Cyprus Banking INSIGHT

ASSOCIATION OF CYPRUS BANKS

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BULLETIN

Dr Michael Kammas

At the issue of the present edition of "The Cyprus Banking Insight" the world's economy begins to tentatively emerge from recession. At the same time, Cyprus' economy where the business cycle traditionally lags 6 months behind that of the rest of Europe, is just now slowing down. According to the latest estimates, Cyprus' economy is expected to shrink by 0.5% in 2009, compared to a decline of 4.2% for the eurozone.

Given this negative environment, Cyprus Banks are championing the interests of their clients, stakeholders and the Cypriot economy in general. Cyprus Banks have secured loans from the European Investment Bank and are in the process of lending these funds out to small and medium enterprises. Furthermore, the Banks are working together with the Cyprus Government and the Central Bank of Cyprus to pursue additional measures to maintain adequate levels of liquidity in the market through the issue of special government bonds and through covered bonds (as soon as the legal framework is in place). By remaining profitable and maintaining healthy levels of capital adequacy and liquidity and by pursuing rigorous risk management activities, banks uphold their credit ratings, which enable them to borrow funds at competitive rates.

Looking ahead, a number of new opportunities await our members. At long last, the Cyprus Parliament has voted for amendments in the tax regime which relate to collective investment funds. The new laws clarify the tax regime and provide tax incentives for investing in such funds. As a result, the way is now clear for the development of UCITS and other collective investment schemes in Cyprus. In addition, Cyprus' inclusion in the OECD's "white list" of jurisdictions and the effective removal from Russia's list of territories offering preferential tax treatment validate our country's reputation as a sound financial centre and preferred holding company jurisdiction.

It can be seen that apart from navigating the year ahead, which is expected to be a difficult one for our economy, the government and economic players should focus on sowing the seeds of future growth and developing our financial industry further in the context of rapid European and global developments.

In this issue, we are happy to present an article from KPMG and Bank of Cyprus Public Company Ltd as well as two articles from Hellenic Bank Public Company Ltd.

Dr. Michael Kammas
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Newsflash: Tax incentives for the establishment of collective investment funds

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Even though Cyprus has harmonized its mutual fund regime with the UCITS Directive in 2004, the tax laws that have been in place until now have proved prohibitive for the development of investment funds. The tax regime has finally been rectified in October 2009, when the Parliament voted through a number of amendments which clarify the tax regime as well as provide tax incentives for investing in collective investment funds. The amendments relate to investment in both UCITS and non-UCITS and can be summarized as follows:

- Investors in such funds are not liable for any income tax upon disposal or redemption of their units / shares.
- Investment funds pay income tax of only 10% on interest received.
- Dividends received by the fund from abroad are exempt from tax (under certain conditions)
- Cypriot investors in collective investment funds are liable to a reduced tax rate of deemed dividend distribution (3% as opposed to 15% tax on deemed dividend distribution in other companies).

The new tax regime (which is applicable for the tax year 2009 onwards) is summarized as follows:

Income	Taxation of Investment Fund
Interest received	10% income tax on interest revenue less interest-related expenses
Dividends received from Cyprus companies	Exempt
Dividends received from overseas companies	Exempt (under some conditions)
Grains on disposal of titles	Exempt

Income	Taxation of Investment Fund
Deemed Dividend Distribution	Non-residents exempt, Cypriot investors pay 3% on 70% of taxable profits of collective investment scheme
Dividends received from investment fund	Non-residents exempt, Cypriot investors pay 15% on dividends
Gains on dispodal of units	Exempt

Challenges raised by the recent policy measures on Deposit Guarantee Schemes

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Deposit Guarantee Schemes (DGS) ensure the safety and liquidity of retail depositors, protect the financial system against bank runs and promote financial stability. The financial crisis has revealed a number of weaknesses in the operation of DGS and the functioning of the internal market. Recently, the European Commission (EC) proposed and implemented a number of changes to the DGS Directive in order to better protect depositors, ensure public confidence in the financial system and improve financial stability. Nevertheless, further improvements are required in order to eliminate competitive distortions caused by differences in national DGS arrangements. I will refer to three of these issues explaining why a higher degree of harmonization among DGS needs to be considered.

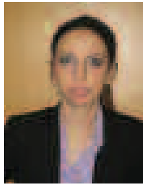
First, is the absence of solid guidance on the funding arrangements of national DGS. It is important to mention that sound funding arrangements are critical to the effectiveness of a DGS. Basically, there are two ways of funding national DGS, the ex ante and the ex post systems. The ex ante funding system involves the advance accumulation and maintenance of funds, prior to a bank failure occurring, to cover deposit claims. The ex post funding system requires banks to provide funds only upon a bank failure and a need to cover claims. The absence of uniform rules regarding the funding method to be applied by all national DGS leads to competitive distortions and an unlevel playing field, both for the banks and for the depositors. Some banks, even banks operating within the same member state, have to pay higher fees to the schemes while other banks pay lower fees or no fees at all. The ex post system is less expensive than the ex ante system as there are no advance contributions and premiums are not collected on a regular basis. On the contrary, the ex ante system ensures a readily available pool of funds to cover deposit claims prior to a bank failure actually occurring, it is more rule based, offers greater certainty and is more equitable because member banks, including those that fail, will help cover the costs through previously regular payments into the fund. The ex ante funding system seems to favour depositors as well because the knowledge that funds have been raised in advance reassures depositors of the safety of their bank deposits, reinforces public confidence in the banking system and minimizes the risk of a bank run. Therefore, the uniform application of an ex ante funding system at the EU level will establish a level playing field and eliminate all competitive distortions in the banking sector.

