Stepping up: Bank of Cyprus (pictured) raised the €1bn in equity capital required of it to pass the 2014 stress tests. This was taken as a sign that the Cypriot banking sector is returning to health

CYPRUS: A RECOVERY IN PROGRESS

Cyprus's banks all passed the European Central Bank's stress tests, a result that is indicative of the recovery that is under way in the country's financial sector. However, for these institutions to return to full health they must tackle their non-performing loans, a feat that is as much in the hands of the country's politicians as its bankers. **WRITER** *Stefanie Linhardt*

Banking sector stress tests tend to be a make or break affair. For Cyprus, the comprehensive assessment by the European Central Bank (ECB) was a blessing. While there still is much to do to ensure economic recovery following the 2013 crisis, Cyprus has worked hard and achieved more than was expected of it in past 18 months.

The country has outperformed the economic forecasts made by the International Monetary Fund (IMF) as well as the government's own, more optimistic estimates. While preliminary gross domestic product (GDP) figures show that the country did not grow in 2014, it is expected to return to growth in 2015.

"In the short term, we have performed well," says George Vassiliou, former president of Cyprus, who was in office between 1988 and 1993. "Cyprus has surprised the experts from the troika [of the EU, ECB and IMF] because we performed [well] and they did not expect this."

Some tough reforms had to be passed, and banks had to be recapitalised and restructured, some with savers' money. Unemployment has shot up to more than 16% from levels as low as 3.6% in 2008, but things seem to be turning around.

"We are entering a new phase," says Michael Kammas, director-general of the Association of Cyprus Banks. "The banking sector is restructured and more robust. The banks have gone through recapitalisations and passed the stress tests, which had a very positive impact on the banking sector and the economy. All banks will be under the supervision of ECB, and four systemic banks will be directly supervised by the single supervisory mechanism. This reinforces trust and confidence in the banking sector."

THE BAIL-IN EXPERIMENT

The largest bank in the country, Bank of Cyprus, was also the one that experienced the biggest difficulties in 2013. "The difference between when I arrived [at Bank of Cyprus] 13 months ago and today is that we are no longer asking if the bank will survive but we are now asking what it is worth," says John Hourican, CEO at the bank.

In early 2013, the bank was merged with the good parts of Laiki Bank, which failed in 2012 and had to be bailed out by the Cypriot government. Soon after this, the financial crisis hit, and the Bank of Cyprus needed capital. Consequently, a decision was made by the Eurogroup – a meeting of the finance ministers of the eurozone – to arrange a bail-in of the bank, which meant a haircut on savers' deposits.

Some 47.5% of the bank's uninsured savings of more than €100,000 were converted into equity at the end of July 2013. Alarmed by this, many depositors withdrew their money from the bank, choosing to store it at home instead, which forced the Central Bank of Cyprus to impose capital controls in a bid to prevent a run on the bank.

"The bail-in [decision] was a deeply unfair outcome for Cyprus," says Mr Hourican. "The banking system in Cyprus was previously largely funded by deposits, and about €10bn of these were destroyed by allowing Laiki to go bust and then bailing in depositors."

July 2014 marked a turning point in the recovery of Bank of Cyprus when it raised €1bn in equity capital to support its capital base, in anticipation of the stress tests.

New shareholders and chairmen Josef Ackermann, a former Deutsche Bank CEO, and Wilbur Ross, a US investor, underline international investor confidence, as does the involvement by the European Bank for Reconstruction and Development (EBRD), which started investing in Cyprus after its shareholders granted it 'country of operation status' in May 2014.

SMALL SHORTFALLS

Elsewhere, Hellenic Bank recorded a €105m capital shortfall in the stress tests, but the bank consequently raised €220m in a rights issue. The third largest bank in the country by loans, Hellenic was also forced to restructure in 2013.

The bank's capital restructuring plan was done without a bail-in, however. Instead it raised €358m through the issue of new shares and convertible capital. This changed the bank's shareholder structure. Its main shareholders became New York-based hedge fund Third Point and Cypriot video gaming business Wargaming.net, each of which held a 20.3% stake, and local investment fund Demetra, which owned 10.6%.

Third Point and Wargaming were both taking up their subscription rights in the €220m rights issue, which left some €130m to be raised in the market by the end of December 2014. The Church of Cyprus, which at one point held 25% of shares in Hellenic and after the restructuring held about 8%, was not participating, which will see its stake drop even further.

