Independent Commission on the Future of the Cyprus Banking Sector

FINAL REPORT and RECOMMENDATIONS

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A.1 The Independent Commission on the Future of the Cyprus Banking Sector was set up in November 2012 by the Central Bank of Cyprus (CBC) to make recommendations on the long term recovery of the Cypriot banking industry from its present crisis. The Commission's Terms of Reference require it to draw lessons from recent events and put forward proposals to make the Cypriot banking industry stronger and better fitted to meet the country's banking needs. This includes examining the size and structure of the industry, the quality of service, and the supervision of banking. In carrying out its work the Commission was asked to take account of international best practice, and the legal and operational requirements of international agreements and treaties.

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

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

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

A.4 Urgent work is now underway to repair the damage, much of it under the terms of the Memorandum of Understanding (MoU) reached by Cyprus with the Troika of the EU, the ECB and the IMF as a condition for a €10bn loan in March 2013. The country's two largest banks have been merged and recapitalised, the co-operative sector has been restructured with an emergency capital injection of €1.5bn, and important improvements are being made to the country's supervisory system. But the country is in recession, confidence in the banks has been severely damaged, and capital controls are holding back recovery, meaning that uncertainty about the outlook remains considerable.

The causes behind Cyprus' banking crisis

A.5 In order to formulate its recommendations, the Commission examined the crisis in detail to ascertain its causes and draw out the lessons. We found that the Cyprus banks' downfall was caused by the interplay of a number of factors and failures, some of them outside Cyprus' control, but many within it.

A.6 **External.** The main external causes were two. One was Cyprus' accession to the EU (2004) and the euro (2008) which rapidly liberalised a previously tightly controlled banking system while simultaneously making it harder for Cyprus to restrain credit growth with traditional monetary levers. The other was the global financial crisis which initially hit the Cyprus banks indirectly through their deep involvement with Greece, but later depressed the Cyprus economy more directly through the shocks to the euro area and its other markets.

A.7 **Internal**. The most significant internal cause was a failure at the national policy level to appreciate that running a big banking industry involves risk as well as reward. The public attitude was that the banks were doing a good job of supporting economic growth and that the international business they brought added to the nation's wealth. Insufficient attention was paid to the fact that the banks were acting imprudently and that the international business was resulting in serious domestic imbalances, or to how any potential shocks might be handled. There may even have been a (possibly subconscious) desire to ignore these risks in order to avoid "spoiling the party". This set an overall climate in which low priority was given to monitoring banking risks, and to supervising the banks themselves. In addition, the government's mismanagement of the budget created a major fiscal crisis which eventually led to Cyprus' exclusion from international financial markets and meant that no resources were available when the banks needed rescuing.

A.8 **Risky strategies.** During the 2000s, the two major banks used the excess liquidity available in the Cyprus banking system to embark on aggressive growth strategies which included lending far beyond prudent levels, and making overseas acquisitions which they had difficulty controlling. Although domestic sources of funding began to run low, they engaged in further expansion, including the fatal step of acquiring €5.7bn of Greek Government Bonds (GGBs), which was to cost them €4.5bn in losses.

A.9 **Weak bank governance.** These reckless ventures were made possible by the failure of the boards of the banks to put independent checks on the ambitions of strong-willed chief executives and to ensure that their banks had risk strategies and controls that were enforced. Instead, directors lived by a culture of deference which was nurtured in some cases by loans and supply contracts. There were also serious weaknesses in the governance of the co-operative banks, particularly as regards the independence of directors and the quality of credit and risk controls. It is no exaggeration to say that the effectiveness of corporate governance in Cyprus' banking sector, while possibly compliant in a formal sense, was close to non-existent in practice as the crisis evolved.

A.10 **Business methods.** Two characteristics of Cyprus' banking methods contributed to the bad loan problem at the heart of the crisis. One was the practice of advancing loans against collateral (usually real estate) and personal guarantee, with insufficient attention paid to cash flow and ability to repay. Although this method looks prudent, it only works if the value of the real estate is sustained or, if not, that the banks can seize the collateral or call on the guarantee in the event of default. The collapse of real estate prices and serious obstacles in Cyprus' legal system both stood in the way of banks recovering their loans. The second was the importance of personal and political relationships in Cyprus banking. Familiarity can cut both ways, by giving the lender comfort, but also by making objective credit judgment more difficult. Unfortunately, it often cut the second way.

A.11 **Role of the international financial centre.** Although much has been made of the risks posed by Cyprus' international financial centre business which operates off Cyprus' advantageous tax arrangements, we found little evidence that this was a direct cause of the crisis. The large deposit balances that accumulated in the Cyprus-based accounts of offshore clients, many of them Russian, were remarkably stable well into the crisis period. However the portion of these balances held in Cyprus banks did contribute indirectly to the crisis by supplying these banks with the liquidity they needed to fund their expansion.

A.12 **Ineffective supervision.** There was also a failure on the part of Cyprus' authorities to act effectively at many of the levels we examined. At the highest, there was little sense in government and supervisory circles of the risks that Cyprus was running with a banking system which, at its height, was equivalent to over nine times the size of the Cyprus economy. Nor was there adequate co-ordination between the two main authorities responsible for financial stability: the Ministry of Finance and the Central Bank of Cyprus. In fact relations between the two were openly hostile for much of the crucial period. All the signs point to a lack of determination on the part of the various public agencies responsible for financial stability to deal firmly with growing banking risk, even though the country's systemic banks were involved.

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

A.14 **Unnecessary delay.** We also concluded that Cyprus made matters worse for itself by failing to agree to the first set of terms drafted by the Troika in July 2012 when the crisis was at its height. The delay, caused by political considerations, stretched official support for the banks to the limit, and exasperated Cyprus' potential lenders. The consequence was a much tougher set of terms in the March 2013 MoU which included an unprecedented haircut on uninsured deposits in the country's two biggest banks, and the imposition of capital controls and restrictions on domestic banking transactions. We believe that many of the terms in the loan agreement will cause unnecessary damage to the Cyprus economy and its banking system, and possibly create longer term structural problems for which no provision is made. The MoU is now part of history, but it sets difficult conditions for the task ahead.

National policy

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

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

A.17 We recommend that, given Cyprus' exceptionally high dependence on its banking sector for financial services, and the continuing potential of this sector to generate foreign earnings and domestic employment, Cyprus develop a national financial services strategy to ensure its future stable development. There needs to be a clear understanding of the risks inherent in a high dependence on banks, and of the risks that accompany the rewards from international banking business. This requires a commitment of resources to monitoring these risks, to ensuring that banks are equipped to manage them and to developing other forms of financial services business, including international, to create greater diversity. We say what the components of such a strategy should be.

A.18 **Culture.** We believe that the introduction of fresh people, new sources of advice, international experience and different attitudes are all essential if Cyprus is to give itself a fresh start. Changes of this kind would transform the banking system in all the necessary ways, by delivering better governance, better provision of financial services, better supervision and – importantly - greater confidence on the part of its international lenders. Cultural change will involve reducing political interference in the management and supervision of the banking system, putting in place objective decision-making processes and creating incentives and sanctions to strengthen personal accountability.

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

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

Reforming the banks

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

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

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

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

A.25 **The international financial centre.** Cyprus' international financial centre business, a major source of earnings for banks and professional firms, is at risk because of the measures emanating from the crisis. We do not find fault with the concept of a well-managed international financial and professional services centre. The problem in

Cyprus is that it was poorly managed: it relied too much on tax appeal and poor supervision, and not enough on financial soundness and quality. Cyprus also allowed it to become associated with tax evasion and money of doubtful origin.

A.26 We believe this business could have a future in a more focused and upgraded form which attracts clients not just for its tax breaks but because of the quality of the skills and services on offer. Cyprus should also make more of its strategic location as a "safe haven" in a politically troubled region.

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

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

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

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

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

A.32 **Service delivery.** Cyprus banks have a high level of personal contact with their customers: they operate the densest branch network in the EU, and personal relationships play a big role in banking transactions. We expect this to change. In order to make themselves more efficient, the banks will have to close a large number of branches and reduce personnel, with a loss of personal touch. On the other hand, the use of new forms of service delivery will expand, such as Internet and telephone banking. The economics of banking will also change and Cypriot bank customers will have to prepare for a major shift in the way they do their banking.

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

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

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

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

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

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

A.39 **Corporate governance.** Strong corporate governance is essential to a healthy business, particularly one like banking which relies heavily on public confidence. We make a number of recommendations to raise the standard of corporate governance in Cyprus' banks as well as in the co-operative banks where there were also serious weaknesses. In particular, we see the need to strengthen the role and composition of boards, raise and maintain the quality of directors, and give boards stronger oversight over crucial areas such as internal audit and risk management.

A.40 **External audit.** The role of the external auditors is important, as is the relationship with the supervisors, whose role they complement. This appears to have been neglected for a crucial period in the build-up of the crisis. The fact that the banks' losses came as a surprise to many people suggests that there is room for improvement. We make recommendations to strengthen auditing, improve oversight of the accounting profession, raise the quality of reporting by listed companies and improve relations between banks, auditors and their supervisors.

Financial stability

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

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

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

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

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

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

A.41.6 inadequate line supervision, including poor enforcement.

A.42 **Banking union.** In considering ways to strengthen financial stability in Cyprus, account needs to be taken of the changes that will be introduced by the EU's Single Supervisory Mechanism (SSM) which is scheduled to start in November 2014. This will transfer responsibility for prudential supervision of the euro area's largest banks to the European Central Bank in Frankfurt. For Cyprus, this means that Bank of Cyprus, the Co-operative Central Bank, Hellenic Bank and Russian Commercial Bank will become the responsibility of the SSM, and that prudential policy as regards significant banks will cease to be the province of the board of the Central Bank of Cyprus.

A.43 **Structure of financial supervision.** Cyprus has a fragmented system of financial supervision with four separate authorities, three of them sponsored by ministries. This leads to confusion, resourcing issues and the risk of political interference. We recommend that these be combined into a single entity and placed within the CBC which has the legal and financial independence to handle this role, and whose supervisory competence is in the process of being strengthened.

A.44 **Independence and accountability of the CBC.** The highly charged political atmosphere surrounding Cyprus' banking system has led to tension between the government and the CBC which is harmful. It is important, for the effective discharge of the CBC's supervisory role, that its independence be recognised and respected, but that this also be balanced by clear CBC accountability and transparency in the supervisory area. The CBC's accountability for financial stability should be made more explicit in the relevant laws.

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

A.46 **Governance of the CBC.** Poor governance arrangements of the Central Bank of Cyprus contributed to the 2012 crisis by concentrating too much power in the hands of the Governor. We share the view that there needs to be greater pluralism at the CBC. However, the options for change are limited by EU law which requires that the independence of the Governor be protected, which we also believe to be important. The solution lies in having a stronger non-executive structure and clearly defined board responsibilities.

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

A.48 We recommend that the CBC have a policy-setting board chaired by the Governor, with two executive directors and four non-executive directors with clear decision-making powers in specified areas. The checks and balances on the executive would be provided by appropriately qualified, independent non-executive directors and effective board committees. We welcome a recent initiative to set up an audit committee with the power to monitor the executive's performance and recommend corrective action if needed.

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

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

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

A.52 We recommend that the financial stability function be strongly resourced in the government ministries and the CBC. Macro-prudential oversight should have clear procedures for identifying and addressing risks consistent with the guidance of the European Systemic Risk Board, and the CBC and ministries should have rigorous procedures for taking action in regard to them. In addition we recommend that the existing Financial Stability Committee be revitalised to improve the CBC's working relationship with other areas of government, and provide a top level forum for policy discussion on supervisory issues in each of the financial sectors, including issues arising out of threats to the system as a whole.

A.53 **Supervision.** The CBC's supervision function is being improved to correct the failings exposed by the crisis. We make a number of detailed recommendations to advance this programme which we consider essential to the recovery of the banking industry. An important recent development was the inclusion of supervision in the CBC's internal audit process, which means it will now be held to account by the CBC board.

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

A.55 We encourage moves to create stricter frameworks for systemically important banks, such as more intensive supervision, higher loss absorbency capacity, and higher standards of corporate governance. In particular, the capital base of the banks needs to be maintained at a high level. The CBC's enforcement function also needs to be separately established to provide it with the necessary independence. Its work needs to be more rigorously applied, and details of enforcement actions made public.

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

A.57 **Consumer protection.** The recovery of the Cypriot banking system will have to include stronger conduct of business regulation to ensure that banks deal honestly and fairly with their customers. The CoCos affair, in which bank customers were not sufficiently apprised by the banks of the risks in unfamiliar savings instruments and had difficulty obtaining compensation when they lost money, highlights the deficiencies.

A.58 We recommend that conduct of business regulation be strengthened by emphasising the CBC's responsibility for regulating the conduct of banks' investment business, including areas such as savings, mortgages and loans. We also recommend that the part played in these areas by the Financial Ombudsman and the Banking Codes be expanded, and that a more concerted effort be put into financial education to raise consumer awareness of financial risk.

Cost/benefit analysis

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

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

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

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

Conclusion

A.63 Although this is a daunting list of challenges, it lies within Cyprus' power to address all of them, and we firmly believe that they will produce the strong and healthy banking system that Cyprus needs. To assist the process, we conclude this Report with recommendations for implementation, with a timetable and responsibilities.

Final Report and Recommendations of the Independent Commission on the future of the Cyprus banking sector

Foreword

We opened our Interim Report in June 2013 with the words: "Cyprus is in a critical situation". Four months later, it is possible to sound a little more optimistic: "Cyprus has embarked on the road to recovery".

An impressive amount has happened over that period. Cyprus has made a determined effort to adjust to the terms of the MoU, a huge programme of legislative reform is passing through Parliament, and the banking sector has been fundamentally restructured. These are considerable achievements. But much remains to be done: the banking system, for example, is still not sufficiently stable to allow for the removal of capital controls.

Restoring a healthy banking sector is central to the task that lies ahead. Although this is a major challenge, it is also an unmissable opportunity to endow Cyprus with a financial system that is sound and up-to-date, and which draws on the best international practice in governance and supervision.

Our mandate as a Commission is to look beyond the immediate turmoil and make recommendations to give banks a sustainable future, and this is the nub of our Final Report. However, we also make recommendations aimed at restoring confidence to the banking system in the immediate future which will allow the longer term transformation to happen.

It should be stressed that we are an independent commission, and that the views we express and the recommendations we make are entirely our own. We therefore feel bound to be candid in our analyses, and to say things that others might wish to say but feel constrained about for a variety of reasons. For example, some of the most fundamental challenges Cyprus faces, we think, have less to do with the technicalities of banking than with cultural attitudes, a theme which permeates the Report.

The temptation in exercises such as this is to recommend more of everything: more controls, tougher rules, and so on. We have tried to avoid this. We know that the banks must play a crucial part in Cyprus' economic recovery, and that they should not be burdened with more costs than are absolutely necessary to get them going again.

We also believe in the need to be realistic. Cyprus' return to health may not be speedy: austerity has only recently begun to bite, the banks are in a state of shock, and overall conditions in the euro area remain uncertain. Against that, we should not be too pessimistic. A small economy like Cyprus could bounce back very quickly if the recent signs of recovery in world markets take root. In the longer term, it is possible to be upbeat about Cyprus' prospects: it is a strategically-placed island with a well-educated and industrious population. With the right solutions and patience there is no reason why it should not flourish once again, but in a more stable and sustainable way.

David Lascelles
Chairman
Nicosia October 2013

Acknowledgements

We are grateful to the many institutions and individuals who supplied information and advice to the Commission, and provided comments on the Interim Report. They are listed at the end of the Report. We would also like to acknowledge, with thanks, the support received from George M. Georgiou, Head of the Office of the Governor at the Central Bank of Cyprus, Roula Avraamidou who heads our secretariat, and Anna Markidou, our researcher.

