Committee of Deutsche Bank where he was Global Head of the Private Wealth Management Division with €300bn of client assets in over 70 countries.

This report

For the last six months, this Commission has been gathering material, conducting interviews and canvassing a wide range of expert opinion in order to understand Cyprus' banking problems and consider our recommendations. This document is the Commission's Interim Report in which we publish our preliminary recommendations for comment before we finalise our report later this year.

We welcome comments from interested parties. These should be sent to comments@icfcbs.org by July 31st 2013.

This report is also available on our web site: www.icfcbs.org.

Foreword

Cyprus is in a critical situation. Following the upheavals in world financial markets and its own severe difficulties, the country is in recession with large debts and a crippled banking system. Although a recovery plan is now in place, the country faces painful adjustment in a period of great economic uncertainty.

One of the most important tasks facing the country is to repair its banks and restore people's faith in them. This will not be easy; restructuring banks and supervisory systems is complicated and expensive. But on the upside it presents Cyprus with the opportunity to create a banking system that is healthy and sound, and draws on best international practice in governance and supervision.

This Commission's mandate is to look beyond the immediate turmoil to the longer term and make recommendations to help the banks achieve a sustainable future. It is important to state at the outset that the purpose of this report is not to point the finger of blame, but to identify weaknesses and make constructive suggestions. It should also be stressed that we are an independent commission, and that the views we express and the recommendations we make are entirely our own.

Our report starts by considering the lessons from the recent banking crisis. There are then two broad sections. The first looks at the banks and makes recommendations on issues such as size, structure and the future of the international financial centre, and corporate governance. The second considers ways the banking system is overseen by the government and its supervisors, and makes recommendations for improving the structure of financial stability management and the quality of supervision.

This is our interim report in which we lay out our initial thoughts for comment. Because of the limited time available we devote more depth to some issues, mainly those where the path to change is clearer, and less to others where there is still uncertainty about near term outcomes. We hope that our final report will give equal weight to all the issues we have been asked to examine. Meanwhile, we welcome comment and feedback on the recommendations drafted in this report so that we can hear what others have to say, and reflect their opinions in our final report at the end of the year. Please send comments to comments@icfcbs.org by July 31st 2013.

Although we were commissioned by the Central Bank of Cyprus, many of our recommendations range more widely: to other regulators, to financial services firms, to different branches of government and to Parliament. We do not specify who should consider each recommendation, but we hope that those who would be responsible for acting on them will find them useful.

As an independent commission, we feel bound to be candid in our analyses, and to say things that others might wish to say but feel constrained about for a variety of reasons. For example, some of the most fundamental challenges Cyprus faces, we think, have less to do with the technicalities of bank management and supervision than with cultural attitudes. Many people told us that Cyprus needed to break out of its local political mindset and open itself to new ideas and more rigorous forms of governance if it wanted to solve its problems. We agree: we saw many instances in the past few months where Cyprus seemed to turn in on itself, finding safety in what was familiar rather than going for something new. This is particularly true of the banking system which needs a complete make-over to acquire management and oversight that is free from political bias and able to take a view rooted in the new realities. This is a theme that recurs throughout this report.

The temptation in exercises such as this is to recommend more of everything: more controls, tougher rules, and so on. We have tried to avoid this where possible. Cyprus is a small, hard-pressed country where elaborate and costly remedies are not appropriate. We want to make recommendations that "keep it simple" (Cyprus' banking system is not that complicated). We also know that the banks will have to play a crucial part in Cyprus' economic recovery, and that they should not be burdened with more costs than are absolutely necessary to get them back to health.

However, we also believe in the need to be realistic about the outlook. Cyprus' return to health may not be speedy: austerity has only recently begun to bite, the banks are in a state of shock, and overall conditions in the euro area remain highly uncertain. Against that, we should not be too pessimistic. A small economy like Cyprus could bounce back very quickly if there was a strong upturn in the wider world. We have been told of the interest of countries like China in increasing their investment in Cyprus. The unsettled conditions in the Middle East could work in Cyprus' favour by channelling more business its way. And further out, there is gas.

In the longer term, it is possible to be upbeat about Cyprus' prospects: it is a strategically-placed island with a well-educated and industrious population. With the right solutions and patience there is no reason why it should not flourish once again, but in a more stable way.

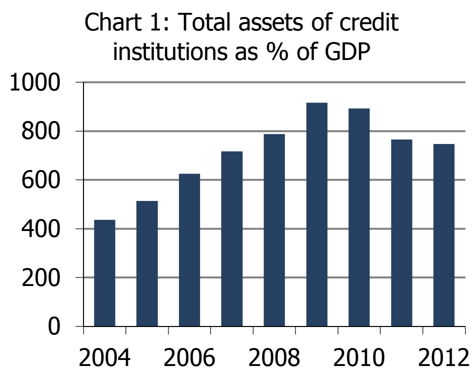
David Lascelles
Chairman
Nicosia June 2013

PART 1: THE RECENT PAST

1. Setting the scene

1.1 Cyprus' banking sector is (or was until recently) extremely big. Before the crisis its assets were equivalent to as much as nine times the country's GDP compared to an EU average of 3.5 times (Chart 1).

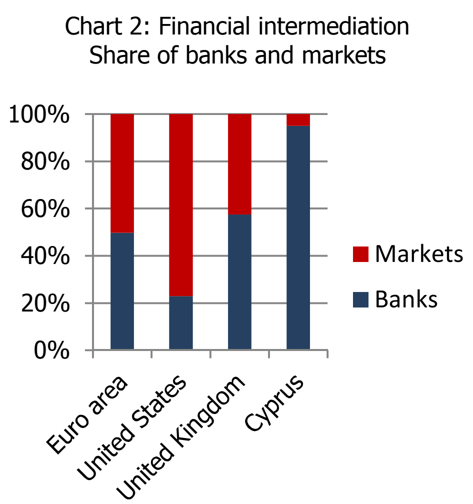
Countries have large banking systems for two main reasons: a high level of international activity, and a lack of alternatives to banks to mediate capital between holders and users. Cyprus fell into both camps. Its foreign-related business was large, and its banks accounted for over 90 per cent of financial intermediation – way above the eurozone average of 50 per cent (Chart 2). This figure alone explains why Cyprus' future is so critically dependent on getting its banks back to strength.



Source: Central Bank of Cyprus

Banking is also important to Cyprus for other reasons: up to the crisis it accounted for over 8 per cent of GDP and 4 per cent of employment (more if ancillary services are included), and it made a major contribution to tax revenue and foreign earnings.

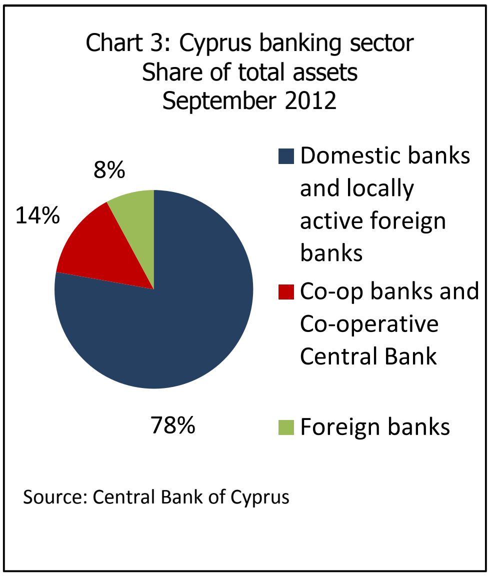
1.2 The three components of the Cyprus banking sector that concern us in this report are domestically active banks, co-operative banks and foreign banks. Their respective market shares are given in Chart 3.



Source: IMF Global Financial Stability Report 2011
Statistical appendix Table 1 p.11.
Cyprus is ICFCBS estimate

1.2.1 **Commercial banks.** These include Cypriot banks and locally active foreign banks offering conventional banking services and, in some cases, insurance and investment services. An important feature of the Cyprus banking system is its high level of personal contact: Cyprus has the densest bank branch network in the EU, and one of the lowest numbers of customers per bank employee. This means that personal relationships are important to banking transactions, possibly to the detriment of sound credit judgment. Structurally, this sector was heavily concentrated with the two largest banks, Cyprus Popular Bank (Laiki) and Bank of Cyprus, accounting for up to half of bank assets. This made both these banks systemically important. All these banks are supervised by the Central Bank of Cyprus (CBC).

1.2.2 The key point about this sector is that it underwent dramatic but poorly managed change in a relatively short space of time. A decade ago it was a solid, domestically focused industry which funded itself almost entirely from its customers' deposits. It then entered a phase of spectacular growth driven by an abundance of liquidity and ambitious management. By the end of the decade it had doubled in size relative to Cyprus' GDP through a combination of strong lending growth and foreign acquisition. But this headlong expansion eventually outstripped the banks' ability to fund it. As the global economic situation worsened in the late 2000s, the major banks were struck by a number of shocks which forced them to turn to emergency funding for survival. By 2011 the situation had become untenable, and in mid-2012, the government was compelled to bail Cyprus Popular Bank out with a €1.8bn loan. From then on, Cyprus' largest banks have lived on Emergency Liquidity Assistance (ELA) from the Central Bank.

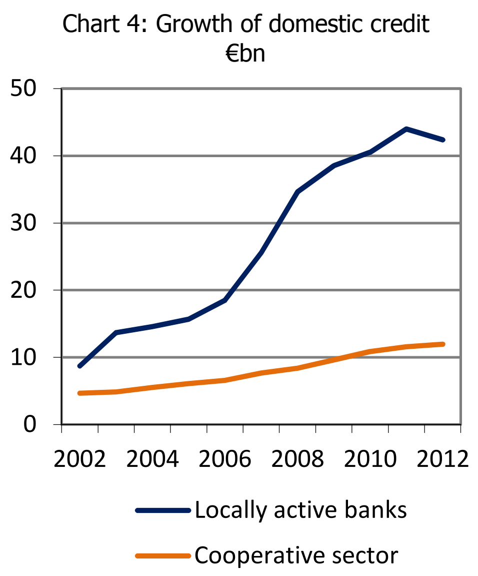


1.2.3 This sector was recently restructured to dissolve Cyprus Popular Bank and fold it into Bank of Cyprus. The future of the sector now depends on the successful resolution of the combined bank, an outcome which cannot be predicted with total certainty.

1.2.4 Although the picture looks dramatically different now, it should be noted that banking developments over much of this period were viewed very positively. In its history of the Cypriot economy published last year[1], the CBC observed: "Overall, the Cyprus banking sector has fulfilled very satisfactorily its financial intermediation role and was the key driver of the robust economic growth and stability that the country experienced following the Turkish invasion". The persistence of this attitude well into the crisis is one of many reasons which explain the dramatic rise and fall of this industry.

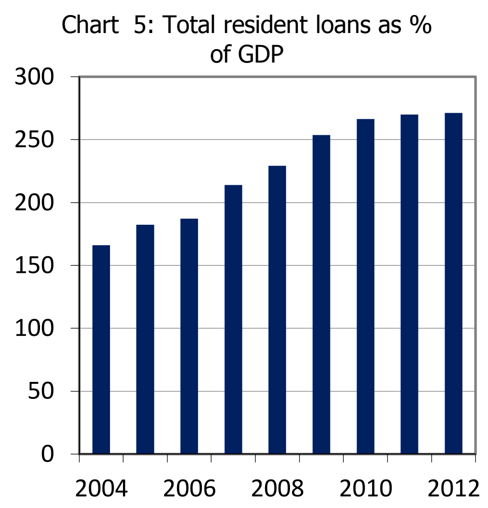
[1] Orphanides A. and G. Syrichas, Eds. *The Cyprus Economy, historical review, prospects, challenges.* Central Bank of Cyprus 2012, p. 280.

1.2.5 **Co-operative credit institutions (CCIs).** This sector consists of 93 banks offering conventional banking services at a local level, with some specialising in serving professions such as teachers or civil servants. These banks occupy a special place in Cyprus society with community links going back a century or more[2]. They operate under the umbrella of the Co-operative Central Bank which acts as their banker and service supplier, and through which they guarantee each others' liabilities. However the co-ops have also been severely hit by bad loans due to their over-friendly lending practices, and are now in need of a €1.5bn rescue. A law was recently passed to demutualise them and turn them into limited liability companies and enable them to raise private sector capital. They have until July 31 to do this: if they fail they will have to be bailed out by the government. The intention is that they should be restructured to take out non-viable banks, and consolidated down to a smaller number. Until recently, the co-ops had their own supervisor but, under new arrangements, regulatory responsibility will come under the ultimate responsibility of the CBC, though at the time of writing the precise arrangements were uncertain.



Source: Central Bank of Cyprus

1.2.6 **Foreign banks.** This sector consists of foreign banks which use Cyprus as a base to serve international customers for tax and other reasons, but have little contact with the local economy. This part of the banking system has also grown very rapidly in the last ten years, encouraged by Cyprus' policy of promoting itself as an international business and financial centre, and has been responsible for attracting large amounts of foreign deposits, particularly from Russia. Although this sector made an important contribution to the Cyprus economy, its future is now uncertain because of the controls recently imposed on international capital movements as a consequence of the crisis.



Source: Central Bank of Cyprus

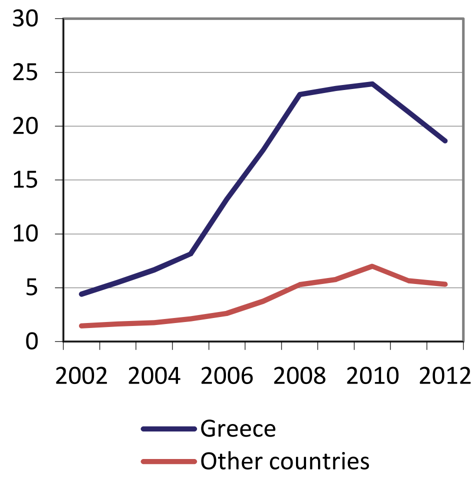
[2] The first co-operative bank was set up in 1909 in Lefkoniko.

1.3 This brief overview of recent events in the Cyprus banking sector highlights a number of crucial issues.

1.3.1 **National policy.** The most significant high level cause of the crisis was a failure at the national policy level to appreciate that running a big banking industry is about risk as well as reward. The public attitude was that the banks were doing a good job of supporting economic growth and that the international business they brought in added to the nation's wealth. Insufficient attention was given to the fact that the banks were acting imprudently and that the international business was creating serious domestic imbalances, or to how any potential emergency might be handled. There may even have been a (possibly subconscious) desire to ignore these risks in order to avoid "spoiling the party". This set the political tone for an environment in which low priority was given to monitoring banking risks, and to supervising the banks themselves.

1.3.2 **Excessive growth.** By any standards, the growth of the Cypriot banking industry over this period was spectacular, verging on reckless. In the three years to 2008 alone, domestic credit advanced by the locally active banks more than doubled. The corresponding figure for the co-operative system was a more modest, but still remarkable, 37 per cent. As Chart 4 shows, lending by the banks and the co-ops continued to grow up to 2011, in other words well into the crisis period when prudence would have suggested it was time to ease off. Although other countries also saw large banking growth over these years, Cyprus' was exceptional: by 2012, private sector indebtedness reached 271 per cent of GDP, the highest level in the EU (Chart 5). A large part of this lending was channelled into the real estate sector which was the most dynamic part of the economy, led by strong demand from non-residents.

Chart 6: Commercial banks' foreign lending €bn



The figures refer to the three largest Cypriot banks which operate abroad through branches or subsidiaries

Source: Central Bank of Cyprus

1.3.3 Equally striking are figures for the commercial banks' foreign operations[3]. In the three years 2006 to 2008, lending abroad soared by 177 per cent, equivalent to an annual growth rate of

[3] The figures refer to the three largest Cypriot banks which operated abroad through branches or subsidiaries.

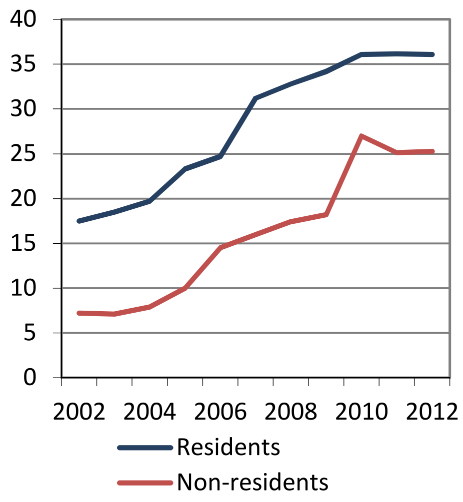
40 per cent. Most of this occurred in Greece where the annual growth rate was 41 per cent (Chart 6).

1.3.4 **Reasons.** There were many reasons why Cyprus banks and co-ops grew so rapidly. One was an abundance of liquidity though much of the resulting growth in lending was against collateral (mainly property) or personal guarantee, rather than a more rigorous assessment of the borrower's ability to re-pay the loan. When Cyprus' property bubble burst, the banks often found that the collateral could not be seized, or had fallen sharply in value. However, rather than recognise these loans as bad, the banks used various practices to treat them as good, for example by extending the repayment terms or accruing the interest on them at penalty rates, which had the effect of boosting both the balance sheet and revenue. Rules governing the recognition of non-performing loans were also lax.

1.3.5 A second factor was the introduction of generous incentive schemes for senior bank executives which rewarded them for achieving short term growth targets, and encouraged risky behaviour.

1.3.6 A third was aggressive expansion overseas. During the 2000s the three largest Cypriot banks acquired or established banking operations in Greece, followed by wider expansion in South East Europe and culminating in Bank of Cyprus' €450m acquisition of an 80 per cent stake in Uniastrum, a Russian bank with over 220 branches and 3,700 employees. This acquisition was completed in the autumn of 2008, just after the collapse of Lehman Brothers in New York, one of the key events in the global crisis. A year later, Bank of Cyprus spent a further €58m to secure a 9.7 per cent stake in Banca Transilvania in Romania. Cyprus Popular Bank also moved into foreign markets such as Serbia, Russia and Malta.

