Independent Commission on the Future of the Cyprus Banking Sector

FINAL REPORT
and
RECOMMENDATIONS

Executive Summary

OCTOBER 2013

Executive summary

A.1 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.

A.2 In June 2013, the Commission published an Interim Report laying out its analysis of the issues facing the Cyprus banking sector, and the proposals it was minded to make. We received approximately 50 responses to this document, and we took these into account in preparing this Final Report. It is an independent Report in which the views we express and the recommendations we make are entirely our own.

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

A.3 Over the last three years the Cyprus banking system has suffered a series of disasters which have transformed what was once a large and prosperous industry into a national catastrophe.

A.4 Urgent work is now underway to repair the damage, 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. The country's two largest banks have been merged and recapitalised, the co-operative sector has been restructured with an emergency capital injection of €1.5bn, and important improvements are being made to the country's supervisory system. But the country is in recession, confidence in the banks has been severely damaged, and capital controls are holding back recovery, meaning that uncertainty about the outlook remains considerable.

The causes behind Cyprus' banking crisis

A.5 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 factors and failures, some of them outside Cyprus' control, but many within it.

A.6 **External.** The main external causes were two. One was Cyprus' accession to the EU (2004) and the euro (2008) which rapidly liberalised 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 euro area and its other markets.

A.7 **Internal**. The most significant internal cause was a failure at the national policy level to appreciate that running a big banking industry involves 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 resulting in serious domestic imbalances, or to how any potential shocks 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 an overall climate in which low priority was given to monitoring banking risks, and to supervising the banks themselves. In addition, the government's mismanagement of the budget created a major fiscal crisis which eventually led to Cyprus' exclusion from international financial markets and meant that no resources were available when the banks needed rescuing.

A.8 **Risky strategies.** During the 2000s, the two major banks used the excess liquidity available in the Cyprus banking system to embark on aggressive growth strategies which included lending far beyond prudent levels, and making overseas acquisitions which they had difficulty controlling. Although domestic sources of funding began to run low, they engaged in 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.9 **Weak bank governance.** These reckless ventures were made possible by the failure of the boards of the banks to put 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 serious 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 the effectiveness of corporate governance in Cyprus’ banking sector, while possibly compliant in a formal sense, was close to non-existent in practice as the crisis evolved.

A.10 **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 or call on the guarantee 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 of personal and political 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.11 **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.12 **Ineffective supervision.** There was also a failure on the part of Cyprus' authorities to act effectively at many of the levels we examined. At the highest, there was little sense in government and supervisory circles of the risks that Cyprus was running with a banking system which, at its height, was equivalent to over nine times the size of the Cyprus economy. 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. All the signs point to a lack of determination on the part of the various public agencies responsible for financial stability to deal firmly with growing banking risk, even though the country's systemic banks were involved.

A.13 **Culture.** We found that a common cause behind many of Cyprus' problems lay in culture and attitudes. A frequent observation made to us was that the Cyprus establishment was too inbred, 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 new people and ideas. We agree. We found it striking, for example, that there were so few people with international experience on the boards of banks in a country which operates an international financial centre. This is a theme which permeates the report.

A.14 **Unnecessary delay.** We also concluded that Cyprus made matters worse for itself by failing to agree to the first set of terms drafted by the Troika in July 2012 when the crisis was at its height. 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 uninsured 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 difficult conditions for the task ahead.

National policy

A.15 We recommend a number of steps, both at the national policy and administrative levels, to restore health to the Cyprus banking system.

A.16 **National financial services strategy.** The most significant high level cause of Cyprus' banking crisis was insufficient awareness that the banks' apparent business successes created enormous vulnerabilities for Cyprus should conditions change for the worse – as they did.

A.17 We recommend that, given Cyprus' exceptionally high dependence on its banking sector for financial services, and the continuing potential of this sector to generate foreign earnings and domestic employment, Cyprus develop a national financial services strategy to ensure its future stable development. 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, to ensuring that banks are equipped to manage them and to developing other forms of financial services business, including international, to create greater diversity. We say what the components of such a strategy should be.

A.18 **Culture.** 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 provision of financial services, better supervision and – importantly - greater confidence on the part of its international lenders. Cultural change will involve reducing political interference in the management and supervision of the banking system, putting in place objective decision-making processes and creating incentives and sanctions to strengthen personal accountability.

A.19 **Cleaning up.** It is essential that the revived Cyprus banking industry start with a clean sheet – one that will not later be besmirched by unfinished business. This implies the need for a forthright approach to the errors of the past and for anticipating likely problems in the future, such as a surge in bad debts.