Second, is the presence of moral hazard implications of DGS. This refers to a situation where an insured bank intentionally pursues added risks because it can shift losses to the DGS. Usually, the higher the extent of the guarantee the greater the risk of moral hazard. This issue is closely related to the funding method of national DGS. Under the ex post funding method all member banks are assessed at the same rate thus penalizing the more prudent managed banks. In the absence of any disincentive not to engage in unsound and risky activities, low-risk banks subsidize higher-risk banks. All these concerns can be narrowed to a great extent by introducing the ex-ante funding risk based contributions method. The ex ante risk based funding system incorporates the risk of the bank into the contribution structure so that banks which pose higher risk for the DGS pay higher premia. This creates the right incentives for banks to take a more prudent approach to risk management, thus eliminating to a certain extent moral hazard problems and competitive adversities between DGS member banks.

Third, is the coexistence of different levels of deposit protection provided to depositors within the same country. This is especially obvious in the case of local banks and branches of foreign (EU / non-EU) banks operating in the host country. The branches of foreign banks belong to the home country's DGS which in some cases offers lower deposit protection than the host country's DGS. In this case the host country's banks (local or foreign subsidiaries) are at a disadvantage because their funding cost is much higher than that of the foreign branches. During times of stress this can create or cause a lack of coordination between the relevant authorities of the home and host countries. The recent financial crisis has illustrated the importance of this issue and problems and confusion it can create, both for the banks and their customers (UK and Iceland). Recently enforced EU rules stipulate that the minimum deposit guarantee amount should be €50,000 (subsequently €100,000 as of end 2010) across EU countries, but there are still DGS in some countries that offer a higher deposit protection.

A well function DGS contributes to the integrity of a country's financial system and promotes financial and

economic stability. In order to meet its objectives of protecting small depositors and maintaining public confidence, sound and adequate funding arrangements must be in place. The diversity of the DGS within the EU, especially the different funding arrangements, causes several adverse implications that lead to competitive imbalances between EU banks. Lately, there is growing debate about the possibility of setting up a pan-European DGS. Despite the fact that this solution offers some benefits it is important to analyse thoroughly the main features of such a pan-European DGS (coverage, membership, functioning and funding arrangements) before any decisions are taken. No DGS, by itself, will be able to contend with a large scale financial crisis. The gap between resources and financial obligations is usually covered by giving DGS access to additional financing, either from the government or the market.



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Cyprus Special Bond Issue: Basic Facts Report

In the light of the financial turmoil, Cyprus as many other Member States, has finally enacted a 'Special Bond Issue' Legislation, aiming mainly to restore the confidence in the financial markets and the enhancement of liquidity. The 'Special Bond Issue' is to be used as collateral by eligible credit institutions for obtaining liquidity from the European Central Bank and/or interbank market.

The basic facts stated in the Special Bond Issue Legislation and in the ministerial decree (Decree) enacted for implementation reasons, are stated in summary herein.

a) **Nature of Issue:** The issuance and lending to eligible credit institutions of up to EURO 3 billion worth zero coupon special government bonds. These bonds are to be listed on the Cyprus Stock Exchange, are to be issued and allocated in nominal value, in packages of ?1mln,against payment of a commission to the Cyprus Government.
b) **Length of measure:** The maturity of the special bond is up to three years and the offering of bonds to eligible institutions is to last for six months from the entry into force of the Decree
c) **Eligibility requirements** for beneficiary credit institutions (Eligible Institutions)

The Special Bond Issue Legislation and Decree lay down a number of eligibility requirements that eligible institutions need to comply with, in order to be able to apply for special government bonds.

The most important requirements are as follows:

> *The issuance and lending to eligible credit institutions of up to EURO 3 billion worth zero coupon special government bonds.*

-Types of Institutions: Eligible Institutions are credit institutions which were granted a license by the Central Bank of Cyprus (CBC) and the Authority for the Supervision and Development of Cooperative Credit Institutions (ASDC) to carry out activities in the Republic of Cyprus, not excluding subsidiaries of foreign credit institutions.

-Allocation of liquidity: The eligible institutions must contribute to the financing of domestic households and SMEs as at 31 December 2008, calculated on the basis of each credit institution's aggregate domestic market share in business and housing loans.

-Assignment of collateral: The Eligible Institutions should assign adequate collateral to the Government of Cyprus. The collateral is to be kept at the CBC or Authority for the Supervision and Development of Cooperative Credit Institutions and is going to be assigned by virtue of bilateral agreements to be signed with the eligible credit institutions.

- Capital Adequacy Ratios: Eligible Institutions will need to maintain capital adequacy ratios of more than 8%.

- Restriction of access: Each Eligible Institution may not have access to special government bonds having an overall value exceeding 7% of their client deposits as at 31 December 2008.

Collateral Eligibility Criteria

The Decree specifies the level of haircuts to be applied to collateral provided by the eligible institutions to the Cypriot government in return for the special bonds allocated to them.

In addition the Decree states the kinds of the different categories of eligible collateral. These eligible collateral include amongst others: (i)any kind of collateral which is eligible in the Eurosystem,(ii) loans completed with physical persons having a loan to value ratio of 80%, which are guaranteed by a domestic residential property mortgage, (iii) any kind of loans which the CBC and the Authority for the Supervision and Development of Cooperative Societies decides upon its discretion.

