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Developments in the Banking Sector in Cyprus during 2013-2022 and priorities ahead for soundness and expansion

Abstract

Amidst concerns about the sustainability of Cyprus's public finances, as well as for the country's financial sector, the Cypriot authorities requested in June 2012 financial assistance from the Euro Area Member States and the IMF. In March 2013, the Eurogroup reached a political agreement on the key elements of an Economic Adjustment Programme for Cyprus with a financial envelope of up to €10 bn. The relevant MoU included a number of bank resolution, recapitalisation and restructuring measures. Further regulatory and supervisory measures were designed and implemented in the following years. The extensive restructuring of the banking sector continued, both between and within the banking institutions. The main purpose of this focus note is to present the most important developments and trends in the Cypriot banking sector during the period 2013-2022 for which adequate data are available on the various structural, economic performance and soundness indicators, with an ulterior target to depict the challenges ahead ten years after the 2013 crisis, together with relevant measures and pol-icy recommendations.

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1. Introduction – aspects and imbalances of the banking sector prior to the Economic Adjustment Programme

Amidst concerns about the sustainability of the Cyprus's public finances, as well as of the country's financial sector, the Cypriot authorities requested in June 2012 financial assistance from the Euro Area Member States and the IMF. The conditions in the banking sector deteriorated further in early 2013, due to a drop in confidence leading to continuous and substantial deposit outflows. On March 16, 2013, the resolution and restructuring of the two largest banks was announced, namely of Laiki Bank and Bank of Cyprus, a bank holiday was declared for Tuesday 19 March, Monday 18 March being a regular bank holiday, and this was extended several times until Wednesday 28 March. Meanwhile, on March 25, 2013 the Eurogroup reached a political agreement on the key elements of an Economic Adjustment Programme (EAP) for Cyprus with a financial envelope of up to €10bn, including the restructuring and substantial downsizing of the banking sector, the reinforcement of efforts on fiscal consolidation and the implementation of structural reforms and privatisations.

A report of the appointed by the Central Bank of Cyprus (CBC) Independent Commission on the Future of the Cyprus Banking Sector (ICBS), published in October 2013, analyses in detail the reasons that led to the banking crisis, which necessitated the above unprecedented actions.[1] In brief, for many years prior to the 2013 crisis, «The banking sector in Cyprus, in common with some other countries, adopted poor internal governance and risk management practices. This led to a credit boom dominated by as-set-based lending and an overexpansion in the real estate market and in overseas markets, such as Greece».[2] Furthermore, according to the ICBS report, «the banks had pursued a risky investment strategy of high returns, failing to properly assess the risks and limit their concentrations». The banks' overexposure to the high-yielding Greek debt «meant that the Greek Private Sector Involvement (PSI) in 2011 severely distressed the two major systemic banks at that time, Bank of Cyprus and Laiki Bank».

According to the European Commission report for the launch of the EAP, «The earlier expansion (of the financial sector in 2005-2009) was mainly financed by attracting deposits, especially from non-residents, who found in Cyprus a favourable tax and business environment. Some of the attracted resources were working balances for international companies established in Cyprus, some were re-routed as Foreign Direct Investment and some fuelled the property boom in Cyprus or were used for lending in Greece. Poor risk management practices, insufficient capacity to exercise prudential oversight compared to the size of the financial sector, and excessive concentration of investments led to the unprecedented challenges for the system».[3]

The remainder of this focus note first analyses the measures of the EAP affecting the banking system and the subsequent developments during the initial, crucial year for the implementation and success of the programme. Next, it presents the policies for the banking sector and the restructuring procedures during the next two years, up to the completion of the EAP, as well as trends in key figures. Then, it discusses the main events in the post-programme period, up to 2021, are presented, along with the dynamics in key

[1] Commission on the Future of the Cyprus Banking Sector (2013)
[2] Central Bank of Cyprus (2014)
[3] European Commission (2013)

banking indicators. The focus note concludes with a focus on the main challenges and opportunities in the current period and the medium term, accompanied by proposals about relevant actions and measures.

2. EAP policies and measures for the banking sector in 2013 and related developments

The bank resolution measures were at the heart of immediate policies about the banking sector included in the Memorandum of Understanding (MoU) signed with the EC, the ECB and the IMF. These measures comprised:

- Laiki Bank (former Cyprus Popular Bank) was resolved immediately, with full contribution of equity shareholders, bond holders and uninsured depositors. Laiki Bank's business, staff, branches and assets in Cyprus (with the exception of its investments in foreign subsidiaries), as well as insured deposits up to €100.000 and Emergency Liquidity Assistance were transferred to Bank of Cyprus, which was also placed under resolution in accordance, with the Eurogroup of March 25 decisions.
- Following an independent valuation of its assets and liabilities conducted by an international audit firm, the Bank of Cyprus was recapitalised through a deposit/equity conversion of uninsured deposits, with full contribution of equity shareholders and bond holders. In line with the Eurogroup's decisions, no funds from the financial envelope were used to recapitalise Bank of Cyprus and, in accordance with the EU legislation, insured depositors were fully protected.

As a result of the above measures on one hand and of EU legislation on insuring deposits on the other hand, 4% of depositors in Laiki and Bank of Cyprus were affected.[4] However due to the unprecedented market shock and deterioration in confidence because of the bank resolution and restructuring actions, capital controls were implemented after the end of the bank holiday on March 27, to protect the liquidity of the banking sector. The overall objective was to limit capital transactions while at the same time allowing current transactions for purchasing goods and services inside and outside the country. The regime was applied to all banks including foreign banks, whereas some entities were exempted including the Central Bank, the State and the local authorities. The most significant limitations initially placed were the following:

- Cash withdrawals limited to €300 per day and per bank account
- Free payments for salaries and excess living expenses up to €5,000 per quarter
- Payments and/or transfers outside Cyprus, via debit and/or credit and/or prepaid cards not allowed to exceed €5,000 per month per person in each credit institution
- General ban on cashless payments or transfers of deposits/funds to accounts held abroad or to other credit institutions. However, an authorisation regime applied for transactions falling within "normal business practices", e.g., for buying goods. Initially, payments for such purposes up to €5,000 per day, per bank account, were allowed, and in early April this upper limit was extended to €25,000, while from €25,001 to €200,000, they were subject to approval, and beyond €200,001 prior authorisation was necessary, taking into account the liquidity buffer of each credit institution

[4] Central Bank of Cyprus (2014)

- Regulated termination of fixed-term deposits prior to their maturity

A year after the start of the EAP, the restructuring of the banking sector had proceeded further. Specifically:

- A new board of directors was elected in Sep-13 at the Bank of Cyprus and a new CEO was appointed. After its recapitalisation at the beginning of the EAP, the bank had a strong capital base according to the Central Bank of Cyprus[5] and was implementing its restructuring plan, including the integration of Laiki Bank, a branch restructuring programme and cuts in operating costs
- The merging of the 93 cooperative credit institutions into 18 new entities that started in October 2013 was completed on schedule in March 2014. A new board of directors and a CEO were appointed at the Central Cooperative Bank, while the process of appointing new members to the boards of individual cooperative credit institutions was in progress in spring 2014
- The Cooperative Central Bank and the cooperative credit institutions were recapitalised through a capital injection by the financial envelope of the EAP, amounting to €1.5bn
- The Hellenic Bank Group successfully completed the strengthening of its capital base by raising €358mn in private funds. Despite adverse economic and financial conditions domestically, as well as in Greece, the capital raised exceeded the target set in the PIMCO adverse scenario (€294mn), highlighting a strong interest on the part of foreign investors

Regarding reforms to the supervisory and regulatory framework of the banking sector, the most important changes implemented within the first year of the EAP were the following:

- The CBC amended its capital requirements directive and imposed a minimum Core Tier 1 ratio of 9% on all institutions by end-December 2013 despite capital losses earlier that year and the ongoing restructuring process, in line with the relevant requirement in the 2012 EBA pan-European stress test, up from the 8% requirement prior to the 2013 crisis
- The Banking Law was amended to stipulate that the Chairman and majority of the board members of the banking institutions must be independent. Bank lending to independent directors was forbidden, while lending to non-independent, non-executive directors was capped at €500.000
- New CBC directives in relation to NPLs and the effective management of loans in arrears. The definition of NPLs was updated and was brought broadly in line with the relevant EBA definition implemented across the EU since Sep-14
- New CBC directive aiming to ensure the prudent application of the IFRS on the issues of loan impairment and provisioning. The directive required banks to have in place adequate provisioning policies and procedures based on conservative assumptions, in order to correctly and promptly identify impairments and take adequate provisions

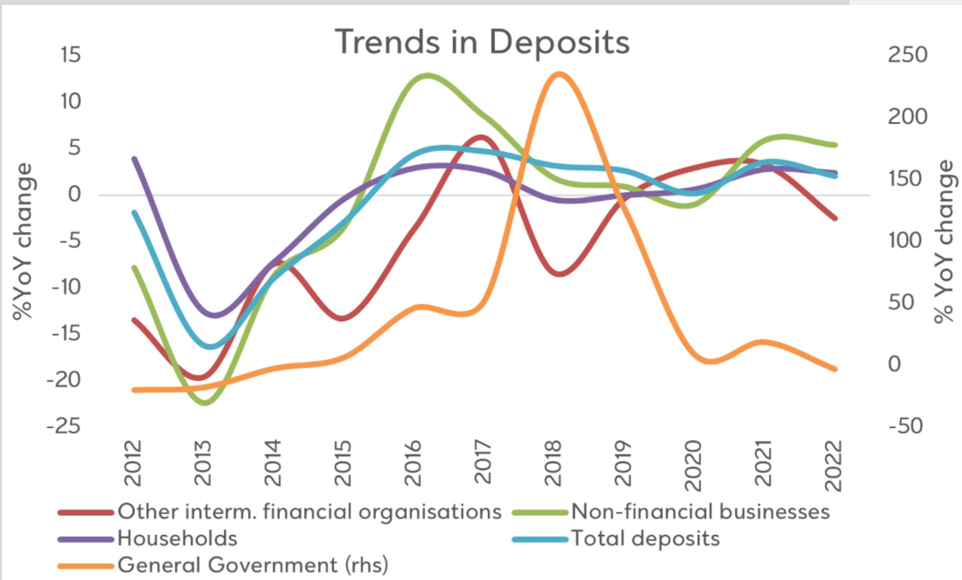
The most important supervisory reform at EU level in 2013 was the introduction of the Single Supervisory Mechanism (SSM) for credit institutions in the Euro Area and, potentially, in other EU member states, with Council Regulation (EU) No. 1024/2013, of Oct-13. The SSM was created in the context of the European

[5] Ibid.

banking union. All the Euro area countries participated by default in the SSM. Member states outside the euro area could choose to participate in the SSM by introducing "close cooperation" of their national competent authorities with the ECB. The ECB undertook fully its supervisory duties in Nov-14.

Above-mentioned extensive reforms and restructuring processes in the banking sector and uncertainty on whether would prove adequate for restoring banking system's soundness, resulted in a 6.7% annual decline of loans to domestic non-financial corporations in 2013, the biggest fall since at least 2007, after an expansion by 9.4% a year earlier (Figure 2). Credit contraction towards households was moderate, by 2.2%, following an increase of almost the same magnitude in 2012 (+2.9%). The downward trend in deposits in 2013 was much stronger compared to that in loans, mainly as result of the impairment of uninsured deposits at the Bank of Cyprus using the bail-in method, a deterioration in business and household confidence from heightened uncertainty about the viability of some of the banks, but also because of the strong economic recession, as GDP declined by 6.3% in 2013, after a recession of 3.6% in 2012. The 2012 GDP fall came primarily from a contraction in gross fixed capital formation (GFCF: -19.5%) and secondly from a fall in private consumption (-2.8%), reflecting the worsened economic climate after the request on June 2012 of financial assistance from the Euro Area and the IMF. The 2013 recession was also driven by a decline in private consumption (-7.0%) and GFCF (-15.7%), with significant cuts in public consumption due to the EAP (-4.8%) further accelerating the GDP fall. On the back of these adverse developments, deposits contracted for a second year in a row in 2013, by 16.2%, after an 1.9% fall a year earlier (Figure 2). The shrinkage was more pronounced in non-financial businesses (-22.4%) and other intermediate financial organisations (-19.6%), with general government (-17.7%) and households (-12.6%) following in close distance. Towards the end of 2013, non-performing loans (NPLs) reached, according to the newly introduced definition since June 2013, 38% and 44% of total credit facilities granted by banks and cooperative credit institutions, respectively.[6]

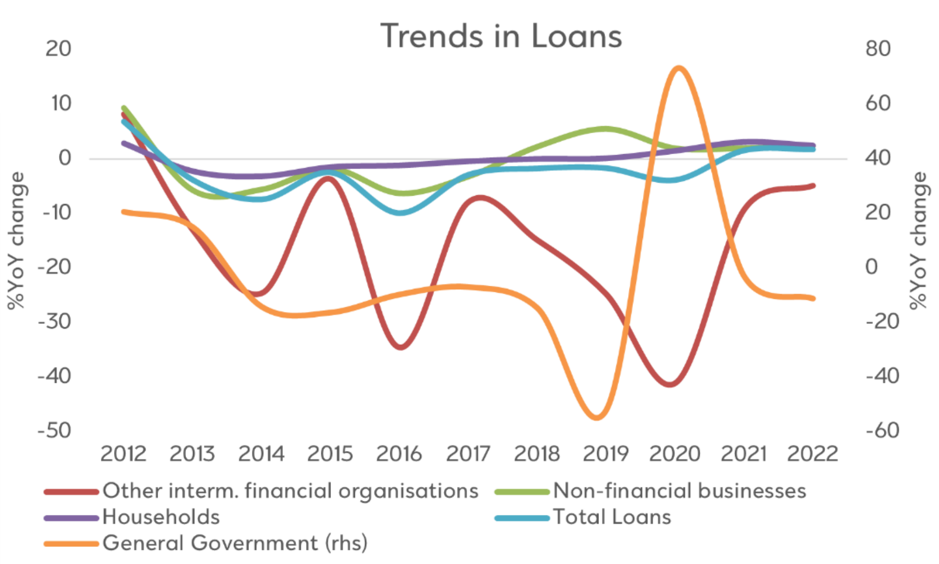
Figure 1



Source: Central Bank of Cyprus, Eurobank Research

[6] European Commission (2014)

