

# **Systemically Important Banks in Cyprus: Risks and Policy Implications**

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# 1. The risks of systemically important banks (SIBs)

# Definitions

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- Definition of systemic risk: “the risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the economy” (IMF, BIS and FSB, 2009)
  - Time and cross-sectional dimensions
- Definition of systemically important financial institutions (SIFIs): “Financial institutions whose distress or disorderly failure... would cause significant disruption to the wider financial system and economic activity” (FSB, 2010)
  - SIBs are the clearest example of SIFIs

# Criteria for Assessing Systemic Importance

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- Certain criteria identified in literature...
  - Size, interconnectedness, degree of substitutability (IMF, BIS and FSB, 2009)
  - Above 3 criteria plus cross-border activity and complexity (used by Basel Committee to identify global SIFIs)
- ... but need to be complemented by supervisory judgment
  - Time-varying and context-specific assessment
  - Conjunctural vulnerabilities should also be considered

# The Too-Big-To-Fail (TBTF) Problem

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- The absence of policy measures to adequately monitor and control the risks of SIBs contributes to the expectation by market participants of government support in case of trouble
  - Allows SIBs to borrow at preferential rates, operate with higher levels of leverage, and engage in excessively risky activities
- Adverse implications for competition (unfair advantage) and for financial stability (increased risk-taking beyond a socially optimal level)

# International Experience

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- The financial crisis has confirmed the risks posed by SIBs and illustrated how their failure can have wider fiscal, economic and social costs
  - Iceland, Ireland, Switzerland, United Kingdom, United States
- It has also confirmed government support of SIBs in case of trouble
  - SIBs have been disproportionate beneficiaries of rescue packages

# Identifying SIBs in Cyprus

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- Based on the aforementioned criteria, BOC and CPB are systemically important
  - Very large size (compared to economy)
  - Dominance of most financial services segments
  - Implicit government support reflected in their credit ratings (and in the sovereign rating)
- These banks are also exposed to considerable conjunctural vulnerabilities
  - High exposures to Greece as well as to troubled domestic real estate and construction sectors, significant amount of non-resident deposits