1. The Commission

The Independent Commission on the Future of the Cyprus Banking Sector was set up in November 2012 by the Central Bank of Cyprus (CBC) to make recommendations on the long term recovery of the Cypriot banking industry. Its Terms of Reference require it to draw lessons from the current crisis and put forward proposals to make the Cypriot banking industry stronger and better fitted to meet the country's banking needs. This includes examining the size and structure of the industry, the quality of service, and the supervision of banking. In carrying out its work the Commission was asked to take account of international best practice, and the legal and operational requirements of international agreements and treaties.

Under the terms of the financial facility granted to Cyprus by the European Union, the European Central Bank and the International Monetary Fund (the "Troika") in March 2013, urgent changes are already being made to the structure of the banking industry and to supervision. In April 2013, the Commission's Terms of Reference were revised to take this into account. The Revised Terms of Reference are on page 114.

The members of the Commission are:

David Lascelles, chairman. David Lascelles has been analysing the banking industry for more than 30 years as Banking Editor of the Financial Times and more recently as Senior Fellow of the Centre for the Study of Financial Innovation, an independent London think tank. David has also been a university lecturer in banking and a bank non-executive director.

George Charalambous has been a key figure in the Cypriot financial sector for many years, as senior general manager of the Bank of Cyprus and more recently as chairman of the Cyprus Securities and Exchange Commission. A graduate of the London School of Economics and the Athens School of Economics, he has also held senior positions at several other institutions including the Central Bank of Cyprus and the Cyprus Development Bank.

David Green is a leading international expert on financial stability matters with over 40 years as a central banker and financial regulator. During his career he has worked in the Bank of England and the Financial Services Authority, and more recently in the UK's integrated regulator for corporate reporting, the Financial Reporting Council. He has been a risk adviser at the Central Bank of Ireland as well as providing consultancy advice to financial authorities in other jurisdictions.

Pierre de Weck is a senior Swiss banker with more than 35 years experience of banking at the international level. During his career he has held senior positions at Citibank, UBS and Deutsche Bank, working in Europe, North America and with the Middle East. Most recently he was a member of the Group Executive Committee of Deutsche Bank where he was Global Head of the Private Wealth Management Division with €300bn of client assets in over 70 countries. He is now a non-executive director of Bank of America.

2. This report

2.1 For the past year, this Commission has been gathering material, conducting interviews and canvassing a wide range of expert opinion to understand Cyprus' banking problems and prepare its recommendations. In June 2013, we published our Interim Report in which we analysed the issues and laid out our proposed recommendations for public consultation. We received about 50 responses from a wide range of individuals and institutions in Cyprus and abroad, for which we are very grateful.

2.2 This document is our Final Report in which we lay out our formal recommendations along with our proposals for implementation. The Report is in three parts. In the first we examine the recent past to find the causes of the crisis and identify faults that need fixing. In the second we lay out our recommendations for improving the banking sector, and in the third we do the same for financial stability and banking supervision.

2.3 This Report differs from our Interim Report in important respects, for a number of reasons. One is that events in Cyprus have moved on. Reform of the banking system is underway and some of the measures we proposed in June have already been implemented, for example in the area of banking supervision. Another is that the changing scene has highlighted the need for new recommendations. A third is that the responses we received contained new ideas, fresh information and criticisms which prompted us to amend, remove or add to our original proposals.

The main differences between the two Reports can be summarised as follows.

2.3.1 **Causes of the crisis.** Although many of the responses we received agreed with our analysis of the crisis and the lessons to be drawn from it, this remains a difficult area open to different interpretations, for example as to whether the failings, aside from those of the banks themselves, lay mainly with government policy or banking supervision. In our view it was both. However since our remit is to focus on banking rather than macro-economic policy, this is the aspect we develop. We recognise, however, that there are limits to what banking supervision can achieve when government policy is unhelpful (as it unquestionably was in the 2008-12 period), and we have qualified a number of our comments and recommendations to take this into account. (3.0)

2.3.2 **National financial services strategy.** In our Interim Report we said that Cyprus should have a national strategy to handle its financial services sector, given the importance of banking to the economy and the fact that the absence of such a strategy had, in our view, contributed in a major way to the crisis. This proposal received strong support. We have consequently developed it and used it to give shape to the whole report. The elements of such a strategy are essentially what this report is about. (5.2)

2.3.3 **Confidence building measures.** In the four months since our Interim Report, the need to restore confidence in the banks has become increasingly urgent. We have therefore added a section on confidence-building measures, specifically calling for a state guarantee of bank deposits to enable capital controls to be lifted as soon as possible to revive the economy. (6.2)

2.3.4 **Labour reform.** We examine the need for labour reform in the banking sector to reduce costs and introduce more flexibility. (5.24)

2.3.5 **Reforming the banking sector.** Now that the major structural changes to the banking sector have been achieved (merger of Cyprus Popular Bank and Bank of Cyprus, and reform of the co-operative credit institutions), we devote more of the Report to the consequences of change, and to the measures needed to build a healthy and balanced banking system. (7.0, 8.0, 9.0, 10.0)

2.3.6 **Banking union.** We include an assessment of how the EU's plans for the introduction in 2014 of a Single Supervisory Mechanism as an element of the wider plans for banking union will affect the supervision of Cyprus' banks and the responsibilities of the CBC. (15.0)

2.4 There are also parts of our Interim Report which aroused controversy but which we have decided not to change. These can be summarised as follows.

2.4.1 **Co-operative credit institutions.** Although measures have been taken to integrate and slim down the co-ops, we continue to recommend that they be transformed into a single joint stock entity which is commercially and competitively managed. Recent reforms will not, in our view, fully eliminate the co-ops' weaknesses. (8.4)

2.4.2 **International financial centre.** Despite doubts arising from the shocks to banking confidence, we continue to believe that Cyprus can and should seek to rebuild its international financial centre business, but with a focus on soundness, quality and diversity. (11.0)

2.4.3 **Single regulator.** We continue to believe that Cyprus should address the inefficiencies inherent in its fragmented system of financial regulation, with four different supervisors, three of them sponsored by ministries. They should be combined into a single regulator located in the Central Bank of Cyprus. (16.0)

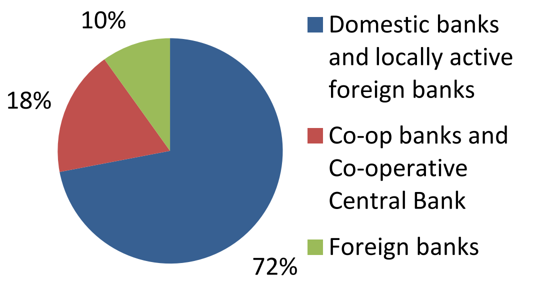
2.4.4 **Governance of the Central Bank of Cyprus.** Recent legislative initiatives have introduced changes to the governance of the central bank which are, in general, welcome. However we believe that they should be improved and extended in line with our earlier recommendations. (17.10)

3. The causes behind Cyprus' banking crisis

3.1 Banking is of crucial importance to Cyprus. Unlike countries which have alternative sources of finance such as investment markets, Cyprus depends almost entirely on its banks for financial intermediation. The country's international professional services business also attracted a large amount of foreign banking business. Until the recent crisis, the industry was an important contributor to the economy, accounting for a sizeable percentage of the workforce and the GDP. Resolving the banking crisis is therefore crucial to Cyprus' economic recovery.

3.2 The three components of the banking sector with which we concern ourselves in this report are locally active banks (which include some foreign banks), co-operative credit institutions and foreign banks which have a presence in Cyprus as part of the country's international financial centre, but have little or no contact with the domestic economy. The locally active banks have the largest share of the market, - nearly three quarters – followed by the co-ops with 18 per cent and the foreign banks with 10 per cent. The commercial banks are supervised by the Central Bank of Cyprus; the co-ops until recently had their own supervisor, but are now to be supervised by the CBC as well.

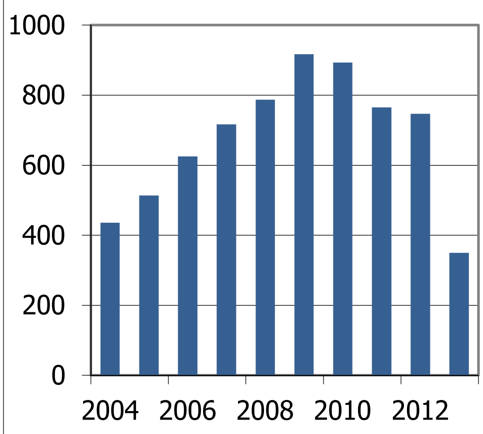
Chart 1: Cyprus banking sector
Share of total assets
March 2013



Source: Central Bank of Cyprus

3.3 Cyprus' banking sector is undergoing what is possibly the most severe banking crisis of any country in the EU. Following the collapse of the system in 2012 under losses equivalent to nearly the size of the country's GDP, the banks are being restructured and recapitalised with a combination of public money and uninsured customer deposits under a rescue programme directed by the EU, the ECB and the IMF (the "Troika").

Chart 2: Total assets of credit institutions as a % of GDP

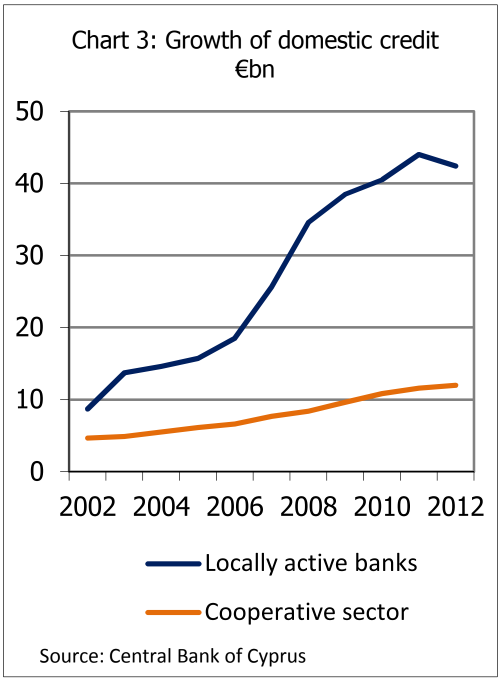


Source: Central Bank of Cyprus. 2013 is MoU estimate

3.4 We examined the causes behind these developments in detail and reached a number of conclusions. These are:

3.4.1 That over the period 2004-2010, Cyprus' banks grew dangerously large through a combination of aggressive management and weak governance, compounded by a failure by the public authorities to appreciate the risks that the banks were running, and therefore to take effective measures to rein them in. At its height in 2009, the banking sector was equivalent to nine times the country's GDP, one of the highest levels in the EU (see Chart 2).

3.4.2 That the banks engaged in imprudent lending both domestically and through their rapid expansion abroad, mainly in Greece and East Europe because of failures in their risk management systems and poor lending practices. This included taking on an inappropriate and ultimately fatal €5.7bn exposure to Greek Government Bonds (GGBs). Poor lending practices also occurred at the co-operative banks because of weak governance and internal controls, causing them to suffer extremely large loan losses. In 2012, private sector indebtedness in Cyprus reached 271 per cent of GDP, the highest level in the EU, with most of this secured on property that was declining in value.



3.4.3 That while Cyprus' international financial centre, based on foreign deposits and tax-driven business, was remarkably stable in the circumstances, it nonetheless channelled large amounts of liquidity into the domestic market and contributed strongly to the problem of excessive credit growth which the authorities did not do enough to control.

3.4.4 That the government's failure to correct Cyprus' deteriorating financial position in the 2009-2012 period concealed underlying weakness and precipitated a fiscal crisis which caused it to be excluded from the international capital markets, and which left it without the resources to support its banks when they entered their critical phase in 2012. The government's reluctance in 2011-12 to seek outside support from the EU and the IMF, followed by long delays in agreeing rescue terms, made matters considerably worse.

3.4.5 That Cyprus' failure to take adequate precautionary action against the combined threats of a real estate bubble on the domestic market and increasingly turbulent conditions on the international financial markets showed a lack of awareness as to the country's potential vulnerabilities on the banking front.

3.4.6 That there were supervisory failures at many levels, including poor co-ordination between the Central Bank of Cyprus and the Ministry of Finance over the mounting risks to the system, and the ineffectiveness of the supervisory agencies when it came to controlling the banks and the co-ops, due mainly to lack of firm leadership, influenced by a prevailing attitude in political circles and the international agencies that all was sufficiently under control[1].

3.4.7 That there were also external factors, notably Cyprus' entry into the EU (2004) and the euro (2008) which liberalised the banking system very rapidly and gave it access to new sources of funds while also removing Cyprus' ability to control credit expansion by monetary means. Although the subsequent global financial crisis did not much affect Cyprus directly, it had a large indirect impact through its banks' involvement with Greece and through the collapse in foreign demand for residential real estate on the island. Turbulence in the euro area placed further stresses on the Cyprus economy and banking system, and also greatly complicated Cyprus' later efforts to obtain financial support.

Comment

3.5 The comments we received on our Interim Report broadly supported our reading of events, though there were divergent views over the relative importance of fiscal and supervisory failures. One area where new evidence has caused us to modify our views concerns the reasons for the apparent ineffectiveness of banking supervision. It is clearer to us now that line supervision and macro-prudential analysis were operating, but that they were hampered by a lack of determination when it came to dealing firmly with the banks and passing up unwelcome messages. We develop this theme more fully in the report.

The current position

3.6 Cyprus reached a critical stage in the first half of 2011 when it lost access to the international capital markets and opted to turn to Russia for a €2.5bn emergency loan. Shortly afterwards, the country's two leading banks suffered a €4.5bn "haircut" on their GGBs during the second Greek bail-out, creating losses which they were unable to make good in the capital markets. The position was most critical at Cyprus Popular Bank (Laiki Bank) which had outstripped its ability to fund itself with domestic deposits and turned increasingly to wholesale funding and, ultimately, to Emergency Liquidity Assistance, the source of crisis funds from the European Central Bank. These borrowings eventually amounted to over €11bn. In mid-2012, the government had to bail Cyprus Popular Bank out with a €1.8bn capital injection. Shortly afterwards, the government itself had to turn to its EU partners for help. After a long delay, caused

[1] See, for example, Argyridou-Dimitriou C., E. Kanaris, *The financial system of Cyprus.* Chapter 7 in Orphanides A. and G. Syrichas, Eds. *The Cyprus Economy, historical review, prospects, challenges.* Central Bank of Cyprus 2012, p. 280. "Overall, the Cyprus banking sector has fulfilled very satisfactorily its financial intermediation role and was the key driver of the robust economic growth and stability that the country experienced following the Turkish invasion".

mainly by political procrastination, Cyprus agreed terms for a €10bn loan from the Troika in March 2013.

3.7 The country is now undergoing a severe adjustment programme which has major implications for the banking sector. The overriding aims are to shrink the sector down to a more manageable size and to rebuild the commercial and co-operative banks.

3.8 Much of this has already been achieved. The two largest commercial banks have been restructured by folding Cyprus Popular Bank into the largest bank, Bank of Cyprus, and by using 47.5 per cent of BoC's uninsured deposits (i.e. those over €100,000) to rebuild their capital. The advantage of this arrangement is that it keeps the business of both banks going. But it also has serious disadvantages, the main one being the damage that the compulsory conversion of deposits into share capital has done to banking confidence, and the accompanying need to impose capital controls on the movement of funds both within Cyprus and abroad to prevent deposit flight. The other is that it results in the creation through unplanned merger of a very large bank controlling half the market, which raises practical, structural and stability concerns.

3.9 Of the sector's other major players, the country's previously third largest commercial bank, Hellenic, is being recapitalised out of public funds. The co-operative sector, which needs €1.5bn to cover bad loans, has been recapitalised the same way. The sector's 90-plus members are being consolidated down to 18 under the Central Co-operative Bank, and supervision is being transferred from its specialist supervisor to the CBC.