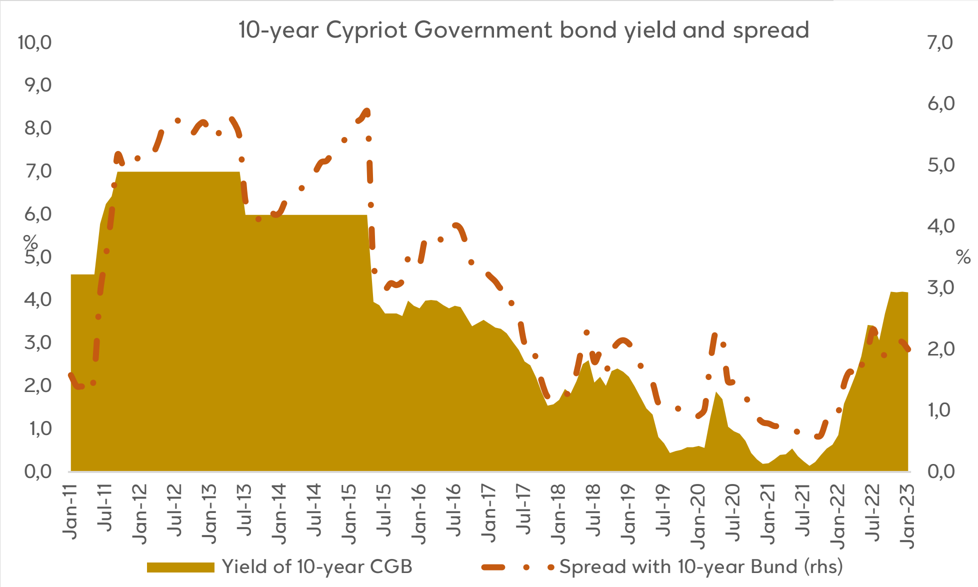
Figure 2



Source: Central Bank of Cyprus, Eurobank Research

Disturbances in the confidence of global investors to the Cypriot economy were reflected in the yield of the 10-yr bond of Cyprus, which started rising from Jul-11, after the country lost access to the financial markets in May-11, as well as in the spread vis-a-vis the 10-year German Bund (Figure 3). The yield of the Cypriot bond increased through Sep-11, reaching 7.0%, and remained unchanged up to Jul-13, a few months after the entry to the EAP, with the spread standing at all-time highs from Sep-12 to May-13, to 550-580bps, highlighting the markets' strong uncertainty about the prospects of the Cypriot economy. The yield and the spread eased somewhat up to end-13, returning to early 2012 levels (6.0% and 410-445 bps).

Figure 3



Source: European Central Bank, Eurobank Research

3. Developments in the banking sector in 2014-2015 – Exit from the Programme and capital controls

The restructuring of the banking sector continued in 2014-2015, albeit at a slower pace than in 2013, and further reforms were adopted.

Starting from the adoption of reforms about the banking sector, the regulatory framework for the resolution of credit and other financial institutions was revised in Jun-2014, with the adoption by the House of Representatives of Law No.90(I)/2014. The major change introduced by the law was the designation of the CBC as the Resolution Authority which, based on a prior law (Aug-13), consisted of the Minister of Finance, the CBC and the Chairperson of the Board of the Cyprus Securities and Exchange Commission. The new law also provided for the establishment of a Resolution Committee as the executive decision-making body of the Resolution Authority, consisting of the Governor and the executive directors of the CBC. Furthermore, a Resolution Unit was established, based at the CBC and staffed by its personnel. The new Unit is operationally independent from the supervisory functions of the CBC. Finally, Law No.90(I)/2014 provides that the CBC, in its capacity as the competent supervisory authority, is the only authority that can take a decision on the non-viability or potential non-viability of a credit or other financial institution.

Furthermore, the CBC issued a number of directives concerning the assessment of the management of banks. Specifically:

- Directive on Loan Impairment and Provisioning Procedures (Jan-14): The purpose of this Directive was to ensure prudent application of IFRS to the financial statements of the assessed credit institutions (ACIs) regarding the procedures applied in the identification, assessment and measurement of loan impairments as well as disclosure requirements of policies, valuation methods and analysis of the loan portfolio of the ACI
- Directive on Arrears Management (Feb-14): this directive amended a related Sep-13 directive. It set out the regulatory framework with regards to the application of efficient and effective strategies, policies, structures, procedures and mechanisms for the management of arrears of credit facilities and attainment of fair and viable restructurings. Appendix II of the Directive includes the Code of Conduct for the handling of borrowers in financial distress
- Governance and Management Directive (Aug-14): This directive replaced the Directive on the Framework of Principles of Operation and Criteria of Assessment of Banks' Organisational Structure, Internal Governance, and Internal Control Systems of 2006 - 2012. The main provisions of the Directive concerned (a) requirements on the governance structures of credit institutions; (b) requirements regarding the roles and responsibilities of management bodies and senior management
- Directive on the Assessment of the Fitness and Probity of the Members of the Management Body and Managers of Authorised Credit Institutions (Nov-14): This directive replaced the Directive on the Assessment of the Fitness and Probity (Assessment Criteria) of Directors and

Managers of Banks of 2006, by introducing the European Directive 2013/36/EU and the Guidelines issued by the European Banking Authority with regard to the assessment of the members of the management body and key function holders

- In Jan-15, the Single Resolution Board (SRB) was set up pursuant to Regulation (EU) No.806/2014 for the establishment of the Single Resolution Mechanism as the second pillar of the Banking Union. The Single Resolution Mechanism came into force in Jan-16. In 2015 the CBC participated in SRB committees mandated to prepare manuals for resolution planning, crisis management and resolution, cooperation and decision making within the SRM

Regarding the restructuring of the banking sector, the Resolution Authority continued in 2014 the implementation of the resolution measures for Cyprus Popular Bank (CPB, ex. Laiki Bank) adopted in Mar-13 and proceeded to the adoption and implementation of resolution measures for the Federal Bank of the Middle East (FBME) branch in Cyprus. The resolution measures for the latter bank were adopted in Jul-14 on the basis of an announcement issued earlier in that month by the Financial Crimes Enforcement Network of the US Treasury Office (FinCEN), which named FBME as a financial institution of primary money laundering concern. This action by FinCEN had a negative impact on the capacity of the FBME branch to execute customer transactions and to meet its obligations. Other operations of the Resolution Authority during 2014 included the preparation for the transposition in national law of Directive 2014/59/EU, for the recovery and resolution of credit institutions and investment firms, and the participation of the newly established Resolution Unit in working groups for the establishment and operation of the Single Resolution Mechanism in accordance with the provisions of Regulation (EU) No. 806/2014.

In 2015, the implementation of the resolution measures for CPB and the branch of FBME continued. The measures concerning CPB comprised of the sale of its remaining assets, mostly investments in foreign subsidiary banks, as well as in ordinary shares of Bank of Cyprus. Regarding the resolution measures for the FBME branch in Cyprus, after not receiving any offers from credit institutions for the acquisition of the operations of the FBME branch, the Resolution Authority decided on Oct-15, the suspension of the resolution measure of the sale of operations. After concluding that no other resolution measure could have been applied, the Resolution Authority recommended the revocation of the license granted to FBME for the operation of a branch in Cyprus.

Within the framework of compliance with the provisions of Council Regulation (EU) No 1024/2013 regarding the establishment of the SSM, a review of banks determined as significant by the ECB was undertaken in 2014 and was concluded in October of that year. For an institution to be classified as significant and thus to be subject to direct supervision by the ECB, the following criteria were considered:

- total value of assets should exceed €30bn;
- total assets should be greater than 20% of the GDP of the country in which a bank is established;
- the size of cross-border transactions is considered significant;
- whether the bank has requested and was granted public financial support by the European Systemic Mechanism (ESM) or the European Financial Stability Facility (EFSF).

In Cyprus, the Bank of Cyprus, the Central Cooperative Bank, Hellenic Bank and RCB Bank were considered to be significant. The ECB review was based on a Core Tier capital ratio of 8% in accordance with the Directive on Capital Requirements IV and Regulation CRDIV/CRR. All four banks were found to be adequately capitalised under the stressed scenario, with the exception of Hellenic Bank which presented a small capital shortfall. This shortfall was covered before the end of 2014 with the issuance of capital to existing shareholders.