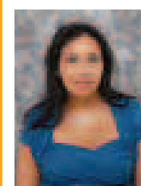
Reporting Obligations
The Decree foresees quarterly reporting obligations for eligible institutions to be sent to the CBC.

Role of the Central Bank
The Special Bond Issue Legislation requires a recommendation of the Governor of the CBC prior to the adoption of any ministerial decrees determining the terms of its implementation.

Monitoring of the 'Special Bond Issue'
A special committee comprising of six expert members, is going to be set up, for the proper implementation of the 'Special Bond Issue'. The latter committee shall have the task of monitoring the draft law's implementation and ensuring that the liquidity secured by beneficiary credit institutions benefits domestic borrowers and the national economy at large.

As a conclusion it is important to note that in the wake of the enactment of the legislation on "Covered Bonds", the Special Bond issue is a considerable opportunity for the credit institutions to enhance their liquidity, thereby indirectly contributing to a attenuation of the pressure on lending interest rates.

Suggested measures to enhance Cyprus' attractiveness as financial services centre


Christina Pierides
Senior Officer
Financial Markets

Through its favourable tax system as well as its strong banking and professional services infrastructure, Cyprus has succeeded in establishing itself as a reputable International Financial Centre. Accession to the EU, and the elimination of exchange rate risk through adoption of the euro, have positioned Cyprus to become an ideal gateway for inbound and outbound EU investors.

There are many opportunities to build on this success. Indeed, the Ministry of Finance has set as priority the enhancement of Cyprus's attractiveness as a financial services centre. It can be seen that a number of important factors are already in place, since Cyprus offers one of the lowest tax rates in the EU and has negotiated a number of advantageous double tax treaties, while at the same time complying with all EU requirements as well as OECD requirements against harmful tax practice. Moreover, the island is strategically located and has high living standards, the labor force is highly qualified and there is a wide network of legal, accounting, banking and shipping services.

In the midst of the financial crisis, there have been some external developments that create new opportunities towards the above goal. Following a renewed global resolve to act against tax havens, the OECD has included Cyprus in a "white list" in recognition of the island's implementation of internationally agreed standards of cooperation. Additionally, Cyprus and Russia have successfully renegotiated their double-tax treaty, effectively ending the inclusion of Cyprus in Russia's "blacklist" of countries offering preferential tax treatment.

In order to seize the external opportunities and further increase Cyprus's attractiveness as a financial services centre, we outline below our suggestions for measures that need to be taken:

1) Non-UCITS legislation

The current law addressing funds such as hedge funds, funds targeting professional investors and high net worth individuals (collectively referred to as non-UCITS), is outdated. Furthermore, it allows for the registration of private investment schemes but does not allow for the registration of investment schemes targeting professional investors. With an updated legislation, Cyprus will be well placed to cater to the increasing demand for registration of funds from Russian and other third countries which are looking for an EU-regulated jurisdiction to be based in.

Another problem that needs to be addressed is the regulation of UCITS and non-UCITS funds by two separate regulators.

2) Enhance sophistication of local capital market

Legislation is now being drafted to permit the issuance of covered bonds. This effort should be intensified. As far as sovereign debt is concerned, there is a need to restructure the primary and secondary market for government bonds since at present there is no depth in the market and the secondary market is practically non-existent. These problems have been identified several years ago and the decision was taken to restructure the operation of the primary and secondary markets, while introducing primary dealers. However, there have been substantial delays in implementation.

3) VAT reform

A number of steps can be taken to clarify the VAT regime by issuing detailed guidance on the VAT treatment of financial services. This would reduce the number of rulings requested from VAT authorities and in turn would reduce the administrative burden for financial services companies and government authorities alike.

A further measure would be to allow for the creation of cost-sharing groups in the financial services sector. This would have the effect of allowing a financial organization to pool investments and re-distribute the costs for these investments exempt from VAT from the group to its members. This would make it attractive for financial organisations to set up centres of excellence to take advantage of economies of scale. In combination with Cyprus's favourable income tax regime, this measure is expected to attract foreign direct investment as financial groups from EU members and third countries would find it attractive to locate their centres of excellence here.

4) Efficiency of regulators

Following Cyprus's accession to the EU, numerous financial and investment services firms have been attracted to Cyprus, taking advantage of the EU passport to offer their services to clients across the EU. The number of regulated firms has increased from 18 prior to EU accession to around 70 to date, and numerous more firms are anticipated, especially from Russia. It is important for the local regulator to have in place all necessary resources and organisational set up to be able to respond quickly to their questions and permit requests. In the area of company registration, procedures should be automated to expedite registration. It takes 2 – 3 weeks to register a company in Cyprus, whereas competitive jurisdictions boast registration periods of 2 – 3 days.

5) Leasing

Currently in Cyprus the only type of leasing being offered is hire-purchase, whereas financial leasing is not very widespread due to the existence of tax disincentives. It is necessary to amend the tax legislation in order to remove these disincentives.

To conclude, it needs to be emphasized that the above measures should be implemented without any further delay. Global developments in the financial sector are fast and volatile, and any delay of two or more years to implement the above could mean that the opportunity to create a competitive advantage for Cyprus would pass us by.

Legal Framework for Open Ended Collective Investment Schemes in Cyprus

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Recently, there has been an increasing demand for the registration of private funds in Cyprus (from Russia, CIS countries, central Europe, the Middle-East and Gulf Countries). Currently, there are around 50 private funds, mainly private equity in investment strategy, and around 12 real estate funds. Funds addressed to experienced investors are only now beginning to emerge, but their number is expected to increase due to recent tax incentives given by the Government (as explained in "Tax Incentives for the Establishment of Collective Investment Funds"). Presently, officials have 15 applications before them (both private and addressed to experienced investors).