A.20 **Labour reform.** Cyprus' banking labour market is highly unionised and relatively inflexible, and is likely to hold back reforms in key areas such as cost reduction and restructuring. Although the banking union has offered salary cuts and voluntary redundancy programmes, change needs to go further. Management must be given greater control over key issues such as wages, working hours, manning levels and promotion. A more flexible labour market is also essential to Cyprus' wider economic prospects, particularly its ability to attract foreign direct investment. We recommend that labour market reform be treated as an urgent component of Cyprus' recovery plan.

Reforming the banks

A.21 More immediate steps need to be taken to speed the recovery of Cyprus' banks.

A.22 **Confidence-building.** The most urgent task is to rebuild confidence in the banking system. Our concern is that the present programme, based on the restructuring of the country's major banks, will take a long time, possibly many years during which it will be difficult to lift capital controls because of the risk of deposit flight. Meanwhile, deposit erosion will continue and economic prospects will remain weak.

A.23 We believe that Cyprus' prospects would be greatly improved if capital controls are lifted soon, and a state guarantee of all deposits in Cyprus banks was issued to reduce the risk of deposit flight. This would require a credible commitment from the relevant European institutions to provide the necessary capital and liquidity backing, should this be required. Such a move would restore confidence much more quickly: it would shore up the banks and enable normal economic conditions to return. It would also revive the savings industry and the flow of credit, and restore foreign business confidence. The deeper transformation of the banking sector could still go on, but in the background under less stressful conditions. Since this option would involve European assistance, the decision to take it would essentially be one for the European institutions, who would be guided by wider policy considerations about conditions in the euro area. The main risk for Cyprus in this route is that it would take pressure off the government and the banks to reform themselves. This would have to be resisted by setting a clear timetable of tasks and responsibilities.

A.24 **Bank of Cyprus.** Confidence in Bank of Cyprus will best be created by taking out the non-performing loans (NPLs) and placing them in a separately incorporated entity owned by the bank's shareholders, funded by the BoC and managed by private sector individuals with strong incentives to recover value. This will free it from its NPL burden and give greater transparency to its true operating performance, which should improve. BoC urgently needs strong executive leadership to manage its transformation and extract the full benefit from the merger with Cyprus Popular Bank.

A.25 **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 a well-managed international financial and professional services centre. The problem in Cyprus is that it was poorly managed: it relied too much on tax appeal and poor supervision, and not enough on financial soundness and quality. Cyprus also allowed it to become associated with tax evasion and money of doubtful origin.

A.26 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 the skills and services on offer. Cyprus should also make more of its strategic location as a "safe haven" in a politically troubled region.

A.27 **Size of the banking system.** Under the terms of the MoU, Cyprus' banking sector is being reduced in size by as much as half through restructuring, disposals and deposit attrition. The challenge is to find the sector's optimal size, which will be determined by the availability of deposits and capital, by the scale of profitable business opportunities, and by the capacity of the country to supervise and stand behind it.

A.28 We believe that it is inevitable that Cyprus will end up with a banking system that is of more than average size, for several reasons. One is that it has few alternatives to banks when it comes to savings and loans. Another is that we believe Cyprus could still maintain banking as an industry servicing the needs of international customers. This raises the importance of having a strong supervisory framework - and of the need to encourage alternative sources of finance to reduce banking dependence.

A.29 **Structure of the banking system.** The current restructuring leaves Cyprus with one large bank (Bank of Cyprus) with nearly half the market, a co-operative sector about half its size, and a No. 3 bank (Hellenic Bank), plus a few smaller banks and branches and subsidiaries of foreign banks. This is an unsatisfactory structure because the existence of a dominant bank raises competition and stability concerns, and we recommend that it be kept under review.

A.30 The restructuring of **the co-ops** has reduced their number drastically from over 90 to 18, but has stopped short of transforming them into a single joint stock company, which we believe should be the ultimate objective. Only in this form will the co-ops become a strong and efficiently managed commercial entity providing a full range of banking services and giving a stimulus to competition.

A.31 **Banking service quality.** It is important that the reshaping of the Cyprus banking industry produce a structure which encourages healthy competition and delivers a top rate banking service.

A.32 **Service delivery.** Cyprus banks have a high level of personal contact with their customers: they operate the densest branch network in the EU, and personal relationships play a big role in banking transactions. 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, the use of new forms of service delivery will expand, such as Internet and telephone banking. The economics of banking will also change and Cypriot bank customers will have to prepare for a major shift in the way they do their banking.