Chart 7: Deposits in locally active banks €bn



Source: Central Bank of Cyprus

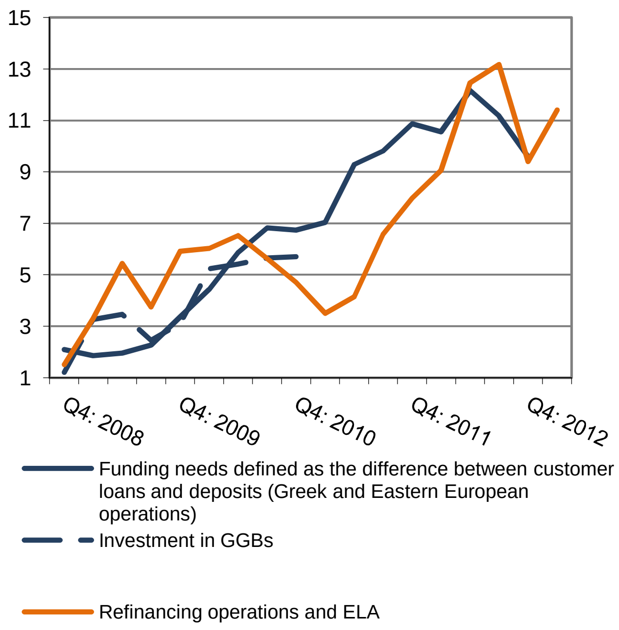
1.3.7 As it turned out, these more extended acquisitions did not contribute directly to the banks' later financial problems, but they added greatly to their balance sheet size and raised questions about their ability to manage such ambitious strategies. The banks' international losses were largely confined to Greece.

1.4 Greek problems

> *"In the past, the business community was proud of the banking system: it was efficient and attentive, and we were not bothered by foreign expansion: it seemed a good idea."*
> ***Business executive***

1.4.1 Greece was the obvious country for ambitious Cyprus banks to expand into. Apart from its strong cultural links, it lay nearby within the EU single market and, in the early 2000s, was enjoying an economic boom. Yet a major part in the two large banks' downfall was played by their decision to acquire €5.7bn in Greek Government Bonds (GGBs) in 2009-10 despite the fact that Greece's boom had by then turned sour. These bonds had been marked down by the credit rating agencies, but the banks took the view that so long as Greece continued to service them, they would make a profitable investment, especially since the banks were able to finance them using low cost funding from the ECB's refinancing facilities and later from its ELA programme (Chart 8). However, in early 2010, Greece's worsening problems brought on a further downgrade of GGBs to junk status. The Cypriot banks were able to avoid reporting losses on many of these bonds by treating them as "hold to maturity", i.e. claiming that they would ultimately be redeemed at full value. But an inescapable blow came a year later when Greece's new bail-out agreement included a "haircut" of about 80 per cent on private sector holdings of GGBs. This cost the Cyprus banks €4.5bn.

Chart 8: Cypriot banks' funding needs
€bn



Source: Central Bank of Cyprus

1.4.2 Another important event was the decision, in April 2011, by Cyprus Popular Bank to convert its Greek subsidiary into branches of the parent company in Cyprus. The reasons behind this unusual move are complex, but the key point is that it transferred regulatory responsibility for the business from Greece to Cyprus, as well as any contingent liabilities, adding greatly to Cyprus' banking problems.

1.4.3 As Greece's crisis deepened, the Cypriot banks' Greek operations suffered a higher level of bad debts than their domestic business, and also experienced a massive flight of deposits of nearly €10bn between 2008 and 2012, forcing the banks to transfer funds from Cyprus to Greece, putting upward pressure on Cyprus' domestic rate structure at a bad time for the local economy.

1.5 Weak control

> *"Cyprus had a credit boom without a credit culture"*
> ***Senior banker***

1.5.1 **Bank governance.** Much of the imprudent behaviour by the commercial banks over this period can be attributed to a lack of effective governance. It is clear that the boards of key banks failed in their responsibility to ensure that their institutions had proper strategies and procedures to monitor and control risk, and to provide the necessary checks on the executive. A culture of deference rather than challenge prevailed in the face of domineering chief executives who increasingly ignored their boards and bypassed what controls did exist. This was particularly dangerous in the case of the two largest banks which were driven by intense rivalry and, over time, by an increasingly desperate need to generate income to finance their greatly expanded operations, and meet their bonus targets. Directors had strong conflicts of interest which prevented them from exercising the required independence, as when they received loans from the bank or were granted supply contracts. In the co-ops, there was also an unhealthy convergence between the interests of boards, management and customers which led to loan favouritism and failure to recognise default.

1.5.2 **Banking supervision.** Any country running an exceptionally large banking sector has to have exceptionally good measures in place to ensure its stability. These need to take the form of strong supervisory control, backed by an awareness in government that it could be called on to support its banks if they got into trouble. Cyprus had neither: supervision was not strong enough to ensure prudent banking practice, and the government did not have the means to support its banks without outside assistance.

1.5.3 Although the necessary powers and processes existed in the CBC to supervise the banks and ensure that they were operating prudently, these were not closely followed or rigorously enforced, with the result that banks were able to operate without serious regulatory challenge until it was too late. All the signs point to inadequate will on the part of the various public agencies responsible for financial stability to identify banking risks and deal with them firmly, even though the country's two systemic banks were involved. There may even have been a reluctance to restrain the banking sector because of the perception, in the late 2000s, that it was the country's golden goose, fuelling the economy and bringing in valuable foreign revenues[4]. Furthermore, governance flaws in the Central Bank of Cyprus meant that the supervision function was not independently assessed, and that the CBC itself was not explicitly required to account politically for its handling of its supervisory responsibilities.

1.5.4 The situation was complicated by the openly hostile relations that existed between the CBC and the Ministry of Finance, and the absence of effective mechanisms for co-ordinating intra-governmental work on financial stability.

1.5.5 Various attempts were made by the CBC to rein in bank lending, for example by lowering the loan-to-value ratio on second homes in 2007, but this move was reversed the following year. A similarly half-hearted attempt was made to query the banks' purchase of GGBs: letters were sent to the banks but not followed up. The CBC also notified the government of its concern about Cyprus' deteriorating fiscal position as the economy moved into recession in 2011, but again this provoked no remedial action. Meanwhile, the property market collapsed and bad debts began to mount.

1.5.6 The CBC became concerned about the strength of the banks as their losses began to mount in 2011, and tightened up their capital requirements, but by then the banks were no longer in a position to raise more than a fraction of the sums they needed[5], and in May 2012 the government was forced to bail Cyprus Popular Bank out.

1.6 External factors

1.6.1 **EU accession.** In addition to its self-inflicted wounds, Cyprus was subject to strong external pressures. One of these was its accession to the EU in 2004, an event which altered market conditions for Cypriot banks in ways which do not seem to have been anticipated. For example the EU's single market freed up a banking system which had operated in a closely regulated environment of controls on capital flows, interest rate ceilings and domestically focused banking rules. Cyprus' entry into the euro four years later transformed the banking

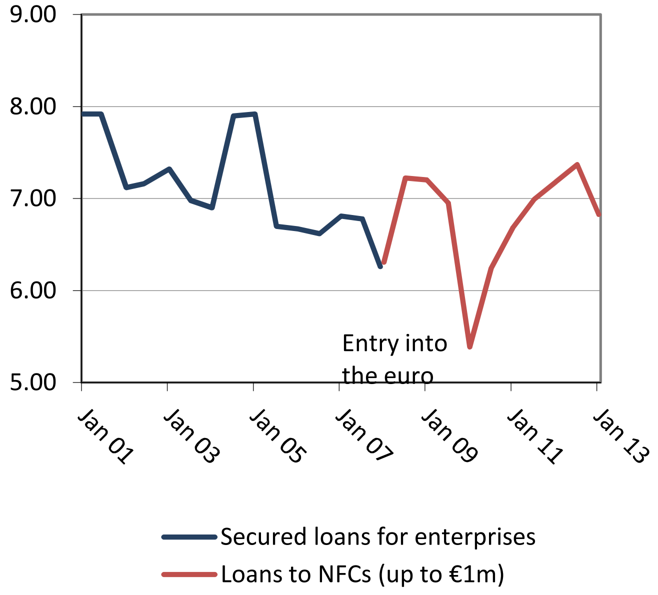
[4] As late as June 2009, the IMF's Article IV report on Cyprus concluded that "Banks, supervisors and policymakers have reacted appropriately to the crisis," – a conclusion that gave the government considerable comfort at the time.

[5] In May 2011, Bank of Cyprus and Cyprus Popular Bank raised €1.9bn of non-core Tier 1 capital, including €1bn of contingent convertible bonds (CoCos) which were later to cause troubles of their own. (see p. 84)

system's euro deposits by non-residents, which were subject to high liquidity requirements as foreign currency, into domestic currency where the requirements were lower, producing a 10 per cent surge in liquidity[6]. The convergence of Cyprus interest rates with euro rates also brought loan costs down at a time when credit was in strong demand (Chart 9). The industry was quick to take advantage of these new opportunities, but the response of the authorities was slow. As a member of the single currency, Cyprus no longer had monetary levers to control credit growth, but nor did it use the supervisory controls it did have to constrain lending to good effect. At the same time, the government allowed the country's fiscal position to deteriorate to the point where its bonds were reclassified as junk, and Cyprus was shut out of the international capital markets in 2011.

1.6.2 **Global crisis.** Another important factor was the global crisis which erupted in 2007. Although the banks were shielded from its immediate shocks by their strong domestic funding base and conventional business models, their increasing foreign exposure meant that they were not totally immune. The weakness of other economies made itself felt in various ways: demand for Cyprus holiday real estate began to fall off, driving down property prices (and therefore loan collateral), and tourism declined. But the severest blow came through Greece where the Cypriot banks suffered the major setbacks already described.

Chart 9: Interest rates on loans to non-financial corporations %



Source: Central Bank of Cyprus

[6] Clerides, M. and C. Stephanou. *The Financial Crisis and the Banking System in Cyprus* (2009). Cyprus Economic Policy Review, Vol. 3, No. 1, 2009

1.6.3 **Euro crisis.** A third was the lack of consistency in the EU's approach to dealing with sovereign bail-outs. As the number of cases rose, it became necessary for the "Troika" of the EU, the European Central Bank and the IMF to apply increasingly severe "one-off" measures to sustain political support for their very expensive rescue programmes. Cyprus suffered one of the severest of these, the GGB haircut in 2011, and, when its own turn came in 2013, the severest of all, the haircut on uninsured bank deposits.

1.7 The 2013 rescue

1.7.1 It has to be said that the Cyprus government made matters worse for itself in its handling of the crisis, in particular through its failure to act decisively once it had been shut out of the international capital markets in 2011. Had it agreed to the terms originally offered by the Troika in mid-2012 it might have obtained a more lenient rescue package. Instead it stretched the patience of its lenders to the point where they insisted on the toughest terms yet imposed on an ailing euro country.

1.7.2 The loan agreement of March 2013 makes €10bn available to Cyprus in return for a severe adjustment programme which includes restructuring the banking system to resolve Cyprus Popular Bank into the Bank of Cyprus and a "bail-in" of the combined entity using uninsured deposits. There are also measures to shrink the banking industry as a whole and restructure the co-operative sector, and to strengthen banking supervision, all of which are now being implemented. In order to stabilise the financial situation locally, temporary capital controls had to be imposed on the movement of funds within and out of Cyprus in March 2013.

1.8 **Losses.** The total losses incurred by the banking sector from this series of disasters has been put by an independent assessment by PIMCO[7] at just under €14bn, implying a capital gap in bank balance sheets of nearly €6bn by 2015. However this is under a so-called "base scenario". A more pessimistic (and in our view more likely) "adverse scenario" forecasts total losses by 2015 of €18.5bn, implying a capital gap of €8.9bn. Losses of this order would amount to more than Cyprus' total GDP. Meanwhile the "new" Bank of Cyprus only survives thanks to over €11bn of emergency liquidity assistance from the ECB.

Table 1
Main components of Cypriot bank losses
€bn

Bank of Cyprus	- in Cyprus	3.6
	- in Greece	2.5
Popular Bank	- in Cyprus	2.5
	- in Greece	4.5
Co-operative banks		1.4
GGBs		4.5

Source: PIMCO

[7] PIMCO: *Independent due diligence of the banking system of Cyprus 2013.* P. 16.

1.9 Conclusion

1.9.1 Cyprus' extraordinary banking crisis was due to failures at several levels: national policy, macro-economic management, banking supervision, and the governance of the banks themselves, as well as in banking practices, particularly lending, all happening within an exceptionally difficult economic and political environment.

1.9.2 This may seem a daunting list of challenges, but in our view they all need to be addressed if the banking system is to be brought back to health and confidence restored. A start is being made: the weaknesses in banking supervision and corporate governance are being tackled, tougher audit and risk management practices are being introduced, and the scale of the bad debt problem has been assessed. But the process still has a very long way to go. The encouraging thing is that it is within Cyprus' power to do something about all of them.

Cyprus chronology

1980s Beginnings of Cyprus' policy to become an international business and financial centre.
2004 Cyprus joins the European Union.
2006 Domestic bank lending begins to grow rapidly.
2007 The largest Cypriot banks embark on a period of international expansion in Greece, the Balkans, Russia and the Ukraine.
2008 January: Cyprus joins the euro.
February: General election brings AKEL to power.
September: Collapse of Lehman Brothers. Acquisition by Bank of Cyprus of Uniastrum in Russia for €450m.
2009-2010 Largest Cypriot banks buy €5.7bn worth of Greek government bonds.
2010 Deterioration in Cypriot government finances. Cyprus begins to move into recession.
2010 April: Greek sovereign debt downgraded to junk status.
2011 Cypriot banks begin to suffer heavy losses because of the economic crisis.
2011 April: Cyprus Popular Bank converts its Greek subsidiary into branches.
April: Government imposes a levy on bank deposits to raise revenue.
May-June: Cyprus sovereign debt is reduced to junk status. Cyprus loses access to international capital markets, obtains a €2.5bn emergency loan from Russia.
May: Bank of Cyprus and Cyprus Popular Bank raise €1.9 billion of non-core Tier 1 capital (including contingent convertible bonds (CoCos) of about €1 billion).
2011 October: Cypriot banks suffer an 80 per cent "haircut" on their Greek government bonds, creating a loss of €4.5bn.
2011 Cyprus' three largest banks suffer aggregate losses of €6.5bn.
2012 March: CoCos are partly converted into equity capital, creating large investor losses.
May: Cyprus government rescues Cyprus Popular Bank with a €1.8 billion recapitalisation. New top management at Cyprus Popular Bank and Bank of Cyprus.
May: Cyprus seeks assistance from EU, ECB and the IMF.
2013 February: General election brings Democratic Rally to power.
March: Cyprus Popular Bank is dissolved and its business folded into Bank of Cyprus.
March: Haircut on uninsured deposits at Cyprus Popular Bank and Bank of Cyprus; controls placed on movement of capital.
March-May: Signing of MoU and disbursement of first loans.

2. The Memorandum of Understanding

Although Cyprus arguably brought the tougher terms of the second MoU on itself by failing to sign up for the original terms in mid-2012, the conditions it now faces pose a major challenge to the economy and its banks. We have strong concerns about a number of its provisions.

2.1. **Severity.** The terms of the agreement are exceptionally severe by the standards of other eurozone bail-outs. The focus on "front loaded" austerity and bank restructuring measures contains the danger that insufficient thought has been given to Cyprus' longer term recovery and the future of the banks. The agreement is now part of history, but it creates difficult conditions for the task ahead.

2.2. **The merger of Cyprus Popular Bank with Bank of Cyprus.** This provides the Troika with an expedient way of dealing with Cyprus Popular Bank's immediate problems, and assembling enough collateral to secure the ECB's emergency funding. But it is a difficult merger which contains considerable execution risk, and will be open to legal challenge. Furthermore, it will leave Cyprus with a dominant bank controlling 40-50 per cent of the domestic market – which could become problematic for competition and financial stability later on.

2.3. **The haircut on deposits**. Although the terms of the MoU have, in the end, only hit uninsured deposits in Cyprus' two largest banks, the inclusion of a deposit haircut and the accompanying capital controls will affect banking confidence in the eurozone more widely. For Cyprus, it will raise fears about the safety of deposits if the current round of financing proves insufficient, making it harder for Cyprus to lift capital controls. Also, the haircut arrangements radically alter the shareholding structure of Cyprus' largest bank with consequences that are hard to foresee. The selective way in which the haircut was applied raises questions of equity when depositors in foreign branches were spared, and other credit institutions in Cyprus receiving public money were not required to call on their depositors or members.

2.4. **The shrinkage of the banking system.** Cyprus has been told to reduce its banking sector to the EU average of 3.5 times GDP – an arbitrary figure. The forced pace of the shrinkage has already created fire sale losses, and may cause more. The precise terms of the sale of the Greek branches of Cypriot banks are hard to establish but appear to have crystallised heavy losses for their owners, while the hectic pace of the disposal appears to have been dictated by the need to avoid frightening off Greek depositors. This is an unnecessarily costly and disruptive way to downsize a banking system. Cyprus' banking sector should have been left to find its optimal size within a more reasonable time frame, whatever the concerns about its reliance on international business.

2.5. **The shrinkage of the international financial centre.** We do not consider the presence of a large foreign banking business to have been of itself a major direct contributor to the crisis, though the inflow of foreign deposits was a reason for the sector's unwieldy size and made possible the banks' imprudent expansion. Until the MoU negotiations threw up the possibility of a haircut, non-residents' deposits had been remarkably stable, and provided the foundation for a tax-based international banking business that was profitable. The case for shrinking this sector was driven by certain countries' concern about its legitimacy rather than its impact on the soundness of the banks, which is a different issue which could have been dealt with by supervisory means.

2.6. **Lack of measures to promote growth.** There is nothing in the agreement actively to promote Cyprus' economic recovery: the emphasis is mostly on fiscal austerity and banking reform, though the latter will certainly provide a foundation for future growth. In order to recover, the economy will need to find new sources of growth, and the banks will have to be able to earn substantial profits to return to full health and attract funding to replace their official liquidity assistance.

PART 2: THE BANKS

3. Reforming the banking sector

The Cyprus banking system needs to undergo fundamental changes if it is to recover and serve the economy. We see the objectives being to

3.1. restore normal banking conditions as soon as possible,

3.2. make the banking system stronger and better able to absorb losses, of which there will be more,

3.3. improve the governance and management of banks so that they adopt sensible and sound strategies,

3.4. develop a competitive banking market that delivers a quality service using modern methods of delivery, and

3.5. identify opportunities for Cyprus to use its financial and professional skills as a national asset in a safe and productive way.

In this section we discuss the major issues and consider recommendations.

3.6. The need for change

Before we get into technicalities, we make a recommendation of a different kind: that there be radical change in the culture of the banking industry and in the politics surrounding it. Banking in Cyprus has become highly politicised, which is not healthy on two accounts. One is because political interference in the management and supervision of banks seldom makes things better. The other is that we observe a tendency in Cyprus to deal with problems by recycling familiar elements of the establishment, be it people or ideas, rather than breaking out and finding new solutions. It is striking, for example, that there are virtually no non-Cypriots in the governance of domestic banks, - this in an island which claimed until recently to be running an international financial centre. We believe that the introduction of fresh people, new sources of advice, international experience and different attitudes are all essential if Cyprus is to give itself a fresh start. Changes of this kind would transform the banking system in all the necessary ways, by delivering better governance, better banks, better supervision and – importantly - greater confidence on the part of its lenders.