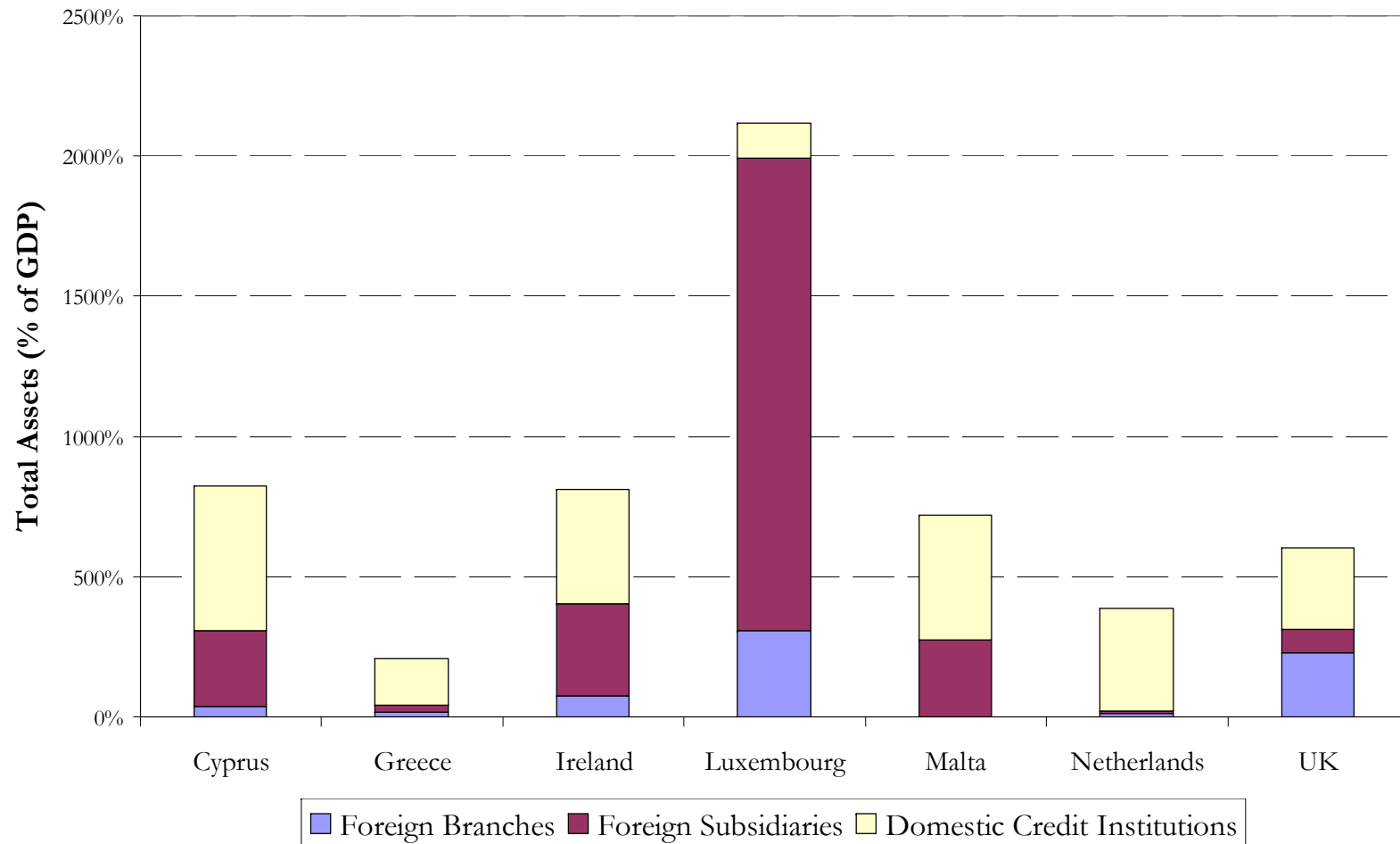


# Identifying SIBs in Cyprus (cont.)

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- There exist mitigating factors...
  - Strong domestic franchises, traditional model
  - Conservative prudential framework
- ... but they do not change the fact that the collapse of one of them (however unlikely) could disrupt the flow of financial services and have a significant negative impact on the economy and on Cyprus's reputation as an international business centre
- Other banks in Cyprus may also be (or become) systemically important, particularly in times of crisis

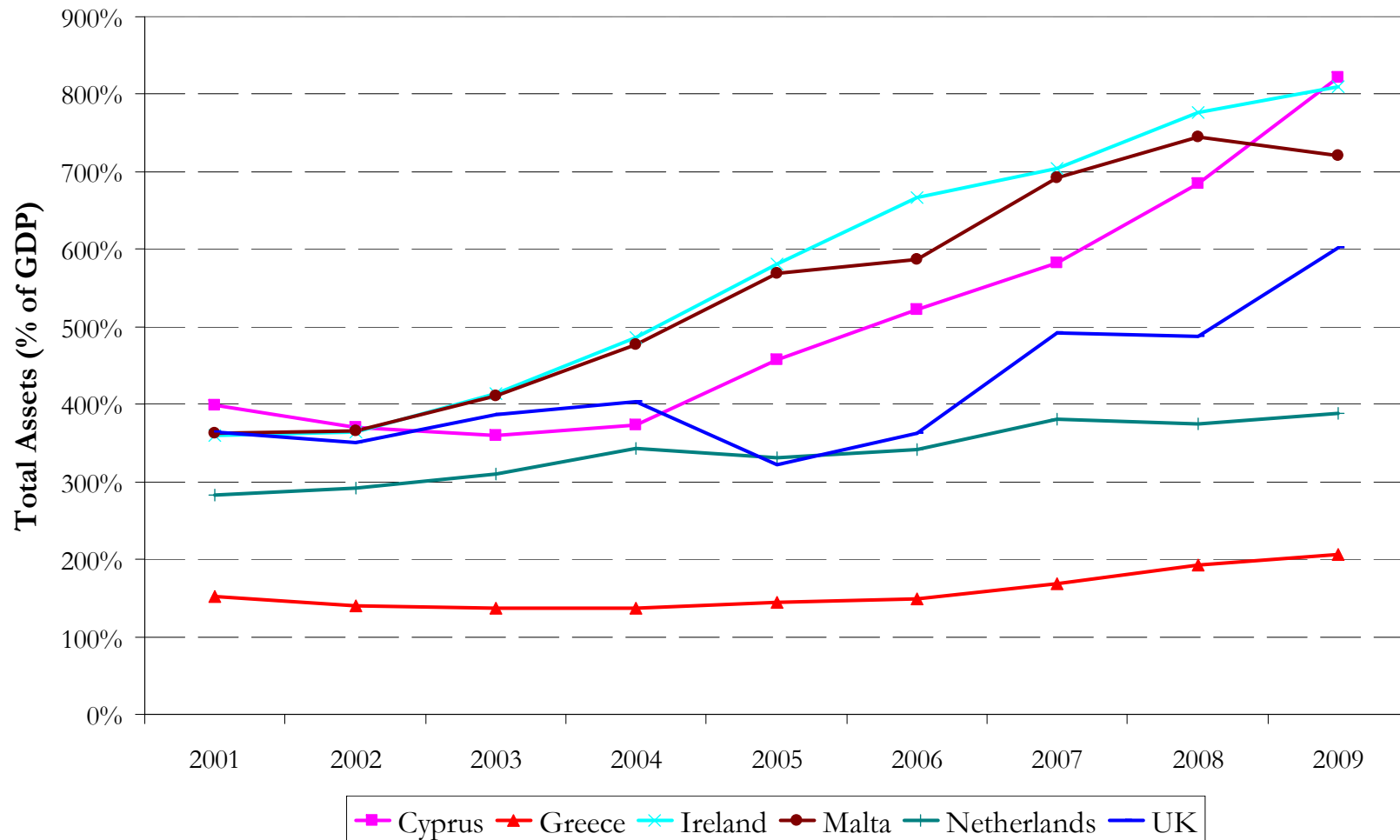
# Banking Sector Size for Selected Countries (end-2009)