A.33 **Interest rates.** Cyprus has traditionally had a high interest rate structure due to the intensity of competition for deposits and, more recently, crisis conditions in the markets. Attempts are now being made, by administrative means, to bring them down, with only partial success because of exceptional market conditions. It will take a difficult balancing act to have deposit rates that are high enough to attract and retain funds and yet low enough to make borrowing affordable, while also leaving the banks with a sufficient margin in between to service their capital. Cyprus should move as soon as possible to a situation where interest rates find their natural level through the interplay of market forces. This is a further reason for adopting measures, such as a deposit guarantee, to speed up the return to normality.

A.34 **Availability of credit.** As well as the cost, there is also concern about the availability of credit, for a number of reasons. The main one is the shortage of liquidity in the banking system which will constrain lending capacity. Banks are also understandably risk averse in the present economic climate, and burdened by additional capital costs. A further consideration is that Cypriot banks will need to develop more sophisticated lending methods requiring credit judgment skills which may be in short supply. There are also competition concerns in the business lending segment of the market which we address with a number of recommendations.

A.35 **Savings.** Less noticed, but equally important in our view, is the lack of savings possibilities in the Cyprus market since the crisis. Confidence in bank deposits has been severely damaged, the stock market has been forced to close down, and the provident funds have suffered from the haircut, some to the point where they have decided to liquidate. The revival of savings is an urgent priority in the process of restoring health to the banks and the wider economy.

A.36 **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, headed by a dominant Bank of Cyprus with 50 per cent of the market, and a number of smaller competitors. A more balanced structure will need to be encouraged. It is possible that the Bank of Cyprus and the co-ops will shrink as they consolidate and write off bad debts. Hellenic Bank may seek a merger with another bank and become a stronger No. 3. Also, foreign banks might see an opportunity to expand in a market where local players are constrained, or by buying a strategic stake in a Cyprus bank. A particular focus of competition concern is the business lending market where capacity could be tight. This is where a single commercially-driven co-op bank could become a competitive force offering a full range of banking services. Depending on a large number of variables, further structural changes will almost certainly be needed to achieve a healthier balance in the Cyprus banking system.

A.37 **New entrants.** In order to ease the competition problem, we recommend that measures be developed to encourage new entrants to the lending market (by lowering capital requirements for start-ups for example), particularly those using different banking models such as online banks, microfinance and Islamic banking.

A.38 **Alternative sources of finance.** The problems of bank dominance could also be addressed by encouraging alternative sources of finance. Although Cyprus has a stock exchange, it has never become an important source of business capital. Cyprus needs to develop alternative forms of market-based finance (bond markets, investment funds, private equity etc.) to raise long term capital and reduce its bank dependence. New finance models such as peer-to-peer lending and crowd funding are also emerging. This will require initiatives from both the public and private sectors, for example by creating appropriate legal and supervisory frameworks, and developing new skills, and through progress at the EU level to complete the cross-border market in capital-raising.

A.39 **Corporate governance.** 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 as well as in the co-operative banks where there were also serious weaknesses. In particular, we see the need to strengthen the role and composition of boards, raise and maintain the quality of directors, and give boards stronger oversight over crucial areas such as internal audit and risk management.

A.40 **External audit.** 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. The fact that the banks' losses came as a surprise to many people suggests that there is room for improvement. We make recommendations to strengthen auditing, improve oversight of the accounting profession, raise the quality of reporting by listed companies and improve relations between banks, auditors and their supervisors.

Financial stability

A.41 We found critical shortcomings in the supervision of the banking system, from high level failure to recognise the "big picture" risks that were building up in financial markets, down to the ineffective discharge of key supervisory functions in what we recognise were difficult circumstances. In particular we observed:

A.41.1 The absence of a clear institutional framework at the national level to identify and act upon banking risk;

A.41.2 the disjointed structure of financial supervision in Cyprus, and the lack of co-ordination between the various public authorities with responsibility for financial stability;

A.41.3 the politicisation of relations between the CBC and government;

A.41.4 flaws in the governance of the CBC itself;

A.41.5 failings in responding to macro-prudential considerations; and

A.41.6 inadequate line supervision, including poor enforcement.

A.42 **Banking union.** In considering ways to strengthen financial stability in Cyprus, account needs to be taken of the changes that will be introduced by the EU's Single Supervisory Mechanism (SSM) which is scheduled to start in November 2014. This will transfer responsibility for prudential supervision of the euro area's largest banks to the

European Central Bank in Frankfurt. For Cyprus, this means that Bank of Cyprus, the Co-operative Central Bank, Hellenic Bank and Russian Commercial Bank will become the responsibility of the SSM, and that prudential policy as regards significant banks will cease to be the province of the board of the Central Bank of Cyprus.

A.43 **Structure of financial supervision.** Cyprus has a fragmented system of financial supervision with four separate authorities, three of them sponsored by ministries. This leads to confusion, resourcing issues and the risk of political interference. We recommend that these 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.