3.7. Bank of Cyprus

Much the biggest issue facing the banking sector is the future of the Bank of Cyprus, whose recovery is crucial to rebuilding confidence in the banks and helping to get the economy back on its feet. Almost everything else flows from this: the removal of capital controls, the easing of Cyprus' high interest rate structure, and a resumption in the flow of credit, and therefore economic recovery. In our view, Cyprus will only have one opportunity to make this restructuring work, because failure would throw all the items just mentioned into reverse, with incalculable consequences.

3.7.1. In order for the restructuring to work, it will have to produce a bank with a capital structure that removes all uncertainty about a future call on depositors, with a strong management team (preferably with previous merger experience) with a convincing business plan, and a board of experienced and independent directors free from political influence. There also has to be no doubt about the CBC's ability to supervise the new institution effectively.

3.7.2. The merger will have to be swift and thorough if it is to deliver the cost savings which are the main positive element behind it. Experience shows that if the cost benefits of a merger are not secured within 18 months, they become much harder to extract as staff build up entrenched positions, and the sense of urgency is lost. To achieve this, there needs to be a clear timetable and schedule of tasks.

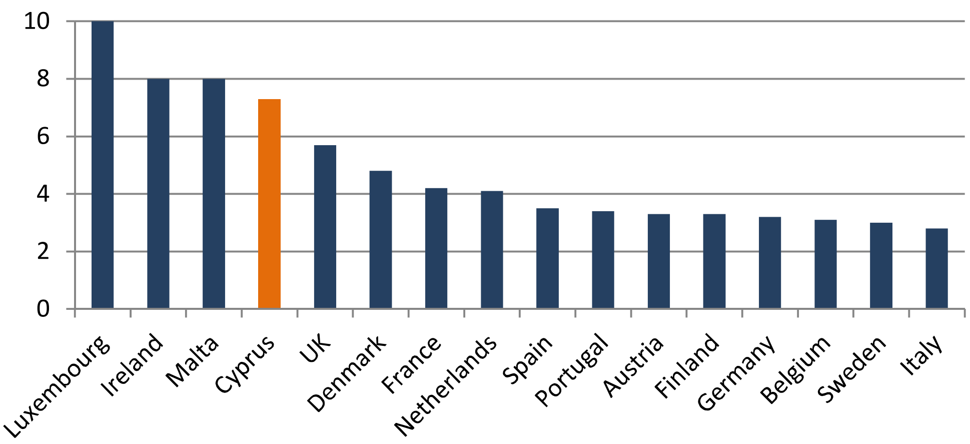
3.7.3. In order to rationalise costs, one of the two systems environments will have to be discontinued, and clients migrated swiftly on to the surviving system. This is a very complex task which is likely to consume management resources for 18 months. Redundant branch closures will need to be made rapidly. These changes also need to set a precedent for the substantial staff reductions and more flexible salary and labour practices which will be necessary to Cyprus' banking future.

3.8. **Size**

3.8.1. Under the terms of the Troika bail-out, Cyprus must halve its banking sector from over seven times GDP to 3.5 times. Much of this shrinkage has already come from the resolution of Cyprus Popular Bank and its merger into Bank of Cyprus, from the restructuring of the co-operative banking sector, from disposals of foreign businesses, and from the flight of deposits. Some foreign banks may also leave.

3.8.2. Some degree of shrinkage is clearly necessary: Cyprus' banking system had grown beyond the country's ability to manage it. The challenge is to find its optimal size. This is unlikely to be 3.5 times GDP, which is merely an EU average. We believe that there are acceptable reasons why Cyprus could have an above average sized banking system. One is that, until other financing channels emerge, it has no alternatives to bank finance, so the banks will need to play an important role. Another is that financial specialisation is a respectable option for an economy with limited choices; in other words, an international finance business could continue to play a role, though accompanied by a

Chart 10: Banking sector assets as multiple of GDP (2010-11)



Note: Cut off at 10. Luxembourg is 24.
Source: Liikanen Report, EC. October 2012 based on 2010-11 data

greater awareness of the need for sound policies. (We examine this possibility on p. 40).

Conclusion and recommendations

3.8.3. A major obstacle in the way of Cyprus banking reform lies in the politicisation of the banking sector and a reluctance to allow in new people and ideas. **We recommend that Cyprus give priority to restoring the independence of the banking system, and reinvigorating it with fresh people, new ideas, and international sources of advice. Changes of this kind would transform the banking industry in all the necessary ways, by delivering better governance, better banks, better supervision and greater trust internationally.**

3.8.4. **The re-launch of a new and strong Bank of Cyprus has to be the central objective for the banking sector, and we recommend that a clear timetable be set to achieve that goal, and that priority be given to securing the cost savings which are the main positive element behind the merger.** This will also help dispel other uncertainties, such as the timing of the removal of capital controls. Ultimately, the size of the sector will be dictated by the availability of capital, the capacity to attract deposits and the prospects for profit, each of which is hard to forecast today.

3.8.5. **We believe that there are sound reasons why Cyprus might have a larger than average banking sector in the longer term, including the revival of a sound international banking business once suitable supervision is in place and confidence has returned**. We make further recommendations about this later in the report.

How other countries coped

It is tempting to look at other countries in financial difficulty to see whether they offer any lessons for Cyprus. Iceland and Ireland, both small island economies with large banking sectors, now recovering from massive crises, are obvious ones.

In Iceland, the three major banks collapsed in 2008 after a period of dizzying expansion and had to be nationalised, leaving the economy in crisis and the country with large external debts which required a $10bn international loan. Like Cyprus, Iceland had to impose capital controls to forestall capital flight. Controversially, it reneged on the liabilities of its banks in foreign countries, particularly the UK and the Netherlands.

The good news is that Iceland is recovering thanks to the scale of its adjustment and the strength of its tourist industry. Since it was not in the euro, Iceland had more options than Cyprus: it was able to let its currency fall to regain competitiveness. However, it remains deeply indebted, and while an international court has ruled that it is not liable for its banks' foreign liabilities, this issue is likely to plague Iceland's trade and financial relations for a long time. Five years later, capital controls are still in place.

Ireland offers closer parallels to Cyprus. It had an exceptionally large banking sector fuelled mainly by property lending. There was also a sizeable tax-based foreign component in the form of its International Financial Centre which included not just banks but insurance companies and fund managers.

Ireland's banks were brought down by the collapse of the property bubble in 2008, and a combination of reckless management and poor supervision[8]. This forced the government to issue an unlimited guarantee for the six largest banks' liabilities which eventually amounted to over 300 per cent of the country's GDP. But it meant, unlike Cyprus, that all deposits were safe. Later, the government obtained a €85bn rescue from the EU and the IMF. This was supplemented by a further €10bn and an extension of repayment terms by seven years in March 2013.

Like Cyprus, Ireland is in the euro, which means that all its adjustment must come internally through austerity and restructuring (wages have fallen 15 per cent). Its banking sector is also being shrunk to 3.5 times GDP, which has been painful. Nonetheless, there are signs of recovery: five years later, growth has returned and Ireland expects to exit from its adjustment programme later this year, though the banking system is still not back to health, and bad debts continue to grow.

[8] Regling K. and M. Watson. *A preliminary report on the sources of Ireland's banking crisis*. Central Bank of Ireland. 2010.

Europe Minister Lucinda Creighton recently said of Ireland's adjustment: "Hopefully we'll provide not so much an example but an inspiration for other countries which are going through difficult times."

But there are also fundamental differences between Ireland and Cyprus, the main one being that Ireland entered its crisis at a time when lending countries were still willing to bail out banks. There were no haircuts or capital controls on Irish deposits, and loan terms were more generous. Cyprus marked the first time that a country received no money to recapitalise its banks, and had to haircut large deposits and impose capital controls. Cyprus' maximum debt servicing capacity was set at 100 per cent of GDP (compared to 120 per cent for Greece). Furthermore, the process of resolving both systemic banks simultaneously was much the most complicated yet seen, involving cross-border resolution and the difficult merger of two large banks.

A final point is that, looking ahead, Ireland has alternative industries to financial services while Cyprus has few of these, making recovery prospects less certain.

3.6 Structure

Major changes to the structure of the Cypriot banking system are required by the MoU, mainly in the form of consolidation to make it stronger and more efficient.

3.7 **The banks.** On the banking side, the merger of Cyprus Popular Bank with Bank of Cyprus will leave Cyprus with one very large bank, a relatively smaller bank, (Hellenic Bank), a consolidated co-operative bank sector, a locally active foreign bank sector, and a non-locally active foreign bank sector.

3.7.1 These arrangements have the advantage of expediency: they ensure that Cyprus' weakest bank is quickly resolved. However, as we indicated earlier, we would not have recommended this structure because it makes for a difficult merger and creates a dominant bank with potential consequences for stability and competition. There is also likelihood that further structural change will reinforce the dominance of the Bank of Cyprus: i.e. the co-operative sector will shrink, and the international banking sector may be reduced by departures. The countervailing consideration is that the Bank of Cyprus will itself shrink as it deleverages and writes off bad assets. It is also possible that foreign banks will take advantage of the weakness of domestic banks to strengthen their position in the Cyprus market, even make acquisitions. This would be welcome because it would bring competition and mark a sign of confidence. A further possibility is that opportunistic online banks will spring up to take advantage of a distressed economy, as has happened in many other European countries – which might be less welcome.

3.7.2 Although new measures are being taken by the government to resolve troubled banks without recourse to the taxpayer, it is impossible completely to eliminate the systemic risks posed by large banks, meaning that supervision will need to be accordingly robust to handle this structure.

3.7.3 We deal in greater detail with the competition issues raised by this restructuring in the next section. Suffice it to say here that Cyprus' new banking structure will need to be reviewed before long.

3.8 **The co-operative credit institutions.** Co-operative banks are a distinctive and popular feature of Cyprus' banking system. However the financial crisis exposed serious faults in the way they were managed and supervised, and we support moves to restructure the industry to make it stronger and create a more balanced banking sector for Cyprus overall. The question is how far restructuring should go.

3.8.1 While the co-ops are very much part of the fabric of Cypriot society, the perception that they were better and safer than banks was clearly false. Many of them were poorly managed and engaged in imprudent lending practices often based on personal connections rather than objective credit assessment. The co-ops guaranteed each other through the Co-operative Central Bank, which protected them from failure, but also encouraged irresponsible behaviour. On two previous occasions, the commercial banks and the government have had to bail the co-op system out of its losses[9].

3.8.2 To address these problems, legislation has been passed to demutualise them and consolidate them down to a much smaller number. Supervision is being transferred from their special authority to the CBC, though at the time of writing the new arrangements had not been finally decided. Capital amounting to €1.5bn is being raised to recapitalise them, though whether this comes from the government or private investors remains to be seen. Although two thirds of the co-ops had unlimited liability, meaning that members could be called on to make good their losses, this liability was never called.

3.8.3 Although these changes will drastically alter the character of the co-ops, it is nonetheless a solution which grants them important favours. They will receive a government bail-out without having to make any contribution of their own, and they will perhaps retain a specialised supervisory regime to protect their "special character".

[9] According to Orphanides A. and G. Syrichas. *op. cit.* p. 282, the coops received CY£22m from the government and the commercial banks in the late 1970s, and a further CY£67m in the late 1980s.

3.8.4 This, in our view, is an unsatisfactory outcome which only amounts to a "half way house" on the road to the thorough restructuring which the sector needs. The economy that they serve today is not the agrarian one to whose success they contributed in the past. Instead, we believe that the co-ops should be merged into a single institution, and that this bank be transformed into a joint stock company owned by the government (at least initially) and supervised directly by the CBC. The government would later be able to sell its stake and recoup its investment.

3.8.5 The reasons for considering this recommendation are that, user-friendly as the co-ops may be, their survival comes at great price. They need to be transformed into an efficient and competitive group, with centralised professional management and freedom from political and personal influence. Elements of favouritism, such as a specialised regulatory regime and the promise of support, need to be removed because they only risk perpetuating poor banking practice.

3.8.6 It is true that this approach would wipe out much of the traditional character of the co-ops and reduce the diversity of the Cyprus banking sector. However we believe it is more important to use this opportunity to transform the co-ops into a modern, profit-making and competitive force for the benefit of the wider economy. The co-ops may enjoy popular support, but they have become an expensive luxury for Cyprus, the true cost of which seems not to be generally understood.

3.9 Conclusion and recommendations

3.9.1 The structure of the Cyprus banking industry that emerges from the present changes is likely to be unsatisfactory because it will contain a dominant bank with associated risks to competition and stability. **We recommend that the banking structure be kept under review, particularly in regard to potential competition and financial stability issues in the longer term.**

3.9.2 On the co-op side the risk is that the proposed restructuring arrangements will not eliminate fundamental weaknesses in the sector and could perpetuate poor banking practices. **We recommend that the co-ops be combined into a single institution with a joint stock structure and a commercial culture to make them a healthy competitive force on the banking market, and that this institution be placed under the direct supervision of the Central Bank of Cyprus.**

4. Cyprus' international financial centre

4.1 The banking crisis places a question mark over Cyprus' future as an international financial centre. The country's lenders have made it clear that they think this business is potentially unstable and of questionable legitimacy. The tax and regulatory reforms contained in the MoU aim to shrink it down and make Cyprus less attractive as a banking destination. The fact that a deposit haircut and capital controls were needed to complete the task has made matters worse.

4.2 Even the partial loss of this business would be costly for Cyprus. At its height, it accounted for 40 per cent of the deposits in the Cyprus banking system (this includes domestic banks which had a large part of the business). Although these deposits later came to be a political liability for the reasons just mentioned, they constituted an important – and stable – part of the country's banking activity well into the crisis period. They also brought a lot of fee-earning business (trade finance, foreign exchange, money transfer and wealth management). Altogether this activity came to account for over a third of Cyprus bank profits at the operating level (i.e. before provisions for bad debts) before the crisis.

4.3 The question is whether any of this business can and should be saved, and if so, how? It is too early to give firm answers to these questions because much will depend on how the current uncertainty is resolved. However, in this section, we examine the issues that would have to be addressed to retain this feature of the Cyprus economy.

4.4 **A tax business.** Although this is frequently referred to as a banking business, it is at heart driven by tax, in particular by Cyprus' low corporate tax rate and its extensive network of double taxation agreements with other countries. These permit businesses to book, in Cyprus and at Cyprus' tax rates, profits earned in high tax countries. On top of tax, a whole superstructure of banks and professional firms has evolved to provide bank accounts and money transmission services, and to create and manage the necessary corporate vehicles and trusts. Because many of the clients involved are individually wealthy, there is an associated wealth management industry, though it is small.

4.5 Cyprus' appeal is also geographical: it provides an EU-based haven for nationals in countries in the Eastern Mediterranean who live with local uncertainties (which is why there is a strong Middle Eastern banking presence), as well as a location where nationals of the former Soviet Union can operate confidently and confidentially, and enjoy some sunshine. Cyprus also provides a platform for investment flows into countries in the region: it accounts for 20 per cent of foreign investment in Russia for example (much of it by companies with ultimate Russian ownership).

4.6 Many foreign banks operate subsidiaries in Cyprus to handle this business without any contact with the domestic economy. However a proportion also passes through the largest Cypriot banks which, in the process, acquire large deposit balances.

4.7 It is important to stress, however, that this business does not always require the involvement of banks, or if it does, the banks need not necessarily be in Cyprus because the balances can be held elsewhere. The key point is that Cyprus should be the location where business is booked for purposes of tax, and also in some cases for confidentiality and political safety.

4.8 **Weaknesses of the Cyprus model.** We do not find fault with the concept of an international financial centre: this can be a legitimate business which serves a genuine financial and tax planning need and contributes to economic growth. Many other countries, such as the UK, the Netherlands and Switzerland have such centres. However it has to be well managed.

4.9 The problem in Cyprus is that it was poorly managed: it grew too fast, it was inadequately supervised, it was insufficiently diversified geographically, and its distorting effect on the local economy went uncorrected for too long, particularly the large overhang of deposits which could not be usefully absorbed locally. Although other financial centres are much bigger (e.g. Luxembourg and London), Cyprus' was distinctive in that it was dominated by local banks, which should have made the task of controlling it easier. The fact that it failed to do so is a strong reproach.

4.10 The financial centre was also, in our view, of insufficient quality, relying too much on tax appeal and a hospitable environment, and not enough on value-added services and financial soundness. Cyprus also allowed it to become reputationally associated with tax evasion and money of doubtful origin.

4.11 **The future.** In considering the future of this business, we should examine the motivation of people and businesses which use Cyprus as a base.

4.11.1 **Tax driven business.** One is the tax-driven business through banks, i.e. international transaction flows which pass through Cyprus bank accounts for tax and legal reasons. Some people have called this the "through Cyprus" business because it does not touch the local economy. Little has changed here: the corporate tax rate has increased from 10 per cent to 12.5 per cent, but this still leaves Cyprus at the bottom end of the EU tax scale. The double taxation agreements remain in place. What did damage the business was the introduction of capital controls because these severely disrupted international business cash flows. Although controls on these movements were among the first to be lifted, confidence was already damaged, and some foreign banks threatened to leave. The haircut on uninsured deposits at the two large Cypriot banks also caused large losses.

4.11.2 The continuation of this business depends on an early return of confidence, which in turn depends on whether Cyprus' new financial position is sustainable. If there are doubts about Cyprus' ability or willingness to meet its MoU targets, there will also be fears about more haircuts and capital controls. However, it is also likely (though this is hard to gauge) that businesses which use Cyprus are faced with tax and other considerations elsewhere which more than offset any deterioration in Cyprus' appeal. Furthermore there may be contractual ties which bind these businesses to Cyprus (bank deposits used as security for loans or investments for example) making it difficult for them to move at all. Also, if they leave Cyprus, where would they go? All financial centres have their pluses and minuses.

4.11.3 **Savings.** The second is the class of customers who put their savings in Cyprus-based banks out of considerations of tax, attractive interest rates and personal convenience. These were hit by capital controls and, if they banked with Cyprus Popular Bank or Bank of Cyprus, by the deposit haircut. It is expected that many of these depositors will move their funds out as soon as capital controls are lifted, given the added consideration that the tax on savings interest has just been increased. However it is worth noting that projections by PIMCO[10] suggest that the greatest outflows are likely to be of domestic rather than foreign deposits (10 per cent versus 4 per cent) because foreign depositors may have countervailing reasons for keeping their money in Cyprus.