Source: ECB.

Note: These figures include the overseas assets of domestically-owned banks.

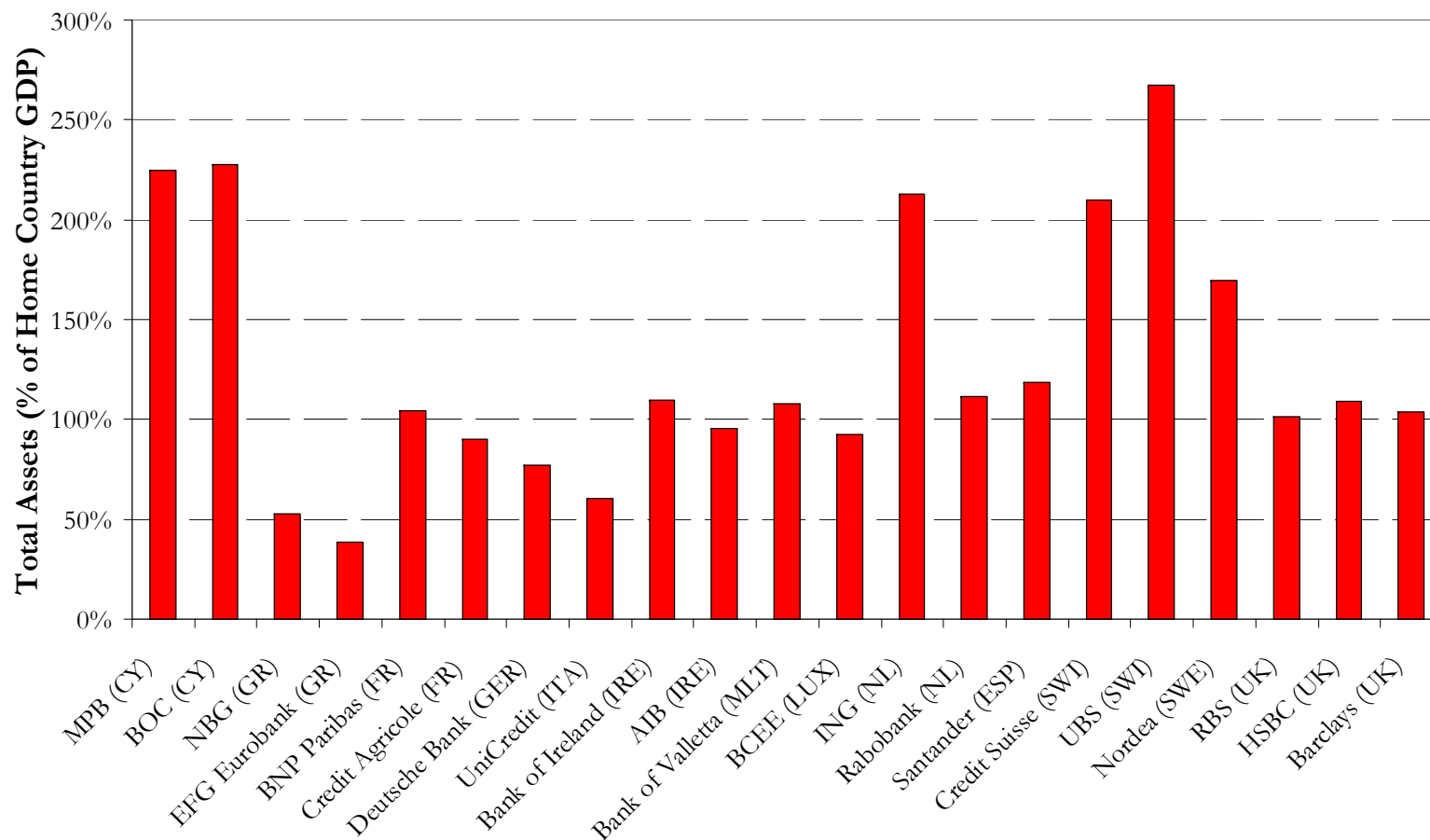
# Evolution of Banking Sector Size for Selected Countries (2001-09)