Legal Framework

Opened Ended Collective Investment Schemes in Cyprus are governed by two different pieces of Legislation: first the Undertakings for Collective Investment in Transferable Securities (UCITS) Law, which transposed the EU Directive; and secondly the International Collective Investment Schemes Law (ICIS Law), which is a national law.
The UCITS law concerns funds addressed to the general public and the competent Supervisory authority is the Cyprus Securities and Exchange Commission, while the ICIS Law concerns private funds (i.e. funds not addressed to the general public with up to 100 unit holders) and funds addressed to experienced investors. The competent Supervisory Authority is the Central Bank of Cyprus (CBC). Below follows a description of the ICIS Law.

Legal Forms

Under the ICIS legislation a fund may take one of the following forms:

1. International Fixed Capital Company (SICAF equivalent)
2. International Variable capital company (SICAV equivalent)
3. International Unit Trust Scheme
4. International Investment Limited Partnership

All four types may be established with limited or unlimited duration and may be open-ended or closed-ended. In addition, the Law allows the funds to be structured in such a way as the promoters may determine, provided however that adequate protection is in place for the unitholders.

Manager, Custodian

Under the Law, a fund must have a manager and a custodian, which must act independently of each other. It is noted that a private fund is not obliged to appoint a manager or custodian, but in practice the CBC requires their appointment.

A manager must have sufficient financial and operational resources and sufficient investment expertise to meet its liabilities and to enable it to conduct its business effectively. In practice, the Manager may be a Cyprus Investment Firm or an investment Firm based abroad. Alternatively the directors of the Fund may act as its Managers.

A custodian may be a Cypriot bank or bank in a country which in the opinion of the CBC exercises equate banking supervision in its jurisdiction; or indeed any other person, which provides trustee services to the public at large; or a company incorporated in Cyprus which is a subsidiary of either a bank or a trustee company. So, far the CBC allows banks to be custodians, but it remains possible, depending on the structure, to allow Cyprus Investment Firms or an Investment Firm abroad to act as custodians.

Funds addressed to Experienced Investors

Under the Law, an experienced investor is a natural or legal person that provides financial services or frequently enters into investment transactions of substantial size, taking also into account the risk involved.

A fund marketed to experienced investors must contain in its constitutional documentation and offering memorandum clearly defined rules and procedures in order to ensure that marketing of the fund is restricted to experienced investors. There is also a minimum subscription of USD 50,000. Such a fund may not issue bearer units. Finally, such a fund is not required to make public the sale and redemption or repurchase prices of its units but shall make the sale and redemption or repurchase prices of its units available to experienced investors at their request.

Private Fund

Under the Law the constitutional documentation of a private fund must: (a) restrict the right to transfer its units; (b) limit the number of its unitholders to one hundred; (c) prohibit any invitation to the public to subscribe for any units of the scheme; and (d) prohibit the issue of bearer units.

Private Funds may not have physical presence in Cyprus. Those which do not have a physical presence in Cyprus, must appoint a company (Administrator), which is based in Cyprus, to carry out the administration work. In practice, the Administrator may be the same with either the custodian or the manager, or indeed, the Cyprus Investment Firm, mentioned above. Finally, it is noted that the directors may be based either in Cyprus or abroad.

Devise a clear strategy with a clear focus

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The global economy is facing its greatest crisis since the 1930s. The inter-bank market is still effectively closed and the securitisation markets have just re-opened. These are unusual circumstances and it is not reasonable to expect that all banks could position themselves so that they would comfortably align their strategy to 'survive', maintain profitability and market share.

In contrast to European banks, most banks in Cyprus have benefited from a stable deposit base, strong capital adequacy and non-exposure to sub-prime lending. Even if the situation is undoubtedly challenging, it seems that many bank managers are pre-occupied with the short-term actions required to ensure that their organisation remains competitive. Such reactive decisions could potentially damage their long-term profitability. Therefore, banks must rise above these short-term distractions to take an uncompromising look at their strategy, and not let economic stability be consumed by 'crisis management'. This article explores a number of fundamental strategic issues that the banks should take into account if they want to prosper, and stay competitive in the near future.

Banks must devise a clear direction in re-defining: (a) core strategy, (b) attitude to risk, and (c) how they can build the 'right' business plans/models to deliver them. Proactive monitoring of progress against strategic goals, and strict implementation of the business plans, will be essential for future success. Moreover, banks need to identify the market segments where they add value to the organisation, and focus on clients and divisions where they have distinict capabilities. To do so, they must first understand their true competitive advantage in the market, and focus their effort and resources (and possibly capital) where they can be more succesful than others. By re-shifting their focus on core competencies, healthy and existing customer relationships, they could easily compete and potentially increase their market share.

Cost reduction is another key aspect. Cutting costs in the Cyprus banking system is not an easy task. Therefore, banks need to be strategic and seek to streamline their business models by reducing operating expenses. They must review the complexity that has been built up over many years, better integrate their policies, systems and processes, achieving improved efficiency and communication between different parts of their businesses. As banks sought out 'higher return-higher risk' strategies, this has consequently increased the overall complexity of the bank and driven up the cost base. Therefore, managing return expectations for all banks must be sustainable and responsible. Over-ambitious return targets, which are not fulfilled, have a damaging effect on the banks' trustworthiness and future forecasts.