The outcome of the ECB assessment was a decisive factor to the improvement of confidence in the banking sector. Above mentioned reforms concerning the banking sector, the ECB assessment, along with the successful implementation of the EAP in 2013 and 2014, reflected in the programme reviews,[7] which strengthened the overall confidence of businesses and households to the prospects of the Cypriot economy, paved the way for the full lift in Apr-15 of the capital controls, two years after they came into force. The improved confidence is reflected in the strong deceleration in the fall of deposits of the non-monetary and financial institutions (MFIs) excluding the general government during 2014, from -21.5%YoY in Jan-14 to -4.1%YoY at the end of the year, the trend being stronger in non-financial businesses (from -29.7%YoY in Jan-14 to -2.6%YoY in Dec-14). Deposits of non-MFIs (excl. general government) remained on the same path in 2015, after the lift of the restrictive measures, which resulted to a reversal of their trend from Dec-15 onwards (+0.2%YoY), with the increase in households' deposits starting in Aug-15 and reaching a pace of 1.9% by the end of 2015.

Despite successful recapitalisations, enhancements in numerous aspects of the regulatory framework and the significant ease in the decline of deposits in 2014 (turned positive the next year), the very high level of NPLs deterred banks from providing more credit to the economy. By end-2014 NPLs stood at 47.8% of total loans or €28.4bn, whereas one year later they were slightly lower, at 45.8% or €27.3bn. As a consequence, the decline in bank credit to the non-financial sector (excl. general government) accelerated in 2014, to 7.3%YoY from 4.1%YoY in the previous year, with the downward trend easing in 2015 (-2.2%YoY). The decline was more pronounced in 2014 among other intermediate financial organisations (-24.6%YoY) and in 2015 in insurance companies and pension funds (-62.9%YoY).

Regarding the trends in the confidence of global investors in 2014-2015, the yield of the 10-yr bond of Cyprus remained unchanged from Jul-13 to Apr-15, to 6.0%, indicating the persisting uncertainty about the prospects of the Cypriot economy. The yield spread vs. 10-year Bund started escalating from an already high level in Jan-14 (424 bps) up to May-15, when it stood to the highest level ever (588 bps, Figure 3). The 10-yr bond yield declined sharply in May-15, after the successful issuance of a 7-year bond in end April, the first with such high maturity since May-11, when Cyprus lost access to the international financial markets and the second after the entry to the EAP. Following this bond issuance the spread de-escalated sharply, falling below 300bps for the first time since Jul-11 and moderately increasing in the following months, up to the completion of the EAP.

Cyprus successfully completed the Economic Adjustment Programme in March 2016, making use of €7.8bn out of €10bn of the related financial envelope.

[7] In the reports following the reviews, it was highlighted that the fiscal targets were met with significant margin, along with advances in the implementation of restructuring plans and capital raising for banks and enhancements towards strengthening supervisory monitoring and operational capacity to address NPLs

4. Developments in the post-adjustment programme period (2016-2022)

The successful completion of the Economic Adjustment Programme in Cyprus paved the way for gradual sovereign rating upgrades by the credit agencies. In Sep-18, S&P upgraded Cyprus' sovereign rating to the BBB- notch, with the country restoring its investment grade almost seven years after the downgrade by S&P to junk (Jan-12). In the coming months, Fitch (Oct-18) and DBRS (Nov-18) upgraded Cyprus to the same rating. The S&P upgrade came, inter alia, due to «measures by Cypriot policymakers to markedly reduce the stock of nonperforming assets in the banking system via financial support and legislative changes», which «have improved the sector's health and are likely to facilitate further recovery efforts». Overall, the return to investment grade was a very crucial development for reinforcing confidence, not only to the Cypriot economy, but also to the banking sector. The restoring confidence is reflected in the return of the spread with the 10-yr Bund since Jul-19 (and barring a blast when the pandemic erupted), to levels prior to the loss of access to the financial markets in May-11 (87-110bpts, Figure 3).

On the part of the regulatory and supervisory framework for the banking sector, the following reforms are considered to have contributed to the return to investment grade:

- Harmonisation with European Directive 2014/59/EC, on establishing a framework for the recovery and resolution of credit institutions. This directive is widely known as BRRD. The BRRD's provisions were transposed into national law in the context of the "Resolution of Credit Institutions and Investment Firms Law" (Law No 22(I)/2016), which replaced Law No 17(I)/2013
- Completion of the harmonisation with European Directive 2014/65/EU, widely known as "MIFID II", with the enactment of the law concerning the provision of investment services, the carrying out of investment activities and the operation of regulated markets (Law No 87 (I)/2017). The law entered into force from Jan-18. For completing the institutional framework of MIFID II, the CBC issued a directive in December 2017, entitled "Protection of Customers' Assets, Monitoring of Products and Inducements Directive of 2017"
- Amending law of the "Sale of Credit Facilities and Related Matters Law", which entered into force in 2018. The new law included provisions in order to improve the functionality of the existing law and facilitate the transactions related to the acquisition of credit facilities

The restructuring of the banking sector continued after the exit from the programme, up until the current period, so as to take advantage of economies of scale and synergies, of the legal framework for the reduction of distressed loans etc.:

- Sale of certain assets and liabilities of Cyprus Cooperative Bank (CCB) to Hellenic Bank (Sep-18), after the former officially collapsed in Aug-18, and transformation of CCB into a credit acquisition company. The latter company took over the management of approximately €7 billion of NPLs not transferred to Hellenic Bank, which reduced significantly the amount of NPLs in the banking system (Figure (5a)), also contributing decisively to the return to investment grade.[8] Prior to the sale-transformation, CCB had the largest network of branches and ATMs and was the first bank in terms of residents' deposits

[8] Central Bank of Cyprus (2019)

- Sale of €2.8bn of NPLs by the Bank of Cyprus in Aug-18 (project Helix)
- Completion in Oct-19 of the acquisition of USB to AstroBank, approved in Apr-18
- In Jul-21, Eurobank announced the acquisition of a 9.9% stake in Hellenic Bank and the conclusion of a share purchase agreement with Third Point Hellenic Recovery Fund L.P. for the acquisition of an additional 2.7% stake, which was completed in Dec-21
- In Feb-22, a few days before the Russian invasion in Ukraine, VTB bank, a Russian majority state-owned bank, sold its controlling stake in RCB to Cypriot shareholders, thus making the bank entirely Cypriot-owned. In Mar-22, the ECB announced its decision to phase out the operations of RCB. The winding up process was completed in Oct-22. A company under this trade name currently operates as an asset management company
- In Apr-22, sale of c.€0.74 billion of NPEs by Hellenic Bank (project Starlight)
- In early Dec-22, Eurobank Cyprus raised its stake in Hellenic Bank from 12.6% to 26% by buying the stake of Wargaming. In end Dec-22 Eurobank bought the 3.2% share of Senvest Management LLC. For companies listed on the Cyprus stock exchange, once the stake of a shareholder is 30% or higher, a public proposal for the majority stake must be submitted. Other Hellenic Bank shareholders are Demetra 21%, Poppy Sarl (Pimco) 17.3%, Wargaming 6.8%, Senvest 1.9%

The completion of the EAP marked the emergence of new trends in figures of economic activity, performance, and sustainability of the banking sector. In particular, total turnover of the four biggest banks[9] for which publicly available data exist throughout the examined period (2016-2021), declined during 2016-2018 and recovered sharply in 2019 (+16.4%), after the return to an investment grade (Figure 4(b)). The implications of the pandemic in 2020 also affected the banking sector, but the lift of the restrictive measures during most of the time in 2021, in combination with the financial support policies backed by the ECB (e.g., Pandemic Emergency Purchase Programme, PEPP, and extension of the Asset Purchase Programmes, APPs) expanded the liquidity of banks and their activity in that year, which reached the highest level since 2016. The bank institutions that overall achieved an expansion of turnover in the post-programme period up to 2021, are Eurobank (cumulative increase: +45.8%) and Hellenic Bank (+21.1%). Bank of Cyprus holds steadily the highest share to total deposits in Cyprus, Hellenic Bank achieved their biggest increase in 2016-2021 because of the acquisition of Cyprus Cooperative Bank (CCB), with Eurobank following in deposits growth terms.