Source: ECB.

Note: These figures include the overseas assets of domestically-owned banks.

# Size of Selected Credit Institutions to GDP (end-2010)



Source: The Banker, World Bank.

Note: These figures represent a bank's total assets at group level, including from overseas operations. The acronyms in brackets indicate the country where the bank is based: CY=Cyprus, GR=Greece, FR=France, GER=Germany, ITA=Italy, IRE=Ireland, MLT=Malta, LUX=Luxembourg, NL=Netherlands, ESP=Spain, SWI=Switzerland, SWE=Sweden, UK=United Kingdom.

## 2. Policy measures

# Lessons from International Experience

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- The ability of the authorities in various countries to support their banking system (particularly SIBs) ultimately depended both on the scale of the problem and on macroeconomic conditions
- Two main lessons from the financial crisis
  - Importance of containing (via effective prudential regulation and supervision) the contingent liabilities to the government arising from a large banking system
  - Need for strong macroeconomic fundamentals, including fiscal space, to act as a shock absorber in case related risks materialize (not discussed here)

# Macroprudential Policy Framework

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- Macroprudential policy is characterised by:
  - Its objective (to limit systemic risk)
  - Its scope (entire financial system, including interactions with the real economy)
  - Its instruments and associated governance (use of prudential tools targeting sources of systemic risk)
- Important steps have been taken to date, but the development and implementation of relevant frameworks is still at an early stage
  - Use of wide range of indicators for identification of systemic risk and of policy instruments to mitigate them
  - New country-specific tools and institutional arrangements can only be assessed over time

# International Framework for SIFIs

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- FSB's policy framework to address the systemic and moral hazard risks associated with SIFIs
  - Key attributes of effective national resolution regimes (responsibilities, instruments and powers)
  - Requirements for resolvability assessments, recovery and resolution planning (RRPs), and institution-specific cross-border cooperation agreements for G-SIFIs
  - Additional loss absorption capacity for G-SIBs (1-2.5% of risk-weighted assets, to be met with common equity)
  - More intensive and effective supervision
  - Stronger core financial market infrastructures
- Policy framework for SIFIs complements Basel III