Attitude to risk is another important dimension which must be aligned with the banks' strategic planning. It seems that too much reliance has been placed on quantitative models based on historical data, to make assessments of current and future risk exposures. Banks need to design organisational structures with risk at the centre addressing behavioural traits that have been a consistent feature of the banking system. Importantly, banking institutions will need to be able to make robust decisions based on a clear understanding of true profitability, after having reflected upon the return required for the risk and capital used.

Today, it seems that only a few banks have a good understanding of the costs and profitability of specific products, customers and channels. This is a consequence of weak cost-allocation practices, poor management and availability of information, and a strong sales/revenue orientation from banks' business units. For some banks, as long as the balance of total revenue and total costs was a positive one, not enough key questions were asked. Thus, banks need to better understand their true product/ customer profitability, and get to grips with their cost bases, using a reliable and robust cost allocation structure and pricing.

Banking is of vital importance to the economy, therefore a successful, profitable, and competitive system is essential. It is critical that banks in Cyprus address all these strategic aspects to ensure that processes and policies are aligned, having a clear long-term strategic direction. This is what will differentiate successful organisations from the second-tier players in the future. Banking conditions have changed fundamentally and permanently, thus banks need to act quickly to develop specific strategies, and business plans to stabilise core functions and then to move ahead.

The market of cards in Cyprus

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The last several years the market of cards in Cyprus presented a regular increase of the order 20% year to year. The plastic money gained continuously the confidence of the public. The world economic crisis of 2009 however influenced internationally the use of cards something which inevitably had its corresponding impact also in Cyprus. The behavior of consumers in relation with their daily expenses changed and this appears from the fact that the medium sum of each transaction was decreased. At the same time the total cards turnover (at the local market) presents today a reduction of 6% in relation with the corresponding period last year.

The Cypriot market constitutes primarily by "credit-revolving" cards with more than 100 banking products promoted under the brands of Visa, MasterCard and American Express.

The cards local market is considered saturated since there are more than 800,000 charge and credit cards in an island with a population of 700,000 residents. The prospects though of the use of cards are extremely promising since the cash transactions still possess roughly 84% of total transactions (including government payments).

Charge cards give the customers direct access to the money available in their running accounts (credit balances and/or credit limits). Customers who want to maintain an absolute control in the management of their expenses consider the charge card as an ideal solution. Credit cards offer a 40 day interest free period to repay the outstanding balance. Alternatively customers can choose to repay only a proportion of the amount and the rest stays in their account and is charged with interest. Even if credit cards bring higher interest on their balances, they are the only banking product that has an interest free period. The conscientious customers, that control their expenses and keep a strict economic plan, can profit from this process by having interest free lending (up to the limit of their account) each month. In addition if the customers do not want to exercise this interest-free period they have a choice of how much of the outstanding balance they will pay each month. Moreover as an available additional limit, the credit card limit gives the customer the security that there will be funds available in the occasion of an urgent need to acquire various products and services.

Using the cards, transactions are made in Cyprus and abroad with cross-border transfers and in the internet. Cards give to the customers easy and safe access to their money at any time providing also detailed information through statements or electronic banking. Moreover banks offer a variety of incentives and loyalty schemes that offer big prizes in draws, return of money through cash back or gift coupons in addition to special discounts. At the same time there are significant advantages to the merchants that accept cards, decreasing operational costs and increasing safety levels.

Finally evaluating the developments that have been made the last years, one can mention technology and safety. Measures have been taken to prevent fraud and promote safety in all parties, customer, merchants and banks. In 2006 and 2007 jointly Banks and JCC organized a controlled transition to chip cards. This was a big step since it involved changes in the systems of the Banks, JCC Payments Systems Ltd and merchants on top of the necessary training of all parties involved. In March 2007 successfully and swiftly the PIN & PAY cards were introduced to the Cyprus market. Today 90% of the cards are using this new technology and 75% of the merchants have changed their equipment to the new one to accept the new cards. At the new Larnaka Airport the new system ECR is adapted to the new technology. The target is to abandon the magnetic tape on the cards and the use of PIN to become obligatory.

Generally speaking the Banks today in Cyprus offer a big range of card products that cover the needs of the customer and the merchant. What will make the difference and will further strengthen the confidence of public in the use of cards, is the right evaluation of needs of customers and offering the right information to them as far as the safety and the simplicity of the use of cards.

As previously mentioned the majority of the transactions in Cyprus are not made using cards so there exists a big opportunity for the Banking Institutions to be creative and take the challenge to increase the use of cards considerably.

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The Consumer Credit Directive: a new credit world is evolving

The Consumer Credit Directive (CCD) 2008/48/EC was published in the official journal of the European Union (EU) on the 23rd of April 2008. The CCD replaces the Council Directive 87/102/EEC on credit agreements, which contained minimum requirements and few information obligations. Even more, individual member states went beyond the Directive's requirements and enacted different rules leading to a diverse and complex regulatory environment across the EU. This legal diversity in connection with other national obstacles (i.e. language differences, culture) inhibited cross-border credit across the EU. This is illustrated by the results of a European study on cross border lending conducted with national banking associations. The majority of the associations that participated in the survey responded that less than 0.1% of total consumer credit transactions of their member banks concerned cross-border credit.