3.10 A large number of other measures are also being taken to strengthen supervision of the banking sector, to address the bad loan problem and to dispose of the leading banks' overseas acquisitions.

3.11 Although we understand the political exigencies in the wider euro area which led to the decision to take these drastic measures, we consider them to be exceptionally harsh and potentially damaging to the recovery prospects of the Cypriot banking sector and therefore the Cyprus economy. The task of restoring confidence in Cyprus banks after the "haircut" is enormous: deposit flight remains a major risk, and with it the danger that Cyprus banks will suffer liquidity problems that will constrain their ability to lend. The problem of non-performing loans, whose exact size remains unknown, will almost certainly continue to grow. The good news is that the country's

Table 1

Main components of Cypriot bank losses €bn

Bank of Cyprus	- in Cyprus	3.6
	- in Greece	2.5
Popular Bank	- in Cyprus	2.5
	- in Greece	4.5
Co-operative banks		1.4
GGBs		4.5

Source: PIMCO "adverse scenario"

two largest banks have been merged and brought out of resolution. The challenge now is to turn them into a strong, viable entity which will win the confidence of depositors and contribute to the country's economic recovery.

3.12 **Losses.** The total losses incurred by the banking sector from this series of disasters has been put by an independent assessment by PIMCO[2] at just under €14bn, implying a capital gap in bank balance sheets of nearly €6bn by 2015. However this is under a so-called "base scenario". A more pessimistic "adverse scenario" forecasts total losses by 2015 of €18.5bn, implying a capital gap of €8.9bn (see Table 1). Losses of this order, which now seem more likely, would amount to more than Cyprus' total GDP.

Issues arising from the crisis

This brief overview of recent events in the Cyprus banking sector highlights a number of crucial issues which form the body of our recommendations.

3.13 **National policy.** The most significant high level cause of the crisis was a failure at the national policy level to appreciate that running a big banking industry is about risk as well as reward. The public attitude was that the banks were doing a good job of supporting economic growth and that the international business they brought added to the nation's wealth. Insufficient attention was paid to the fact that the banks were acting imprudently and that the international business was creating serious domestic imbalances, or to how any potential emergency might be handled. There may even have been a (possibly subconscious) inclination to ignore these risks in order to avoid "spoiling the party". This set a political tone in which low priority was given to monitoring banking risks, and to supervising the banks themselves.

3.14 **Weak bank governance.** Much of the imprudent behaviour by the commercial banks over this period can be attributed to a lack of effective governance. It is clear that the boards of key banks failed in their responsibility to ensure that their institutions had proper procedures to monitor and control risk, and to provide the necessary checks on the executive. A culture of deference rather than challenge prevailed in the face of domineering chief executives who increasingly ignored their boards and bypassed what controls did exist. This was particularly dangerous in the case of the two largest banks which were driven by intense rivalry and, over time, by an increasingly desperate need to generate income to finance their greatly expanded operations, and meet their bonus targets. Some directors had strong conflicts of interest which prevented them from exercising the required independence, as when they received large loans from the bank or were granted supply contracts. In the co-ops, there was also an unhealthy convergence between the interests of boards, management and customers which led to loan favouritism and failure to recognise default.

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[2] PIMCO: *Independent due diligence of the banking system of Cyprus 2013.* P. 16.

3.15 **Poor lending practices.** Much of the rapid growth in lending in both the commercial banks and the co-ops was against collateral (mainly property) or personal guarantee rather than a more rigorous assessment of the borrower's ability to re-pay the loan. When Cyprus' property bubble burst, the banks often found that the collateral could not be seized, or had fallen sharply in value, and that the guarantees could not in practice be called. However, rather than recognise these loans as bad, the banks used various practices to treat them as good, for example by extending the repayment terms or accruing the interest on them at penalty rates, which had the effect of boosting both the balance sheet and revenue. Rules governing the recognition of non-performing loans were also lax.

3.16 **Ineffective banking supervision.** Although many of the necessary powers and processes existed in the CBC to supervise the banks and ensure that they were operating prudently, the record shows that banks were able to proceed without serious regulatory challenge until it was too late. All the signs point to a weak ability on the part of Cyprus' financial stability function to deal firmly with banking risk, even though the country's two systemic banks were involved. This position was supported by surprisingly encouraging reports from the international agencies which scrutinised Cyprus' financial condition[3]. Furthermore, governance flaws in the Central Bank of Cyprus meant that the supervision function was not independently assessed, and that the CBC itself was not explicitly required to account politically for its handling of its supervisory responsibilities.

3.17 The situation was complicated by the openly hostile relations that existed between the CBC and the Ministry of Finance, and the absence of effective mechanisms for co-ordinating intra-governmental work on financial stability.

Conclusion

3.18 Cyprus' extraordinary banking crisis was due to failures at several levels: national fiscal policy, macro-prudential oversight, banking supervision, and the governance of the banks themselves, as well as in banking practices, particularly lending, all happening within an exceptionally difficult economic and political environment.

[3] As late as February 2011, the IMF's Article IV report on Cyprus concluded that "The Cypriot banking system has weathered the economic difficulties well and appears to be in sound overall condition. It has benefited from reliance on deposits rather than less stable sources of financing, conservative lending practices, close attention to capital and liquidity buffers, and vigilant supervision. These factors have helped shield the banking system from the pressures that are prevalent in many other countries. The ongoing risks in international financial markets call for a continuation of conservative balance sheet management and careful supervision." This striking conclusion gave the authorities considerable comfort at the time.

Cyprus chronology

1980s Beginnings of Cyprus' ambition to become an international business and financial centre.
2004 Cyprus joins the European Union. Banking system is liberalised.
2006 Domestic bank lending begins to grow rapidly.
2007 The largest Cypriot banks embark on a period of international expansion in Greece, the Balkans, Russia and the Ukraine.
2008 Strains building up in international markets
January: Cyprus joins the euro.
February: General election brings AKEL government to power.
September: Collapse of Lehman Brothers. Acquisition by Bank of Cyprus of Uniastrum in Russia for €450m.
2009-2010 Largest Cypriot banks buy €5.7bn worth of Greek government bonds.
2010 Deterioration in Cypriot government finances. Economy moving into recession. CBC putting pressure on banks to raise more capital
April: Greek sovereign debt downgraded to junk status.
2011 Cypriot banks begin to suffer heavy losses because of the economic crisis.
April: Government imposes a levy on bank deposits to raise revenue.
May-June: Cyprus sovereign debt is reduced to junk status. Cyprus loses access to international capital markets, obtains a €2.5bn emergency loan from Russia.
May: Bank of Cyprus and Cyprus Popular Bank raise €1.9 billion of non-core Tier 1 capital (including contingent convertible bonds (CoCos) of about €1bn).
July: EU adopts "private sector involvement" approach to dealing with Greece's problems.
Cypriot banks suffer an 80 per cent "haircut" on their Greek government bonds, creating a loss of €4.5bn.
2011 Cyprus' three largest banks suffer aggregate losses of €6.5bn.
2012 March: CoCos are partly converted into equity capital, creating investor losses.
May: Cyprus government rescues Cyprus Popular Bank with a €1.8bn recapitalisation. New top management at Cyprus Popular Bank and Bank of Cyprus. Appointment of new CBC Governor.
June: Cyprus seeks assistance from EU, ECB and the IMF.
2013 February: General election brings Democratic Rally to power.
March: Negotiation of Memorandum of Understanding with the Troika. Cyprus Popular Bank is dissolved and its business folded into Bank of Cyprus. Haircut on uninsured deposits at Bank of Cyprus; banking controls introduced.
June: First Troika review of Cyprus' progress.
September: Newly merged Bank of Cyprus comes out of resolution.

4. The Memorandum of Understanding

Although Cyprus arguably brought the tougher terms of the 2013 MoU on itself by failing to sign up for the terms originally offered in mid-2012, the conditions it now faces pose a major challenge to the economy and its banks. We have strong concerns about a number of its provisions.

4.1 **Severity.** The terms of the agreement are exceptionally severe by the standards of other euro area bail-outs. The focus on "front loaded" austerity and bank restructuring is putting additional stress on a severely weakened economy. The agreement is now part of history, but it creates difficult conditions for the task ahead.

4.2 **The merger of Cyprus Popular Bank with Bank of Cyprus.** This provides the Troika with an expedient way of dealing with Cyprus Popular Bank's immediate problems, and assembling enough collateral to secure the ECB's emergency funding. But it is a difficult merger which contains considerable execution risk, and will be open to legal challenge. At the time of writing, more than six months after it was initiated, the merged bank still has no up-to-date balance sheet or business plan. This is valuable time wasted. So long as uncertainties about the banks' future persist, economic recovery will be difficult. Furthermore, it will leave Cyprus with a dominant bank controlling 40-50 per cent of the domestic market – which could become problematic for competition and financial stability later on.

4.3 **The haircut on deposits**. Although the terms of the MoU have "only" hit uninsured deposits in Cyprus' largest bank, the impact on depositor confidence more generally has been enormous, creating a liquidity crisis in the banking system which will constrain credit availability at a crucial moment, and delay the lifting of capital controls. The haircut has also devastated the Cyprus savings market, both for personal savers and provident funds. The selective way in which the haircut was applied raises questions of fairness when depositors in foreign branches were spared, and other credit institutions in Cyprus receiving public money were not required to call on their depositors or members. The impact of this unprecedented measure is certain to be felt more widely in the euro area if banks in other countries get into trouble. Separately, the haircut arrangements radically alter the shareholding structure of Cyprus' largest bank with consequences that are still unclear.

4.4 **The shrinkage of the banking system.** The forced pace of the shrinkage has already created fire sale losses, and may cause more. This is an unnecessarily costly and disruptive way to downsize a banking system. Cyprus' banking sector should have been left to find its optimal size within a reasonable time frame, whatever the concerns about its reliance on international business.

4.5 **The shrinkage of the international financial centre.** We do not consider the presence of a large foreign banking business to have been of itself a major direct contributor to the crisis, though the inflow of foreign deposits was a reason for the sector's unwieldy size and made possible the banks' imprudent expansion. Until the MoU negotiations threw up the possibility of a haircut, non-residents' deposits had been remarkably stable, and provided the foundation for a tax-based international banking business that was profitable. The case for shrinking this sector was driven by certain countries' concern about its legitimacy rather than its impact on the soundness of the banks, which is a different issue which could have been dealt with by supervisory means.

4.6 **Lack of measures to promote growth.** There is nothing in the agreement actively to promote Cyprus' economic recovery: the emphasis is mostly on fiscal austerity and banking reform, though the latter will certainly provide a foundation for future growth. In order to recover, the economy will need to find new sources of growth, and the banks will have to be able to earn substantial profits to return to full health and attract funding to replace their official liquidity assistance.

4.7 Although we are concerned about the provisions of the MoU, we nonetheless support many of its objectives, specifically as regards the need to

4.7.1 reduce the size of the banking system,

4.7.2 recapitalise the banks

4.7.3 restructure the co-ops,

4.7.4 strengthen corporate governance in banks,

4.7.5 strengthen the capital and liquidity position of banks,

4.7.6 improve the banks' loan origination and management practices,

4.7.7 strengthen anti-money laundering action,

4.7.8 and improve banking supervision.

However we also go further than the MoU in a number of areas. Some of our recommendations take the MoU provisions to a more evolved stage, others are intended to strengthen processes through which Cyprus could achieve a speedier and more sustainable recovery.

4.8 **National financial strategy.** We believe Cyprus should develop a national financial services strategy to provide an overall framework for one of its most important industries.

4.9 **Cultural change.** We urge changes in the culture of politics and business, specifically to bring more openness and objectivity to decision-making.

4.10 **Reform the labour market.** We believe that the banking labour market needs to be substantially reformed in order to introduce greater efficiency and flexibility.

4.11 **Confidence building.** We believe that more explicit measures should be taken to restore confidence in the Cyprus banking system, in particular the issuance of a blanket deposit guarantee backed by European institutions, and clearer structures to deal with non-performing loans.

4.12 **The political process and the Central Bank.** We urge that greater attention be paid to the need to achieve a balance between the need for accountability at the Central Bank of Cyprus and independence of the supervisory process.

4.13 **Financial stability.** We address the problem of poor communication between public authorities responsible for financial stability, and recommend a formalised structure.

4.14 **Integrate the regulators.** We recommend that Cyprus combine its four separate financial regulators into a single entity to make them more efficient.

4.15 **Finish the job with the co-ops.** We believe that reform of the co-ops should go a stage further to create a single commercial entity with a joint stock structure.

4.16 **Reform CBC governance.** We offer detailed recommendations for the reform of the governance of the Central Bank of Cyprus and correct its weaknesses.

4.17 **Get the international financial centre going.** We see a future for Cyprus' international financial services business, and make recommendations on how this can be achieved.

4.18 **Banking union.** Our recommendations take account of the likely effect of the EU's banking union on the way Cyprus banks are supervised and on the role of the CBC.

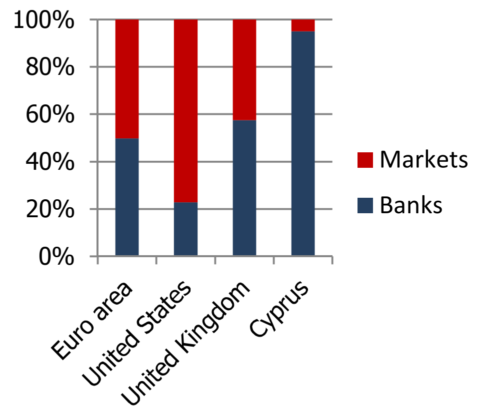
5. Banking policy

5.1 The most significant high level cause of Cyprus' banking crisis was insufficient awareness that the banks' apparent business success created enormous vulnerabilities for Cyprus should conditions change for the worse – as they did. The combination of loose fiscal policies, ineffective supervision, and the lack of formal arrangements to deal with a crisis opened the way to catastrophe. Cyprus was not alone in this regard, but relatively speaking, this was one of the worst cases of self-inflicted damage in the EU. This raises national policy issues both as to how the financial sector should be managed, and how recovery can best be achieved.

National financial services strategy

5.2 Banking is of crucial significance to Cyprus because the country has few alternatives to banks when it comes to placing savings and obtaining loans. Also, banking is an important source of foreign earnings and will, in our opinion, continue to be so provided confidence can be restored. Because of these considerations, we recommend that Cyprus adopt a national strategy to provide a framework for its financial services industry, including banking, insurance and investment services.

Chart 4: Financial intermediation
Share of banks and markets



Source: IMF Global Financial Stability Report 2011
Statistical appendix Table 1 p.11.
Cyprus is ICFCBS estimate

5.3 Apart from stimulating a much-needed debate about the role of financial services in Cyprus and creating a better understanding of the issues, we believe that the adoption of a national financial services strategy will make a major contribution to restoring international confidence in Cyprus as a financial and business centre. In the comments we received on our Interim Report, there was strong support for such a strategy. One respondent said: "We have one for tourism, why not for banking?"

5.4 Another bank-dependent country which recently formulated such a strategy was Switzerland. The strategy consists of measures to maintain and improve the quality, stability and integrity of Switzerland's financial centre, while also boosting its competitiveness and combating abuses[4]. Its objective is to "create the best possible, internationally accepted environment conducive to a strong and competitive financial market." This should also be Cyprus' goal.