# International Framework for SIFIs (cont.)

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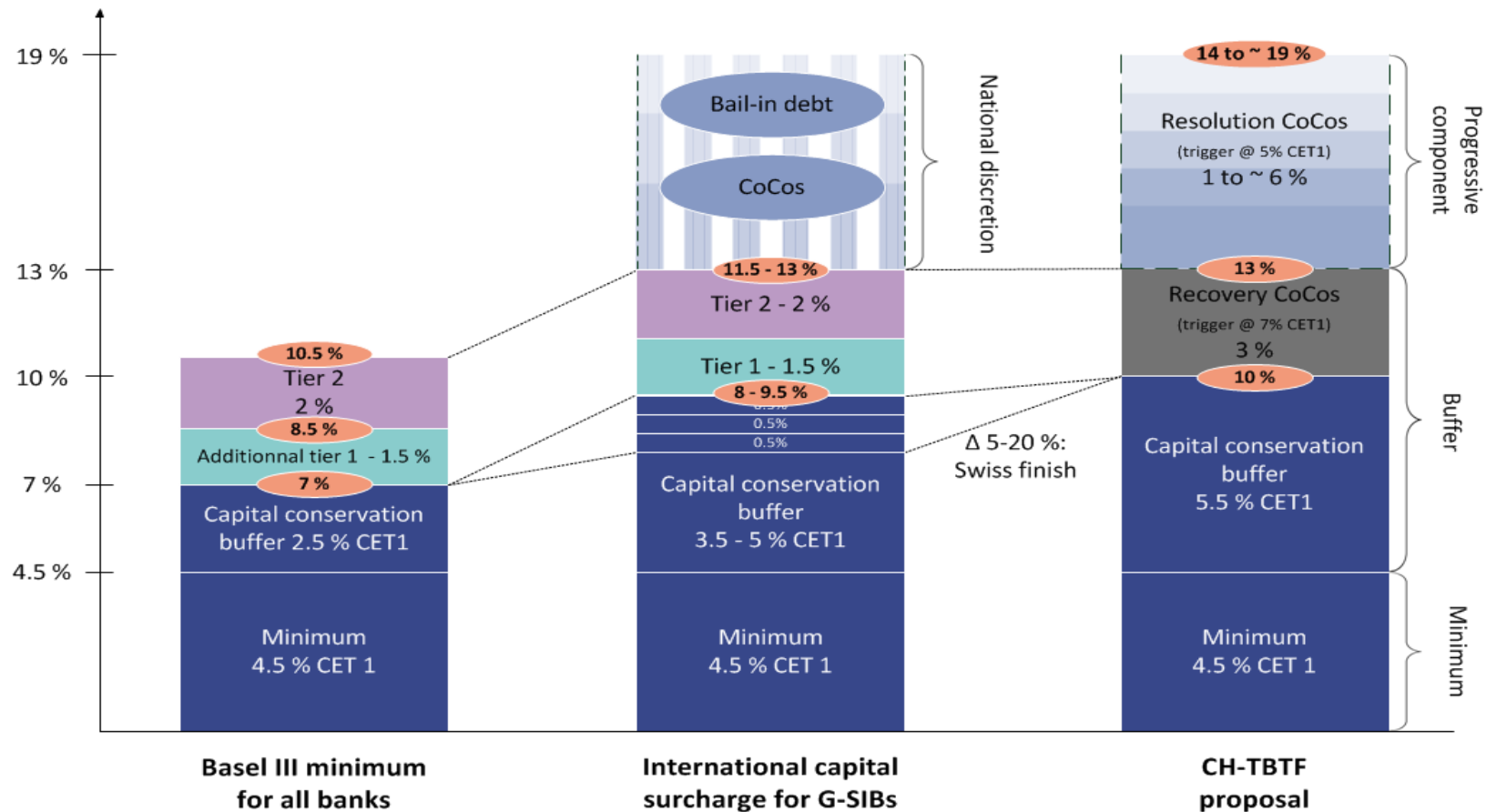
- FSB and Basel Committee have identified an initial group of 29 G-SIBs to which (some of) these requirements will apply
  - Phased implementation of G-SIFI requirements
  - The group of G-SIFIs will be updated annually
- Work is currently underway to extend the policy framework to all SIFIs
  - Non-bank financial institutions, domestic SIFIs

# Examples of National SIFI Policies

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- Austria
  - Higher capital requirements for big 3 banks and funding restrictions on their lending business abroad
- Sweden
  - Higher CET1 capital requirements for 4 big banks
  - Creation of Financial Stability Fund
- Switzerland (TBTF package)
  - Higher capital requirements (see next page) and stricter liquidity, organisational structure, risk diversification and resolution measures for 2 big banks

# Switzerland's Capital Requirements under the TBTF Package



Source: FINMA.