CO-OPERATIVE NETWORK

The Cypriot co-operative banking sector, which required a €1.5bn bailout by the government in early 2014, and together is the country's second largest bank, also passed the comprehensive assessment. Still, Marios Clerides, CEO at Co-operative Central Bank, says that during the period of the stress tests, there were some "mild panics".

"During the period of the stress tests, and when the House of Representatives was not voting for the foreclosure legislation [which had to be passed for troika funding to continue], people thought that if there was no money coming from the EU, then the co-operatives would need money and would therefore have to be bailed-in," he says.

Branch managers were reporting a flight of deposits, as well as withdrawals of cash, he adds. But, things have changed since the results have come out. "November was the first month since the stress tests that we have ended the month with more deposits than we started the month with," says Mr Clerides.

With the government bail-out of the co-operative sector in 2014 also came requirements for change. The Co-operative Central Bank was established, which now owns the co-operative network. Meanwhile, the co-operative network was shrunk from 93 to 18 banks. This followed earlier consolidation when Cyprus joined the EU and the number of institutions was shrunk from 365 to 93.

ON TRACK

Meanwhile, the fourth systemic bank is Russian RCS Bank, which only operates in Cyprus, and is owned by financial institutions VTB and Otkritie. RCS also passed the ECB's assessment. Overall, it seems as if the Cypriot banking sector is emerging from its difficulties. "The biggest worry of the people was that there would be another haircut, and [those fears are] over," says Mr Vassiliou. "It's clear that there is no chance that this would happen. That has helped confidence."

Since the stress tests, Bank of Cyprus has refloated on the stock exchange after a 22-month suspension. It was also in the market with a €100m public offering for retail investors, which was due to end in early January 2015.

Meanwhile, the wider economy is recovering quicker than initially expected, and while it is still posting a contraction in GDP in 2014, the outlook for 2015 is for growth – even according to the more pessimistic forecasts by the International Monetary Fund, which predict real GDP growth of 0.4% in 2015.

This improved performance is largely attributed to the government's efforts to honour the financial assistance agreement that it signed with the troika in March 2013, as well as to its reform plans.

"I see a lot of parallels with reforms in the 1990s in central Europe, where a large section of the population accepted that changes were necessary and had a cohesive approach to deep and comprehensive reforms and, as a result, these countries emerged from the initial shocks of transition much faster and the recovery was much more robust," says Libor Krkoska, the head of the EBRD's newly established office in Nicosia. "In the long term, I would expect that the Cypriot economy will be much more robust than others that are in a global recession [and] where reforms were not implemented."

INTERNATIONAL SUPPORT

One factor that may slow the country's recovery is the fact that the government has lost its majority in parliament, following the decision in February 2014 by the Democratic Party, known as Diko, to withdraw from the coalition government. This is making it harder to push necessary reforms through, and is one of the reasons why it took longer than anticipated to pass the foreclosure law in September 2014.

The foreclosure legislation is key to helping the banking sector deal with its problem loan portfolio. But, even though the foreclosure law itself has now been passed, key legislation allowing for the implementation of the law is still awaiting approval, as is the needed insolvency and bankruptcy law.

The European Stability Mechanism (ESM) has, despite these difficulties, agreed to pay the sixth tranche of its €9bn commitment to the country in the second week of December. This will bring its total payments to Cyprus up to €5.7bn, with the remainder set to be paid in quarterly instalments until March 2016, provided that certain requirements are met. An €86m payment was »

"IT WOULD NOT BE IN THE BANKS' INTERESTS TO DO MASS FORECLOSURES ON ECONOMICALLY CHALLENGED PEOPLE'S HOMES BECAUSE IT WOULD IMPACT THE WHOLE ECONOMY AND IT WOULD IMPACT OUR ENTIRE LOAN BOOK" ***John Hourican*** also expected to be disbursed by the IMF.

"There was a big discussion about whether [the troika] would accept [the adoption of the foreclosure law as sufficient for the next payment] and it has, which is the best proof that the troika was satisfied with the progress made by the government," says Mr Vassiliou. "This sent the right message."

Mikis Hadjimichael, the director of emerging markets policy at the Institute for International Finance, disagrees. "The troika is doing a great service to Cyprus by insisting, as committed by Cyprus under the memorandum [that it signed with the troika], that an appropriate, balanced legal framework – the foreclosure law and the bankruptcy law – be in place before resuming lending," he says.