[9] Also, in terms of turnover

Figure 4

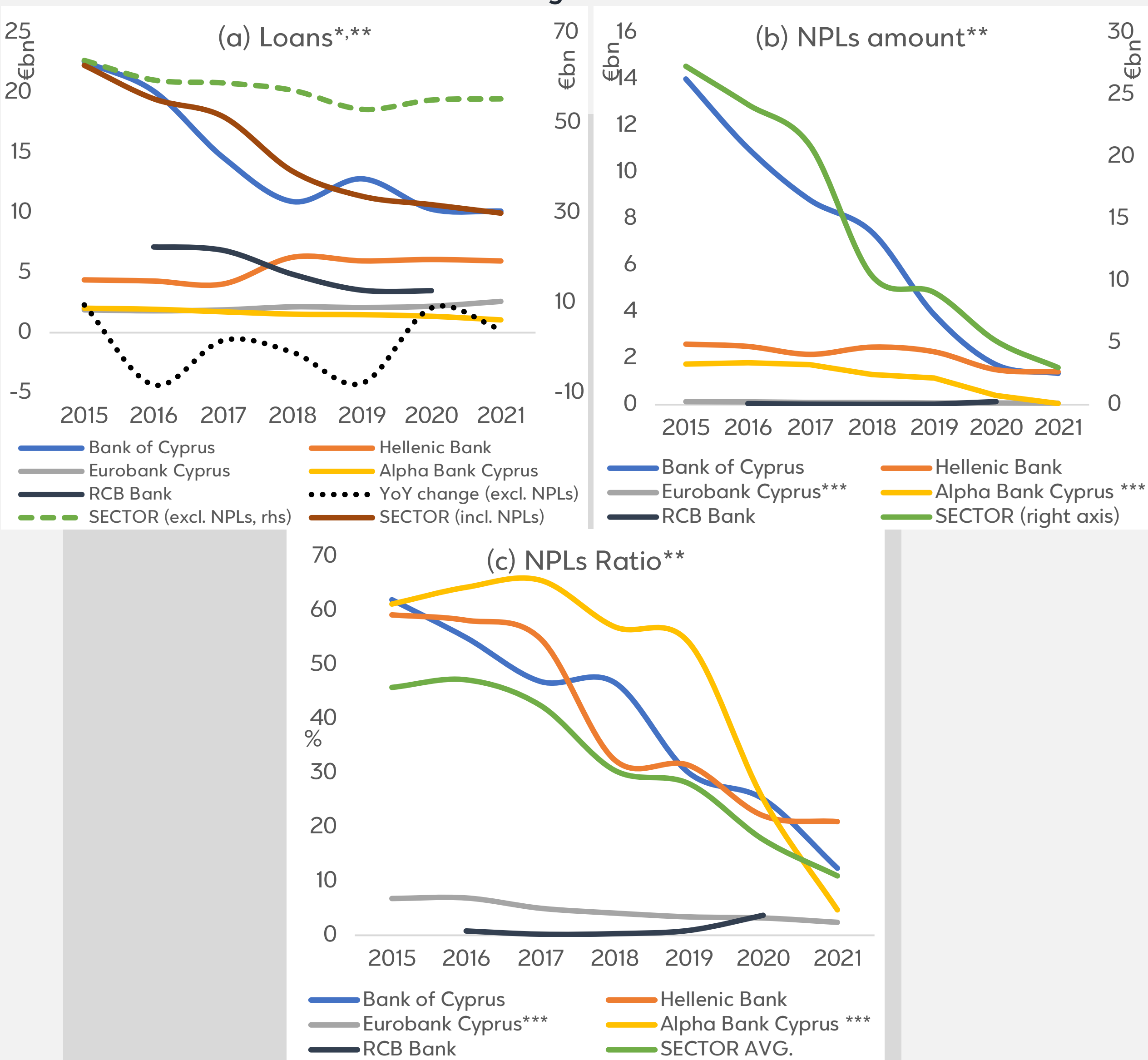
*In net cash flows from operating activities terms
** In total revenues terms
Source: banks' financial statements, Central Bank of Cyprus, Eurobank Research

The above presented crucial developments in the banking sector and the Cypriot economy during 2016-2021 and their effects on business and consumer confidence are reflected in the fluctuations of deposits. The abolition of capital controls in 2015 and the exit from the EAP in early 2016 are considered to be the main reasons behind the steep rise of deposits in 2016 (Figure 4(a)). Pending the return to investment grade and amid restructuring processes in the banking sector in 2018, deposits moderately fell in 2017-2018 and returned on a growth path afterwards, temporarily halted in the first year of the pandemic. On the other hand, deposits were most possibly reinforced in 2021 by emergency support measures to tackle the implications of the pandemic for the private sector.

Regarding the overall economic performance, the economic results (after taxes, government levies) of the banking sector fluctuated significantly in 2016-2021 (Figure 4(c)), to a large extent because of the impact of restructuring processes, such as acquisitions of other financial institutions, impairment of loans and advances to customers, costs of voluntary staff exit plans, as well as because of emergency provisions, e.g., projected credit losses due to the pandemic (additional cost of risk). Indicatively, such effects are largely evident in the economic results of the Bank of Cyprus in 2017-2018 and in 2020, of Hellenic Bank in 2017, 2018 and 2021, of Alpha Bank in 2020. Eurobank was the only financial institution with positive economic results throughout the examined period, RCB also was profitable from 2016 up to the last year of its operations, however Hellenic Bank achieved on average the highest profits (after taxes, government levies) in 2016-2021. The continuous profitability of Eurobank and RCB is linked to the (very) low level of NPLs in their portfolio, as will be shown next.

Regarding developments in the critical issue of non-performing loans, which significantly affected profitability, as analysed above, the outstanding amount of NPLs has been drastically reduced during 2016-2021, as well as their ratio to total loans. Most of the reduction in the absolute level of NPLs was achieved through sales (e.g., transfer of approx. €7 billion of NPLs to the credit acquisition company that preceded the CCB, sale of €2.8bn of NPLs by the Bank of Cyprus in Aug-18 with project Helix and of another €886mn in Jun-20 with Project Helix 2 Portfolio A). The reduction of NPLs was in part achieved through the more careful provision of new loans, e.g., by following a wider set of lending criteria or amending existing criteria to be more demanding. This is reflected in credit growth after excluding changes in NPLs during 2016-2021, which was negative in four out of six years (Figure 5(a)), however without implications for fixed investments that expanded on average by 10.7%YoY, exceeding since 2019 the pre-crisis (2010) level. Consequently, the compound annual growth rate (CAGR) of the outstanding amount of loans excluding changes caused by NPLs was negative, by 2.4%. On the other hand, credit contraction slowed down the fall of the NPLs ratio, as the denominator fell sharp. The CAGR of the amount of NPLs during the examined period was 30.8%, resulting to an overall strong fall of 89.1% (Figure 5(b)). As a result of these two falls, the NPLs ratio stood at 11.0% at end-2021 from 45.8% at end-2015 (Figure 5(c)). According to the most recent data available, the NPLs ratio in Nov-22 stood at 10.5%. Despite the progress in reducing non-performing loans, the NPLs ratio in Cyprus is still much higher than the Euro Area average. Among the most significant financial institutions in Cyprus, Alpha Bank achieved the most extensive reduction of the NPLs ratio during the examined period (-565bpts, to 4.7% at end-2021), followed by the Bank of Cyprus (-496bpts, to 12%). Eurobank had the lower average NPLs ratio in 2016-2021, at 4.2%, reflecting the small amount of non-performing loans in the bank's loan portfolio perennially.