The Commission therefore sought a more harmonised credit model and after years of discussions the CCD was enacted. The CCD aims on the one hand, at increasing consumer protection and confidence, and on the other hand, it is part of a bigger drive to unify the €800 billion EU consumer loans market which is still largely fragmented. The implementation of the CCD is expected to stimulate consumer credit throughout the EU, leading to increased competition and economies of scale, incentives for credit product innovation, variety of product choice and significantly to lower interest rates. The scope of the directive is restricted and applies to credit agreements between €200 and €75,000 entered into by natural persons for non- business purposes. The CCD does not, however, cover mortgage loans.

The Directive imposes a number of new requirements on creditors. One essential provision is the obligation to provide a set of information to consumers in good time before the contract is concluded. This pre-contractual information is given to the consumer by the lender in a new, comparable and standardized form (Standard European Consumer Credit Information). The SECCI includes, among other useful information, the Annual Percentage Rate of Charge (APR) that is the total cost of credit (the interest rate, commisions, taxes, and other applicable fees in connection with the credit). At this pre-contractual stage, the APR is indicated through a representative example. An important modification from the original directive is that the APR is harmonized and is calculated in the same way throughout the EU. In this way, the consumer can compare different credit offers both nationally and cross-border. Transparency becomes the new order of the day and consumers can choose the credit offers that better suit their financial capabilities and needs. In the credit agreement itself, a set of information similar to the pre-contractual requirements is specified in a clear and concise manner as well.

Adding to the above, consumers are entitled to change their minds and withdraw from the contract within the first 14 days (right of withdrawal). Furthermore, consumers have the right to repay fully or partially the credit at any time (right of early repayment). In this case however, the creditor is entitled to a 'fair and objective compensation' to cover possible costs linked to the early repayment.

All EU member states are asked to transpose the Directive into national law by 11 June 2010. Existing regulation in Cyprus covers credit agreements from £100 – £12,000 (approximately €170 - €20,000) as well as mortgage loans up to £50,000 (approximately €85,000). The Ministry of Commerce, Industry and Tourism (MCIT) has issued a draft regulation after a consultation period with all involved stakeholders. The local draft regulation is fully harmonised with EU provisions, contains the same scope and does not cover mortgage loans. The MCIT plans to enact a different legislation in the future for the coverage of mortgage loans. It is anticipated that the final draft of the credit agreement legislation will be laid before the House of Parliament during the beginning of 2010. However, as full implementation is only a few months away, all financial institutions must soon proceed with the updating of their systems and processes (i.e. SECCI documentation) in order to meet the new legal requirements on time and before June 2010.

Even though a level playing field approach is important for the creation of a single market for consumer credit, there is no evidence at this time that the CCD will actually enhance cross-border transactions. On the contrary, according to a study that was conducted one year before the enactment of the CCD, an integrated credit market cannot be achieved solely with the harmonization of the legislation. As noted in the study 'the first step towards integration will be rather through creditors establishing themselves in other Member States than by the emergence of a large market for cross-border selling of credit products'. Nevertheless the overall actual costs and benefits and the broader economic impact of the Directive will be assessed only in 2013, when the Commission will undertake a review of the provisions laid down in the Directive.

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Revision of Regulation 2560/2001 - New Rules on Cross-Border Payments

On 22 April 2009, the European Parliament approved a proposal modifying and extending the provisions of Regulation 2560/2001 on cross-border payments in euro. The main provision of both the original as well as the revised Regulation, is that banks should not be permitted to impose different charges for domestic and cross–border payments up to 50.000 Euro, within the European Union The main changes of the Regulation include: (1) the extension of price parity requirements to direct debits, (2) rules on multilateral interchange fees for direct debits and (3) mandatory reachability for SEPA direct debit collections in the euro area, from 1st November 2010 onwards. Most provisions of the revised Regulation should be applied by all member states from 1 November 2009 onwards.

The revised Regulation further states that it is important for Banks to facilitate the efficient execution of cross-border payments, by promoting standardization. One tool for achieving standardization is the use of the International Bank Account Number (IBAN) and the Bank Identifier Code (BIC). The Regulation therefore states that banks should easily provide their customers with the IBAN of their account, as well as their own BIC. It also recommends to the suppliers of goods and services (merchants) of the Community, to always print their IBAN and BIC on their invoice slips, so that it will be easily identifiable by their customers. Banks in Cyprus are already following the above requirement, since the IBAN and BIC of their customers is easily provided to them, either through their bank statements, or through the use of internet banking.

The main changes of the Regulation are further analyzed below.

(1) Extension of the price parity requirements to direct debits

The principle of price parity with regard to domestic and cross-border transactions was until now, only applied to credit transfers and card transactions. The revised Regulation extends the price parity to direct debits, with transactions up to 50.000 Euro. For any transactions exceeding the ceiling of 50.000 Euro, banks are allowed to impose different charges.

(2) Rules for multilateral interchange fees for direct debits

The revised Regulation states that in the absence of any bilateral agreement between the banks of the payee and the payer, a maximum multilateral interchange fee (MIF) of €0.088 shall apply for each cross-border direct debit transaction executed before 1 November 2012, unless a lower (or even zero) MIF has been agreed between the two payment service providers concerned. The said fee shall be payable by the bank of the payee to the bank of the payer. The revised Regulation further states that in cases where a cross-border MIF has been reduced or abolished before 1st November 2012, such reduction or abolition shall also apply to any domestic direct debit transactions executed before that date.