"That way, an urgently needed balanced framework for the rights and responsibilities of bank lenders and borrowers is in place to rectify the problems experienced in the past, to facilitate, in due course, a resumption of bank credit expansion and thus output and employment growth, and to ensure that the programme achieves lasting adjustment and returns on the right track."

He argues that by merely passing the foreclosure law while failing to pass the implementing legislation, sufficient progress has not been made, adding that this is especially problematic in a parliament where the opposition hold the majority.

PROBLEM LOANS

Political wrangling aside, non-performing loans (NPLs) are the big challenge in Cyprus. About half of all loans on the books of the banks are not performing – by far the highest level in the eurozone.

Bank of Cyprus has about €13bn-worth of NPLs. About €7bn of these are related to larger corporates, of which about €5bn is held by the country's leading 30 companies – with which the bank has explicit negotiations to restructure their facilities – while the remainder belongs to small and medium-sized enterprises (SMEs) and retail customers. Hellenic Bank's split is similar, while the majority of NPLs belonging to the co-operative banks are relating to small businesses and retail clients.

"It is a big challenge to restructure those NPLs," says Mr Clerides. "The asset quality review stress tests didn't reveal any extra provisions that were necessary and, because of the way that the co-operatives used to do business, which was very much security driven, we have a good collateral cover for the problem loans. But we need to see how we are going to handle foreclosures without tarnishing the image of the co-operative banking sector as more humane and friendly to the customer than a commercial bank."

WE NEED TO SEE HOW WE ARE GOING TO HANDLE FORECLOSURES WITHOUT TARNISHING THE IMAGE OF THE CO-OPERATIVE BANKING SECTOR

Marios Clerides

CLOSING UP LOOPHOLES

The topic of foreclosures is, unsurprisingly, a delicate one in a country that is still struggling to get back on its feet. While there is a need for resolution, many members of parliament are warning that banks could foreclose on people's mortgages on their first homes.

"You need law that is universal and then you need regulation that ensures that the application of that law is done in a way that is sensible towards society," says Mr Hourican. "It would not be in the banks' interests to do mass foreclosures on economically challenged people's homes because it would impact the whole economy and it would impact our entire loan book.

"But it wouldn't be right to give excessive protection on certain homes because that would create difficulties lending against that criteria again. And then it becomes a social housing issue, and then it would become a deeper issue for society."

Up to September 2014, the banks had restructured 13,500 loans worth €3bn – about 20% of GDP – after establishing workout units in early 2014, according to Mr Kammas. However, as the country's outdated legislation is not forthcoming in the resolution of NPLs, and even offers a loophole for borrowers not to repay even though they can, the introduction of the foreclosure law was necessary.

"The reform of the debt restructuring legal framework is important because it removes incentives for strategic defaulters," says Mr Kammas. "That is important because it gives the credit institutions additional tools to go after people who are able to pay but not willing to pay."

LOOKING AHEAD

For Cyprus to prosper, the next big task is for the financial sector to boost lending. Banks have already been active in promoting mortgage and car loans, among others, but the uptake has not yet been strong. "In an economy that is overly indebted, the general stock of lending contracts in a recession," says Mr Hourican. "We see people using their deposits to repay their loans, we see savings being quite modest and new lending being very modest."

Mr Clerides says that it is now time to scale up. "Now that we see a stabilisation, we need to start lending. Not with the old mentality, but using a more up-to-date analysis of the borrower," he says.

One positive sign is that foreign direct investment into the country has increased. Activity has been strong in the hotel industry, as well as in the real estate sector, which has seen sales rise approximately 20% over the first three quarters of 2014, according to Christodoulos Angastiniotis, chairman of the Cyprus Investment Promotion Agency. He also points to further investment opportunities likely to stimulate investment. "There has been a political decision to privatise the state-owned telecom and energy companies, as well as the port authority," he says.

One of the parties interested in investments across industries is the EBRD. "We are looking at Bank of Cyprus as well as other banks and at other financial products we could provide to further increase the confidence in the local banking sector and to help with the financial restructuring," says Mr Krkoska. "This could include areas such as trade finance, support for SMEs, particularly on energy efficiency and sustainable energy financing. We are also looking at setting up advisory services for local SMEs."

SMEs make up by far the largest share of businesses in the country, which is why the EBRD is looking to support the sector. SMEs are also getting a boost in the form of a €125m initiative by the European Investment Bank, which is designed to support lending to these businesses. TB