Figure 5



*outstanding amount, unless otherwise specified
**end-year level, ***non-performing exposures data
Source: banks' financial statements, Central Bank of Cyprus, Eurobank Research

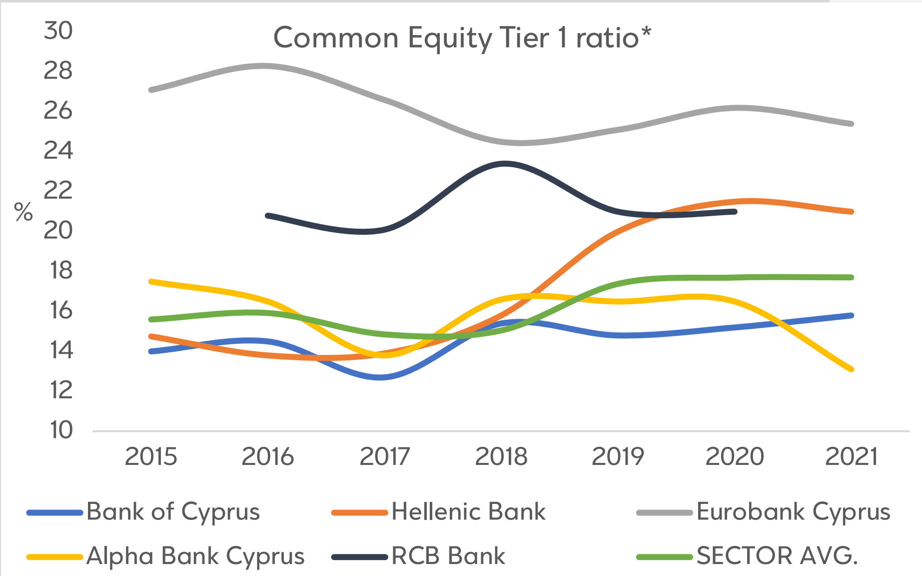
Besides the strong downward trend in NPLs, the amount of Stage 2 loans (according to IFRS 9)[10] remained elevated at end-2021 compared to the pre-pandemic period, at 16.1% of serviced loans from 12.6% in Dec-19 and 14.2% in Dec-18.[11] At the beginning of the pandemic, Cypriot banks moved a large part of their exposures to tourism and transport businesses into Stage 2, which entails a higher level of risk, as both sectors were heavily affected by the COVID-19 crisis. Later, part of these exposures was reclassified as Stage 1.[12]

[10] Stage 2 assets are financial instruments that have deteriorated significantly in credit quality since initial recognition but offer no objective evidence of a credit loss event
[11] Central Bank of Cyprus (2022)
[12] Stage 1 Assets in the context of IFRS 9 are financial instruments that either have not deteriorated significantly in credit quality since initial recognition or have low credit risk

Cyprus remained in 2022 among the EU countries with the highest proportion of Stage 2 and Stage 3 exposures,[13] together comprising 24% of the loan portfolio.[14]

Regarding trends in indices concerning capital adequacy, after improving during the EAP, the Common Equity Tier 1 (CET1) ratio decreased moderately in 2017 and 2018 compared to previous years (to 14.9-15.1% from 15.6-15.9% in 2015-2016), mainly because of additional provisions for doubtful debts (Figure 6). In 2019 the CET1 increased significantly, by 230bpts, to 17.4% and improved marginally in 2020-2021 (to 17.7% in both years), despite the implications of the pandemic. The latter were to some extent tackled by means of the prudential measures adopted in Jun-20 in the context of the Capital Requirements Regulation (the so-called "Quick Fix" set of measures), mainly from the advanced application of the SME and infrastructure supporting factor, which allows for a more favourable treatment of certain exposures, thus supporting credit flows to these two segments of the economy under the adverse economic conditions caused by the COVID-19 pandemic. Banks' cautiousness in providing loans in 2020-2021 also kept the CET1 relatively un-affected by the pandemic. In Sep-22, the CET1 had improved further relative to end-2021, to 18.0%, based on the latest data available. Among the most significant financial institutions, Eurobank steadily performs better in CET1 (avg. 2016-2021: 26.0%), followed by Hellenic Bank (17.7%) and Alpha Bank (15.5%). RCB was achieving a high CET1 up to 2020, based on available data (avg. 2016-2020: 21.3%).

Figure 6



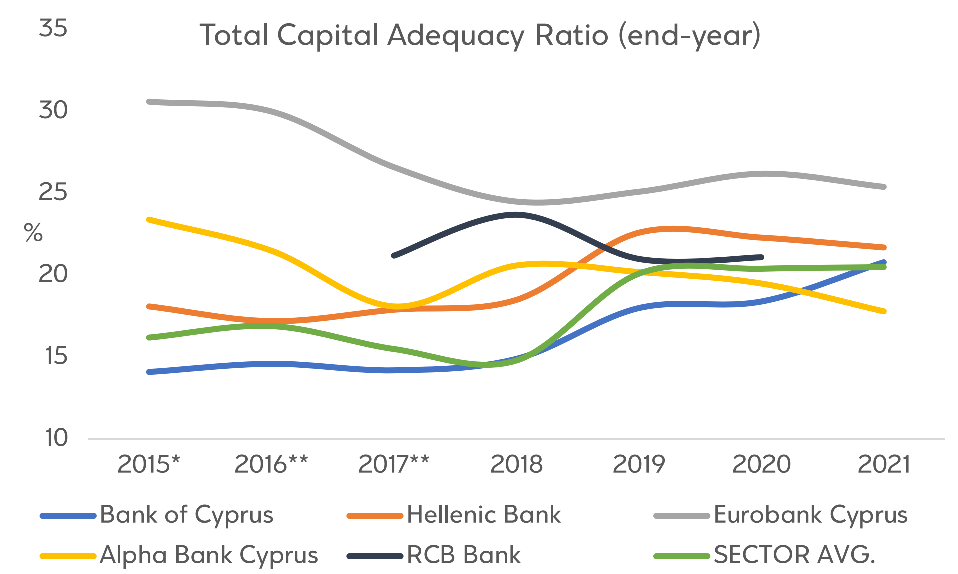
*End-year values. Including transitional provisions at bank level
Source: banks' financial statements, Central Bank of Cyprus, Eurobank Research

The Capital Adequacy Ratio index (CAR) had a similar fluctuation in 2016-2021 with the CET1 index, at bank level, as well as for the overall banking sector, albeit at somewhat higher levels. The rebound of the CAR in 2019 after the worsening in 2017-2018 was stronger compared to the increase of the CET1, most possibly due to the overall strong impact of loan portfolio restructuring by certain banks in 2019 to reduce their

[13] Stage 3 loans are considered credit impaired, i.e., a loss has occurred
[14] European Commission (2022)

NPLs. Since 2019, the CAR index for the banking sector stands slightly above 20% (Figure 7). Among the most significant banks, Eurobank performs better also in terms of the CAR index (avg. 2016-2021: 26.9%), with Alpha Bank (20.2%) and Hellenic Bank (19.8%) following. RCB was also achieving a high CAR up to 2020, according to available data (avg. 2016-2020: 21.8%).