4.11.4 **Professional services.** The third is the tax structuring business run by banks, lawyers and accountants whose growth will depend on its ability to "originate" new clients for Cyprus. Existing business will probably continue, but new business may be harder to come by after recent events.

4.11.5 **Safe haven.** Cyprus also obtains business as a regional "safe haven" for customers living in less stable countries, particularly the Middle East, which is why there is a sizeable Middle Eastern banking presence. Since these customers' main consideration is safety they will be concerned about the security of their deposits and appropriate confidentiality rather than issues such as corporate structuring and tax. Notwithstanding recent events, Cyprus' membership of the EU and of the euro area should continue to be attractive to potential customers.

4.12 **The outlook.** The considerations that determine the outlook for this sector are:

4.12.1 **Macro-economic stability.** A major concern among the users of Cyprus' international facilities will be the soundness of the country itself, and the risk of more turbulence and controls if Cyprus needs to raise more money. To create certainty on this front, Cyprus will need to achieve an orderly economic

[10] PIMCO. *op. cit.* p 28.

recovery and eliminate doubts about the sustainability of its fiscal position and the strength of its banks.

4.12.2 **Tax stability.** Since tax is the foundation of the international financial centre business, Cyprus will have to provide certainty about tax conditions as well. This will be difficult since many of its tax provisions are vulnerable to forces outside its control. For example, there is an aversion to tax competition in the EU, and strong pressure for tax convergence. If Cyprus' recovery programme proves fiscally unsustainable, the Troika will very likely demand a further increase in tax rates. The country's double tax treaties could also come under renegotiation pressure from partners who are, themselves, in fiscal difficulty. In any case, it would be prudent for Cyprus to reduce its reliance on tax-driven business because of these uncertainties, and use its skill base to develop other lines of business.

4.12.3 **Financial stability.** The financial centre will have to be better supervised. This is already happening. Major improvements are being introduced to banking supervision to make it more alert and effective, and the two largest local banks are also being recapitalised. However, it might be worth exploring the possibility of bringing in more outside expertise in the form of technical assistance or a senior supervisory figure with financial centre experience.

4.12.4 If concerns persist about the risks that the foreign banking business poses to the domestic economy, it may be desirable to ring fence it in some way, for example by requiring the country's locally active banks to set up separately capitalised subsidiaries to handle it. These would be prohibited from conducting local business, and would be subject to stricter liquidity requirements. Most foreign banks in Cyprus already operate a model of this kind.

4.12.5 **Size and structure.** In the past, the Cyprus banks' international financial centre activities generated a surplus of bank deposits which they recycled into excessive lending growth domestically and risky foreign expansion. This does not need to happen. Bank of Cyprus and Hellenic Bank could remain in the more profitable side of the international business, handling trade and payment flows which generate fee income and channel any excess balances into businesses where their clients, not the banks themselves, are at risk, such as fiduciary deposits and wealth management where we sense the opportunities to provide an attractive service are insufficiently exploited. This business would, therefore, add value to the economy without creating the same distortions in the domestic market.

4.12.6 **Legal certainty.** Confidence in the rule of law is fundamental to the success of a financial centre. The haircuts have shaken that confidence in Cyprus, and it will need to be rebuilt. Other aspects of the legal system will also need to continue to be seen as reliable, such as the efficiency and fairness of the courts and the law officers, and the arrangements for realising security. It has been put to us by some people that more may need to be done to update company law which we understand remains based on now-outdated versions of English law.

4.12.7 **Legitimacy.** It is important that the international business be both clean and seen to be clean, which requires rigorous control of client acceptance and transparency. Cyprus must put together a determined programme to correct the failings identified by the recent anti-money laundering (AML) investigation, triggered by strong concerns on the part of other governments, and show a high level of commitment to transparency and compliance. This will involve the banks, their supervisors, as well as professional bodies such as the Cyprus Bar Association and the Institute of Public Accountants of Cyprus whose members play an important role in business origination. Any future lapse of any kind in client acceptance or continuation would have very damaging consequences.

4.12.8 **Quality of the service.** Much could be done to improve the range of the services offered by the international financial centre. The business that Cyprus built up over the last decade was impressive in its size but relied too much on easy breaks such as tax and light supervision. The banks' product offering was simple, and the range narrow. We see opportunities to expand the range by offering off-balance sheet services such as wealth management, custodian services and fund administration which, as well as being less risky, are potentially more profitable. We recognise that this will involve considerable work and the importation of external expertise, including probably by foreign banks. However, this seems necessary if Cyprus is to be recognised as a full financial centre rather than simply the passive recipient of tax-diverted business.

4.12.9 The professional services accompanying the financial centre did not fully exploit opportunities to add more value locally. We were told, for example, that some of the high valued added legal and accounting work in corporate structuring was done in London and other financial centres and only implemented in Cyprus. For many customers, Cyprus was little more than a "booking centre" for business flows. Ironically, for all its size, given the apparent skills of its workforce, Cyprus could have been earning much more from its financial centre. This will involve investment in upgrading local legal and accounting skills to the level where it is possible to repatriate higher value-added work from elsewhere.

4.12.10 Although there is already a certain amount of business from neighbouring countries in the Middle East, we think more could be done to market sound financial and wealth management services to businesses and individuals for whom Cyprus is a relatively safe haven politically and, in security terms, is a member of the EU and uses the euro. This will involve more imaginative and assertive marketing which successfully addresses recent concerns than has been needed in the past.

4.13 Conclusion and recommendations

4.13.1 Although the shock to Cyprus' ambitions as an international financial centre has been severe, it is possible to identify the steps that would need to be taken to bring about its recovery. Cyprus still retains advantages as a financial centre. It has a well developed infrastructure, professional skills, a highly educated workforce, the English language and internationally recognised English-style company law. It also remains a relatively safe haven in a troubled region. However, these advantages should not be taken for granted: laws and tax arrangements need constant updating to keep them in line with the demands of a very competitive market. The same goes for skills. Cyprus would also have to mount a considerable promotion effort to repair the damage done to its reputation, and get the message out that it was still in business, though of a higher quality.

4.13.2 But it also needs to be aware of its disadvantages which – apart from bad publicity and lost confidence - relate to uncertainty about property rights, taxation and capital controls. The current highly charged political environment is also unsettling for foreign business. Overriding all of this is the question whether the Troika would welcome a recovery of international financial activity in Cyprus. At best, only cautiously, though Cyprus' creditors will need to consider the country's pressing need to generate economic activity, particularly of a kind which brings business into the EU.

4.13.3 **As a first step, we recommend that Cyprus seek to raise the quality and scope of the present skill base of its international financial centre business so that customers choose to use it for its breadth and sophistication, not just the tax breaks, and that the banks develop their product range to include higher class wealth management and off-balance sheet services, and later custodian services and fund administration. Supervision will also need to be improved, possibly by drawing on outside assistance to give confidence to users of these services, and anti-money laundering controls will have to be strictly and visibly enforced. If concerns persist about the risks that the foreign banking business poses to the domestic economy, it may be desirable to ring fence it in separate legal entities.**

5. Banking competition and service quality

Our Terms of Reference require us to consider "the improvement of levels of banking competition and service quality for the benefit of consumers and businesses". We have taken the view that conditions in the market are currently so exceptional that they provide a poor basis for making longer term recommendations on these issues. Instead, we propose to postpone our recommendations in this area to our final report later this year by which time the picture may have become clearer.

However we identify the following areas as being of importance as the new market evolves.

5.1 **The quality of service.** Market research and the experience of Cyprus bank customers suggest that the quality of bank services in Cyprus is high. Branches are exceptionally numerous[11], the level of personal attention is high, and savers enjoy high rates of interest[12]. The level of customer satisfaction – at least up to the crisis – was high, particularly as regards bank accounts and credit cards[13]. New types of service delivery such as telephone and internet banking are also good.

5.2 But this level of service comes at a price: the cost of borrowing in Cyprus is high compared to many other countries in the eurozone, and cost structures are plainly unsustainable. Cyprus' branch-intensive banking model will have to be pared back: if Cyprus were to reduce its branch density only to the EU average, for example, more than half its branches would have to go. We therefore expect that the level of service in the traditional sense will decline. However, access to bank services is developing in other ways, through ATMs, telephone and online banking. This makes sense, in our view, but it does mean that the Cypriot bank customer will have to prepare for a major and rapid shift in the way bank services are delivered. The economics of banking will also change.

> *"Cyprus banking is about the personal touch."*
> ***Bank area manager***

5.3 This will not be popular, particularly since it will mean reducing the element of personal relationship which, as we noted earlier, drives much of Cyprus banking. A public relations offensive will be needed from the banks.

5.4 **Interest rates.** A key issue for banks and the wider economy will be the interest rate structure of bank services: deposits and loans. This structure has recently been high, for successive reasons:

[11] EU Banking structures. ECB 2010
[12] 7th EU Consumers Scoreboard May 2012. DG Health and Consumers (SANCO).
[13] European Central Bank, Central Bank of Cyprus 2012.

5.4.1 First, the intensity of competition for deposits to fund the banks' aggressive expansion strategies in a market that was heavily overbanked, and

5.4.2 more recently, crisis conditions and the need to compensate depositors for perceptions of increased risk in order to maintain funding.

5.1 These high interest rates will have to come down to reduce borrowing costs and support economic recovery. However it will take a difficult balancing act to keep deposit rates high enough to attract funds and low enough to make borrowing affordable, while also leaving the banks with a sufficient margin in between to service their capital. This challenge lies at the meeting point of all the major issues to do with the health of the banking system: the need to stop deposit flight, to allow the banks to make a fair but not excessive profit, and the need to keep loan rates at affordable levels.

Table 2

Eurozone lending and deposit rates %

	Interest rates		Deposit rates	
	on loans for consumption	on loans to SMEs <€1m		
Portugal	10.97	6.53	Greece	4.68
Greece	10.54	6.46	**Cyprus**	**4.52**
Italy	9.06	4.40	Spain	2.95
Spain	8.32	4.93	Italy	2.65
Cyprus	**7.21**	**7.29**	Portugal	2.34
France	6.61	2.22	Malta	1.93
Ireland	6.58	4.04	France	1.73
Germany	5.99	2.94	Austria	0.83
Austria	5.66	2.22	Germany	0.79

Source: ECB. December 2012

5.2 As things stand, it will require a certain amount of administrative intervention because market forces are not operating. The CBC recently launched an initiative to bring interest rates down by imposing extra capital requirements on banks which offer deposit rates that are more than 300 basis points above the euro interbank offered rate (Euribor), though this will need to feed through to lower lending rates if it is to benefit the economy. But there will also have to be a clear policy to restore confidence in the banking sector and to create a natural market as soon as possible by removing rather than imposing administrative measures. The best way to get there is by creating strong banks which do not have to pay exceptional deposit rates to attract funds, and a stable economic environment. A less overbanked market with smaller balance sheets than in the past may also reduce competition for deposits and ease upward pressure on deposit rates.

5.3 **Cost and availability of lending.** It is likely that credit demand will be slack in the immediate future because people and businesses need to get their debts down and strengthen their financial position. However, the availability of credit will eventually become a key concern, and we see possible obstacles. One is that the more concentrated and regulated banking system that comes out of the restructuring will have too little rather than too much capacity to lend. Another is that it will also be risk averse, and a third is that the cost of bank funding, and therefore of lending, will remain high because confidence in banks is slow to return. There are also competition concerns in this area of the market which we address in the next section.

5.4 A further consideration is that the Cyprus banks' lending practices are largely collateral-based which, in the present property environment, is likely to restrict lending availability. **There is a need for banks to develop more cash-flow based lending, which will require them urgently to acquire new processes and skills.** However, it will be important that banks are able to distinguish genuinely creditworthy borrowers from the rest.

5.5 **Competition.** The Cyprus banking market has, historically, been heavily overbanked, though more in terms of branches than number of banks. It has the densest branch network in the EU and the highest level of personal contact between bank and customer. But this level of overbanking will almost certainly decline in the period ahead as branch networks are slimmed down to save costs. This could be healthy because excessive rivalry between Cyprus banks contributed to the crisis by driving them to take large risks and engage in damaging practices such as over-bidding for deposits.

> *"Prices will have to come down. The cost of banking is too high, both as to charges and interest rates."*
> ***Senior banker***

5.6 But it could also produce a more concentrated banking structure in which the "new" Bank of Cyprus dominates the market and has an undue influence on pricing and services. Its main competitor would be an integrated co-op sector about half its size, a No. 3 in Hellenic Bank, with the rest of the market served by much smaller banks and foreign bank branches. Foreign banks may be less ready to enter the Cyprus market partly because of its highly unsettled conditions, but also because of the cultural problems we touched on earlier: the political nature of Cyprus banking, and the establishment's wariness of foreign intrusion.

5.12. We commissioned a study of the competitive conditions in the Cyprus banking market from the School of Business and Economics of Loughborough University in the UK, one of Europe's leading academic centres for banking studies[14]. Although the analysis is based on data before the recent restructuring, it contains a number of conclusions which are relevant to the evolving situation. The main one is that the area of the market most vulnerable to competition constraint is the supply of lending to small and medium sized businesses. Given that the market has become more concentrated since the study was done, this would reinforce concerns about the cost and availability of lending in this key market segment.

[14] Milne A. and M. Yahaya. *The competitive structure of the Cypriot banking system: a descriptive analysis and a possible pointer to the future*. School of Business and Economics, Loughborough University. April 2013. This paper can be downloaded from the Commission's website: www.icfcbs.org.

5.13 We favour a more balanced scenario. It is possible that both Bank of Cyprus and the co-ops will shrink as they consolidate and write off bad debts. Hellenic Bank might seek a merger with another domestic bank or a foreign bank and become a stronger No. 3. Also, despite the comment we have just made, foreign banks might see an opportunity to enter or expand in a market where the domestic players are preoccupied with reorganisation. This is speculation. **But we do see the need for further restructuring of the Cyprus banking sector to achieve a healthier balance.**

5.14 These are long term issues because there is still great uncertainty about precisely what structure will finally emerge. Also, for the time being, Cyprus bank customers will be more concerned about bank safety than the cost of bank services. However, one of the reasons we recommend a stronger and more unified co-op bank structure is to bring more balance to what could be a lop-sided banking market.

5.15 Government policy should also aim to encourage new entrants into the Cyprus banking market. These could be foreign banks, venture capitalists and new banking models such as peer-to-peer lenders.

5.16 **Alternative sources of finance.** As we noted at the outset of this report, banks account for most of the financial intermediation that takes place in Cyprus: over 90 per cent. Banks have their advantages: they are much the best source of flexible short-term funding for people and businesses, and specialised lending such as mortgages. But they don't normally supply the long-term funds and equity capital that are necessary to build healthy businesses. Furthermore, as Cyprus has discovered, a high dependence on banks can be dangerous when there are few alternatives, and the local stock exchange has found it difficult to play a meaningful role because of investor mistrust.

5.17 For both these reasons, we believe that one of Cyprus' long term objectives should be to encourage the development of new sources of finance such as securities markets and investment funds.

5.18 **Conclusions**

5.18.1 The big changes affecting the Cyprus banking market will have an important impact on the quality of banking services and the way they are delivered. The quality of banking services in the traditional sense will go down because it will lose some of the convenience and personal touch provided by an over-dense branch network. But this is also an opportunity to create a much leaner banking system based on modern methods of service delivery, particularly electronic.

5.18.2 Overbanking and the associated problems of over-bidding for deposits should also ease, though there are justified concerns about the cost and availability of credit in the coming recovery period. In the longer run, the structure of the Cyprus banking market could be a concern because of over-concentration, but there are opportunities to bring on new competition, particularly by creating a stronger No. 3 and by encouraging foreign bank participation.

5.18.3 In the long run, it is also in Cyprus' interest to reduce its excessive dependence on bank finance and develop new sources of funds, particularly around markets.

5.18.4 This is a brief summary of the main issues we see in this area, and we would welcome further thoughts and suggestions.

6. Corporate governance

The failure of corporate governance was one of the most important reasons why Cyprus' biggest banks brought disaster upon themselves. Strong corporate governance is essential to a healthy business, particularly one like banking which relies heavily on public confidence. Although there were serious lapses in Cyprus, it was not alone in this regard. A Parliamentary Commission in the UK has just proposed that the reckless misconduct of senior bank staff be made a criminal offence.[15]

In this section we consider action that is needed to improve bank governance. Much of what follows applies equally to the co-operative banks.

6.1 The evidence from bank documents and recent investigations supports the now widely accepted view that

6.1.1 Weak boards failed to carry out their responsibility to ensure that their banks were run prudently, with strong policies and with an attitude of independence and challenge.

6.1.2 This allowed powerful senior executives to pursue risky strategies that were strongly influenced by personal ambition, and to bypass internal controls and procedures.

6.1.3 Proper board procedures were flouted, reporting lines were diverted, and necessary information did not reach the directors. In some cases, non-executive board members were deliberately kept in the dark about controversial management decisions, and board minutes did not always accurately reflect what had actually happened at board meetings.

6.1.4 A risk management culture was missing at all management levels.

Much work is already being done to correct these weaknesses, and it is not necessary for us to comment on them in detail. The main issues as we see them are:

6.2 **Culture.** There appears to have been little belief in the value of strong corporate governance in the banks. This is partly a matter of having the right structures and procedures, but it is above all about attitude: believing that governance matters.

6.3 **Restoring the status of boards.** The role of boards was diminished during the crisis by the dominance of executives. This needs to be reversed. <u>Boards should reassert their responsibility to set policies for key areas of the bank's operation, and</u>

[15] Parliamentary Commission on Banking Standards. *Changing banking for good.* June 2013. UK Parliament.

impose checks and balances on the power of the executive, to oversee the running of the bank effectively, and to be fully informed on important issues. They also need to be sure that the bank complies with the relevant governance codes.

6.4 **Board members**: A fundamental problem lay with the character of boards where the culture was one of deference rather than challenge. Bank boards contained an insufficient number of individuals with the knowledge and expertise to ensure that risks were being properly assessed and managed, and with the independence to stand up to management.

6.5 It is clear that the gene pool from which non-executives are drawn should be widened to bring more diversity and experience into the boardroom. We recognise that this is not easy in a small country like Cyprus. However we note that there are few women on bank boards and virtually no persons from outside Cyprus. We believe it is essential for Cyprus to end the practice of appointing directors for their business and political affiliations, and to bring in fresh blood, including non-Cypriots who would offer wider experience, and be free from political taint. This is now standard practice in the world's leading banks. We recommend that bank boards have a nominations committee to identify suitable candidates, and that larger bank boards contain two persons from outside Cyprus.