[4] For more details see *Report on Switzerland's Financial Market Policy*. Federal Council. December 2012. http://www.sif.admin.ch/themen/00827/index.html?lang=en,

5.5 The components of a national financial services strategy in Cyprus should include:

5.5.1 A statement of the objectives of the strategy. These are Cyprus' need to have a stable and healthy financial system to ensure the supply of financial services to the economy, and to strengthen international confidence in its financial institutions and markets;

5.5.2 A recognition that running a financial services industry is about risk as well as reward, and that the country must therefore have sound economic and fiscal policies, and a commitment of the necessary resources to ensuring financial stability;

5.5.3 Structurally, the government and its agencies and departments must have processes to co-ordinate their work and ensure that necessary decisions for action are taken. These would include clear procedures for crisis management, bank resolution, and for dealing with "too big to fail" banks;

5.5.4 A commitment to introduce and maintain the highest standards of financial supervision, including respect for the independence of the supervisory process. This would cover not only banking but insurance and investment services and auditing;

5.5.5 A commitment to introduce and maintain the highest standards as regards the strength and governance of banks;

5.5.6 A commitment to maintain the highest standards of probity, including anti-crime measures, and the rule of law;

5.5.7 An ongoing legislative programme to ensure that issues such as legal rights, banking law, company law and labour law are appropriate and kept up to date;

5.5.8 Policies to develop alternatives sources of finance to banking, such as capital markets and investment funds, in order to diversify the country's financial structure;

5.5.9 Policies to encourage new entrants into the financial services market to stimulate competition and innovation, including foreign banks, start-up banks and investment firms;

5.5.10 The commitment of resources to support Cyprus' role as a provider of international business services;

5.5.11 The commitment of resources to promote Cyprus internationally as a sound and competitive business and financial centre;

5.5.12 A continuous process to benchmark Cyprus against international best practice in key policy areas, such as political and economic stability, business environment, infrastructure, human resources and service quality.

Culture

5.6 We found that a common cause behind many of Cyprus' problems lay in culture and attitudes. A frequent observation we heard was that personal and political considerations played too great a role in the country's business affairs, and that there needed to be more objectivity and openness, and greater receptiveness to different ideas and people. We agree. We found it striking, for example, that there were so few people with international experience on the boards of banks in a country which operates an international financial centre.

5.7 However, there was also agreement that bringing about cultural change will not be easy. Many current practices are deeply ingrained, vested interests are strong, and the political establishment seems to have difficulty accepting that the banking system and its regulators need to be independent. A particular issue is the lack of respect for confidentiality: independence cannot be protected if highly sensitive documents are constantly being leaked.

5.8 Some comments we received suggested this would take a generation to achieve. We believe that Cyprus should deal with these issues more urgently if it is to turn itself around.

5.9 Politically, there needs to be a better understanding that interference in the management and supervision of banks seldom makes things better.

5.10 The aim must also be to reduce the part played by personal interest and to encourage objective processes. Important appointments should be made on merit rather than personal connection. We believe that a larger presence on the management and boards of banks of people with strong international experience, including non-Cypriots, would be healthy. Ireland's banking recovery was aided by the appointment of non-Irish people to senior positions in the Central Bank of Ireland and the major banks.

5.11 To some extent, change is already being introduced with the improvements to banking supervision and corporate governance. But it may also be necessary to have more direct incentives and sanctions to strengthen personal accountability. We welcome the more rigorous "fit and proper" test which will be applied by the regulators to senior appointments in banks, and later in this report we also recommend stronger and more explicit supervisory enforcement action not just against firms but also against individuals. A Parliamentary Commission in the UK recently proposed that reckless misconduct by senior bank staff be made a criminal offence.[5] While we are not recommending this for Cyprus, this is an indication of the type of measure that could be considered.

Recommendations

5.12 **We recommend that, given Cyprus' exceptionally high dependence on its banking system for financial services, and the potential of the financial services industry to generate foreign earnings, Cyprus adopt a national financial services strategy to ensure its stable development. There needs to be a clear understanding of the consequences of a high dependence on banks, and of the risks that accompany the rewards from international banking business. This requires a commitment of resources to monitoring these consequences and risks and ensuring that the country and its banks are equipped to manage them.**

5.13 **We recommend that Cyprus give priority to strengthening the independence of the banking system, and reinvigorating it with fresh people, new ideas, and international sources of advice. Cultural change of this kind would transform the banking industry in all the necessary ways, by delivering better governance, sounder banks, and greater trust internationally.**

Cleaning up

It is essential that the revived Cyprus banking industry start with a clean sheet – one that will not later be besmirched by unfinished business. This implies the need for effective procedures for dealing with the past, and for anticipating likely problems in the future.

5.14 **Scandals.** There should be no doubt that Cyprus has got to the bottom of its banking crisis. We received the following comment on our Interim Report from a person close to the Irish situation which carries wise advice for Cyprus:

> "The revelations […] from the release of the Anglo-Irish tapes[6] should remind everyone in Cyprus that there is merit in sapping the poison in a meaningful way as early as possible. It is not good for my countrymen that, five years after the crisis broke, its reputation as a place of shady corporate behaviour is making the news. Much of this could have been dealt with through a sort of truth and reconciliation process. It now looks as if 2013-2015 will be spent washing dirty laundry in full view of the

[5] Parliamentary Commission on Banking Standards. *Changing banking for good.* June 2013. UK Parliament.

[6] In June 2013, Ireland was rocked by the publication of a taped telephone conversation between senior executives at Anglo-Irish Bank at the time it was seeking a €7bn public bail-out in 2008, which showed that they held their supervisors in contempt, and that they knew they would need a much larger sum.

same people whose support is needed for an ex-post bail-out of the banks. Not good."

5.15 The lesson is that official investigations need to be thorough and conducted on a proper legal basis with their integrity beyond reproach, focusing essentially on whether laws or regulations have been breached. Where responsibility is established, prosecution or enforcement action should be initiated. There have been encouraging developments in this respect. However, the process needs to carry public conviction and proceed at all speed consistent with the need to ensure due process. Until this is achieved, people will worry that those responsible for the crisis remain unpunished rather than getting on with the task of reconstruction. Cyprus cannot afford to disappoint its lenders or its own people further down the road.

5.16 **Legal issues.** A large number of legal actions involving the banks are pending as a result of the crisis, and more may follow, including criminal prosecutions. These should be allowed to proceed in an orderly way, free from political pressure.

5.17 **Money laundering.** It is essential that all doubts about Cyprus' commitment to anti-money laundering be quelled. Measures have already been taken to create a co-ordinated approach by supervisors and professional associations using common standards to ensure that the identity of depositors and beneficial owners of companies is known. In future, fines for breaches of the regulations will be publicised, providing an additional disincentive. However, this is an area where problems can lie hidden for a long time, and where a rigorous approach is essential if Cyprus' reputation is to be restored.

5.18 **Non-performing loans.** Although much work has been done to address Cyprus banks' and co-ops' non-performing loan problems, it must be assumed that these will continue to grow because it is very difficult to identify all bad debts, and the recession will add to the tally. The accumulation of further non-performing loans needs to be anticipated and measures put in place to deal with them. This is an area where Cyprus must avoid unpleasant surprises because they will damage banking confidence and put its rescue programme at risk. Again, in Ireland, the persistence of the bad debt problem five years after the crisis broke is dogging the country's efforts to clean up its banking system.

Recommendation

5.19 **Cyprus' reformed banking system must not be vulnerable to unpleasant surprises in the period ahead. The "cleaning up" process of the past must be thorough and swift, and arrangements must be in place to deal with further likely problems, particularly the management of bad loans.**

Foreign investment

5.21 The Cyprus economy is in recession, and will remain there until banking confidence is restored. We believe that one of the main objectives for recovery must be to create conditions which will attract renewed foreign direct investment (FDI) into the country. These include not only a healthy financial system, but the right tax and regulatory conditions, and flexibility in key areas such as labour (see below). Apart from being an important indicator of confidence, FDI could have a rapid and beneficial effect on economic conditions.

5.22 We believe that Cyprus' small size could make recovery more achievable than in larger countries going through a similar process. For example, the unsold inventory of vacation houses is about 50,000. Provided prices are lowered sufficiently after repossession by the banks, an inventory of this relatively small size could be cleared quickly through sales to foreigners. NPLs will be reduced quickly and the banks will deleverage.

5.23 Although Cyprus' unemployment rate is high, in absolute numbers it is only about 70,000. A small number of foreign direct investments in the manufacturing, business services or hospitality sectors could make a big dent in this number without having to rely on a slow recovery of domestic demand. Further opportunities lie in activities such as call centres, banking back offices and the location of international business headquarters.

Labour reform

5.24 Changes will be needed to the banking labour market to achieve the cost savings that the Cyprus banking industry needs for a return to profitability.

5.25 Cyprus' banking labour force is highly unionised (99 per cent of bank employees belong to ETYK, the banking union), and powerfully organised. Collective agreements involving all banks mean that there is no wage competition between them. The union also effectively controls bank opening hours, manning levels, recruitment and promotion. This has resulted in a well-paid but relatively inflexible labour force which has raised banks' operating costs and arguably held back innovation and discouraged new entrants into the banking market.

5.26 While, from a bank customer's point of view, this situation supports the exceptionally high level of personal service offered by the retail banks, it is not practical in the new banking realities. Labour accounts for two thirds of the banks' operating costs, making this a key area where savings can be made.

5.27 ETYK has agreed to wage cuts and a voluntary retirement programme at Bank of Cyprus which has brought substantial cost savings, which is welcome. It has also made proposals covering the rest of the banking sector which will shortly be negotiated. However, this is only a start. Further reform is needed to the collective agreement to bring greater management control over wage scales, manning levels and other operating issues so that the banking industry can achieve its essential transformation from one based primarily on physical branches to one using more electronic forms of service delivery.

Recommendation

5.28 **A flexible labour market is essential not just to the recovery of the banking sector, but also to Cyprus' wider economic prospects, particularly its ability to attract foreign direct investment. We recommend that labour market reform be treated as an urgent component of Cyprus' recovery plan.**

6. Banking reform

6.1 It is important that the reshaping of the Cyprus banking industry produce a stable structure which encourages healthy competition and delivers a top rate banking service. People want a strong but well-balanced banking industry, and one which can be relied on to meet their banking needs. We see the objectives being to

6.1.1 restore normal banking conditions as soon as possible, particularly by getting Bank of Cyprus back to health,

6.1.2 introduce measures that rebuild confidence in the banking system,

6.1.3 make the banking system stronger and better able to absorb losses, of which there will be more,

6.1.4 improve the governance and management of banks so that they adopt sensible and sound strategies,

6.1.5 develop a competitive banking market which delivers a high quality service using modern methods of delivery,

6.1.6 identify opportunities for Cyprus to use its financial and professional skills as a national asset in a safe and productive way, and

6.1.7 create conditions to attract foreign investment into Cyprus.

Before longer term issues can be addressed, a number of urgent steps need to be taken.

Confidence building

6.2 The most urgent task is to restore confidence in the banks following the bail-in and reduce the leakage of deposits which is threatening their stability, despite the imposition of capital controls. Unfortunately, more than six months have passed since the MoU was negotiated, meaning that valuable time has been lost. The longer exceptional conditions last, the harder it will be to rebuild confidence: already the leakage problem has spread beyond the most directly affected banks.

6.3 Our concern is that the present recovery programme, based on the restructuring of the country's major banks, will take a long time, possibly many years, during which it will be difficult to lift capital controls because of the risk of deposit flight. Meanwhile, deposit erosion will continue to hamper the banks, and economic prospects will remain weak.

6.4 We believe that Cyprus' prospects would be greatly enhanced if capital controls were lifted soon. For this to happen, a state guarantee of all deposits in Cyprus banks would have to be issued to provide a bulwark against deposit flight. Because the government does not have the resources to provide such a guarantee, it would require a credible commitment from the relevant European institutions to provide the necessary capital and liquidity backing, should this be required. In our view, a move of this kind would restore confidence much more quickly: it would shore up the banks and speed up the return to normal economic conditions. It would also revive the savings industry and the flow of credit, and restore foreign business confidence. The deeper transformation of the banking sector could go on in the background under less stressful conditions.

6.5 Since this option would involve European assistance, the decision to take it would essentially be one for the European institutions, who would be guided by wider policy considerations about conditions in the euro area. The main risk for Cyprus in this route is that it would take pressure off the government and the banks to reform themselves. This would have to be resisted by setting a clear timetable of tasks and responsibilities.

6.6 **Bank of Cyprus.** Confidence in BoC specifically needs to be raised by tackling its legacy of non-performing loans (NPLs). The traditional good bank/bad bank strategy where the government takes over the bad bank would not be feasible in this case because BoC is a going concern, owned by private shareholders. Such a strategy would create a huge windfall profit for these shareholders, and deliver no benefit to the government. A further option - creating a privately-owned, spun-off entity holding all the NPLs but having no current income - would not work either because such an entity would not be able to fund itself.

6.7 The only feasible solution is to take out BoC's non-performing loans and place them in a separate incorporated entity. This would be owned by the bank's shareholders, funded by BoC and managed by private sector individuals with strong incentives to recover value. Apart from enabling BoC to pursue its recovery strategy more directly, this would also create greater transparency in the bank and raise depositor confidence.

6.8 It is essential that the Bank of Cyprus' new executive capability be established as soon as possible. This will involve recruiting an appropriately qualified chief executive, and setting up a high level executive structure, including an executive committee. The new directors and management will have to demonstrate strength and independence to restore business health, as well as skill in managing difficult mergers. The bank must produce an up-to-date balance sheet and a viable business plan as soon as possible. In our view, Cyprus will only have one opportunity to make this restructuring work because failure would throw all confidence-building measures into reverse, with incalculable consequences.

6.9 The merger will also have to be swift and thorough if it is to deliver the cost savings which are the main positive element behind it. If these savings are not secured within 18 months, they will become much harder to extract as staff build up entrenched positions, and the sense of urgency is lost. In order to rationalise costs, one of the two IT systems currently in use will have to be discontinued, and clients migrated swiftly on to the surviving system. This is a complex task which will require a major commitment of management resources.

6.10 **Shareholder structure.** There will also be unfamiliar issues surrounding the new shareholder structure at BoC. The majority of the shares are now owned by depositors who lost money in the restructuring and have a strong interest in recovering it through the performance of the bank. Two thirds are owned by non-residents, many Russian. Following recent elections, six out of the 16 new board directors are foreigners, again mostly Russian, including the vice-chairman. Although this creates an unprecedented situation, we view these developments positively: they mean that the bank will be driven by people with a strong incentive to increase shareholder value, with a lower risk of the cronyism that tainted bank governance in the past.

Recommendations

6.11 **The restoration of confidence in the Cyprus banking system is the top priority. We recommend that this be achieved by removing capital controls on the banks and by issuing a state guarantee, backed by liquidity and capital support from the European authorities, of all deposits in Cyprus' domestic banking system. Only this way will deposit leakage be staunched and economic recovery initiated within a reasonable time frame.**

6.12 **The re-launch of a new and strong Bank of Cyprus is the central objective for the banking sector, and we recommend that a clear timetable be set to achieve that goal. The priorities must be to establish a strong executive team, to secure the bank's liquidity position, to execute the merger and create a credible business strategy.**

6.13 **We recommend that non-performing loans be taken out of BoC and placed in a separately incorporated entity, to be owned by the same shareholders, funded by BoC and managed by private sector individuals with strong incentives to recover value. Apart from enabling BoC to pursue its recovery strategy more directly, this would also create greater transparency in the bank and raise depositor confidence.**

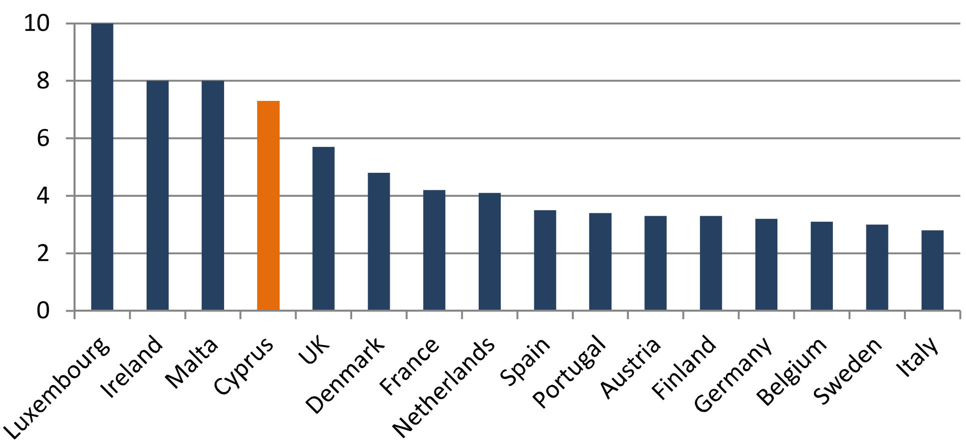
Size of the banking system

7.1 Under the conditions set by the MoU, Cyprus must drastically reduce the size of its banking sector. Much of this has already come from the resolution of Cyprus Popular Bank and its merger into Bank of Cyprus, from the restructuring of the co-operative banking sector, from disposals of foreign businesses, from deleveraging and from the flight of deposits. Some foreign banks may also leave.