Figure 7



*June value at sector level, **September value at sector level
Source: banks' financial statements, Central Bank of Cyprus, Eurobank Research

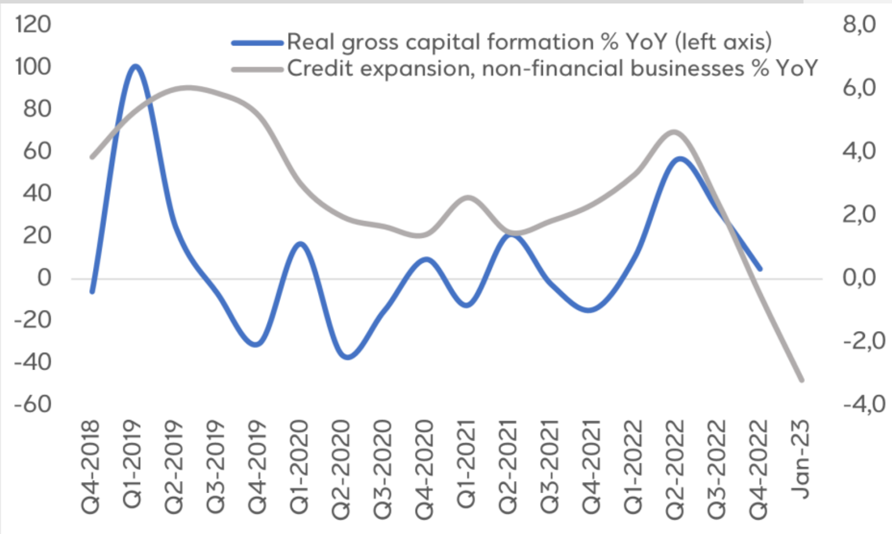
From the above analysis it is understood that reforms on the regulatory and supervisory framework of the banking sector continued after the completion of the EAP at a slower pace, which was largely expected given the number and importance of changes during the programme. The restructuring of the banking sector did not lose as much steam, both between (acquisitions) and within banking institutions (drastic reduction of NPLs, voluntary staff exit plans, restructuring of branch networks). Trends in indices of banks' economic activity, performance, and sustainability show that the continuing restructuring-consolidation procedures and extensive efforts to reduce the high NPLs legacy of the past leave their imprint on the sector's economic results and will continue to do so for some years ahead, although results are gradually improving. The amount of NPLs was drastically reduced, as well as their ratio to total loans, with most of the reduction achieved through sales and in part through the more careful provision of new loans, reflected in credit contraction during most of the said period. Despite the strong downward trend in NPLs, the amount of Level 2 loans (Stage 2 according to IFRS 9) remains elevated compared to the pre-pandemic period, as well as relative to the Euro Area average (at 7.5% in Sep-22 excluding cash balances vs. 1.84%). Capital adequacy improved further from 2019 onwards, in terms of CET1, despite the implications of the pandemic, which were to some extent tackled by means of extraordinary amendments in the Capital Requirements Regulation ("Quick Fix" set of measures), mainly those concerning the favourable treatment of SMEs' loans.

5. Challenges-priorities for the banking sector ahead

The banking sector in Cyprus underwent a massive restructuring process during the Economic Adjustment Programme period, but also after it, with some characteristics unprecedented for an EU country, a process that is still ongoing. It involved, inter alia, resolutions (one with the full contribution of equity shareholders, bond holders and uninsured depositors), the implementation of the bail-in method on uninsured deposits, recapitalisations, acquisitions from other banks, bank transformations (e.g., to credit acquisition company).

Furthermore, extensive restructuring of the sector's assets has been implemented, focusing on drastically reducing non-performing exposures and strengthening the capital base. These efforts resulted in significantly limiting the NPLs ratio, despite some adverse implications of the EAP for economic activity in Cyprus and private debt servicing. Nonetheless, the NPLs ratio is currently still the highest in the Eurozone (excluding NPLs held by the Central Bank), implying that a further reduction is needed.[15] Also, the NPLs fall was partially based on cautious new lending so as to limit exposure of loan portfolios to potential further threats for their quality, which resulted to credit contraction in most years from 2013 onwards, with negative effects on economic growth; it has to be noted that the correlation in Cyprus between the trend in credit to business and that in investments is high, usually with a few quarters time lag (Figure 8). Accordingly, the restoration of credit expansion on a relatively permanent basis should be included in the main targets of the banking sector, without undermining the qualitative characteristics of new borrowing. Below in this section some approaches to tackling the high NPLs ratio are presented, which in turn could facilitate banks in steadily rising credit. Significant capital resources for the Cypriot economy are available up to the medium-term, which could support credit growth. The relevant financing programmes are also presented in the remainder of this section, along with some indicative sector proposals for channeling the new credit.

Figure 8



Source: CYSTAT, Central Bank of Cyprus, Eurobank Research

[15] European Central Bank (2023)

Towards further improving the quality of loan portfolios, the elevated amount of Stage 2 loans should also be gradually limited, to return to pre-pandemic period levels.

Regarding the achieved strengthening of capital adequacy, the Common Equity Tier 1 (CET1) index value remains well above the 9% minimum requirement by the ECB already since 2014. Furthermore, the CET1 index exceeds the Eurozone average since 2018, which is remarkable for a banking sector that has been under such extensive restructuring.[16] However, the relative stability of CET1 in the range of 18% in 2020-2022, has been partially achieved by means of the "Quick Fix" set of prudential measures within the context of the CRR, especially of those concerning SMEs. In order to avoid potential fluctuations of CET1 when the "Quick Fix" is eventually terminated, it would be better to implement precautionary measures and policies to further strengthen the capital adequacy of the banking sector. Some relevant approaches, related to the use of the "Quick Fix" toolkit in Cyprus, are presented below in this section.

It is noted that some of the available measures and policies concerning the above issues presented below could tackle to some extent more than one of them simultaneously.

Specifically, developments on the issue of the protracted foreclosure suspension, e.g., through a drastic revision of the scope of the current scheme to cover those borrowers in real need of protection, will contribute to organically deleveraging banks' NPL portfolios, improve the conditions for NPL sales, facilitate loan servicers and credit acquiring companies to resolve NPLs. According to the latest estimations available, currently NPLs of €12-14bn fall under the foreclosure suspension, of which €8–10bn are held by credit acquisition companies, another €600mn – €1bn from banks and approx. €2.9bn from the Housing Finance Corporation (ΚΕΔΙΠΕΣ). The amount held by banking institutions currently corresponds to 22-36% of their NPLs, thus it constitutes a significant part of them, which could be reduced after significant revisions in the foreclosure suspension framework. The very high stock of NPLs under this protection scheme held by CACs is a major deterring factor to banks providing new lending, not only to respective loan holders, but also through its repercussions for the functioning of the real estate market, thereby inhibiting investment and consequently economic growth and improvement of competitiveness. These implications make clear the significance for the economy of Cyprus of effectively dealing with the issue of foreclosure suspension in the period ahead.

A further reduction of banks' NPLs could be achieved with means of the systemic solution that will emerge from the relevant study recently commissioned by the Central Bank of Cyprus to a consortium of international consulting firms, with proven experience in deleveraging methods of the financial sector worldwide, according to the relevant announcement. The scope of the study extends over other problematic assets of the Cypriot banking system as well. The new approach is not intended to replace the existing tools for reducing NPLs but to have a role complementary to this procedure. Evidently, the results of approaches implemented so far in Cyprus to limit non-performing loans should be taken into account, with a particular attention on the characteristics of those approaches falling behind target, in order to trace and resolve potential drawbacks, but also on international best-practices, from countries with same structural characteristics in their NPLs etc.

Financial resources from NextGenerationEU and the MFF 2021-2027 are considered of vital importance for strengthening credit expansion towards businesses in the medium-term. The disbursement in December

[16] Ibid.