The European authorities have not adequately clarified their position as far as the level of MIFs after the 1st of November 2012. In fact, the European Central Bank and the European Commission have issued a joint statement on 24 March 2009 advising that "the imposition of a –per transaction- MIF for direct debit transactions after the 1st of November 2012, does not seem justified for efficiency reasons and therefore does not appear compatible with the EU antitrust rules". The European banks have criticized the above statement for being vague and advised that it will create confusion between member states as well as distortion in the uniformity of the treatment of MIFs.

(3) Mandatory reachability for SEPA direct debit collections

According to the revised Regulation, European banks should have a mandatory availability (reachability) of payment accounts for direct debit payments, across the SEPA participating countries. By reachability meaning that if a resident or non-resident keeps an account with a bank in Cyprus, he should be able to effect direct debits and pay his utility bills to any participating company / organization within the SEPA zone. It should be noted that the above requirement shall apply only to direct debit transactions which are available to consumers under a direct debit scheme. For member states that have not yet adopted the euro, the rules of mandatory reachability will apply a year after their entry into the euro area, but no later than 2014.

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A misunderstood theory:

The efficient market hypothesis

In his P.h.D thesis in 1900, the French mathematician Louis Bacheleir compared stock fluctuations on the Paris Bourse to Brownian motion, the random movement of particles floating in air or immersed in fluid. Over seven decades later, Princeton Professor Burton Malkiel corroborated Bachelier's claims in his classic work, A Random Walk Down Wall Street, suggesting that: "A blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by the experts."

Numerous such 'monkey' portfolio experiments have been conducted over the past decade using children, computers and actual monkeys with various degrees of success. The fact that such random portfolios often do outperform portfolios run by professional managers, whilst entertaining, generally tends to ignore the real-world constraints of liquidity, size and mandate restrictions typically imposed on real managers. All of this simply serves to highlight the fact that in any venture where the outcome is uncertain, it is often exceedingly difficult to determine whether the results achieved were arrived at through luck or skill even after the fact. The problem is that probability theory tells us a certain number of managers in any group will do significantly better than the average for no particular reason other than luck.

The above ideas have been repeatedly discussed in the financial community under the umbrella of the 'Efficient Market Hypothesis' theory. One of the originators of this theory, Eugene Fama, a Chicago economist published a seminal paper in the 1970's. In one sentence it can be summed up as:
"Prices in financial markets reflect ALL the known information."

In other words, gather all the information available, all the potential for positive and negative, plug it into the "free market" and 'voila' - one measure is produced, the price. Nothing is better at doing this than the "market" - the market is "perfect".

Many investors, disagreeing to the efficiency of the market, try to 'Beat the stock market' through searching for undervalued stocks that they think will increase in price. The Efficient Market Hypothesis argues that the stock market is "smart," so smart that all current

information about the stock is known and is included in the price of the stock. Further, followers of the Efficient Market Hypothesis believe that all future information about the stock cannot be known by any investor, so that any future price growth of a stock is purely random.

Extensive analysis has taken place on stock market returns to prove the Efficient Market Hypothesis, concluding that over time, the vast majority of mutual fund managers and other investors do NOT beat the overall stock market.

The main reason mean monkeys beat median analysts is that most fund managers really don't understand the sustainable economic value drivers behind the businesses they invest in and therefore can't allocate well at the individual equity level. Mean monkeys picked by journalists have one of the key behavioral principles in investing → ignorance. They don't know or even pretend to know anything.

And this is exactly one of the reasons that contributed to the recent credit crunch!!! The fact that people ended-up investing in products they couldn't understand (or even worse thought that they could), taking way more risk that they could afford, in an effort to 'Beat the Market' and achieve abnormal returns.

During the crisis, the 'Efficient Market Hypothesis' became popular again, with those supporting it and those against it feeling even more intensively about it.

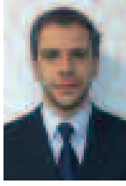
When Queen Elizabeth was asking a practitioner 'Why did no one see the crisis coming?', she gave food for thinking for most of the analysts studying the crisis. Working groups in world's best business schools started questioning the predictive ability of economics. Their main argument was that, in order for somebody to be in a position to predict the future, this implies that there are inefficiencies in the market for that person to discover, or equivalently that not all available information are reflected in the prices.

So, does the recent financial crisis imply that the markets are indeed efficient? And that if all the information is indeed reflected in the prices, trying to outperform the market is equivalent to throwing darts or tossing coins? And maybe this blind faith in the Efficient Market Hypothesis could be a reason why all these professionals failed to predict the future? The answer to this question is of course 'NO'!

According to Mathematical theory, you may have a million cases supporting a theory, but you are still in no position to state with certainty that the theory under examination holds, whereas it only takes one anti-paradigm to bring it down. And there were numerous cases where the market behaviour has been anything than efficient.

Especially in markets that are not developed, such as the Cypriot market, an analyst should be careful into reading between the lines when it comes to basic assumptions underlying this theory. First of all, this theory requires a large number of profit maximizing participants to be analyzing and valuing securities independent of each other, secondly new information comes to the market in a random fashion and that the timing of news announcements is independent of each other, and third investors adjust their estimates of security prices rapidly to reflect their interpretation of the new information received. Assumptions that are not valid to a small market like the Cypriot one.

So how should one treat this theory? As with most of the theories, this is not a black or white situation, and the grey areas require careful investigation. The efficient market hypothesis is valid and applicable in periods where the market is indeed efficient, and the distinct expert analyst should be in a position to identify these periods and divert its research and analysis in alternative techniques in order to achieve the desired 'Abnormal Returns', for example using Behavioural finance techniques. Similarly, in periods where the market is inefficient, and these periods have been recognized and reported in the past via anomalies such as the 'January effect', the 'Monday effect', 'Small firm effect' e.t.c., the focus should be on identifying these periods in a timely manner, and taking advantage of the 'Beating the Market' opportunity as early as possible, before the market forces swipe this opportunity away.