7.2 A degree of shrinkage is necessary: Cyprus' banking system had grown beyond the country's ability to manage it. The challenge is to find its optimal size. We believe that it is inevitable that Cyprus will have a banking system that is above the EU average size of 3.5 times GDP, for a number of reasons. One is that, until other financing channels emerge, it has no alternatives to bank finance, so the banks will need to play an important role. A second is that it has few alternatives to deposits for financial savings. A third is that financial specialisation is a respectable option for an economy with limited choices; an international finance business could continue to play an important role for Cyprus. (We examine this possibility on p. 53).

7.3 The size of the banking system will be determined by the availability of deposits and capital, by the scale of profitable business opportunities, and by the capacity of the country to stand behind it and supervise it. However the optimal size of the industry is hard to predict because there are so many uncertainties. There are also few comparable banking models. (See Chart 5).

Chart 5: Banking sector assets as multiple of GDP (2010-11)



Note: Cut off at 10. Luxembourg is 24.
Source: Liikanen Report, EC. October 2012 based on 2010-11 data

7.4 **We believe that it is inevitable that Cyprus will have a larger than average banking sector in the longer term because of the absence of alternatives to banks for credit and savings, and because an international banking business**

could continue to be an important component of the Cyprus economy once confidence has been restored. However this underlines the importance of adopting policies to diversify the structure of the country's financial system.

How other countries coped

It is tempting to look at other countries in financial difficulty to see whether they offer any lessons for Cyprus. Iceland and Ireland, both small island economies with large banking sectors, now recovering from massive crises, are obvious ones.

In Iceland, the three major banks collapsed in 2008 after a period of dizzying expansion and had to be nationalised, leaving the economy in crisis and the country with large external debts which required a $10bn international loan. Like Cyprus, Iceland had to impose capital controls to forestall capital flight. Controversially, it reneged on the liabilities of its banks in foreign countries, particularly the UK and the Netherlands.

Iceland is recovering thanks to the scale of its adjustment and the strength of its tourist industry. Since it was not in the euro, Iceland had more options than Cyprus: it was able to let its currency fall to regain competitiveness. However, it remains deeply indebted, and while an international court has ruled that it is not liable for its banks' foreign liabilities, this issue is likely to plague Iceland's trade and financial relations for a long time. Five years later, capital controls are still in place.

Ireland offers closer parallels to Cyprus. It had an exceptionally large banking sector fuelled mainly by property lending. There was also a sizeable tax-based foreign component in the form of its International Financial Centre which included not just banks but insurance companies and fund managers.

Ireland's banks were brought down by the collapse of the property bubble in 2008, and a combination of reckless management and poor supervision[7]. This forced the government to issue an unlimited guarantee for the six largest banks' liabilities which eventually amounted to over 300 per cent of the country's GDP. But it meant, unlike Cyprus, that all deposits were safe. Later, the government obtained a €85bn rescue from the EU and the IMF. This was supplemented by a further €10bn and an extension of repayment terms by seven years in March 2013.

Like Cyprus, Ireland is in the euro, which means that all its adjustment must come internally through austerity and restructuring (wages have fallen 15 per cent). Its banking sector is being shrunk to 3.5 times GDP, which has been painful. Nonetheless, there are signs of recovery: five years later, growth has returned and

[7] Regling K. and M. Watson. *A preliminary report on the sources of Ireland's banking crisis*. Central Bank of Ireland. 2010.

Ireland expects to exit from its adjustment programme at the end of this year, though the banking system is still not back to health, and bad debts continue to grow.

But there are also fundamental differences between Ireland and Cyprus, the main one being that Ireland entered its crisis at a time when lending countries were still willing to bail out banks. There were no haircuts or capital controls on Irish deposits because of the issue of the bank guarantee, and loan terms were more generous. Cyprus marked the first time that a country received no money to recapitalise its biggest banks, and had to haircut large deposits and impose capital controls. Cyprus' maximum debt servicing capacity was set at 100 per cent of GDP (compared to 120 per cent for Ireland). Furthermore, the process of resolving two systemic banks simultaneously was much the most complicated yet seen, involving cross-border resolution and a difficult merger.

8. Structure of the banking system

8.1 **The banks.** The merger of Cyprus Popular Bank with Bank of Cyprus leaves Cyprus with one very large bank controlling half the market, a relatively smaller bank, (Hellenic Bank), a consolidated co-operative bank sector, a locally active foreign bank sector, and a non-locally active foreign bank sector. These arrangements have the advantage of expediency: they ensured that Cyprus' weakest bank was resolved. However, they create a structure with a dominant bank which has important consequences for stability and competition. There is a risk that, once it has recovered, Bank of Cyprus will dominate the market while simultaneously being "too big to fail", presenting Cyprus with the worst of both worlds.

8.2 It is possible that changes will occur to this structure. The Bank of Cyprus may shrink through deleveraging and deposit attrition. There is also a possibility that BoC will have to be split into a good and a bad bank, or that competition considerations will require it to be divided into two. Hellenic Bank may find a partner and increase its size, and the co-ops could undergo a period of strong growth in a revitalised form, all of which would bring more balance. It is also possible that foreign banks may seek to take advantage of the weakness of domestic banks to strengthen their position in the Cyprus market, or take a strategic stake in a Cyprus bank. A further possibility is that opportunistic online lenders will see opportunities in a distressed economy, as has happened in many other European countries – which might be less welcome because of their high interest rates.

8.3 There are many possibilities. But until major structural change does occur, this is an area which will need to be watched closely. Although new measures are being taken by the government to resolve troubled banks without recourse to the taxpayer, it is impossible completely to eliminate the systemic risks posed by large banks, meaning that supervision will need to be up to handling this structure, and that measures must be in place to deal with the risk of "too big to fail". We address the competition issues raised by this restructuring in greater detail in the next section.

8.4 **The co-operative credit institutions.** Cyprus' co-op banks are also being fundamentally restructured to repair the damage caused by severe loan losses and weak management practices. The question is how far restructuring should go.

8.5 Legislation was recently passed to demutualise them, and inject new capital through a €1.5bn state loan. Their number is also being drastically reduced from more than 90 to 18 in order to consolidate them and remove non-viable institutions. Supervision has been transferred from their special authority to the CBC.

8.6 We welcome all these moves: they are in line with the recommendations we made in our Interim Report in June. However these changes still leave the system in a fragmented form with management inefficiencies and local boards through which outside influence could be exerted. Many of the individual co-ops will be tiny: on average they will each have only 1.5 per cent of the market. Furthermore, the capital injection is in the form of a government loan carrying an exceedingly high 10 per cent rate of interest, which appears to be designed to force the pace of change. For all these reasons, we believe that the co-ops need to undergo further reform, and that the present crisis represents an opportunity to bring this about.

8.7 We recognise that co-op reform is controversial. Many respondents to our Interim Report argued that the co-ops offered a unique level of personalised service to the consumer banking market which would be lost if their essential character was changed. But the economy they serve today is not the agrarian one to whose success they contributed in the past. Moreover, their special character comes at a considerable price to the taxpayer which needs to be recognised[8].

8.8 In its present form, the sector's ownership future is also highly uncertain. The position is that co-op members have an option eventually to buy out the government loan and recover ownership of the group. But the cost will be very high. More likely is an acquisition by another party such as a foreign bank.

8.9 We remain convinced that our original recommendation for a single commercial entity with a joint stock structure is right so that the co-op banks can become an efficient and competitive group with centralised professional management and an independent character. Such a group would be primarily retail, but it could also expand into the business lending sector where a shortage of capacity is likely in the period ahead.

Conclusion and recommendations

8.10 The structure of the Cyprus banking industry that emerges from the present changes is likely to be unsatisfactory because it will contain a dominant bank with associated risks to competition and stability.

8.11 **We recommend that the new banking structure be kept under close watch, particularly as regards potential financial stability problems surrounding a bank that may be "too big to fail".**

8.12 **We recommend that this opportunity be used to combine the co-operative credit institutions into a single entity with a joint stock structure and a commercial culture to make them a stronger competitive force on the banking market.**

[8] This will be the third time in living memories that the co-ops will have been bailed out. According to Orphanides A. and G. Syrichas, *op. cit.* p. 282, the coops received CY£22m from the government and the commercial banks in the late 1970s, and a further CY£67m in the late 1980s.

9. Banking competition

9.1 The Cyprus banking market has, historically, been heavily overbanked, though more in terms of branches than number of banks. It has the densest branch network in the EU and the highest level of personal contact between bank and customer. But this scale of overbanking will decline as the MoU's measures to merge banks and downsize the sector begin to bite.

9.2 A reduction in overbanking will be healthy because excessive rivalry between Cyprus banks contributed to the crisis by encouraging them to engage in risky practices, such as over-bidding for deposits. It should also improve the economics of the banking industry by opening up profit margins, which will be vital to the banks' recovery. However there may also be disadvantages. As we noted earlier, restructuring will produce a more concentrated banking structure in which the "new" Bank of Cyprus has a 50 per cent share of the market. Its main competitors will be the newly integrated co-op sector about half its size, a No. 3 in Hellenic Bank, with the rest of the market served by much smaller banks and foreign bank branches.

9.3 As we also noted in the previous section, there are countervailing considerations: the BoC may shrink for various reasons: deleveraging, deposit attrition, good bank/bad bank restructuring. Another is that liquidity constraints may prevent it from fully exploiting its strong market position, making it easier for others to mount an effective challenge. The co-ops, under stronger commercial management, might enlarge their market share.

9.4 A further set of possibilities surrounds new entrants to the market: foreign banks seeking to take advantage of the current uncertainties to acquire market share through direct entry or by acquiring a strategic stake in a bank, new start-ups exploiting different business models etc. At some point, the government will need to sell its new stake in the co-operative banks. Although the current position is that it can be sold back to co-operative bank members, there is nothing to prevent it going to a new player – other, possibly, than a political desire to protect the traditional ownership of the co-ops.

9.5 However, we believe that the likelihood of major new players entering the Cyprus banking market in the foreseeable future is small. For all the remedial work that is going on, conditions remain unsettled: many issues such as legal challenges to the restructuring, the foreclosure problem, the state of the banking labour market, the size of non-performing loans and Cyprus' own uncertain economic prospects would deter potential acquirers.

9.6 There are many variables which make it hard to be certain how banking competition will evolve over, say, the next five years. In a positive scenario, we could see reinvigorated banks and new banking blood produce a more balanced structure and a healthy market. A downsized BoC plus an expanded Hellenic Bank and a strong integrated co-op bank would form a healthy and competitive core to the sector (this is one reason why co-op reform is so important). In a negative one, our concern would be that BoC exerts a heavy-handed dominance over the market, stifling competition and discouraging change.

9.7 These are medium to long term issues. For the time being, Cyprus bank customers will be more concerned about bank safety than the cost of bank services. However, this is an area where we recommend the government to keep open the possibility of further restructuring to achieve a healthy balance. The central bank should also monitor the level of competition and its impact on interest rates.

9.8 **New entrants.** Although the prospect of new banks entering the market are currently small, government policy should nonetheless seek to encourage the formation of new banks by ensuring that entry barriers (such as start-up capital requirements[9]) are low and that Cyprus offer a healthy business environment in areas such as tax, regulation and labour practices. These policies should aim particularly at new banking models, such as online banks, microfinance and Islamic banking, for which the legal basis exists in Cyprus.

9.9 **Alternative sources of finance.** As we have noted, banks account for most of the financial intermediation that takes place in Cyprus. Banks have their advantages: they are much the best source of flexible short-term funding for people and businesses, and specialised lending such as mortgages. But they don't normally supply the long-term funds and equity capital that are necessary to build healthy businesses. Furthermore, as Cyprus has discovered, a high dependence on banks can be dangerous when there are few alternatives, and the Cyprus Stock Exchange has found it difficult to play a meaningful role because of investor mistrust.

9.10 For both these reasons, we believe that one of Cyprus' long term objectives should be to encourage the development of new sources of finance such as capital markets, particularly a local bond market, and investment funds. This can be based on local initiatives in the areas of tax and regulation, but also on wider moves at the EU level to complete the single market in financial services and improve access for EU member states to new sources of capital.[10] Other new sources of finance include innovations such as peer-to-peer lending and crowd funding.

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[9] In April 2013, the UK's Prudential Regulation Authority reduced the capital requirements for new banks in order to encourage new entrants.

[10] See Sapir A. and G.B. Wolff*. The neglected side of banking union: reshaping Europe's financial system.* Bruegel September 2013

Conclusion and recommendation

9.11 The structure of the new Cyprus banking industry will need to be closely watched because of the risk of over-concentration and loss of competition which would damage service quality and affect the cost and availability of important banking services such as business credit.

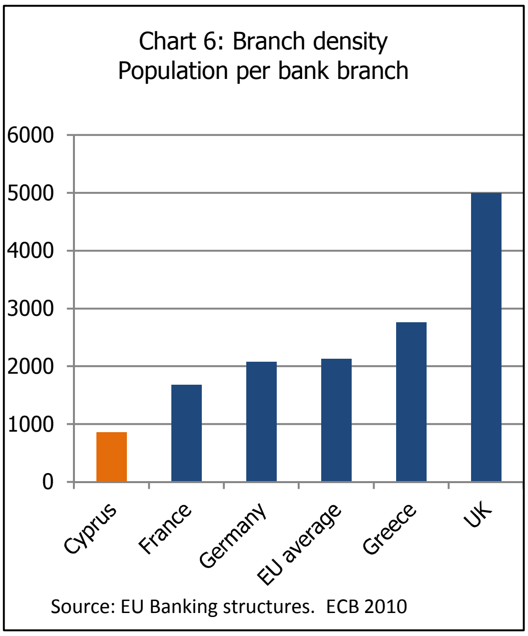
9.12 **We recommend that Cyprus adopt policies which strengthen competition in the banking market through structural reform, by encouraging new entrants such as start-ups and foreign banks, and by fostering alternative forms of finance.**

10. Quality of service

10.1 It is important that Cyprus banks emerge from the crisis offering a high quality banking service to their personal and business customers, measured in terms of

- range and quality of products,
- convenience and
- value for money.

10.2 Along with the major changes that are taking place in the structure and economics of Cyprus banking, we expect to see an extensive re-design in the way banking services are delivered. Because of the conservative nature of people's banking habits, these are likely to be controversial.



10.3 **Service delivery.** Ironically, for all the criticism they now receive, the service that Cyprus banks offered to their customers in pre-crisis days had many positive aspects to it. It was one with a strong level of personal service: there were more bank employees and branches[11] per customer than anywhere else in the EU, and the interest rates the banks paid to depositors were among the highest in the EU[12]. Credit was usually easy to obtain. All this matched the Cyprus bank customer's desire for close personal attention and ensured that Cyprus banks scored well in satisfaction surveys[13]. But this labour intensive model came at a price: bank operating costs were high, as were borrowing costs. The ready availability of credit was often based on poor lending practices whose true costs were only measured later. The quality of service delivery was also constrained by a highly unionised workforce which dictated banking hours which were often inconvenient, and held back the promotion of good staff.