6.6 **Composition of the board.** The balance between the executive and non-executive sides became dangerously tilted during the crisis, and allowed the executive to accumulate too much power. Since the executive always has the advantage over the non-executive side because of its greater information and influence, it should be outweighed by a majority of independent directors.

6.7 **Board procedures.** Internal communication systems (and especially the reporting of risks to the boards) did not ensure that comprehensive and clear information was delivered in a regular and timely manner. Even when it was, it is not clear that the boards were always able, or permitted by the executive, to take full notice of it. For example, the decision by the Bank of Cyprus to buy Uniastrum in Russia, at €450m by far the largest acquisition ever made by a Cyprus bank, was presented to the board as a *fait accompli*. The boards of the two banks were not informed of the content of the CBC's letter expressing concern about their investments in GGBs.

6.8 **Strengthening board committees.** Board committees provide independent oversight of key areas of a bank's activities. They need to be strongly constituted under the chairmanship of an independent and experienced director, and act as the point of accountability for the relevant area of the bank. It is up to each board to decide which committees it needs. We stress three in particular: audit, risk and remuneration.

6.9 **Audit.** The audit function of a bank provides an independent check on its internal workings, and is essential to its sound operation. It should be independent, well resourced, and it must have a clear reporting line to the relevant board committee which should be chaired by an independent director with audit experience.

6.10 **Risk.** Every bank should have a clear risk policy, and the assurance that it is adhered to. During the crisis, the Cyprus banks cannot have had a sufficient understanding of the risks they were courting with their strategies, or the means to control them. Bank boards should be responsible and accountable for the risk strategy of the bank, and should promote the right risk culture. This means that they should define the bank's risk appetite, and approve business strategies which conform to that appetite, and systems which can monitor and control it. The risk function, too, needs to be independent of any profit centre and with a clear direct reporting line to the board. The stature of the credit risk officer and his decision making powers should be strong.

6.11 **Remuneration.** Flawed incentive schemes played an important role in Cyprus' banking crisis. These need to be corrected to generate prudent behaviour and restore public trust in bankers. Many recommendations are currently being prepared in international regulatory circles, including controls on the pay of executives and directors at banks receiving state aid[16]. The aim should be to set incentive payments over the long-term, reduce their size relative to base salary, and make an important portion of them payable in the form of shares.

6.12 **Transparency.** For many years, the banks did not provide full transparency on key issues such as their growth strategies, their risk appetite and their remuneration policies. Full information should be disclosed on all these aspects of business to generate confidence, and also to strengthen accountability inside and outside the bank. We hope that this will encourage shareholders to play a more active role in holding the banks to account than they have in the past.

6.13 **The co-operative banks.** Although the most dramatic corporate governance failings occurred in the large commercial banks, it is clear that there were also serious deficiencies in the running of the co-operative banks. The interests of the boards and management of many of these banks were closely intertwined with those of their customers, particularly their borrowers; they were subject to political influence, and poorly supervised. One of the main purposes behind the restructuring of the co-op movement must be to extirpate this culture and introduce governance that is strong and, above all, independent.

[16] For example: *The Liikanen Report*, EU, October 2012.

6.14 Board responsibility for financial reporting

The board also plays a key role in ensuring that financial information about the bank is collected and accurately reported. The fact that the losses suffered by Cyprus' largest banks came as a surprise to many people, including bank directors, is evidence of serious failures in this area.

6.14.1 **Internal audit.** External audit cannot cover all the checks and balances needed for sound bank governance and, in consequence, greater attention needs to be paid to the role of internal audit. Indeed, internal audit is now

The role of internal audit

The primary role of internal audit should be to protect the assets, reputation and sustainability of a bank.

Internal audit's scope should be unrestricted and should independently determine the key risks that face the organisation and how effectively they are managed. Its scope should include the processes and controls supporting strategic decision-making, and whether the information presented to the board and executive management is complete, accurate and fairly represents the benefits, risks and assumptions associated with the strategy.

Internal audit should include the risk and control culture of the organisation, the risk of poor customer outcomes, capital and liquidity risks and key corporate events such as acquisitions and divestments, the introduction of new products and services and significant business process changes.

Internal audit should be present at, and issue reports to, the board audit committee and the board risk committee. The function should not be part of the risk management, compliance or finance functions and should rather evaluate their adequacy.

The chief internal auditor should be senior enough to have the standing and authority to challenge the executive. The primary reporting line should be to the chairman of the board, with that responsibility delegated where appropriate to the chair of the audit committee. If there is a secondary reporting line, it should be to the CEO to preserve independence from any particular business area or function.

The audit committee should appoint the chief internal auditor and be responsible for ensuring that the internal audit function has the right skills and resources.

widely viewed as an early line of defence for stakeholders, the board and management to ensure that a bank is soundly run.

6.14.2 The Commission believes, on the basis of what it has been told, that a stronger internal audit function in the banks could have played a significant role in averting the Cyprus banking crisis.

6.14.3 Since the Cyprus banking system continues to face serious strategic and control challenges, we recommend that boards of banks and the CBC ensure that internal audit functions operate to the highest standards[17].

6.14.4 **Shareholders.** It is regrettable, though not unusual, that shareholders played so little role in holding Cyprus' banks to account in the period running up to the crisis. Their failure to do so was an important reason why their investments were wiped out, though they were arguably not given much opportunity to challenge the banks' strategies, or adequate information. As owners, they have a direct interest in strong governance, transparency, rigorous audit and effective supervision, and they should exercise their rights and responsibilities. We note that Bank of Cyprus will have a very different shareholding structure after its restructuring and the future behaviour of its new shareholders will be critical in its governance.

6.15 Conclusions and recommendations

The weaknesses in corporate governance in Cyprus' banks were severe, and a crucial cause behind the banking crisis. The main fault was that governance was rooted in a culture of deference to the executive rather than one of independence. Boards did not exercise their responsibility to pass judgment on the management of the banks, and ensure that they had the structures and controls to make them soundly run. Although work has now begun to strengthen bank boards and practices, the task that lies ahead is still very big.

In this section we make recommendations to raise the standards of governance in the banks and the co-ops, including the need to

6.15.1 **instil a new culture of independence in the boardroom, and raise the status of boards,**

6.15.2 **improve the quality of directors, and to appoint at least two non-Cypriots to the boards of the major banks,**

[17] See, for example, *Effective Internal Audit in the Financial Services Sector.* Draft recommendations to the Chartered Institute of Internal Auditors, UK. February 2013

6.15.3 **increase the non-executive component of boards to counter-balance the executive,**

6.15.4 **strengthen board procedures to ensure that board members are fully informed of the bank's affairs,**

6.15.5 **strengthen board committees, particularly in the areas of audit and risk,**

6.15.6 **devise incentive schemes which commit executives to long term objectives,**

6.15.7 **strengthen the internal audit functions to provide additional independent checks and controls,**

6.15.8 **improve the quality of financial reporting by strengthening internal and external auditing, and**

6.15.9 **have shareholders play a more active role in holding the banks to account.**

PART 3: FINANCIAL STABILITY

7. The safety and soundness of banks

As our earlier analysis of the Cyprus banking crisis showed, there were critical shortcomings in the supervision of the banking system, from high level failure to recognise the risks in having banking as a major part of the economy, down to inertia in the discharge of key supervisory functions.

These were not necessarily caused by wilful negligence. They might better be described as inbuilt. The overall system was badly organised, it lacked a sense of purpose and it failed to connect at many levels. Furthermore, it operated in an environment where close supervision of the banking system was not seen as a priority, and was even discouraged insofar as it might hold back a valuable industry.

What we find particularly striking is the fact that Cyprus had the authorities and powers necessary to run a safe banking system but did not use them effectively because, we believe, it was not able to make an objective assessment of the risks owing to political and personality issues.

In this section, we focus on the main failings, which we identify as follows:

7.1 The absence of a clear national policy which recognised that the benefits of a large banking industry also brought risks which the government needed to recognise and for which it needed to be prepared;

7.2 the disjointed structure of financial supervision in Cyprus, and the lack of co-ordination between the various public authorities which had responsibility for financial stability;

7.3 the politicisation of relations between the CBC and government;

7.4 the governance of the CBC itself, where weaknesses contributed to the ineffectiveness of banking supervision;

7.5 failings in macro-prudential oversight; and

7.6 the poor performance of line supervision.

One caveat: although we see a need for radical changes, we are also conscious of the danger of over-reaction. There is much public pressure for tougher controls on banks, but this needs to be balanced by an understanding that the banks must be allowed to recover if they are to support Cyprus' economic revival.

8. National policy

8.1 Countries with banking systems which play an important contribution in the economy through their size and foreign business need to be aware of both the risks and rewards. As we noted at the beginning of this report, Cyprus has an exceptionally heavy dependence on banks as a source of domestic credit and foreign earnings, yet many of the causes of the crisis can be traced to the fact that it paid too much attention to the rewards and not enough to the risks. In the run-up to the crisis, there is evidence of complacency and even of a disregard for the risks that the banks were running, possibly to avoid "spoiling the party".

8.2 If Cyprus is to continue having a large banking system (and in one sense it has no choice because banks supply over 90 per cent of the country's finance), it needs to possess both a clear awareness of the risks, and have in place procedures to monitor and act upon them to ensure that the banking system remains safe and does not become a public liability[18].

8.3 This requires a number of components, including

8.3.1 means for monitoring "big picture" risks, such as emerging asset bubbles and signs of economic weakness,

8.3.2 good communications between the areas of government that are responsible for banking safety;

8.3.3 well-defined procedures and responsibilities for taking action,

8.3.4 a clear understanding of the interconnections that create "systemic risk", and

8.3.5 effective supervision to ensure that the banks are not taking unnecessary risks.

8.4 None of these links in the chain worked properly in the pre-crisis years. We make recommendations to strengthen all these links, but the overarching requirement is for a clear national policy to provide the objectives and the motivation.

8.5 **We recommend that Cyprus have a clear policy on the role of banking in its economy given its importance both as the major source of credit and its potential to generate foreign earnings. There needs to be a clear understanding of the risks inherent in a high dependence on banks, and of the risks that accompany the rewards from international banking business. This requires a commitment of resources to monitoring these risks and ensuring that banks are equipped to manage them.**

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[18] For a fuller discussion of this "policy trade-off", see Stephanou, C.: *Big Banks in small countries: the case of Cyprus*. Cyprus Economic Policy Review 2011.

9. The structure of financial supervision

Cyprus has a fragmented structure of financial supervision with, following reforms already decided on, five responsible bodies:

- the CBC with responsibility for licensed banks and, in a way yet to be determined, for the co-operative banks[19],
- the Co-operative Central Bank, probably with delegated authority from the CBC to supervise the co-op sector[20],
- the Superintendent of Insurance with responsibility for insurance companies,
- the Cyprus Securities and Exchange Commission with responsibility for investment firms and the Stock Exchange, and
- the Supervisory Authority for Pension & Provident Funds with responsibility for firms which manage pension funds.

9.1 We think this structure should be streamlined to increase its effectiveness and give it greater independence. Specifically, we recommend that Cyprus should consolidate these functions into a single regulator which would be located outside the ministries. Some movement is already being made in this direction: under the terms of the MoU, the co-operative banks will become the responsibility of the CBC, though probably indirectly through the Co-operative Central Bank.

9.2 Our case is built partly on efficiency: having one agency rather than five will save money, but more importantly it would give the regulator an integrated view of the Cyprus financial sector. Some 50 countries have found that it makes sense to create a "one-stop shop". True, many countries have kept their specialist supervisors, like the US, though often at the expense of efficiency and effectiveness, and their number has tended to decline. There can also be conflicts of interest when a financial supervisor is part of a related government department.

9.3 A further reason is the need to streamline relations among Cyprus' supervisors by eliminating unnecessary demarcation lines and obstacles to information flows. Specialised regulators also run a greater risk of regulatory capture.

9.4 **Constitution.** An important question is how a consolidated financial regulator should be constituted. It could stand as an independent agency, like the Financial

[19] At the time of writing it was not clear exactly what the supervisory arrangements for the co-operative banks would be.
[20] Ditto

Services Authority of Japan or the Malta Financial Services Authority. Alternatively, it could exist as part of the central bank, as in Ireland or Singapore.

9.5 It is more common for an integrated regulator to be outside the central bank to avoid conflicts with the central bank's monetary role, a consideration that no longer applies directly to the CBC. However, we believe that Cyprus would be best served by placing the integrated regulator inside the CBC. We recognise that the CBC's stock is currently low because of earlier regulatory failures. But we favour this model for a number of reasons:

9.5.1 the CBC has the necessary financial and legal independence to carry out this role,

9.5.2 it is in the process of taking over responsibility for the co-operative banks,

9.5.3 its supervisory capability is being greatly strengthened, and

9.5.4 this would save having to create a new regulatory body.

9.6 Transferring regulatory power often arouses controversy, particularly when it concentrates power in a single institution. However we found considerable support for this proposal in official and financial circles. For example, both the IMF and the Financial Sector Assessment Program have, at times, commented that Cyprus' system of financial supervision is too fragmented[21].

9.7 **Conclusion and recommendation**
The current structure of financial supervision in Cyprus is fragmented, which leads to inefficiency and exposes it to the risks of political influence and regulatory capture. These risks contributed to the recent banking crisis.

We recommend that its five components be combined into a single entity and placed within the CBC which has the legal and financial independence to handle this role, and whose supervisory competence is in the process of being strengthened.

[21] Orphanides A. and G. Syrichas, *op. cit.,* p. 266

10. The Central Bank of Cyprus

This section considers a number of measures to strengthen the independence and accountability of the CBC, to improve its governance, and to clarify responsibilities between the CBC and the government. We believe that, together, these would provide a firmer foundation for planned improvements to the supervisory function. It should be noted at the outset that major governance changes to the CBC would need the approval of the ECB to ensure adherence to the requirements of EU law.

10.1 Independence and accountability

10.1.1 The highly charged political atmosphere surrounding Cyprus' banking system has led to tension between the government and the CBC which could be harmful. It is important for the effective discharge of the CBC's distinct monetary and supervisory duties that the central bank's independence be recognised and respected, but that this also be balanced by clear accountability in the supervisory area.

10.1.2 The CBC's independence is protected by the Maastricht Treaty[22] (which takes precedence over Cypriot law) but only insofar as monetary policy is concerned. Cyprus' Central Bank Laws give it more general protection[23], including its supervisory role:

> "When carrying out the tasks conferred upon them under this Law, [which include supervision] neither the Bank nor any member of its decision-making bodies shall seek or take instructions from the Community institutions or bodies, from the Government or any government of a Member State or from any other body."

10.1.3 The Laws contain two accountability requirements[24]. The CBC must present the President and the House of Representatives with an annual report on the monetary policy of the previous and the current year, and the Governor may be asked to appear before the relevant committees of the House to report on "matters relating to the fields of competence of the Bank". Given the greater importance now attached to the CBC's supervisory role, it would be desirable to have a specific reference to accountability for financial stability generally and the exercise of banking supervision in particular. This is relevant to the extent that the House of Representatives has responsibility for national legislation (i.e. not EU legislation) in relation to supervision. It is also important that the CBC

[22] Protocol on the Statute of the European System of Central Banks and of the European Central Bank, Chap. 3 Art 7.
[23] Central Bank of Cyprus Laws of 2002-2007, part 2 section 7.
[24] *Ibid.* Part 55, section (1) and (2).

have the opportunity to set out the limits to what supervision cannot achieve as well as what it should.

10.2 Relations between the CBC and government

10.2.1 Relations between central banks and their governments are always delicate and need to be managed carefully to allow constructive communication, within a framework of respect and clear recognition of roles. In Cyprus, this relationship has been strained by the crisis and needs to be restored to a stable condition.

10.2.2 It is essential, in our view, that the supervisory process be independent to ensure that unbiased judgments are made and that confidence is preserved. Any political involvement in supervision would mean, obviously, that politicians took on ultimate responsibility for financial stability and perhaps the soundness of individual banks – which may not be their wish. However it is also recognised that the independence of the central bank in relation to supervision is different in character from that in relation to monetary policy. It cannot be complete insofar as supervision, at the end of the day, is about protecting the public purse in which the Ministry of Finance has a direct interest. This aspect of the relationship is governed by a 2007 Memorandum of Understanding between the CBC and the Ministry of Finance which recognises the CBC's supervisory independence up to the point where public money might be needed for a bail-out, when the MoF has the right to access confidential banking information and to dictate action. This is now a fairly standard approach internationally, but this MoU's provisions might need revisiting to clarify responsibilities in greater detail, for instance in relation to the legislative framework[25]. The MoU should also make provision for regular meetings between the Minister of Finance and the Governor of the CBC to discuss broad macro-prudential issues.

10.3 Conclusions and recommendations

10.3.1 Cyprus needs an independent but accountable central bank to reinforce confidence in the banking system. At the moment there are weaknesses in the arrangements governing the accountability of the central bank and its relations with other areas of government which we believe contributed to the mis-management of the recent crisis. These need to be corrected by putting CBC-government relations on a firmer institutionalised footing.

10.3.2 **We recommend that the CBC's accountability for financial stability and banking supervision be made more explicit in the relevant laws. We also recommend that the Memorandum of Understanding between the CBC and the Ministry of Finance be reviewed to ensure that it**

[25] For a fuller discussion, see Hüpkes E., Quintyn M., and Taylor M.W. *The Accountability of Financial Sector Supervisors: Principles and Practice* by, IMF Working Paper (2005).

establishes a clear understanding of the role and responsibilities of the parties involved. It should also incorporate formal arrangements for top level regular meetings between the Governor of the CBC, the Minister of Finance and the heads of other supervisory authorities.

10.4 **Governance of the CBC**

10.5 Poor governance arrangements of the Central Bank of Cyprus unquestionably contributed - over a number of years - to the 2012 crisis by concentrating too much power in the hands of the Governor, and by tolerating an ineffective internal audit function which, in turn, led to supervision becoming lax. Although there are no standard models of central bank governance around the world, both these flaws single the CBC out as having weaker governance than many other CBs.