# Examples of National SIFI Policies (cont.)

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- United Kingdom (Vickers ICB report)
  - Ring-fencing of UK retail banking activities with higher loss absorbency requirements (based on a bank's RWAs to UK GDP); depositor preference
- United States (Dodd-Frank Act)
  - Additional prudential requirements for national SIFIs to be determined by recently-established Financial Stability Oversight Council; Volcker Rule
- All of the above measures are complemented by more intensive supervision and enhanced reporting requirements

# Implications for Cyprus

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- Need to take a more macroprudential approach to financial sector oversight in order to identify and control systemic risks
  - Enhance the financial stability function within CBC
  - Strengthen role of National Financial Stability Committee (particularly coordination protocols between CBC and MoF during normal and crisis times)
  - Improve macroprudential oversight mechanisms, whose output should feed into firm-specific supervision
  - Develop additional/calibrate existing prudential tools
- Adopt a package of regulatory and supervisory measures for designated SIBs (see next pages)

# Prudential Measures for SIBs

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- Can take different forms that address distinct dimensions and stages of the problem
  - Curb incentives for excessive risk-taking by SIBs (e.g. due to competitive advantages in funding markets)
  - Enable the early identification of risks before they threaten the solvency and liquidity of the institution
  - Reduce the probability of SIB failure
  - Reduce the cost to the public sector should a decision be made to rescue a failing SIB
  - Reduce the extent or impact of failure, assuming that the SIB is not rescued by the authorities

# Considerations in Structuring the Package of Measures

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- Based on good international practices but adapted to the specific characteristics and needs of Cyprus (and of EU single market)
  - E.g. how should the package be structured so that it preserves the attractiveness of Cyprus as an international business centre?
- Cost-benefits of, and trade-offs between, different measures need to be considered
  - E.g. capital surcharge vs. prudential levy, financial stability vs. deposit insurance fund etc.
- Multi-year effort that should be phased in carefully to avoid unintended consequences

# Considerations in Structuring the Package of Measures (cont.)

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- Package should be informed by lessons from current problems of the SIBs (and outcomes)
  - E.g. which are the core domestic banking activities that should be preserved in times of SIB trouble?
  - E.g. how many of the problems were caused by lax supervision vs. inadequate/inappropriate regulation?
  - Independent analysis of the causes of current problems should ideally precede the development of the package
  - Eventual foreign ownership/control of the SIBs may influence the types of measures to be undertaken
  - Experience of other countries would also be useful



# Possible Package Components (1)

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- More intensive and pro-active supervision
  - Greater and more specialised resources
  - Expanded corrective and remedial powers (e.g. dividend cuts, activity restrictions, fines etc.)
  - Improved supervisory techniques (greater focus on outcomes, stronger board and risk governance assessments, use of stress tests, scrutiny of banks' business models etc.)
  - More frequent communication with SIBs
  - Better use of external auditors

# Possible Package Components (2)

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- Enhanced corporate governance requirements
  - Stricter fit-and-proper rules as well as independence and qualification criteria for board members of SIBs
  - Functioning of Audit and Risk Committees
- Stricter prudential rules
  - Higher minimum capital requirements (tied to riskiness)
  - Align loan provisioning to good international practices
  - Expanded reporting to CBC (and potentially to public)
  - Worth examining options for ring-fencing of core domestic banking activities that should be preserved
  - Worth examining options for discouraging expansion abroad that can pose risks domestically (e.g. via limits on foreign exposures or on their funding from Cyprus)

# Possible Package Components (3)

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- Measures to better resolve SIBs or to reduce the impact of their failure
  - Mandatory RRPs for SIBs
  - Development of special resolution regime for financial institutions (or at least for banks)
  - Bolster size of Financial Stability Fund (and consider merging it with deposit insurance fund)
  - Stronger core financial infrastructures (payments / clearing / settlement systems etc.)

# Concluding Thoughts

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- The risks stemming from SIBs are important
  - Need for a specific set of macroeconomic and prudential measures customized to the needs of Cyprus
- The current crisis provides an opportunity (and need) to rethink the business model for the sector
  - What type of activities should SIBs be involved with?  
How to provide the right incentives?
  - This is not merely a technocratic issue since it involves difficult policy trade-offs that carry implications on the growth model pursued by Cyprus in recent years