10.4 This high level of personal contact is one of the things that will change as banks re-engineer themselves. The number of bank branches and employees is already being cut back. Although there may be improvements in opening hours if more flexible work practices are introduced, the overall effect will be to reduce personal contact at the retail level.

[11] *EU Banking structures*. ECB 2010
[12] European Central Bank, Central Bank of Cyprus 2012.
[13] Source: 7th EU Consumers Scoreboard. May 2012. DG Health and Consumers (SANCO)

10.5 On the other hand, these changes will lead to a greater emphasis on non-branch forms of banking service delivery which are already well developed in Cyprus: online, telephone and mobile banking. This makes sense, in our view, but it does mean that Cyprus bank customers will need to understand the reasons for the changes, and be encouraged to adapt.

10.6 **Interest rates.** A key issue for banks and the wider economy will be the interest rate structure of bank services: deposits and loans. Before the crisis, rates on both sides of the balance sheet were high because banks were competing for deposits and needed to recoup their costs by pricing high on the lending side (see Table 2). The crisis, and the need for banks to hold on to deposits, made this situation worse.

10.7 These high lending rates will have to come down to reduce borrowing costs and support economic recovery. However it will take a difficult balancing act to keep deposit rates high enough to attract and retain deposits and low enough to make borrowing affordable, while also leaving the banks with a sufficient margin in between to service their capital. This challenge lies at the meeting point of all the major issues surrounding the health of the banking system: the need to stop deposit flight, to allow the banks to make a fair profit, and to keep loan rates at affordable levels.

10.8 As things stand, administrative intervention on interest rates has been necessary because market forces are not operating. The CBC recently sought to bring interest rates down by imposing extra capital requirements on banks which offer deposit rates that are more than 300 basis points above the euro interbank offered rate (Euribor). But this has yet to feed through to lower lending rates and benefit borrowers. Legislators are proposing to cap the cost of loans, but this may only introduce new costs and distortions to the market, and we do not see it providing good solutions. Lending rates should be risk-dependent.

Table 2

Euro area lending and deposit rates %

	Interest rates		Deposit rates	
	on loans for consumption	on loans to SMEs <€1m		
Portugal	10.97	6.53	Greece	4.68
Greece	10.54	6.46	**Cyprus**	**4.52**
Italy	9.06	4.40	Spain	2.95
Spain	8.32	4.93	Italy	2.65
Cyprus	**7.21**	**7.29**	Portugal	2.34
France	6.61	2.22	Malta	1.93
Ireland	6.58	4.04	France	1.73
Germany	5.99	2.94	Austria	0.83
Austria	5.66	2.22	Germany	0.79

Source: ECB. December 2012

10.9 The objective, of course, must be to create a market where rates find their natural level. But this market will only emerge once the banks become strong enough to attract deposits without capital controls, which could take some time unless the government guarantees deposits in line with our earlier recommendation and takes those controls off. On the positive side, progress is being made towards strengthening the banks. Also, a less overbanked market with smaller balance sheets may reduce competition for deposits and ease upward pressure on deposit rates. The situation is far from perfect, but it is possible to see the way forward.

10.10 **Cost and availability of lending.** It is likely that credit demand will be slack in the immediate future because people and businesses need to get their debts down and strengthen their financial position. However, the availability of credit for creditworthy borrowers will become a key concern before too long, and we see possible obstacles. One is that the more concentrated and regulated banking system that comes out of the restructuring will have less capacity to lend. Another is that it will be risk averse, and a third is that the banks' poor liquidity position will constrain their lending ability.

There are also competition concerns in this area of the market.

10.11 We commissioned a study of the competitive conditions in the Cyprus banking market from the School of Business and Economics of Loughborough University in the UK, one of Europe's leading academic centres for banking studies[14]. Although the analysis is based on data before the recent restructuring, it contains a number of conclusions which are relevant to the evolving situation. The main one is that the area of the market most vulnerable to competition constraint is the supply of lending to small and medium sized businesses. Given that the market has become more concentrated and constrained since the study was done, this would reinforce concerns about the cost and availability of lending in this key market segment. This could create a need for special measures to support business lending, such as a targeted government funding programme through the banks, a requirement that banks direct a specified portion of the lending to businesses, and that the co-op banks be encouraged to take on more business lending, though initially on a limited basis.

10.12 A further consideration is that the Cyprus banks' lending practices are largely collateral-based which, in the present property environment, is likely to restrict the capacity to lend. There is an urgent need for banks to develop more cash-flow based lending, which will require them to acquire new processes and skills in areas such as credit evaluation. These should aim particularly at modern high growth companies whose assets lie in people rather than physical goods and plant.

10.13 **Savings.** Less noticed, but equally important in our view, is the current lack of savings possibilities in the Cyprus market. Confidence in bank deposits has been

[14] Milne A. and M. Yahaya. *The competitive structure of the Cypriot banking system: a descriptive analysis and a possible pointer to the future*. School of Business and Economics, Loughborough University. April 2013. This paper can be downloaded from the Commission's website: www.icfcbs.org.

severely damaged, the stock market has been forced to close down, and the provident funds have suffered from the haircut, some to the point where they have decided to liquidate. The revival of the savings industry is an urgent priority in the process of restoring health to banks and the wider economy.

Conclusions and recommendations

10.14 Changes in the Cyprus banking industry will have an important impact on the quality of banking services and the way they are delivered. Service quality in the traditional sense will go down because it will lose some of the convenience and personal touch provided by an over-dense branch network. But this is also an opportunity to create a leaner banking system based on modern methods of service delivery, particularly electronic.

10.15 **We recommend that Cyprus have policies to facilitate the transformation of banking service delivery from one based largely on physical contact to one using modern, electronic forms of delivery, for example by ensuring that high speed broadband services are available and affordable.**

10.16 **There are justified concerns about the cost and availability of credit in the coming recovery period, particularly for business. We recommend that the government consider means by which business lending can be stimulated to support economic recovery. These could include:**

- **the introduction of more sophisticated credit evaluation techniques in the banks aimed at high growth service companies;**
- **a requirement that banks have a pot of capital dedicated to business lending;**
- **a government support programme for business lending, and**
- **the entry of the co-ops into this segment of the market, though on a controlled basis.**

10.17 In the longer term, Cyprus needs to develop a more diversified financial system to reduce its dependence on banks. **We recommend that Cyprus encourage the development of new sources of finance such as capital markets, particularly a local bond market, and investment funds. This can be based on local initiatives in the areas of tax and regulation, but also on wider moves at the EU level to complete the single market in financial services and improve cross-border access for EU member states to new sources of capital.**

11. Cyprus' international financial centre

Cyprus' international financial centre business, which has been a major source of earnings for banks and professional firms in recent years, is now seen to be at risk because of the repercussions of the crisis. The question is whether this important sector of the economy can continue.

11.1 The centre is a business driven by tax: Cyprus' low corporate tax rate (12.5 per cent) and double taxation agreements with other countries which enable foreign clients to take advantage of this. The greatest part of the business comes from East Europe, mainly Russia, though it also attracts clients from Middle East countries who see it as an EU-based "safe haven", as well as West European clients, particularly those with interests in the former Soviet Union, for whom the combination of tax planning opportunities with a reliable common law system offers considerable attractions. The centre provides income for the large Cyprus banks, for professional firms like lawyers and accountants who introduce it and provide services, and for foreign banks who locate branches in Cyprus to handle it.

11.2 It is important to stress, however, that this business does not always require the involvement of banks, or if it does, the banks need not necessarily be in Cyprus because the balances can be held elsewhere. The key point is that Cyprus should be the location where business is booked for purposes of tax, and also for confidentiality and political safety.

11.3 We do not find fault with the concept of an international financial centre: if well managed, this can be a legitimate business which serves a genuine financial and tax planning need and contributes to economic growth. The problem in Cyprus is that it was poorly managed: it grew too fast, it was inadequately supervised, it was insufficiently diversified geographically, and the large balances it attracted played a major part in fuelling the domestic credit bubble. As a business, it relied too much on tax appeal and poorly managed supervision, and not enough on financial soundness and quality. Cyprus also allowed it to become reputationally associated with tax evasion and money of dubious origin.

Comment

11.4 We encountered considerable scepticism about the potential for keeping this business alive, essentially for three reasons:

- foreign confidence in Cyprus' banking industry has been severely damaged by the crisis,
- international pressure to reduce the role of tax havens is increasing, meaning that ultimately business of this kind may be doomed,

- it would be technically difficult to insulate, or ring fence, this activity to prevent it having a distorting effect on the local economy.

11.5 On the other hand, we also found considerable support for the view expressed in our Interim Report that this business could survive, provided its quality was raised and that its appeal was expanded beyond tax to include a broader and more sophisticated range of services. We also learnt that Cyprus' creditors have no objection in principle to the continuation of this activity so long as it is well supervised and of a legitimate character. From a wider point of view, Cyprus also needs to preserve potential sources of economic growth because it has few choices.

11.6 We continue to believe that this business could have a future in a more focused and upgraded form which attracts clients not just for its tax breaks but because of the quality of skills and services on offer. Cyprus could also make more of its geographical safe haven role. However this will require a strategy which addresses a number of key issues.

The considerations that determine the outlook for this sector are:

11.7 **Economic stability.** A major concern among the users of Cyprus' international facilities will be the soundness of the country itself, and the risk of more turbulence and controls if Cyprus needs to raise extra money. To create certainty on this front, Cyprus will need to achieve an orderly economic recovery and eliminate doubts about the sustainability of its financial position and the strength of its banks. The recovery of a strong credit rating and renewed access to the international capital markets will be important milestones.

11.8 **Tax stability.** Since tax is the foundation of the international financial centre business, Cyprus will have to provide certainty about tax conditions as well. This will be difficult since many of its tax provisions are vulnerable to forces outside its control. For example, there is an aversion to tax competition in the EU, and strong pressure for tax convergence. If Cyprus' fiscal position comes under renewed pressure, the Troika will very likely demand a further increase in tax rates. The country's double tax treaties could also come under renegotiation pressure from partners who are, themselves, in fiscal difficulty. Therefore it would be prudent for Cyprus to reduce its reliance on tax-driven business, and to use its skill base to develop other lines of business.

11.9 **Financial stability.** The financial centre will have to be better supervised. This is already happening: major improvements are being introduced to banking supervision to make it more alert and effective. However, it might be worth exploring the possibility of bringing in more outside expertise in the form of technical assistance or a senior supervisory figure with international financial centre experience to oversee this process

11.10 If concerns persist about the risks that the foreign banking business poses to the domestic economy, it may be desirable to apply supervisory measures, such as special liquidity ratios for non-resident deposits, and lower loan to value ratios.

11.11 **Size and structure.** In the past, the Cyprus banks' international financial centre activities generated a surplus of bank deposits which they recycled into excessive lending growth domestically and risky foreign expansion. This does not need to happen. Bank of Cyprus and Hellenic Bank could remain in the more profitable side of the international business, handling trade and payment flows which generate fee income. They could then channel excess balances into assets where their clients, not they themselves, are at risk such as fiduciary deposits and other wealth management products where we believe the opportunities to provide an attractive service are insufficiently exploited. This business would add value to the economy without creating distortions in the domestic market, as happened before.

11.12 **Legal certainty.** Confidence in the rule of law is fundamental to the success of a financial centre. The haircuts have shaken that confidence badly. Other aspects of the legal system will also need to be seen as reliable, such as the efficiency and fairness of the courts and the law officers, and the arrangements for realising security. It has been put to us that more may need to be done to update company law which we understand remains based on now-outdated versions of English law.

11.13 **Legitimacy.** It is important that the international business be both clean and seen to be clean, which requires rigorous control of client acceptance and ongoing scrutiny. Cyprus is putting together a new programme to correct the failings identified by the recent anti-money laundering (AML) investigation and is showing a strong commitment to transparency and compliance. This will be a broad initiative involving the banks, their supervisors, as well as professional bodies such as the Cyprus Bar Association and the Institute of Public Accountants of Cyprus whose members play an important role in business origination. We believe this work will pay important dividends: the quality of anti-money laundering controls could become one of the country's competitive strengths, especially in a region where such controls tend to be poor.

11.14 **Quality of the service.** Much could be done to improve the range of the services offered by the international financial centre. The business that Cyprus built up over the last decade was impressive in its size but relied too much on easy breaks such as tax and light supervision. The banks' product offering was simple, and the range narrow. We see opportunities to expand the range by offering off-balance sheet services such as wealth management, custodian services and fund administration which, as well as being less risky, are potentially more profitable. We recognise that this will involve considerable work and the importation of external expertise, including probably by foreign banks. However, this will be necessary if Cyprus is to be recognised as a full financial centre rather than simply the passive recipient of tax-diverted business.

11.15 The professional services accompanying the financial centre did not fully exploit opportunities to add more value locally. We were told, for example, that some of the high valued added legal and accounting work in corporate structuring was done in London and other financial centres and only implemented in Cyprus. For many customers, Cyprus was little more than a "booking centre" for business flows. Ironically, for all its size and skills, Cyprus could have been earning much more from its financial centre. This will involve upgrading local legal and accounting skills to the level where it is possible to repatriate higher value-added work from elsewhere.

11.16 Although there is already a certain amount of business from neighbouring countries in the Middle East, we think more could be done to market sound financial and wealth management services to businesses and individuals for whom Cyprus is a relatively safe haven politically and, in security terms, is a member of the EU and uses the euro. Given the proximity of the Middle East and North Africa, Islamic finance might provide a further business opportunity, particularly now that Islamic products are well-developed in other financial centres and can be readily replicated. Cyprus can also position itself as a business gateway to those areas.

11.17 The marketing of the international financial centre business is largely carried out by professional firms. It may be advantageous, given the importance of this industry, that the government provide stronger support for its promotion agencies.

Conclusion and recommendations

11.18 Although the shock to Cyprus' ambitions as an international financial centre has been severe, it is possible to identify the steps that would be needed to bring about its recovery. Cyprus still retains advantages as a financial centre. It has a well developed infrastructure, professional skills, a highly educated workforce, the English language and internationally recognised English-style company law. It also remains a relatively safe haven in a troubled region. However, these advantages should not be taken for granted: laws and tax arrangements need constant updating to keep them in line with the demands of a very competitive market. The same goes for skills. Cyprus would also have to mount a considerable promotion effort to repair the damage done to its reputation, and get the message out that it was still in business, though of a higher quality.

11.19 But it also needs to be aware of its disadvantages which – apart from bad publicity and lost confidence - relate to uncertainty about property rights, taxation and capital controls. The current highly charged political environment is also unsettling for foreign business.

11.20 **We recommend that Cyprus seek to raise the quality and scope of the present skill base of its international financial centre business so that customers choose to use it for its breadth and sophistication, not just the tax breaks, and that the banks develop their product range to include higher class wealth management and off-balance sheet services, and later custodian services and fund administration. Supervision will also need to be improved, possibly by drawing on outside assistance to give confidence to users of these services, and anti-money laundering controls will have to be strictly and visibly enforced. If concerns persist about the risks that the foreign banking business pose to the domestic economy, supervisory means should be used to contain its growth.**

12. Corporate governance

The failure of corporate governance was one of the most important reasons why Cyprus' biggest banks brought disaster upon themselves. Strong corporate governance is essential to a healthy business, particularly one like banking which relies heavily on public confidence. In this section we consider action that is needed to improve bank governance. Most of what follows applies equally to the co-operative banks.

12.1 The evidence from bank documents and recent investigations supports the now widely accepted view that

12.1.1 While banks were formally compliant with relevant EU/EBA governance requirements, their performance in practice was woefully deficient,

12.1.2 Weak boards, with inappropriately qualified members, failed to carry out their responsibility to ensure that their banks were run prudently, with strong policies and an attitude of independence and challenge.