10.6 A debate has already on the need to correct these weaknesses, and a Bill is currently before the House of Representatives with proposals for change. Significantly, the ECB has queried some of its provisions on the grounds that they might constrain the independence of the Governor whose position as regards matters of monetary policy is safeguarded by EU legislation on the European System of Central Banks (ESCB). However the ECB also takes an interest in the banking supervision function even though this is not a role currently assigned to central banks by EU law. We expect that the introduction of the Single Supervisory Mechanism (SSM), probably in 2014, will have radical implications for the governance of all the national supervisory agencies involved, though we also note that the SSM has no provision for any external governance in its decision making. **Given the legal complexities, we recommend that the HoR not advance the legislation until there has been thorough examination of both the practical and legal issues.**

10.7 Given these constraints, the task is to find appropriate arrangements by which checks and balances can be created. We consider a number of them.

10.8 **Structure of the board.** The structure of the board needs to be such that the non-executive directors (NEDs) are in the majority to provide a check on the executive side, but not in such a large majority that they can exercise a permanent block vote. As one expert in central bank governance put it to us: "The Governor should *just* be able to be outvoted". We therefore recommend that the number of NEDs be set at four, for two reasons. One is that we also recommend the inclusion of two executive directors on the board, in addition to the Governor (see below). The total number of directors would therefore be seven, which would produce a majority in a vote[26]. The second is that four NEDs could just outvote the executives to provide the required check, but without commanding such a large majority that they could make the

[26] According to *Issues in the Governance of Central Banks* (Bank for International Settlements 2009), the most common number of central bank non-executive directors is seven to nine. (p. 88).

Governor's life impossible. If the executive was united on an issue, it would have to convince at least one of the NEDs in order to secure a majority.

10.9 The Governor would be the chairman of the board. However, the NEDs would elect one of their number as lead NED to provide a focus for their discussions.

10.10 We recommend the appointment of two executive directors to add further weight to the board. Depending on the constitutional position, one of them could be the Governor's formal alternate (or deputy) during his necessary absences, and could also take the lead on supervisory matters. The other executive director could be responsible for the CBC's central banking functions.

10.11 **Board committees.** Essential to the functioning of this structure would be a set of board committees consisting of, and chaired by, non-executive directors. These would provide independent checks on the executive, and ensure that the policies and objectives of the bank were being met, and with the power to take action if required. The most important of these would be the audit committee which would receive independent assessments prepared by the internal audit function, and decide on appropriate action. The CBC's current internal audit function would have to be strengthened to cover all the bank's key operations including supervision, and given enhanced status. We make separate recommendations about this in the next section.

10.12 The board would have the authority to establish additional committees as required, for example, a risk committee which would receive reports from the Bank's Risk Office on risks to the condition and objectives of the bank, including areas such as resourcing and threats to its independence. There should also be a nominations committee (see below). Executive directors could attend committee meetings by invitation.

10.13 **Board role.** As a policy-making body, the board would decide on the policies and objectives of the bank, but not involve itself in detailed decisions, particularly in individual cases where supervisory action was required. We attach particular importance here to the creation of a new supervisory decisions committee at executive level (see page 77) which would help ensure that supervisory decisions were taken with appropriate independence. This would create a clearer delineation between board and executive responsibilities which should be stated in the Bank's bylaws.

10.14 The tendency, particularly in recent years, has been for the board to be relegated to a consultative role, or excluded from decisions which the executive regarded as its prerogative, or even not informed at all. This reinforces the need for clarity about the areas of policy where the board should have decision-making powers[27]. The potential list is quite long and includes CBC strategy and objectives, budgeting, financial stability, risk policy, supervisory policy (again subject to the changes resulting from the SSM), internal audit, senior staff appointments and remuneration, management of the country's gold reserves, and the appointment of board committees.

10.15 The arrangements would also make clear the executives' responsibility for implementing policy through an executive committee where there should be a system of collective decision-making (except in areas deemed legally under EU law to fall within the Governor's personal competence) as this has been shown to produce the best results. The arrangements for the functioning of this executive committee should also be clearly specified.

10.16 **Frequency.** This board would meet monthly.

10.17 **Independence of directors.** It is essential that the directors and non-executive directors be independent, and be chosen for their personal qualities and qualifications. For this reason, we recommend that the board establish a nominations committee which would propose the appointment of non-executive directors for approval by the Council of Ministers, providing a stronger guarantee of their independence and of their capacity to make a constructive contribution. The individual board members would need to understand that their responsibility lay to the CBC and its sound functioning, and not elsewhere. The appointment process should be made more transparent by advertising vacancies, and appointments should be staggered to ensure balance and continuity. A similar process should be applied to the appointment of executive directors to ensure their independence.

10.18 **Directors' qualifications.** The qualifications of directors as laid down by the Central Bank Laws are that they "shall be citizens of the Republic of recognised professional qualifications, and/or recognised economic and business experience who are not disqualified for appointment…"

10.19 This definition is insufficiently precise and can create the suspicion that directors have been chosen for their political affiliations. The qualifications should include knowledge and experience of banking, finance, risk management and audit. Also, we see no reason why a CBC board director should have to be a Cypriot; indeed we believe that this is part of the wider cultural problem in Cyprus that we have already touched on. The CBC board would benefit from having at least one director with an international background who could bring a different culture and experience to its deliberations. It is increasingly the practice in Europe for central bank and financial supervision boards (and executives) to have a foreign component. Ireland provides a recent example where confidence was restored following the crisis by bringing in

[27] BIS *ibid.* (p. 88). Group decision-making is more common among central banks internationally. (p. 77).

non-nationals at both the executive and non-executive levels in the face of widespread concern about the narrowness of the social base from which central bank officials were chosen.

10.20 **Directors' interests.** There is currently no requirement for CBC directors to disclose their interests. This should be corrected.

10.21 **Conclusion and recommendations.** Governance of the CBC is currently deficient as regards the effectiveness of checks and balances on the role and power of the Governor and the strength of internal audit. However, any changes will have, in effect, to be approved by the ECB which limits the choices for reform in areas covered by the EU Treaty. The solution lies in having a stronger non-executive structure and clearly defined board responsibilities.

10.22 **We recommend that the CBC have a policy-setting board chaired by the Governor, with two executive directors and four non-executive directors with clear decision-making powers in specified areas. The checks and balances on the executive would be provided by appropriately qualified, independent non-executive directors and effective board committees with the power to monitor the executive's performance and take corrective action if needed.**

10.23 **We recommend the establishment of a nominations committee to oversee a transparent process of board member selection and to propose suitable candidates for Council of Ministers approval. We also recommend that the qualifications for non-executive directors be widened to allow at least one non-Cypriot to sit on the board.**

11. Macro-prudential oversight

The preservation of financial stability is a key function of the CBC. In this section we examine how this responsibility is carried out at both the macro- and micro levels, and consider possible recommendations.

11.1 It should be noted that supervisory responsibility for Cyprus systemic banks will be transferred to the European Central Bank under the euro area's Single Supervisory Mechanism (SSM) next year. At the time of writing, it was not clear what the implications of this would be. The draft legislation implies that a large number of supervisory decisions will be transferred from Nicosia to Frankfurt with radical consequences for supervisory processes, macro-prudential decision-making and for external accountability including to the Cyprus Parliament, as well as for relations with government. Nonetheless, we believe that the recommendations we are considering are important on their own merits and are likely to be consistent with future requirements. Indeed they should smooth the transition to SSM regulation.

11.2 **Macro-prudential supervision.** One of the main causes of Cyprus' banking crisis was a failure by the authorities to anticipate - and mitigate - the risks which faced the banking system over this period, particularly the consequences of overexpansion by the banks and the threats that were building up in world markets. Had these been recognised earlier, it should have been possible to take corrective action and avoid some of the huge losses which subsequently materialised. Although processes existed at the time to keep track of so-called "macro-prudential risk", these were under-resourced and did not function effectively.

11.3 Macro-prudential analysis is now a well-established component of the mechanisms used to monitor "big picture" banking risk, in particular systemic risks which could threaten groups of financial institutions simultaneously[28]. Macro-prudential units with a high level overview can also challenge the myopia and "group think" which tends to afflict the supervision process, as well as the banks and society more generally.

11.4 The European Systemic Risk Board (ESRB) requires eurozone countries to designate a macro-prudential body to carry out these tasks. In Cyprus, this is to be the CBC.

11.5 **Financial Stability Committee.** Cyprus has a Financial Stability Committee consisting of the CBC, other financial regulators and the Ministry of Finance, chaired by the CBC. This body, which was set up in 2007, is supposed to keep an eye on the big picture and co-ordinate the responses of its members. But it, too, was under-

[28] EU Directorate General for Internal Policies. Policy Department A: Economic and Scientific Policy. Review of The New European System of Financial Supervision ("ESFS"). The Work of the European Systemic Risk Board – The ESFS's Macro-Prudential Pillar.

resourced and failed to play an effective role[29]. It seldom met during the crisis, and then usually without the attendance of top personnel. Full information was not made available to it because of confidentiality constraints, and, possibly, tensions between members. If the necessary information had been available, this committee could have alerted financial regulators to emerging risks and prompted action. It could also have brought the government's attention to the fact that banks might need help.

11.6 This Committee should be revived on a permanent basis with a clear mandate to monitor macro-prudential risk to financial sectors and government finances. It would also provide the means for the CBC and other supervisors to explain to the government the consequences of different supervisory approaches. Although it could recommend action, its role would be deliberative rather than decision-making, with each of the parties retaining their own formal responsibilities. International practice varies as to who should chair and resource such a committee. In most countries it is chaired by the finance ministry to ensure its engagement in and understanding of issues which are ultimately about the public purse and potential legislative change (as with the Financial System Oversight Council in the US). In any event, there also need to be MoUs in place between the various parties about the exchange of information and decision-making where responsibilities overlap.

11.7 The upcoming SSM will impinge on financial stability analysis and related decision-making. For example, the interaction between the Financial Stability Committee and the European Systemic Risk Board will need to be worked out, including the extent to which the ESRB will address individual jurisdictions. We have been told that, although Cyprus already fell within the remit of the ESRB in the run-up to the crisis, no recommendations were issued, which raises wider questions about the effectiveness of risk identification and mitigation at the EU level.

11.8 **Financial stability in the CBC.** A Financial Stability Unit was set up in the CBC in 2004 to provide macro-economic information to alert and strengthen the supervisory process. It also wrote the Financial Stability Report for the CBC's six monthly Economic Bulletin. In our view, this unit was under-resourced and failed to send out useful signals about emerging risks that could threaten financial stability - such as the growth of the property bubble in the later 2000s. Nor was there adequate internal process to ensure that risks were acted on. The Financial Stability Report never played an effective role, and was dropped from the Bulletin in 2011 just as risks were reaching alarming proportions.

11.9 The MoU suggests that financial stability reports be resumed. We are doubtful about the value of this in isolation. Wider experience tells us that such reports usually veer on the side of caution and constantly run the risk of handing hostages to fortune.

[29] We were told, for example, that there was only one person in the Ministry of Finance watching over the banking system, and that the committee met only three times at the height of the crisis, and not once in 2012.

11.10 We support the work that the CBC is doing to set up a macro-prudential oversight section drawing on intelligence from its supervisory work and the output of its Economic Research Department. This will provide a basis for supervisory and other decisions. This function will deal, *inter alia*, with the interface between the financial system and the economy. In order to be able to give unbiased analysis it should be co-located neither with the supervisors nor the macro-economists, but rather report independently to the Governor.

Managing "big picture" risk

Macro-prudential oversight is about more than keeping an eye on "big picture" risks to banks. It needs to have rigorous procedures to ensure that risks are identified and that appropriate action is agreed and followed up. It would need to include the following procedures:

- to identify, agree on and prioritise the key risks. As well as taking account of internal work this should include assessment of risks identified by the European Systemic Risk Board, IMF, BIS and other analysis;
- to take a formal decision on each of the risks as to how it should be addressed, including whether to take no action.

Follow up could include

- commissioning further internal research,
- targeted inspections of banks,
- direct supervisory action in relation to individual banks or in relation to banks in general, such as changes in capital requirements,
- ensuring that action that has been agreed is actually carried out,
- issuing warnings to the public, perhaps through speeches or other media,
- requiring measures directly affecting the public rather than just the banks such as changes to loan-to-value or loan-to-income requirements.
- discussing legislative change with the relevant lawmaker to correct any shortcomings in the supervisory toolkit, and
- publishing an annual account of the risks identified and the action taken.

11.11 Conclusion and recommendations

The lack of an effective macro-prudential analytical function to keep track of "big picture" risks, such as a build-up of debt or threats in the international markets was an important reason why Cyprus lost control of its banks. Had it functioned properly, it would have enabled Cyprus to take early corrective action and avoid the need for government support of the banks. There are plans to designate the CBC as Cyprus' macro-prudential authority and to create a macro-prudential oversight section with the central bank, which are welcome initial steps in this direction.

We recommend that the macro-prudential oversight function have clear procedures for identifying risks, and that the CBC have rigorous procedures for taking action in relation to such risks, and following it up. In addition we recommend that the existing Financial Stability Committee be revitalised to improve the CBC's working relationship with other areas of government, and provide a top level forum for policy discussion on supervisory issues in each of the financial sectors, including issues arising out of threats to the system as a whole.

12. Prudential supervision and regulation

In this section we discuss improvements to supervision of the Cypriot banking system, and consider possible recommendations.

Although we begin by analysing the failings of the past, we recognise that big changes are already underway at the CBC's own initiative and under the terms of the MoU (see box). We strongly support these initiatives: they are essential to bring supervision up to international standards. Our recommendations focus on the prioritisation of this work, on resourcing and management of the supervisory process, on aspects of international practice which Cyprus needs to introduce, and on areas for further consideration.

Main banking measures in the MoU

1. "Carve out" of the Greek operations.
2. Resolution of Cyprus Popular Bank and the absorption of selected assets and liabilities by the Bank of Cyprus
3. Recapitalisation of the Bank of Cyprus through a debt to equity conversion, without the use of public money.
4. Maintenance of liquidity in the banking system.
5. Improved capital and liquidity buffers for banks.
6. Central Bank power to enforce capital requirements.
7. Better loan origination practices.
8. Concentration limits on lending.
9. Improved non-performing loan recovery rates: removal of obstacles to property seizure.
10. Better management of non-performing loans.
11. Creation of a credit register of all borrowers.
12. Implementation of best international practices on loan origination, provisioning.
13. Measures to strengthen bank governance.
14. Ban on directors' loans.
15. Better data reporting.
16. Stronger powers to combat money laundering.
17. Annual stress tests of banks.
18. Reform of supervision of co-operative credit institutions.
19. Restructuring of the co-operative sector.
20. Better monitoring of corporate and household debt levels.
21. Measures to deal with troubled borrowers.
22. Investigation into, and closer scrutiny of, money laundering risks.

The handling of banking supervision at both the macro- and the micro- levels in the run-up to the crisis and during the crisis itself was clearly deficient. We recognise that many of the failings have become more obvious with the light of hindsight, and that there may have been acceptable explanations for them at the time. But they all contain lessons which need to be addressed.

Cyprus' failures can be put in a number of categories.

12.1 **Challenging bank strategies.** The failure by the authorities to challenge bank strategies was critical because the safety and soundness of banks depended on their continuing to make money, which in turn depended on the soundness and viability of their business plans. When the largest Cypriot banks embarked on their overseas expansion in the mid-2000s, little attempt was made to question the prudence of these moves, even though they were very large and took banks into potentially difficult markets such as Greece and Eastern Europe. The following table shows the surprisingly high number of branches that were opened by Bank of Cyprus in Greece with the approval of the CBC through the period of Greece's rapidly mounting crisis.

Table 3:
Bank of Cyprus branches in Greece

2007	135	Total existing
2008	25	New approvals
2009	10	"
2010	16	"

Source: Central Bank of Cyprus

12.2 The acquisition by Bank of Cyprus of Uniastrum Bank in Russia in 2008 also went unchallenged. We find no evidence that the CBC sufficiently appreciated the risks involved in foreign business acquisition, or effectively questioned the banks' strategies. The CBC's Financial Stability Report of December 2009 observed that foreign expansion by the banks in Greece and South East Europe exposes the banks to "country risk" but "provides ample growth opportunities".

12.3 **Restraining imprudent lending.** There was no effective attempt by the supervisor to rein in the sharp rise in bank lending which took place in 2006-2008 and led to the funding of a real estate bubble in Cyprus and to a heavy exposure to bad debts in Greece. Again, the Financial Stability Report did not identify this as a matter for concern. In December 2008, it said that doubtful loans were falling, "reflecting the improved quality of banks' loan portfolios". The CBC put the brakes on lending in 2007 by lowering the loan-to-value ratio for second home mortgages from 70 per cent to 60 per cent, but then raised this again to 70 per cent in 2008 because it believed the danger had passed. It made a further attempt to slow lending down in 2009 by raising capital requirements, but by then it was too late.

12.4 **Follow through of regulatory concerns.** The purchase by Bank of Cyprus and Cyprus Popular Bank of Greek Government Bonds in 2010, despite Greece's rapidly worsening economic plight and the downgrading of these bonds by the rating agencies, was queried by the supervisors but not followed through for reasons which have not been adequately explained. The Financial Stability Report for December 2010 commented: "As far as the exposures of domestic banks to Greek sovereign bonds are concerned, these amounted to €5.7bn at the end of September 2010 compared with €5.2bn at end-March 2010. However, most of these exposures, [88 per cent], are classified as 'held to maturity investments' that are not subject to value adjustments affected by potential fluctuations in market prices."

12.5 **Enforcement of strong governance in banks.** Oversight of the banks' corporate governance structures and practices was deficient. The supervisor did not identify, or failed to address, serious weaknesses in the operation of bank boards, in particular as they related to risk management, internal controls, and the role of the executive. This allowed the country's two largest banks to be run effectively as the fiefdoms of strong-willed chief executives. The CBC's guidance to banks on risk management fell short of international standards. For example, it did not adequately address issues of risk concentration such as total country exposures (e.g. Greece). Moreover, the monitoring by the CBC of the banks' risk exposures was inadequate and was not exercised in a frequent and timely manner.

12.6 **Credit origination.** As we noted earlier, loans are granted in Cyprus largely against collateral rather than ability to pay, which leads to poor credit origination and loan recovery practices. Little was done to encourage better practices in this area and introduce more rigorous control of collateral valuations, multiple guarantees etc.

12.7 **Lessons learned.** We believe it would be instructive for the CBC to undertake a "Lessons learned" review from the events of the past eight years, as well as from the many investigations which have now been conducted into the causes of the crisis at a global level. Although much remedial work is now underway, the Bank would benefit from a more systematic understanding of the issues.

12.8 **The challenge.** If we summarise these failures, they lie in poor diligence on the part of the supervisors, but also what we can only describe as an overall lack of will in the CBC, due in part to the governance and internal control weaknesses we identified in the previous section. Many of the powers and procedures needed to prevent these failings were available to the CBC but not exercised.