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A need for change in Bank's Corporate Governance practices

The global banking industry faces its biggest challenge in decades. Hundreds of billions of dollars have been written down and wiped off its market value and shareholders are now looking to the directors to safeguard their interests and make sure the same mistakes do not happen again. Many shareholders, at this time, will be asking how their interests could have been best served and protected and why existing corporate governance mechanisms had entirely failed to prevent, or highlight the possible existence of problems that finally drove the financial system to the worst crisis of the previous years.

Under these developments, earlier this year, the UK Government announced that it had commissioned Sir David Walker, a Senior Advisor at Morgan Stanley International and former Executive Director of the Bank of England, to undergo an assessment of the corporate governance in the UK banking industry.

On the following paragraphs we will be laying out the findings and conclusions emerging from this review, points that definitely are applicable to the Cyprus Banking market and the currently adopted corporate governance practices followed on the island.

The recommendations of the Walker report can be grouped into areas of focus, as follows:

• Board size, composition and qualification

The focus here is mostly on the actions of the Board of Directors ("BoD") rather than the size. Sir Walker recommended that Non-executive directors ("NEDs") should allocate, at minimum, 30 to 36 days a year, under their appointment letters, to the Bank, approximately 50% more than what they currently spent averaging to 25 days. Furthermore, he stressed that the experiences and qualifications of the NEDs must be industry specific. Additionally, the Bank should continually offer support and regular training to the BoD. This will allow the directors to contribute effectively and engage proactively on risk strategy. Additionally on the same point the review expressed the point that the prohibition on the CEOs taking the chairman's role could be lifted.

The need to have a knowledgeable and competent group of independent NEDs capable of questioning and challenging the decisions of the executives was also expressed. On this note, Sir David stressed the need for the non-executives, and particularly chairmen, to be of "strong character", in order to promote a healthy "atmosphere of challenge" in the Board.

• Functioning of the Board and evaluation of performance

This area's focal point is the chairman's role, qualifications and expertise. Sir Walker stressed the fact that the chairman should not only possess adequate experience in the financial industry but also a sound track record of successful leadership experience in other Boards, especially of financial institutions. The need for a chairman that would spend not less than two-thirds of his/her time on the chairmanship role is indicated, with this role taking priority over any other business commitments. The chairman, as stated, should not chair any other BoDs and should be proposed for election annually.

Furthermore, the NEDs should be "ready and encouraged to challenge and test" the executive board's strategy positions and the board should be required to evaluate its performance every two to three years, with the assistance of external advisers, with this evaluation being part of the annual report.

• The role of institutional shareholders

Financial institutions and their regulating authorities need to communicate and engage with institutional shareholders. Boards and the Regulators should ensure that they are made aware of any material changes in the share register, understand as far as possible the reasons for changes to the register and satisfy themselves that they have taken steps, if necessary, to respond. Sir Walker's recommendations include the preparation of a memorandum of understanding among major investors, to establish a flexible and informal approach to issues such as confidentiality and any conflicts of interest that might arise.

• Governance of risk

In this section Sir Walker stressed the need for the financial institutions to improve their ability to demonstrate the effectiveness of their frameworks which anticipate and mitigate adverse events. In addition, they will need to demonstrate a rigorous programme of scenario analysis and stress testing, to show that the level of risk mitigation is satisfactory.

Other recommendations include the establishment of a Board Risk Committee for every financial institution, separate from the audit committee, which should be chaired by NEDs with a majority of non-executive members, and, with the finance director and the chief risk officer (CRO) in attendance. The risk committee's responsibilities should include the oversight of current

risk exposures, future risk strategy and an advisory role to the BoD. Furthermore the Board Risk Committee's report should be included in the annual report and accounts.

On a separate note the review recommends the appointment of an independent chief risk officer (CRO), who should participate in risk management at the highest level and oversee the process on an enterprise-wide level. The CRO should report to the Board Risk Committee, with direct access to the chairman of the committee, if needed. Additionally the Board Risk Committee should also have access to, and expect to draw on, external input to its work in particular with regard to the stress and scenario testing of business strategy. This should allow the members to take full account of relevant experience from elsewhere and to challenge their own analysis and assessment.

• Remuneration

This part of the report is the one that will cause a lot of concerns in the banking world, and for that reason Sir Walker avoided to recommend caps on the remunerations. Although proceeded to make some comments and offer proposals on the remuneration policy of Banks as follows:

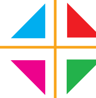
- The powers of bank remuneration committees should be enforced in order to take responsibility for pay policies of the whole institution

- The salaries of "high-earners", defined as those who earn more than 75% of the executive director median in bands, should be published, broken down into their different constituents e.g. bonus, long-term award and pension contribution, etc. These should be reported to and assessed by the Regulators

- The salaries should be linked to performance, and the payout of bonuses for top earners should be spread over five years, with half of their variable remuneration in the form of a long-term incentive scheme with approval subject to a performance condition

Conclusion

The Walker Review transforms the role and responsibilities of NEDs in the oversight of risk strategy and risk-adjusted performance incentives. The boards of Banks will need to re-assess the overall framework of governance and risk management in light of the Walker recommendations.



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