12.1.3 This allowed powerful senior executives to pursue risky strategies that were strongly influenced by personal ambition, and to bypass internal controls and procedures.

12.1.4 Proper board procedures were flouted, reporting lines were diverted, and necessary information did not reach the directors. In some cases, non-executive board members were deliberately kept in the dark about controversial management decisions, and board minutes did not always accurately reflect what had actually happened at board meetings.

12.1.5 A risk management culture was missing at all management levels.

12.2 Much work is already being done to correct these weaknesses, and it is not necessary for us to comment on them in detail. The main issues as we see them are:

12.3 **Culture.** There appears to have been little belief in the value of strong corporate governance in the banks. This is partly a matter of having the right structures and procedures to promote correct behaviour in the interests of all stakeholders, but it is essentially about attitude: believing that governance matters. This will help ensure that decisions are made on the basis of objective criteria and not personal relationships.

12.4 **Restoring the status of boards.** The role of boards was diminished during the crisis by the dominance of executives. This needs to be reversed. Boards should reassert their responsibility to set policies for key areas of the bank's operation, and impose checks and balances on the power of the executive, to oversee the running of the bank effectively, and to be fully informed on important issues. They also need to be sure that the bank complies with the relevant governance codes.

12.5 **Composition of the board.** The balance between the executive and non-executive sides became dangerously tilted during the crisis, and allowed the executive to accumulate too much power. Since the executive always has the advantage over the non-executive side because of its greater information and influence, it should be outweighed by a majority of independent directors.

12.6 **Board members**: A fundamental problem lay with the character of boards where the culture was one of deference rather than challenge. Bank boards contained an insufficient number of individuals with the knowledge and expertise to ensure that risks were being properly assessed and managed, and with the independence to stand up to management.

12.7 The gene pool from which non-executives are drawn should be widened to bring more diversity and experience into the boardroom. We recognise that this is not easy in a small country like Cyprus. However we note that there are few women on bank boards and historically there have been virtually no persons with extensive experience outside Cyprus. We believe it is essential for Cyprus to end the practice of appointing directors for their business and political affiliations, and to bring in fresh blood, including non-Cypriots who would offer wider experience and be free from political taint, or Cypriots whose previous career has been based in leading international firms outside Cyprus. This is now standard practice in the world's leading banks. We recognise that there are practical difficulties in this (time, travel etc.), but these could be overcome by wider use of teleconferencing.

12.8 We recommend that bank boards have a nominations committee to identify suitable candidates. Directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge. To function effectively all directors need to understand the company and have access to its operations and staff. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities, and the chairman should regularly review and agree with all directors their training and development needs.

12.9 **Board procedures.** Internal communication systems (and especially the reporting of risks to the boards) did not ensure that good information was delivered in a regular and timely manner. Even when it was, it is not clear that the boards were always able, or permitted by the executive, to take full notice of it. For example, the decision by the Bank of Cyprus to buy Uniastrum in Russia, at €450m by far the largest acquisition ever made by a Cyprus bank, was presented to the board as a *fait accompli*. The boards of the two banks were not informed of the content of the CBC's letter expressing concern about their investments in GGBs.

12.10 **Strengthening board committees.** Board committees provide independent oversight of key areas of a bank's activities. They need to be strongly constituted under the chairmanship of an independent and experienced director, and act as the point of accountability for the relevant area of the bank. It is up to each board to decide which committees it needs. We stress three in particular: audit, risk and remuneration.

12.10.1 **Audit.** The audit function of a bank provides an independent check on its internal workings, and is essential to its sound operation. It should be independent, well resourced, and it must have a clear reporting line to the relevant board committee which should be chaired by an independent director with audit experience. The audit committee should have arrangements in place by which staff of the company may, in confidence, raise concerns about possible improprieties in financial reporting or other matters.

12.10.2 **Risk.** Every bank should have a clear risk policy, and the assurance that it is adhered to. During the crisis, the Cyprus banks did not have a sufficient understanding of the risks they were courting with their strategies, or the means to control them. Bank boards should be responsible and accountable for the risk strategy of the bank, and should promote the right risk culture. This means that they should define the bank's risk appetite, and approve business strategies which conform to that appetite, and systems which can monitor and control it. The risk function, too, needs to be independent of any profit centre and with a clear direct reporting line to the board. The stature of the credit risk officer and his decision making powers should be strong.

12.10.3 **Remuneration.** Flawed incentive schemes played an important role in Cyprus' banking crisis. These need to be corrected to generate prudent behaviour and restore public trust in bankers. Many recommendations are currently being prepared in international regulatory circles, including controls on the pay of executives and directors at banks receiving state aid[15]. The aim should be to set incentive payments over the long-term, reduce their size relative to base salary, and make an important portion of them payable in the form of shares.

12.11 **Transparency.** For many years, the banks did not provide full transparency on key issues such as their growth strategies, their risk appetite and their remuneration policies. Full, fair, balanced and understandable information should be disclosed on all these aspects of business to generate confidence, and also to strengthen accountability inside and outside the bank. We hope that this will encourage

[15] For example: *The Liikanen Report*, EU, October 2012.

shareholders to play a more active role in holding the banks to proper account than they have in the past.

12.12 **Evaluation.** In view of the poor track record of board effectiveness, the bank board should undertake a formal and rigorous evaluation of its own performance and that of its committees and individual directors. This evaluation should consider the balance of skills, experience, independence and knowledge of the company on the board, how the board works together as a unit and other factors relevant to its effectiveness. The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board, including in relation to contribution and commitment, and, where appropriate, proposing new members to be appointed to the board or seeking the resignation of others. Such board review could usefully be externally facilitated on a periodic basis.[16]

12.13 **The co-operative banks.** Although the most dramatic corporate governance failings occurred in the large commercial banks, it is clear that there were also serious deficiencies in the running of the co-operative banks. The interests of the boards and management of many of these banks were closely intertwined with those of their customers, particularly their borrowers; they were subject to party political influence, and poorly supervised. One of the main purposes behind the restructuring of the co-op movement must be to extirpate this culture and introduce governance that is strong and, above all, independent.

Conclusion and recommendations

12.14 The weaknesses in corporate governance in Cyprus' banks were severe, and a crucial cause behind the banking crisis. The main fault was that governance was rooted in a culture of deference to the executive rather than one of independence. Boards did not exercise their responsibility to judge the management of the banks, and ensure that they had the structures and controls to make them soundly run.

12.15 In order to raise the standard of governance in the banks and the co-ops, we recommend that measures be taken to

12.15.1 **instil a new culture of independence in the boardroom, and raise the status of boards,**

12.15.2 **improve the quality of directors by appointing on merit, and raising the number with international experience,**

12.15.3 **increase the non-executive component of boards to counter-balance the executive,**

[16] See, for example, *The UK Corporate Governance Code.* Financial Reporting Council. London. September 2012, and *Guidance on Board Effectiveness*, Financial Reporting Council, London, March 2011

12.15.4 **provide training for directors, and carry out regular evaluation of board performance,**

12.15.5 **strengthen board procedures to ensure that board members are fully informed of the bank's affairs,**

12.15.6 **strengthen board committees, particularly in the areas of audit and risk, to provide independent checks and controls,**

12.15.7 **devise incentive schemes which commit executives to long term objectives and allow for claw back depending on performance, and**

12.15.8 **encourage shareholders to play a more active role in holding the banks to account by means of greater transparency.**

13. Financial reporting

The board plays a key role in ensuring that financial information about the bank is collected and accurately reported. The fact that the losses suffered by Cyprus' largest banks came as a surprise to many people, including bank directors, is evidence of serious failures in this area. Here we consider the role of internal audit. We cover external audit in section 20, page 95.

13.1 **Internal audit.** External audit cannot – and is not intended to - cover all the checks and balances needed for sound bank governance and, in consequence, attention needs to be paid to the role of internal audit. Indeed, an effective internal audit function is now widely viewed as having considerable potential to assist the board and management to ensure that a bank is soundly run.

13.2 The Commission believes, on the basis of what it has been told, that stronger internal audit functions in the banks could have played a significant role in averting the Cyprus banking crisis.

13.3 Since the Cyprus banking system continues to face serious strategic and control challenges, we recommend that boards of banks and the CBC ensure that internal audit functions operate to the highest standards. The key benchmark for assessing the adequacy of internal audit functions is the International Internal Auditing Standards published by the Institute of Internal Auditors[17]. Because of the special concerns which the crisis has raised about internal audit in banks, some jurisdictions have looked at ways in which the core international standards might be enhanced.

13.4 The IIA standards have been designed to be relevant to a very wide range of organisations. For this reason they do not take into account the specific characteristics of regulated financial institutions, such as banks. Recent recommendations in the UK particularly targeted at the financial services sector may be worth particular attention[18]. The UK recommendations identified a number of characteristics of effective internal audit functions and these are summarised in the box on page 64.

13.5 In any event, the reliance which a board can place on the findings and recommendations of internal audit will be enhanced if external quality assurance reviews are conducted by appropriately certified independent assessors in accordance with International Internal Audit Standard 1300 and any problems identified rectified. Even if a sound internal audit function is in place, the ultimate responsibility for addressing or accepting risks identified rests with the CEO and

[17] http://www.iia.org.uk/resources/global-guidance/international-standards/
[18] *Effective Internal Audit in the Financial Services Sector.* Recommendations of the Chartered Institute of Internal Auditors, UK. July 2013

Internal audit in the financial services sector

The primary role of internal audit should be to help the board and executive management to protect the assets, reputation and sustainability of the organisation.

Internal audit's scope should be unrestricted and it should form an independent view on whether the key risks to the organisation have been identified and assess how effectively they are managed. Its scope should include the processes and controls supporting strategic decision-making, and whether the information presented to the board and executive management is complete, accurate and fairly represents the benefits, risks and assumptions associated with the strategy.

Internal audit should include the risk and control culture of the organisation, the risk of poor customer outcomes, capital and liquidity risks and key corporate events such as acquisitions and divestments, the introduction of new products and services and significant business process changes.

Internal audit should be present at, and issue reports to, the board audit committee and the board risk committee. The function should not be part of the risk management, compliance or finance functions and should rather evaluate their adequacy.

The chief internal auditor should be senior enough to have the standing and authority to challenge the executive. The primary reporting line should be to the chair of the audit committee. If there is a secondary reporting line, it should be to the CEO to preserve independence from any particular business area or function.

The audit committee should appoint the chief internal auditor and be responsible for ensuring that the internal audit function has the right skills and resources.

board, and the supervisors will need to be satisfied that this responsibility is exercised.

Conclusion and recommendation

13.6 Stronger internal audit functions in the banks could have played a significant role in averting the Cyprus banking crisis. **We recommend that boards of banks and the CBC ensure that internal audit functions operate to the highest standards. The key benchmark for assessing the adequacy of internal audit functions is the International Internal Auditing Standards published by the Institute of Internal Auditors.**

14. The safety and soundness of banks

14.1 As our earlier analysis of the Cyprus banking crisis showed, there were critical shortcomings in the macro-prudential oversight of the banking system, from high level failure to recognise the risks in having banking as a major part of the economy, down to ineffectiveness in key supervisory functions.

14.2 These were not necessarily the result of wilful negligence. They might better be described as inbuilt. The system was badly organised, it lacked an overall sense of purpose and it failed to connect at many levels. Furthermore, it operated in an environment where close supervision of the banking system was not seen as a priority, and was even discouraged insofar as it might hold back a valuable industry.

In this section, we focus on the main failings, which we identify as follows:

14.2.1 The absence of a clear national policy which understood that the benefits of a large banking industry also brought risks which the supervisory authorities needed to recognise and for which they needed to be prepared;

14.2.2 the disjointed structure of financial supervision in Cyprus, and the lack of co-ordination between the various public authorities which had responsibility for financial stability;

14.2.3 the politicisation of relations between the CBC and government;

14.2.4 the governance of the CBC itself, where weaknesses contributed to the ineffectiveness of banking supervision;

14.2.5 failings in macro-prudential supervision; and

14.2.6 inadequate line supervision, including poor enforcement.

15. Banking union

15.1 Many of the comments and recommendations we make in this section are subject to the introduction on the Single Supervisory Mechanism (SSM) under the European Union's plans for banking union which will have major implications for the supervision of Cyprus' major banks. Although we believe that our recommendations are important in their own right we have tried to ensure that they are consistent with likely future requirements, and should smooth the transition to SSM regulation.

15.2 The intention is that the SSM, under the direction of the European Central Bank, will assume direct responsibility for the three largest banks in each country, plus other large banks according to their significance, making a total of around 130 banks. Less significant banks will continue to be supervised by their local authorities, though with the SSM taking indirect responsibility. The expected start is November 2014.

15.3 In Cyprus, this means that the Bank of Cyprus, the Co-operative Central Bank and Hellenic Bank will come under the SSM, as will the operations in Cyprus of banks from other euro area countries. Russian Commercial Bank will also be included because of its size. Smaller banks will continue to be supervised by the Central Bank of Cyprus, though the ECB will play an oversight role, and will be able to assume direct responsibility for any of these banks if it chooses.

15.4 The SSM will be run by a Supervisory Board in Frankfurt consisting of officials from the ECB plus the heads of supervision from the participating countries. Each bank will be supervised by a joint supervisory team consisting of an ECB official and other national supervisors including officials from the bank's home country. The national authorities will feed data and recommendations up to the Board where draft decisions will be taken. These will be passed to the Governing Council of the ECB for final approval on a "no objection" basis. The supervisory teams and national authorities will then be responsible for implementing the decisions.

15.5 There will be a parallel channel for passing macro-prudential analysis and recommendations up the line to feed a euro area-wide process to identify "big picture" risk and recommend action, whether at the euro area-wide or national level. The CBC, as national macro-prudential authority, will perform this function for Cyprus.

15.6 Accountability for the effective running of the SSM will lie with the ECB which will be answerable to the European Parliament, and may also be called for "an exchange of views" with national parliaments. The cost of running the SSM itself will be covered by a levy on the banks, yet to be arranged, in addition to whatever levies national supervisors already levy on their banks, though these could be reduced.

15.7 In Cyprus, the SSM means that responsibility for supervising the country's four largest banks will be transferred from the Central Bank of Cyprus to Frankfurt, though the existing supervisory staff will remain part of the process. It also means that responsibility for those aspects of prudential supervisory policy which fall within the remit of the SSM will, as with monetary policy, no longer belong to the board of the CBC. This will significantly reshape the role of the CBC board in relation to supervision, leaving it essentially with the responsibility of ensuring that local prudential supervisory and enforcement processes work as they should do. It will retain its responsibilities in relation to conduct of business supervision, which will need to be subject to an MoU with the SSM.

15.8 As a member of the ECB's Governing Council, the Governor of the CBC will vote in the "no objection" approval process for supervisory decisions, including those involving Cyprus banks. He may also be called, but alongside a member of the Supervisory Board, to explain the SSM's actions to the House of Representatives.

15.9 In preparation for the SSM, all the affected banks will shortly undergo a risk assessment process which will involve the collection of data, an asset quality review, and stress testing. This will not be a "pass or fail" process, but it will alert the ECB to those banks which will need closer attention.

15.10 Although a schedule has been drawn up for the introduction of the SSM, it is still possible that the transfer of responsibility for supervisory decision making could be delayed because of the scale and complexity of the initiative (it will involve the hiring of 800 staff at the ECB, for example), and the fact that other elements of banking union such as a joint fiscal backstop to the system, a common resolution mechanism and a zone-wide deposit insurance scheme have not been agreed, and remain controversial.

16. The structure of financial supervision

In this section we consider the effectiveness of Cyprus' financial supervision structure and consider ways in which it might be improved.