Learning the lessons

The list of investigations into the global crisis is very long. The US, the UK, Switzerland, Spain and Ireland are among many countries which have published reports. The collective lessons from these is very salutary. Many of them contain common themes: a lack of supervisory rigour, failure to understand the risks at the macro level, poor governance in the banks, inadequate resourcing of supervision, human failing etc. The UK Financial Services Authority's investigation into the causes of the failure of the Royal Bank of Scotland contains conclusions which could be applied to many countries:

> "There was insufficient focus on the core prudential issues of capital and liquidity, and inadequate attention given to key business risks and asset quality issues. Too much reliance was placed on assessments that appropriate decision-making processes were in place, with insufficient challenge to management assumptions and judgements."

12.9 Failures are, it is true, often impossible to prevent. Bank supervision is itself a risk taking business. It operates within an uncertain world with extremely limited resources on the basis of information that can often be incomplete or wrong, and uses tools whose impact depends wholly on the behavioural response of others. It also takes a very special kind of individual to face this challenge.

12.10 The main task for a supervisor is to set out publicly exactly what its procedures are and adhere to them tenaciously. A contrast is sometimes made between a tick-box and a judgmental style of supervision, or the policeman and doctor approach. In our view this is a false apposition. The rules have to be met *and* judgements have to be made. If the rules seem not to make sense it is for the supervisor to say so publicly and seek to have them changed. It is not safe to ignore those which seem not to suit or could cause offence.

12.11 **Risk framework**

An effective supervision function needs to operate within a framework in which risks to the banks and the supervisory process itself are clearly identified, prioritised and resourced accordingly. It is not clear to us that such a framework existed in the CBC at the time of the crisis.

12.12 We recommend that such a framework be developed, and suggest that its priorities include:

12.13 **Credit risk**. Bad loans are high and will certainly go higher as the economy worsens. This places a priority on the identification and management of bad loans, and the strict enforcement of the tighter non-performing loan regulations set down by the MoU. For the banks, this will require that they have the human and capital resources to deal with this problem. At the moment, their skills lie more in loan origination than in debt recovery.

12.14 However loan origination will also need to be more rigorous and less reliant on collateral and personal guarantees. "Multibanking" (taking loans from several banks at once) will need to be reduced by the use of a credit register. In the absence of monetary levers to control credit costs in the Cyprus economy, regulatory levers need to play a bigger role in keeping credit expansion under control such as loan-to-value and loan-to-income requirements, and capital and liquidity requirements.

12.15 **Bank governance risk.** The governance of Cypriot banks is weak (though undergoing reform). We believe that the regular evaluation of the banks' governance practices should become a key part of the CBC's supervisory programme.

12.16 We support the work the CBC is already doing in this area by vetting prospective directors, by applying stricter fit and proper tests, and updating its directive on corporate governance. Work is also proceeding to check banks' internal control systems, risk management practices and compliance procedures. Supervisors are scrutinising the minutes of board meetings, and challenging decisions.

In revising its directive on corporate governance, the CBC should stress the need to implement widely accepted sound corporate governance principles relating to

- board practices (including the responsibilities of the board, the qualifications of board members, the role of the chairman and board committees, potential conflicts of interest etc.);
- senior management;
- risk management and internal control functions;
- compensation, and
- transparency.

12.17 The CBC should also have the necessary tools and enforcement powers to address any problems arising from corporate governance weaknesses in a bank.

12.18 Cyprus has a number of different corporate governance codes so far as the banks are concerned (the CBC's, the Stock Exchange's etc.) which could cause confusion.

We recommend that they be aligned so far as the banks are concerned, and that an authority be given the responsibility to keep them up to date.

12.19 One caution is that this work should strengthen rather than diminish the banks' sense of responsibility for their own actions: too much regulatory intrusion can result in the regulator becoming a "shadow director" and taking effective responsibility for a board's decisions.

12.20 **Systemic risk.** Although the size of the banking system will be much reduced, Cyprus will remain susceptible to systemic risk of a different kind because of the more concentrated banking structure demanded by the MoU. The monitoring and control of systemic risk as well as resolution mechanisms for dealing with future crises will need to be robust.

12.21 There is a strong case for creating stricter frameworks for systemically important banks, such as more intensive supervision, higher loss absorption capacity, and higher standards of corporate governance. The UK and Switzerland, two countries with exceptionally large banking systems, have both adopted strong measures to reduce systemic risk. In Switzerland, banks with assets equivalent to more than 50 per cent of GDP are required, under the so-called "Swiss finish" rules, to have capital of 19 per cent consisting of 10 per cent equity and 9 per cent coco bonds. In the UK, banks will have to split off the riskier investment banking side of the business into a separate subsidiary in order to protect the retail side.

12.22 In the medium term, a clear capital framework will need to be established for the period when the Cyprus economy has recovered and the banks are fully back on their feet. These outlines will be dictated by relevant EU legislation.

12.23 The MoU requires all Cypriot banks to raise their minimum core tier 1 capital ratio from 8 per cent to 9 per cent by the end of 2013. While Swiss and British-style measures will not be needed because of the smaller scale and simpler structures of Cypriot banks, we recommend that they be required to hold extra capital as a buffer against risk. This will be particularly important for counter-cyclical purposes if Cyprus returns at some point to boom conditions.

12.24 The authorities may prescribe increased capital requirements within the following guidelines:

12.24.1 The 9 per cent minimum tier 1 capital (as agreed in the MOU) should be maintained, including a 3 per cent capital conservation buffer. If a bank's tier 1 capital falls below the minimum, the authorities should impose restrictions on payments of dividends and bonuses.

12.24.2 Domestic systemically important banks should be required to have additional equity of at least 2 per cent. This stronger loss absorption capacity would reduce the likelihood of having to resort to government aid in times of stress. Systemically important banks would be defined in terms of their size compared to the GDP.

12.24.3 Banks should be expected to further build up their capital in good times which will enable them to absorb losses in bad. The size of this countercyclical buffer may vary (for example between 2-3 per cent) and a higher capital requirement may be imposed in periods of emerging asset price bubbles. Thus this requirement may be used as a tool for economic stabilisation policies.

12.24.4 By the same token, supervisors should consider lowering capital requirements on non-systemic banks to ease their cost burden.

12.25 **Operating risk.** In their weakened state, it is important that Cypriot banks have robust internal operating systems, for example in IT, accounting, personnel and compliance. The crisis has exposed the fact that even basic IT security, including the recoverability of records, seems not to have been observed and there may be shortcomings in financial record-keeping and controls as well, given the difficulty in establishing the balance sheet of the new merged Bank of Cyprus. The CBC needs to have the skills and resources to examine such risks.

12.26 **Supervisory process.** A useful way to gauge the strength of supervision functions and objectives is to review them against the principles laid out by the Basel Committee on Banking Supervision in its report "Core principles for effective banking supervision" (September 2012) which provides a benchmark against which countries can assess the quality of their supervisory systems.

12.27 We think it particularly important that there should be sound due process in relation to the taking of supervisory decisions and recommend that there be a Supervisory Decisions Committee which would prepare recommendations, with all the appropriate arguments set out, for decision by the Governor. This would ensure that recommendations were fully argued and adequately documented, including the final decision. This might be chaired by the head of supervision.

12.28 **Internal audit.** The CBC's supervision function needs to operate within a discipline which ensures that it is rigorous and under constant review. This is not currently the case: the supervision department is not subject to audit, and its performance is not, therefore, independently assessed. No one is asking: "Is supervision really doing what it says it does?"

12.29 The importance of internal audit is that it would hold the supervision function to account by taking a view that was independent of the executive, and had the sponsorship of the board with the clout and commitment to make sure that management addressed its findings. The audit would not challenge the judgments made by supervisors, but would ensure that the procedures that had been laid down were adequate and being followed.

12.30 For this reason we recommend that the CBC's supervisory function be included in its internal audit process, and that regular reports, targeted on a risk basis, be presented to an audit committee of the CBC board for consideration. Such a committee does not currently exist, and would need to be created within the broader reforms to CBC governance which we recommended in the previous section.

12.31 We recognise that supervision is often viewed more as an art than a science: it requires high levels of judgment and the personal touch, and may not be regarded as suitable for the rigours of "audit". For this reason, some countries use "peer review" instead: they bring in supervision experts from other countries to make an independent assessment. Alternatively an external audit firm might be contracted to conduct the review. We do not favour these options, mainly because of their one-off character. Our preference is for internal audit to ensure consistency of process on a continuing basis throughout the CBC. It is possible that an initial audit by an outside body would be necessary to ensure the adequacy of the supervisory processes which internal audit would then regularly review.

12.32 **Enforcement**

It is one thing for a supervisor to have powers; it also needs to use them. The failure of the CBC to enforce its guidelines on a consistent basis during the crisis allowed banks to behave imprudently and diminished respect for the supervisor. In a banking community with Cyprus' recent record, the supervisor needs a big stick.[30]

12.33 The CBC has considerable powers: it can rule that a bank executive or director is not fit and proper for the job, it can place restrictions on a bank's operations, it can impose higher capital requirements to put a brake on certain types of activity, it can restrict dividends, and it can fine banks for breaches of regulations and procedures. The banking laws also empower it to issue guidelines and directives to banks to ensure financial stability. The MoU requires the CBC to use "mandatory supervisory action" when setting banks' capital levels[31]. We judge that the CBC's powers are adequate. But they need to be enforced, impartially, systematically, and regardless of a bank's financial condition and personnel consequences.

[30] In 2009, when the UK was tackling its own banking crisis, Hector Sants, the chief executive of the Financial Services Authority, said "Banks should be very frightened of the FSA".
[31] Para 1.10

12.34 We learnt that there had been only half a dozen enforcement actions by the CBC in recent years, and these had remained confidential. This strikes us as a small number given the scale of the banking crisis and the defiance shown by banks towards the regulator. By keeping them confidential, the opportunity was also lost to set an example.

12.35 Enforcement needs to be directed against individuals as well as firms. It may be in order for a culpable firm or person to respond voluntarily, e.g. by resigning, but there needs to be a documented process around this so that a record is available should repeat offences occur or fresh applications be made. There will always be resistance to enforcement, and the CBC needs to be equipped to meet it.

12.36 Enforcement needs a strong platform because it is against the background of enforceable rules that supervisors make their judgments and their decisions. It is often the practice for the enforcement function to be split out from the supervision department into a department of its own to give it greater independence. It is possible that a separate enforcement department may be unnecessary in a central bank the size of the CBC, but it should be considered. In any event, clear and documented processes are needed to ensure that all decisions are taken properly and can be justified by reasoned evidence.

12.37 We also recommend that enforcement decisions should be made public.

12.38 **Resourcing**

The resourcing of supervision needs to be measured in terms of quantity and quality.

12.39 The CBC's supervision department currently has a staff of 46 and consists of two sections, regulation and examination. The regulation department deals with the preparation of regulations, licensing, implementation of directives etc. The examination section consists of four teams of examiners who supervise particular groups of banks and conduct on site examinations.

12.40 Many improvements have been made to the department in the last two years. Numbers have been raised. Staff rotation has been introduced to reduce the risk of supervisory capture. The range of skills has been extended beyond accounting to include risk assessment, banking and audit, though further specialist skills in anti-money laundering compliance and remuneration and, to the extent that banks go into trading, market risk may be necessary. It may not be possible for every supervisory team to embrace all these skills and many supervisory agencies use a matrix arrangement to make sure that expertise is available from specialist teams to each line supervisory group. Supervisors must have the same skills as the banks they are dealing with.

12.41 At the same time we observe that regulation in Cyprus tends to be dominated by transposition of EU directives. It has been put to us that there could be considerable benefit in issuing more guidance to the banks, for instance in areas where the Basel Committee on Banking Supervision, of which Cyprus is not a member, has provided material for banks to incorporate in good practice. In turn such guidance could assist the inspectors in their assessment of bank behaviour.

12.42 The adequacy of resources is difficult to judge at the moment because of the large amount of additional work that has been created by the crisis, such as the administration of capital controls and handling the resolution processes. The situation is also complicated by the freeze on hiring public officials imposed by the Troika.

12.43 Although the size of the Cypriot banking industry will be reduced by shrinkage and consolidation, the supervision department's work load will be increased by a raft of new regulatory measures and the need to ensure that the shortcomings of bank practice in the past are corrected. The introduction of supervision by the SSM will, at least in the early stages, almost certainly lead to an increased workload rather than the reverse because of the introduction of an extra layer of supervision. We expect that the department will need additional resources in the not-too-distant future. In view of the importance of restoring soundness and health to the banking system, we recommend that the hiring freeze be relaxed for the CBC's supervisory function. Although banking supervision is not always a popular career choice, the crisis will have created a greater public awareness of its purpose, and will also free up more skilled recruits than might be available in boom conditions.

12.44 However, given the size of the task, we also think the CBC should consider applying to the IMF for technical assistance. This would provide a multi-year programme that would bring additional expertise to the CBC's supervisory work and ensure that it met current international standards.

12.45 **Conclusions and recommendations.** Much work is already underway to correct the supervisory failings at the CBC which contributed to the crisis. This will help restore confidence in the banks and reduce systemic risk. However further work needs to be done to make it more effective.

12.45.1 **We recommend that the supervision department be included in the CBC's internal audit process to provide an independent check on its work.**

12.45.2 **We also recommend that the supervisory function have a rigorous risk framework in which risks are clearly identified and prioritised.**

12.45.3 **The CBC's enforcement function needs to be more rigorously applied, and details of enforcement actions made public.**

12.45.4 **In terms of resourcing we recommend that supervision be given more resources to support its enlarged role, but that it also seek long-term technical assistance from a body like the IMF to raise the level of expertise and ensure that it meets current international standards.**

12.45.5 **We recommend that the CBC undertake a review of its supervision functions and objectives against the principles laid out by the Basel Committee on Banking Supervision in its report "Core principles for effective banking supervision" (September 2012) which provides a benchmark against which countries can assess the quality of their supervisory systems.**

12.46 **External auditors**

The role of the external auditors is important, as is the relationship with the supervisors, whose role they complement. This appears to have been neglected for a crucial period in the build-up of the crisis. Subsequent investigations have raised questions about the reliability of accounting and auditing in Cyprus. While we have undertaken no investigations ourselves, we have been told enough by those in a position to know to be sure that there is room for improvement.

12.47 It has been put to us that accounting treatments may sometimes have been out of line with best international practice. One example, mentioned several times, is the treatment of non-performing loans. It seems that where loans were rolled over at a penalty rate because of their poor status, the banks were able to accrue unpaid interest at the higher rate while maintaining the loan at full value so that it appeared that the banks' performance was improving when in fact it was getting worse. Another example relates to the frequent switching of bonds between the "held to maturity" and "available for sale" accounting categories so as to present the bank's performance in the best possible light.

12.48 In the practice of auditing, we also heard concerns about the rotation of engagement partner taking place in name only and with considerable influence played by a relationship partner of long standing. We understand that there is the intention to require banks to tender for both their auditor and legal adviser every five years under fully transparent procedures. There is considerable international discussion about the correct frequency of rotation of auditor, but we believe that compulsory re-tendering at relatively frequent intervals would be highly desirable, particularly in a society where excessive dependence on relationships has been shown to have weaknesses in times of stress.

12.49 Cross-border auditing issues have also been a matter of concern, though with the reduction of the banks' overseas operations, they have become less urgent.

12.50 **Auditor oversight.** In relation to auditing, it is worth noting that Cyprus is one of the last countries in the EU to adopt a system of direct inspections by the public oversight body of auditors of public interest entities: financial institutions as well as listed companies. It is important that the Public Oversight Board of Cyprus be strengthened as rapidly as possible and provided with the capacity, human and financial, to undertake direct inspections, rather than outsourcing them to the accounting institutes.

12.51 The Board is currently resourced by the Accountant General's office, but it would be sensible to explore adopting the widespread practice in other jurisdictions of securing funding from the audit profession or from other market participants such as listed companies.

12.52 Public reporting of the results of inspections, as is the practice in some other EU countries, would help restore confidence in the reporting of financial strength by both financial and non-financial firms. This will be particularly important as Cyprus seeks to attract business to replace that which has been damaged or discredited.

12.53 **Accounting enforcement.** The Cyprus Securities and Exchange Commission is responsible for enforcing the relevant accounting standards in relation to the financial reporting of listed companies. There are sufficient question marks about the quality of accounting in the banks arising from the studies which have already been undertaken for it to be important that this be investigated properly, not just to take enforcement action where necessary, but also to learn any lessons which may be relevant. This should be done as soon as practicable because the quality of accounting will need to be robust in a period when the economy is under stress. Sound accounting judgment will be at a premium as events unfold, and the public at large is unlikely to be forgiving of financial statements which turn out to have been misleading.

12.54 **Trilateral meetings.** The trilateral meetings between the CBC, external auditors and bank boards were allowed to lapse and it is welcome that, in line with now standard international practice (c.f. guidance from the Basel Committee[32]), these have been resumed. It is also welcome that the banks' internal auditors are being included in these meetings as we have heard of instances where the external auditors were persuaded to side with management against the strongly held view of internal audit. A vigorous debate in these expanded trilateral discussions is to be welcomed, not least because the deterioration of the economy will lead to a legitimate rise in uncertainty as to proper accounting treatment.

[32] BIS. *External audits of banks.* March 2013

12.55 Conclusions and recommendations

Questions have been raised about the quality of bank accounting and auditing in Cyprus. From the weaknesses we have identified, we recommend that

12.55.1 **accounting treatments be brought in line with the best international standards,**

12.55.2 **Cyprus' auditor oversight function be strengthened as soon as possible, that it be financed by the profession and/or listed companies, and that the results of its inspections be published,**

12.55.3 **the Cyprus Securities and Exchange Commission raise the quality of financial reporting by listed companies,**

12.55.4 **trilateral meetings between banks, the external auditors and the supervisors be re-established on a firm basis, and that**

12.55.5 **auditors be genuinely rotated.**

13. Consumer protection

The recovery of the Cypriot banking system will have to include a return of popular confidence in banks. Consumers must be convinced not just that banks are safe but that they are getting a fair deal from them and, if not, that they can do something about it. We find that Cyprus needs stronger arrangements for regulating the conduct of banks and for putting things right when they go wrong.