2022 of €85mn, from the first tranche from the RRF, the main financing mechanism of NextGenerationEU, urges for speeding-up the implementation of financing programmes in the context of the national Resilience and Recovery Plan (RRP). Of utmost importance for the banking sector is the activation of the loan-arm of the RRF, with a budget of €0.2bn. According to Cyprus's RRP, 41% of the available resources will be headed towards the Green Transition target and another 23% is earmarked for the Digital Transition target. The economic sectors and investment areas which are expected to be mostly benefited by the RRP and will be in need also of bank financing, are energy production based on renewable resources, the ICT sector, circular economy activities (e.g., sewage and waste management), health services, the primary sector (e.g., aquaculture) and tourism. The recovery of the latter sector was strong in 2022, with revenues rising by 63.2%YoY in the Jan-Nov '22 period, reaching 90.6% of receipts in 2019, and its performance in gross value-added terms standing at 68.7% of the 2019 level (an all-time high), 21 ppts higher than in 2021. Provided that the growth dynamics continue in the coming years, even significantly weaker (e.g., +20%YoY in GVA terms), the sector could have fully recovered its pandemic output losses in a two to three-year period and grow further afterwards. Such a growth trend will have spillover effects to other sectors such as transport, real estate activities, wholesale-retail trade.

Undoubtedly, the energy sector has the strongest growth potential in Cyprus in the medium and long-term horizon, if the estimations about the capacities of the already detected natural gas fields are confirmed and their extraction is feasible, for qualitative, technical and geopolitical reasons. Two new gas fields were detected in 2022, namely "Zeus 1", with an estimated capacity of 3.5 trillion cubic feet, and Cronos 1" (2.5 trillion cubic feet). These two taken together with the two other gas fields detected in previous years ("Glaukos" (est. 5-8 trillion cubic feet), "Aphrodite" (4.2 trillion cubic feet) raise the total potential capacity of the gas fields already identified to 15.2-18.2 trillion cubic feet (approx. 2.62-3.14 bn oil barrels or 22.6%-27.1% of total OPEC crude oil production in 2021). In case these and other gas fields that could be detected in Cyprus are gradually exploited, the country's role to Europe's energy balance and independence will be significantly upgraded, and unprecedented amounts of FDI inflows for extracting and transport will boost GDP growth, through considerably higher investment and exports.

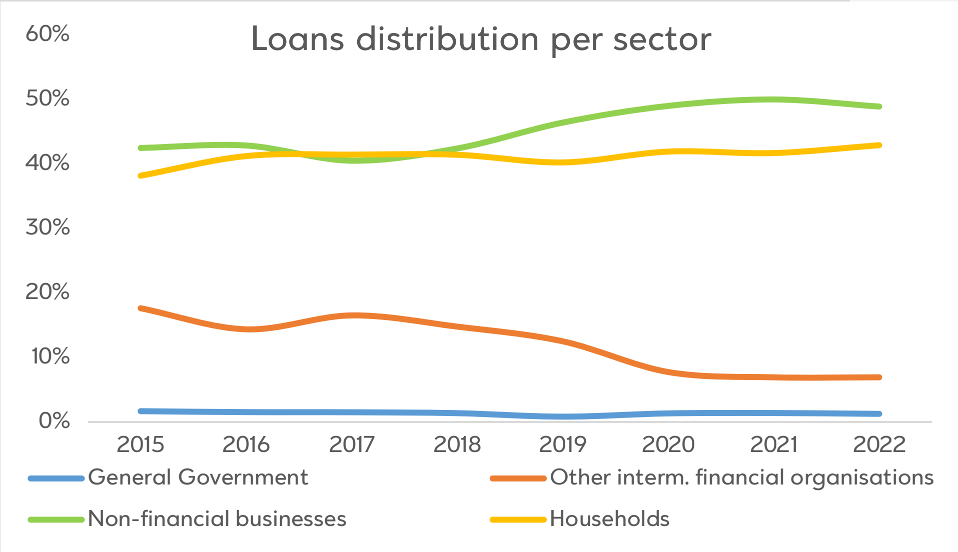
Another sector with a strong growth potential in the medium-term is the ICT sector. Taking advantage of the "Strategy for Attracting Businesses for Activities or/and Expansion of their Activities in Cyprus", ratified by the ministerial council in Oct-21, more than 1100 companies with more than 9000 employees have been registered in the Business Facilitation Unit of the Ministry of Energy, Commerce and Industry since the beginning of 2022.[17] These companies and employees, many of which have moved to Cyprus with their families, have already boosted consumption, professional services and the real estate sector and are expected to strengthen exports. On the other hand, part of their profits will be repatriated to the homeland of investors. If the maximum number of the digital nomad visas is increased, as happened in Mar-22, these dynamics will be reinforced.

Regardless of the anticipated boost to credit and probably to certain economic sectors from the above resources, the banking sector in Cyprus has proceeded since 2018 to a gradual restructuring of its loan portfolio with respect to main sectors of the economy financed. From that year onwards, up to 2022, the proportion of outstanding loans to non-financial businesses to total loans exceeds the respective ratio of

[17] European Commission (2022)

loans to households, which was relatively unchanged in the same period, indicating a shift to the financing priorities of banks towards supporting the production side of the economy. Specifically, during 2018-2022, the share of outstanding loans to non-financial businesses to total loans increased by 8.4ppts, to 48.9%, whereas the share for other intermediate financial organisations, comprising supplementary financial institutions, investment organisations and subsidiaries of financial institutions, moved downwards, by 9.6ppts, falling to 6.9% (Figure 9).

Figure 9



Source: Central Bank of Cyprus, Eurobank Research

On the issue of improving the quality of loan portfolios, the course of the tourism sector is of importance; as previously analysed, the 2022 recovery was strong. If this continues in the coming years, even with a slower yet fast pace, a significant part of exposures to tourism and transport businesses currently falling under Stage 2 assets (according to IFRS 9) due to the pandemic, implying a higher level of risk, could be gradually moved from this class of assets to Stage 1.[18] For this to happen, an improvement in debt servicing on the part of businesses in these sectors is also essential. Such a shift in loan classification, in combination with a further reduction of NPLs through the policy recommendations analysed above (drastic revision of the foreclosure suspension, potential new systemic solutions that will emerge from the study commissioned by the CBC), would also contribute to the strengthening of measures of capital adequacy, such as the CET1 and the CAR.

The above recommendations about the challenges that the Cypriot banking sector is currently facing, as well as other existing potential approaches-solutions to them, indicate that, besides the significant achievements in the period 2013-2022, concerning the sharp reduction of NPLs, much improved economic soundness of banks, as well as their heightened importance for the economy of Cyprus, also under periods of strong crises (e.g., COVID-19 pandemic, war in Ukraine), there are plausible prospects for further progress

[18] Stage 1 assets comprise financial instruments that either have not deteriorated significantly in credit quality since initial recognition or have low credit risk

in these fields, from the period ahead up to the long-term horizon. However, given the extensive restructuring that the banking sector has been in during the last decade, drastically changing the market structure and the banking institutions internally, what the sector is mostly needed in the next years is organic growth. This can be based on a number of factors, such as the above analysed sector growth prospects, especially in the energy, tourism, transports, ICT, real estate sectors, the significantly upgraded credit rating of banks to attract equity and the previously presented ample sources for investment funding (NextGenerationEU, MFF 2021-2027). An exit of the Cypriot and the EU economy from the implications of the pandemic and the war in Ukraine could further reinforce these favourable prospects. In turn, along with the already identified measures, organic growth could contribute to further reducing the NPLs ratio and strengthening capital adequacy and profitability, safeguarding the key role of the banking sector to supporting the long-term growth dynamics of the Cypriot economy.

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