A.44 **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 is harmful. It is important, for the effective discharge of the CBC's supervisory role, that its independence be recognised and respected, but that this also be balanced by clear CBC accountability and transparency in the supervisory area. The CBC's accountability for financial stability should be made more explicit in the relevant laws.

A.45 **CBC relations with the Ministry of Finance**. We recommend that the Memorandum of Understanding which governs relations between the CBC and the Ministry of Finance be reviewed to ensure that it establishes a clear understanding of the role and responsibilities of the parties involved. It should also incorporate formal arrangements for regular top level meetings between the Governor of the CBC, the Minister of Finance, the heads of other supervisory authorities, and their respective staff and for the proper flow of relevant information.

A.46 **Governance of the CBC.** Poor governance arrangements of the Central Bank of Cyprus contributed to the 2012 crisis by concentrating too much power in the hands of the Governor. 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.47 Recent Cyprus legislation requires that the board consist of the Governor, two executive directors and five non-executive members. We believe a more appropriate structure would be the Governor, two executive directors and four non-executives to create a better balance and remove the risk of a 4-4 split vote. The legislation is also worded in such a way that it prevents the executive directors assuming responsibility for work related either to monetary policy or to prudential supervision within the SSM, which reduces the support additional executive resources can bring. For both these reasons, we believe the legislation is flawed and should be amended.

A.48 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. We welcome a recent initiative to set up an audit committee with the power to monitor the executive's performance and recommend corrective action if needed.

A.49 We recommend the establishment of a nominations committee to oversee a transparent process of board member selection and to propose qualified candidates for Council of Ministers' approval. We also recommend that the qualifications for non-executive directors be widened to allow non-Cypriots to sit on the board.

A.50 **Internal audit.** Poor CBC governance arrangements also contributed to the crisis by exempting the CBC's supervision department from the internal audit process, which meant it received no board scrutiny. We welcome recent moves to correct this deficiency.

A.51 **Macro-prudential supervision.** One of the main causes of Cyprus' banking crisis was a failure by the authorities to confront the macro-economic risks which faced the banking system, particularly the growth of a real estate bubble and turbulence in world markets. Had these been dealt with promptly in response to financial stability analysis, it should have been possible to avoid the worst of the losses which subsequently materialised. The functions that did exist at the time to keep track of so-called "macro-prudential risk" were under-resourced and given insufficient attention by decision makers.

A.52 We recommend that the financial stability function be strongly resourced in the government ministries and the CBC. Macro-prudential oversight should have clear procedures for identifying and addressing risks consistent with the guidance of the European Systemic Risk Board, and the CBC and ministries should have rigorous procedures for taking action in regard to them. 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.

A.53 **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 essential to the recovery of the banking industry. An important recent development was the inclusion of supervision in the CBC's internal audit process, which means it will now be held to account by the CBC board.

A.54 We recommend that the supervisory function have a rigorous risk framework in which risks are clearly identified and prioritised, and that, once sufficient time for implementation has passed, it be assessed against international benchmarks such as those laid down by the Basel Committee on Banking Supervision.

A.55 We encourage moves to create 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 separately established to provide it with the necessary independence. Its work needs to be more rigorously applied, and details of enforcement actions made public.

A.56 The resourcing of the supervision department should be increased to support its enlarged role. We also recommend that it seek long-term technical assistance from a body such as the IMF or from elsewhere within the Eurosystem to raise the level of expertise and ensure that it meets the highest international standards.

A.57 **Consumer protection.** The recovery of the Cypriot banking system will have to include 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.

A.58 We recommend that conduct of business regulation be strengthened by emphasising the CBC's responsibility for regulating the conduct of banks' investment business, including areas such as savings, mortgages 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.

Cost/benefit analysis

A.59 Our Terms of Reference require us to provide a cost/benefit analysis of the measures we propose.

A.60 We estimate that the net cost of our recommendations is small, particularly as regards "social costs", i.e. those that would fall on the economy rather than business.

A.61 The major costs lie in the additional capital requirements we recommend for systemically important banks. However this recommendation involves a redistribution of costs associated with the risks in the banking sector from the taxpayer and depositors to the banks' shareholders and bondholders. Thus, the net impact on the economy, if any, would be minimal.

A.62 All the costs should be seen in the context of the huge losses Cyprus has suffered from its crisis - potentially more than a whole year's output. We believe that our recommendations will be money well spent if they reduce the risk of a repetition.

Conclusion

A.63 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. To assist the process, we conclude this Report with recommendations for implementation, with a timetable and responsibilities.