13.1. Conduct of business regulation

13.1.1 Conduct of business regulation is responsible for ensuring that banks deal honestly and fairly with their customers and comply with applicable laws and codes. Deficiencies in this area were exposed by the CoCos affair in 2011-12 when small investors bought so-called contingent convertible bonds from the banks in the belief that they were high yielding but safe savings instruments. The banks had a clear conflict of interest in advising retail customers to buy their own securities. When the banks subsequently converted the bonds into equity, the savers were wiped out. The savers' only redress was to take the banks to court, though the CBC's finding that the bonds had been mis-sold lent support to their case. In a well regulated system, such misconduct should have been prevented, but if it wasn't, the regulator would have fined banks and forced them to pay compensation.

13.1.2 It was also put to us that banks did not always adequately explain to their customers the full implications of their loan agreements, particularly mortgages.

13.1.3 The regulatory situation in Cyprus appears to us confused. The CBC is not specifically charged with an overall responsibility for conduct of business regulation in banking services, though it has responsibility under the EU's MiFID for regulating the banks' conduct of investment business. The regulation of non-banks' investment business comes under the Cyprus SEC. We believe that Cyprus needs a clearer allocation of responsibility, in particular by making more explicit the CBC's role as conduct of business regulator for banking activity, which would include loans, mortgages, savings products, insurance, pensions etc.. An alternative would be to create a separate conduct of business regulator covering the financial services market, though our view is that this would be superfluous as we do not find the arguments for the so-called "twin peaks" approach compelling.

13.1.4 An overall review of the adequacy of customer protection arrangements across banking, insurance, pensions and investment business would be a part of the process we recommend of moving towards an integrated financial regulator.

13.2. **Financial Ombudsman.** We also recommend that greater urgency be attached to existing plans to establish a Financial Ombudsman to act on complaints against the banks. This should be done by the end of 2013. The Ombudsman would be an independent figure funded by the banking industry to adjudicate in disputes between customers and their banks, and make rulings which the banks would bind themselves to accept.

13.3. **Banking Code.** The Cypriot banks have a Code of Conduct (based on an EU template) which sets standards of good banking practice for their dealings with personal customers. However, given recent events, we recommend that it be reviewed to see whether it is sufficiently comprehensive, and that it be more widely promoted. (It is only available in Greek on the Association of Cyprus Banks website which is unsatisfactory for a market with a large number of foreign customers.) Breaches of the Code should also be taken into account by the supervisors when assessing the adequacy of banks' systems and controls, and the fitness and properness of its executives and directors.

13.4. **Financial education.** One of the front line defences for a well-functioning financial system is an educated customer who can judge whether or not a product is suitable (which the buyers of CoCos evidently could not). We recommend that a more concerted effort be put into financial education in Cyprus to increase consumer awareness of financial risk and put pressure on banks to deliver a good service. This work could be sponsored by the banks, or the regulator (as in Malta), a combination of the two, or, as is beginning to happen in the UK, by including it in the standard school curriculum. This is an area where a considerable amount of work is currently being undertaken internationally, for example by the Money Advice Service[33] (which was spun out of the UK's financial regulator, the FSA, as part of the regulator's statutory duty to provide financial education) and which provides very comprehensive material on the internet to help consumers make decisions across a wide range of financial products in the light of their personal financial circumstances. Another source of useful material is the Personal Financial Education Group (PFEG)[34], a finance education charity in the UK which generates material for use by those providing financial education at a variety of age levels, including the very young. It seems likely that much of the material produced elsewhere could easily be adapted for use in Cyprus.

13.5. Conclusion and recommendations

There are clear deficiencies in Cyprus' present arrangements for protecting consumers in their dealings with banks. Much could be done to strengthen confidence in banks by correcting them.

[33] https://www.moneyadviceservice.org.uk/en
[34] http://www.pfeg.org/

We recommend that conduct of business regulation be strengthened by clarifying the CBC's responsibility for regulating the conduct of banks' investment business, as well as areas such as savings, mortgages, pensions, insurance and loans. We also recommend that the part played in these areas by the Financial Ombudsman and the Banking Codes be expanded, and that a more concerted effort be put into financial education to raise consumer awareness of financial risk.

14. What next?

Is it possible to imagine what the Cyprus banking sector might look like in five years' time? Using the analysis and conjectures we have made in this report, we put forward this vision of the future. It is optimistic but not, we believe, unrealistic.

14.1. The essential components, we believe, would be the following. There would be a group of well-capitalised banks with experienced management and strong, independent governance. The focus of their business would be domestic retail and business banking, with a small number of branches abroad whose chief purpose was to serve their international clients. This would resemble Cyprus' pre-crisis banking model with the important difference that it would have the structural and governance strengths to operate in a liberalised marketplace.

14.2. There would initially be three main domestic banks: Bank of Cyprus, Hellenic Bank, and an incorporated co-op bank, plus three or four foreign banks. Later, this structure could change as a result of a number of possible events: a split of Bank of Cyprus to reduce its dominant position, a merger between Hellenic and a smaller bank to create a stronger competitor, foreign acquisition of a Cyprus bank, or a stronger push by foreign banks with an existing presence in Cyprus.

14.3. The delivery of banking services would be based on a leaner model. The dense branch network would have been substantially thinned out, and replaced by electronic and remote delivery systems. The high level of personal service would be replaced by more automated processes, and also by more objective methods of credit origination and management. There would be greater labour flexibility to allow for adaptability and change. Domestic deposits, along with medium term funds raised in the capital markets, would be more than enough to support local loan demand.

14.4. The Cyprus-based international banking business would survive, though in an evolved form. With the Cyprus economy once more stable and growing, confidence would have returned and with it foreign interest in Cyprus' service offering. Although tax would still be a driver of this business, this selling point would have been whittled away by an EU push against tax competition, and by Cyprus' understanding that it can build a more solid business by exploiting its professional skills and strategic location. This business would be pursued by the leading domestically active banks, while a number of foreign banks would continue to choose Cyprus as a base to focus exclusively on foreign clients.

14.5. The excess deposits generated by the international business would no longer be recycled into domestic and foreign lending expansion but redeployed, in an initial phase, into the international money markets in the form of fiduciary deposits. Later, as wealth management skills and the necessary infrastructure evolved, this would include the global securities markets. At this point, Cyprus could aspire to become a regional offshore wealth management centre for the Eastern Mediterranean and the Middle East. It could then move a stage further to develop global custody and fund administration capabilities within its banking system.

14.6. This model would have to be backed by a fortified system of banking supervision at two levels. At the national level, there would be a policy to promote banking as an important element of Cyprus' economic strategy, but accompanied by a clear understanding of the risks involved and by robust mechanisms to meet them. At the supervisory level, there would be a strong, independently managed system of supervision, closely linked to international sources of expertise and experience, which ensured that banks were well run and capitalised. The culture surrounding banking would also be open and free from political interference.

14.7. Naturally, there are risks to this model. The main one is that it will take longer to restore confidence in Cyprus' banking system, and that healthy markets may not return soon. On the other hand, the model we describe is a relatively modest one which we believe to be achievable, particularly if there is improvement in the wider economic environment.

15. Cost/benefit analysis

Our Terms of Reference require us to provide a cost/benefit analysis of the recommendations in our report. We have decided to hold this over until we formulate our final recommendations. At this stage, we would observe that very few of the institutional changes we propose would be costly; some, such as the integration of financial supervision, should produce savings.

The major costs we foresee would lie in the additional capital requirements we recommend for systemically important banks. However these are outlays which would deliver important economic and social benefits in the form of a more stable banking system, and banks which are able to generate more sustainable profits. If they also help avert another crisis on the scale of the recent one, they will also represent a hugely valuable investment.

16. Summary of recommendations

16.1 We recommend that Cyprus have a clear policy on the role of banking in its economy given its importance both as the major source of credit and its potential to generate foreign earnings. There needs to be a clear understanding of the risks inherent in a high dependence on banks, and of the risks that accompany the rewards from international banking business. This requires a commitment of resources to monitoring these risks and ensuring that banks are equipped to manage them.

16.2 We recommend that Cyprus give priority to restoring the independence of the banking system, and reinvigorating it through cultural change with fresh people and ideas, and international sources of advice. Changes of this kind would transform the banking industry in all the necessary ways, by delivering better governance, better banks, better supervision and greater trust internationally.

16.3 The re-launch of a new and strong Bank of Cyprus has to be the central objective for the banking sector, and we recommend that a clear timetable be set to achieve that goal, and that priority be given to achieving the cost savings which are the main positive element behind the merger.

16.4 We recommend that the banking structure which emerges from the present recapitalisation be kept under review, particularly as regards potential competition and financial stability issues in the longer term.

16.5 We recommend that the co-operative banks be combined into a single institution with a joint stock structure and a commercial culture to make them a healthy competitive force on the banking market, and that this institution be placed under the direct supervision of the Central Bank of Cyprus.

16.6 We believe there are acceptable reasons why Cyprus can still aspire to run an international financial centre. We recommend that Cyprus seek to raise the quality and scope of the present skill base so that customers choose to use it for its breadth and sophistication, not just the tax breaks, and that the banks develop their product range to include wealth management and off-balance sheet services, and later custodian and fund administration services. Supervision will also need to be improved, for example by drawing on outside assistance to give confidence to users of these services, and anti-money laundering controls will have to be strictly and visibly enforced.

16.7 Although we do not make specific recommendations on the quality of service in the Cyprus banking market because of current uncertainties, we identify the following as key issues in the near future:

16.7.1 The potential impact on the character and quality of banking services of the shrinkage of the physical branch network and of staffing levels that will be necessary achieve savings. Bank customers will have to prepare for a major shift towards electronic and automated banking services, and the economics of banking will change.

16.7.2 The structure of interest rates which is artificially high and needs to be brought down to reduce borrowing costs, though in a way which does not add to the risk of deposit flight, and gives the banks a sufficient margin to preserve profitability.

16.7.3 The availability of lending which could be constrained by greater concentration in the banking market and the cost of regulation. The need for banks to acquire more sophisticated lending skills is another urgent issue.

16.7.4 The risk that the reduction in bank numbers and the emergence of a dominant bank will cause a reduction in competition, to the detriment of bank service quality and cost.

16.7.5 Cyprus' high dependence on banks and the need to develop alternative sources of finance for reasons both of risk and diversity over the longer term.

16.8 In the area of corporate governance we propose detailed recommendations to raise standards and make banks and co-operative banks stronger. Our recommendations include the need to

16.8.1 instil a new culture of independence in the boardroom, and raise the status of boards,

16.8.2 improve the quality of directors, and to appoint at least two non-Cypriots to the boards of the major banks,

16.8.3 increase the non-executive component of boards to counter-balance the executive,

16.8.4 strengthen board procedures to ensure that board members are fully informed of the bank's affairs,

16.8.5 strengthen board committees, particularly in the areas of audit and risk,

16.8.6 devise incentive schemes which commit executives to long term objectives,

16.8.7 strengthen the internal audit functions to provide additional independent checks and controls, and

16.8.8 improve the quality of financial reporting by strengthening internal and external auditing.

16.9 On bank auditing we recommend that

16.9.1 accounting treatments be brought in line with the best international standards,

16.9.2 Cyprus's auditor oversight function be strengthened as soon as possible, that it be financed by the profession and/or listed companies, and that the results of its inspections be published,

16.9.3 the Cyprus Securities and Exchange Commission raise the quality of financial reporting by listed companies,

16.9.4 trilateral meetings between banks, the external auditors and the supervisors be re-established on a firm basis,

16.9.5 auditors be genuinely rotated on a regular basis, and

16.9.6 that shareholders play a more active role in holding the banks to account.

In the section on financial stability

16.10 We recommend that the current five components of Cyprus financial regulation be combined into a single entity and placed within the CBC which has the legal and financial independence to handle this role, and whose supervisory competence is in the process of being strengthened.

16.11 We recommend that the CBC's accountability for financial stability and banking supervision be made more explicit in the relevant laws. We also recommend that the Memorandum of Understanding between the CBC and the Ministry of Finance be reviewed to ensure that it addresses the failures which contributed to the crisis, particularly by making firm requirements for regular contact between the Minister of Finance and the Governor of the CBC.

16.12 Poor governance arrangements of the Central Bank of Cyprus unquestionably contributed – over a number of years - to the 2012 crisis by concentrating too much power in the hands of the Governor, and by tolerating an ineffective internal audit function which, in turn led to supervision becoming lax. We share the view that there needs to be greater pluralism at the CBC, however the options for change are limited by the requirements of EU law that the independence of the Governor be protected. The solution, we believe, lies in having a stronger non-executive structure and clearly defined board responsibilities.

16.13 We recommend that the CBC have a policy-setting board chaired by the Governor, with two executive directors and four non-executive directors with clear decision-making powers in specified areas. The checks and balances on the executive would be provided by appropriately qualified, independent non-executive directors and effective board committees with the power to monitor the executive's performance and take corrective action if needed.

16.14 We recommend the establishment of a nominations committee to oversee a transparent process of board member selection and to propose suitable candidates for Council of Ministers approval. We also recommend that the qualifications for non-executive directors be widened to allow at least one non-Cypriot to sit on the board.

16.15 We recommend that Cyprus' macro-prudential oversight function be strengthened with rigorous procedures for identifying risks, and that the CBC have clear procedures for taking action in relation to such risks, and following it up. In addition we recommend that the existing Financial Stability Committee be reinvigorated to improve the CBC's working relationship with other areas of government, and provide a top level forum for policy discussion on supervisory issues in each of the financial sectors, including issues arising out of threats to the system as a whole.

In the area of prudential supervision

16.16 We recommend that the supervision department be included in the CBC's internal audit process to provide an independent check on its work.

16.17 We recommend that the supervisory function have a rigorous risk framework in which risks are clearly identified and prioritised, and that it be measured against international benchmarks such as those laid down by the Basel Committee on Banking Supervision.

16.18 We recommend that the CBC's enforcement function be more rigorously applied, and that details of enforcement actions made public.

16.19 In terms of resourcing, we recommend that supervision be given more resources to support its enlarged role, but that it also seek long-term technical assistance from a body like the IMF to raise the level of expertise and ensure that it meets the highest international standards.

16.20 In the area of consumer protection, we recommend that conduct of business regulation be strengthened by clarifying the CBC's responsibility for regulating the conduct of banks' investment business, as well as areas such as savings, mortgages, pensions, insurance and loans. We also recommend that the part played in these areas by the Financial Ombudsman and the Banking Codes be expanded, and that a more concerted effort be put into financial education to raise consumer awareness of financial risk.

ANNEXES AND APPENDICES

People and institutions interviewed

Accountant General, Treasury
Alvarez & Marsal
Association of Cyprus Banks
Association of International Banks
Bank for International Settlements
Bank of Cyprus
Bank of England
Barclays
Basle Committee on Banking Supervision
Commissioner of the Authorities for the Supervision of Co-operative Societies
Co-operative Central Bank
Co-operative Savings Bank, Limassol
Cyprus Chamber of Commerce
Cyprus Consumers Association
Cyprus Economic Policy Council
Cyprus Investment Promotion Agency
Cyprus Popular Bank
Cyprus Securities & Exchange Commission
Cyprus Shipping Chamber
Cyprus Stock Exchange
Deloitte
Directorate General, Competition (DG COMP)
Directorate General, Economics and Finance (DG ECFIN)
Ernst & Young
ETYK
European Banking Authority
Financial Stability Board
Georgiades H., Minister of Finance
Hellenic Bank
HSBC
IMF
Institute of Certified Public Accountants of Cyprus
Ministry of Finance
Morgan Lewis & Bockius
Papadopoulos N., Chairman, House of Representatives Finance Committee
PIMCO
Present and former directors of the Central Bank of Cyprus
Present and former members of the staff of the Central Bank of Cyprus
Present and former officials of the Central Bank of Ireland
Prudential Regulation Authority (UK)
Russian Commercial Bank
Sarris M., Minister of Finance

CENTRAL BANK OF CYPRUS

EUROSYSTEM

Independent Commission on the Future of the Cyprus Banking Sector

Revised Terms of Reference

Context

The crisis in the Cyprus banking sector requires solutions which deal both with the immediate consequences of the financial agreement with the EU, the ECB and the IMF (the Memorandum of Understanding, MoU) and with the longer-term implications for the role of the banks in the Cyprus economy.

The Central Bank of Cyprus (CBC) will be working closely with the relevant authorities to ensure that the banking system is restructured in an orderly way, and that a return to normality can be achieved as soon as possible. However urgent thought also needs to be given to the longer term implications of the restructuring agreement and other requirements in the MoU which will affect the future of the Cyprus banking system.

In November 2012, the CBC established an independent Commission of experts to examine the banking sector with a view to making concrete and practical recommendations about its future. In light of subsequent events, the CBC has revised the terms of reference to focus the Commission's work more directly on the longer term consequences of the MoU for the banking sector.

Scope and objectives

Under the Revised Terms of Reference, the Commission will make recommendations regarding:

- the optimal size and structure of the Cyprus banking sector in the longer term;
- the strengthening of prudential regulation and supervision of the banking sector, including the governance of the Central Bank;
- the improvement of corporate governance in Cyprus banks;
- the improvement of levels of banking competition and service quality for the benefit of consumers and businesses.

  In particular, the Commission will focus on the following issues:

- Reducing systemic risk and moral hazard in the banking sector;
- Reducing both the likelihood and impact of bank failures, including in terms of the cost to taxpayers; and
- Ensuring competition and consumer choice so that the needs of banks' customers (both individuals and businesses) are efficiently served.

In developing its recommendations, the Commission will take into account of

- the causes of banking sector problems in Cyprus (as described in available documents) and relevant lessons of experience from other countries;
- relevant reforms agreed by the Cypriot authorities in the context of the MoU;
- the need to rebuild public confidence in Cyprus banks, both domestically and internationally;
- good international practice as well as ongoing EU and international policy work in this area; and
- legal and operational requirements (including consistency with EU rules) as well as the impact (costs-benefits and trade-offs) of any policy measures.

Approach and process

The Commission will consult widely with public and private sector entities as well as individuals in Cyprus and abroad in order to collect information and to develop a comprehensive picture of the Cypriot financial system. The Commission will also have access to all reports and documents that are necessary to its work. It will prepare an interim report laying out the main findings and potential recommendations being considered which it will publish in order to solicit public feedback from stakeholders. After considering this feedback, the Commission will publish its final report.

The Commission will be supported by a Secretariat, housed within the CBC, which will collect information and make logistics arrangements.

Governance

In carrying out their tasks, Commission members will act with due care and diligence in a personal capacity as subject matter experts. The chair of the Commission, in consultation with the other members, will design the work plan and maintain overall responsibility for the write-up of the report.

The Commission will report its findings and recommendations to the CBC Governor. Both the interim and final reports will be published on the CBC's website.

Timetable

The Commission will produce an interim report by mid-2013, and a final report by the end of November 2013.

Nicosia April 2013

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