16.1 Cyprus has a fragmented structure of financial supervision with four responsible bodies:

- the CBC with responsibility for licensed banks and, following recent reforms, the co-operative credit institutions,
- the Superintendent of Insurance with responsibility for insurance companies,
- the Cyprus Securities and Exchange Commission with responsibility for investment firms and the Stock Exchange, and
- the Registrar of Occupational Retirement Benefit Funds with responsibility for firms which manage pension funds.

16.2 Until recently there was a fifth, the superintendent of the co-operative credit institutions, but that function was taken over by the Central Bank under the requirements of the MoU.

16.3 We think this structure should be streamlined to increase the effectiveness of supervision and give it greater independence. Specifically, we recommend that Cyprus should consolidate these functions into a single regulatory body. We stress that our proposal does not imply criticism of the conduct of regulation by the separate authorities: it is put forward to raise the quality of regulation overall.

16.4 Our case is built partly on efficiency: having one agency rather than four will generate administrative economies, but more importantly it would give the regulator an independent integrated view of the Cyprus financial sector as a whole. Some 50 countries have found that it makes sense to create a "one-stop shop". There is already considerable overlap among Cyprus' financial services: some 70 per cent of the insurance industry is owned by banks, and banks and insurers both operate in the pensions market. Banks also conduct investment business. True, many countries have kept their specialist supervisors, like the US, though often at the expense of efficiency and effectiveness, and their number has tended to decline. There can also be conflicts of interest when a financial supervisor is part of a related government department, as is the case with three of them in Cyprus.

16.5 A further reason is the need to streamline relations among Cyprus' supervisors by eliminating unnecessary demarcation lines and obstacles to information flows and financial stability analysis. Specialised regulators can also run a somewhat greater risk of "regulatory capture", i.e. getting too close to the institutions they supervise.

16.6 It has been put to us that there have been shortfalls in cooperation and information sharing between the separate regulators currently covering different but overlapping sectors (as with the insurance companies owned by the banks). There has also been insufficient information sharing between the different functions within the CBC because of its silo structure. Efficient information sharing is essential to efficient financial supervision[19]. (See box on page 72).

16.7 It is particularly striking that a number of small countries hosting successful international financial centres have chosen this approach e.g., Singapore, Switzerland and, within the euro area, Ireland and Luxembourg. While it is not the responsibility of the regulator to promote international financial services, the existence of streamlined regulation and a single point of entry for supervised firms is attractive to existing firms and potential new entrants. An integrated regulator can also play an important role in formulating a national financial services strategy.

16.8 **Constitution.** An important question is how a consolidated financial regulator should be constituted. It could stand as an independent agency, like the Financial Services Authority of Japan or the Malta Financial Services Authority. Alternatively, it could exist as part of the central bank, as in Ireland or Singapore.

16.9 It is more common for an integrated regulator to be outside the central bank when there is a need to avoid conflicts with the central bank's monetary policy role. But this consideration no longer applies directly to the CBC. We believe that Cyprus would be best served by placing the integrated regulator inside the CBC for a number of reasons:

- the CBC has the necessary financial and legal independence to carry out this role,
- it has already taken over responsibility for the co-operative credit institutions,
- although the CBC's reputation has suffered in the crisis, its supervisory capability is being strengthened, and
- this would save having to create a new regulatory body with the additional costs this would involve.

Comment

16.10 This proposal, which we put forward in our Interim Report, received a mixed response. We found a broad measure of support for our case that there would be efficiency and synergy gains, and that it did not make sense for a country the size of

[19] See Green D. *The interdependence of central banking and supervisory functions; some suggestions for good practice.* Note prepared for the Central Bank Governance Group. April 2013. Available at www.icfcbs.org.

Cyprus to have multiple regulators. In the past, the IMF has commented that Cyprus' system of financial supervision is too fragmented[20]. There was also support for the view that a single regulator would provide "a bulwark against political interference", as one respondent put it.

16.11 However we also encountered scepticism and outright opposition. Conceptually, some commentators were concerned about the concentration of power and conflicts that could result if the integrated regulator was placed in the CBC. This was an argument for having an independent, free-standing regulator. We believe, however, that concentration concerns could be addressed by having robust governance arrangements at the CBC to prevent conflicts and abuse of power. Indeed, appropriate governance at the CBC would have to be a pre-condition for regulatory reform of the kind we propose.

16.12 Another suggestion was that reform should aim to create a "Twin Peaks" structure rather than a wholly integrated one. Under Twin Peaks, regulation is divided into two functions: prudential supervision and conduct of business. The first oversees the soundness of the financial system, the second the integrity of firms' dealings with their customers. Part of the argument is that there can be inherent conflicts between these two functions, with a prudential regulator aiming at stability for the firms it supervises and a conduct regulator requiring maximum transparency for the benefit of customers. However, where such conflicts arise, they still have to be resolved. Furthermore, the managements of the financial services firms themselves also have to address both prudential and conduct concerns. Adoption of Twin Peaks would involve creating a second "peak" with its own resourcing and governance which we believe would be excessive in a country of Cyprus' size and would also create an additional regulatory interface for the firms themselves.

16.13 Concerns were also expressed about the need to preserve the distinctness of insurance supervision which is subject to different laws and directives from banking. This is always an issue when regulators are combined, and it applies not just to insurance. However, in our experience it can be managed. Indeed a number of regulators internationally have combined banking and insurance supervision successfully for many years, as in Canada, and there are models elsewhere in the EU.

16.14 Some of the other existing regulators stressed that current law protects the independence of the regulator, and argued that regulatory diversity should be preserved. A further consideration, raised by a number of respondents, was career risk, and the concern that civil servants in the specialised agencies might not wish to be transferred to the CBC. Again, this is a familiar issue which has been satisfactorily overcome in other jurisdictions.

[20] Orphanides A. and G. Syrichas, *op. cit.,* p. 266

Conclusion and recommendation

16.15 The current structure of financial supervision in Cyprus is fragmented, which leads to inefficiency and exposes it to the risks of political influence and regulatory capture. Although a number of different models are in use around the world, the integrated structure is, in our view, the best for Cyprus because it is the most efficient and streamlined.

16.16 **We recommend that the four components of Cyprus' financial supervision system be combined into a single entity and placed within the CBC which has the legal and financial independence to handle this role, and whose supervisory competence and governance is in the process of being strengthened.**

Information sharing

The financial crisis has served as a stark reminder that co-operation between official bodies engaged in managing the financial system is indispensable and may need to be enhanced, particularly as regards the flow of information between them and between their internal departments.

Finding the right institutional mechanisms for this is not easy because the way is often obstructed by internal politics or institutional self-interest, even personalities. This requires a continuing effort to ensure that information does not fall between the cracks and that, when it does flow, it is in a form which allows the recipient to make the best use of it.

It is easiest to make information flow when all the supervisory and central banking functions are under one roof. When they are not, formal arrangements such as MoUs may be necessary.

While there is usually strong support in principle for such collaboration, there are also obstacles: different functions may not know what the others need; getting data across in the best-formatted and most cost effective way is not straightforward; and it is human nature to try to benefit from exclusive access to knowledge.

There are different kinds of information sets, principally hard data/statistics and soft intelligence, but both need to be transmitted in ways which make them most useful to the recipient. There are also different categories of data flow, for instance, within the CBC, from the payments systems overseers to the supervisors and vice versa, or, outside, between the insurance supervisors and the financial stability function.

One area which has been highlighted by the crisis is the two-way flow between the macroeconomic/financial stability functions and the supervisors. This can be critical in identifying potential areas of stress for the financial system and for the economy.

Because supervisors have frequent access to financial services providers who are among the closest observers of the economic scene, they often possess information which could help improve the quality of forecasts. Supervisors need to be able to record this information and pass it on to macroeconomic analysts, but they tend to have reservations about this because of the cost and the diversion of effort. Nonetheless, it can also be costly for macroeconomic policy makers *not* to take account of the best intelligence available on the economy. In turn, such economic intelligence, if processed and presented properly, should assist the supervisors do their own job better. This is at the core of the central banking/supervisory interface.

17. The Central Bank of Cyprus

This section considers measures to strengthen the independence and accountability of the CBC and clarify responsibilities between the CBC and the government, and to improve its governance. We believe that, together, these will provide a firmer foundation for planned improvements to the supervisory function. It should be noted that major governance changes to the CBC would need to adhere to EU legal requirements, particularly those concerned with protecting the independence of the central bank and its governor.

Independence and accountability

17.1 The highly charged political atmosphere surrounding Cyprus' banking system has led to tension between the government and the CBC which is harmful. It is important for the effective discharge of the CBC's monetary and supervisory duties that the central bank's independence be recognised and respected, but that this be balanced by clear accountability. Independence and accountability are two sides of the same coin.

17.2 The CBC's independence is protected by the Maastricht Treaty[21] (which takes precedence over Cypriot law) but only insofar as monetary policy is concerned. Cyprus' Central Bank Laws give it more general protection[22], including its supervisory role:

> "When carrying out the tasks conferred upon them under this Law, [which include supervision] neither the Bank nor any member of its decision-making bodies shall seek or take instructions from the Community institutions or bodies, from the Government or any government of a Member State or from any other body."

17.3 The Laws contain two accountability requirements[23]. The CBC must present the President and the House of Representatives with an annual report on the conduct of monetary policy in the previous and current years, and the Governor may be asked to appear before the relevant committees of the House to report on "matters relating to the fields of competence of the Bank". Given the greater importance now attached to the CBC's supervisory role, it would be desirable to have a specific reference to accountability for financial stability generally and the exercise of banking supervision in particular. This is particularly relevant to the extent that the House of Representatives has responsibility for national legislation (i.e. not EU legislation) in relation to supervision. In any event, accountability is best exercised and independence best protected by a central bank giving as full as possible public

[21] Protocol on the Statute of the European System of Central Banks and of the European Central Bank, Chap. 3 Art 7.
[22] Central Bank of Cyprus Laws of 2002-2007, part 2 section 7.
[23] *Ibid.* Part 55, section (1) and (2).

explanation for its actions. Indeed, it is public accountability which gives a central bank democratic legitimacy for the independence rightly granted to it.

Relations between the CBC and government

17.4 Relations between central banks and their governments are delicate and need to be managed carefully to allow constructive communication within a framework of respect and clear recognition of roles. In Cyprus, this relationship has been strained by the crisis and needs to be restored to a stable condition.

17.5 It is essential that the supervisory process be independent to ensure that unbiased judgments are made and that confidence is preserved. However the independence of the central bank in relation to supervision is different from that to monetary policy. It cannot be complete insofar as supervision is ultimately about protecting the public purse in which the Ministry of Finance has a direct interest. In Cyprus, this aspect of the relationship is governed by a 2007 Memorandum of Understanding between the CBC and the Ministry of Finance which recognises the CBC's supervisory independence up to the point where public money is needed for a bail-out, when the MoF has the right to access confidential banking information and to dictate action. This is now a fairly standard approach internationally, but the MoU's provisions will need revisiting to clarify responsibilities, for instance in relation to the legislative framework[24]. The MoU should also make provision for regular meetings between the Minister of Finance and the Governor of the CBC to discuss broad macro-prudential issues. We make separate recommendations on this in Section 18 on page 80.

Conclusions and recommendations

17.6 Cyprus needs an independent but accountable central bank to reinforce confidence in the banking system. In the current political climate, that independence is under threat. There are also weaknesses in the arrangements governing the accountability of the central bank and its relations with other areas of government which we believe contributed to the mis-management of the recent crisis. These need to be corrected by putting CBC-government relations on a firmer institutionalised footing.

17.7 **We recommend that the CBC's accountability for financial stability and banking supervision be made more explicit in the relevant laws.**

17.8 **We also recommend that the Memorandum of Understanding between the CBC and the Ministry of Finance be reviewed to ensure that it establishes a clear understanding of the role and responsibilities of the parties involved. It should also incorporate formal arrangements for top level regular**

[24] For a fuller discussion, see Hüpkes E., Quintyn M., and Taylor M.W. *The Accountability of Financial Sector Supervisors: Principles and Practice* , IMF Working Paper (2005).

meetings between the Governor of the CBC, the Minister of Finance and the heads of other supervisory authorities, and their respective staff.

17.9 **We recommend that the CBC provide as full as possible a public account of its actions and the reasons behind them, consistent with the needs of appropriate confidentiality.**

Governance of the CBC

17.10 Poor governance arrangements of the Central Bank of Cyprus contributed - over a number of years - to the 2012 crisis by concentrating too much power in the hands of the Governor, and by exempting the supervision department from the internal audit process which meant it did not receive board level scrutiny. Although there are no standard models of central bank governance around the world, both these failings singled the CBC out as having weaker governance than many other central banks.

17.11 In our Interim Report, we made a number of recommendations for improvement, mainly in the structure of the board and in the audit function. Since then, the House of Representatives has passed a new bank law which introduces a set of changes which are broadly in line with our recommendations though they differ in a number of key details and do not, in our view, resolve the situation satisfactorily. Significantly, the European Central Bank had queried earlier drafts of the legislation on the grounds that they could constrain the independence of the Governor whose position as regards monetary policy is safeguarded by EU legislation on the European System of Central Banks (ESCB)[25].

17.12 **Structure of the board.** The main difference between our proposals and the new legislation lies in the structure of the board. We proposed a board consisting of four non-executive directors and two executive directors, plus the Governor, making a total of seven. The new law creates five NEDs and two executive directors plus the Governor making eight. Although the difference is small it is nonetheless significant because it tilts the balance more heavily against the Governor and the executive of the Bank, and makes possible a 4-4 vote split. We still consider seven to be a more appropriate number. As one expert in central bank governance put it to us: "The Governor should *just* be able to be outvoted".

17.13 The law also says that the duties of the two executive directors shall be exercised "without prejudice to the obligations emanating from the participation of the Bank in the European System of Central Banks and the provisions of the Treaty and the Statute". This provision appears effectively to exclude the executive directors from taking any responsibility in the two crucial areas of monetary policy/operations and of banking supervision where the latter will come under the European Central Bank

[25] Although there is no specific provision in EU legislation about the independence of central banks as regards banking supervision, the ECB takes a strong interest in this area.

when the SSM starts in 2014, and become the exclusive province of the Governor. This means that the executive directors could be bereft of a meaningful role in core areas of the Bank's responsibilities, which is unsatisfactory as well as a waste of resources, and could lead to managerial confusion. At the time of writing it was not clear how this impasse was to be resolved. Our preference would be for the executive directors to be members of the staff, as is common other central banks, where they could take responsibility under the Governor for both supervision and other functions.

17.14 For both these reasons, we believe the legislation is flawed and should be amended. (We expect that, in any case, amendment will be necessary when the SSM comes into effect to remove the new responsibilities of the board in relation to licensing of banks, which will pass to the ECB.)

We now discuss our other recommendations in more detail.

17.15 **Chairman and lead non-executive director (NED).** The Governor would be the chairman of the board. However, the NEDs would elect one of their number as lead NED to provide a focus for their discussions.

17.16 **Board committees.** Essential to the functioning of the structure we propose would be a set of board committees appointed by, consisting of, and chaired by non-executive directors. These would provide independent checks on the executive, and ensure that the policies and objectives of the bank were being met, and with the power to take action if required. The most important of these is the audit committee, which we recommended in our Interim Report, and which has since been established by the new law. Among other things, this committee will receive independent assessments on the CBC's operations prepared by the internal audit function, and make recommendations on appropriate action.

17.17 The board should have the authority to establish additional committees as required, for example, a risk committee which would receive reports from the CBC's Risk Office on risks to the condition and objectives of the bank, including areas such as resourcing and threats to its independence. There should also be a nominations committee (see below). Executive directors could attend committee meetings by invitation.

17.18 **Board role.** As a policy-making body, the board would decide on the policies and objectives of the CBC, though this role is will be much reduced by the transfer of responsibility for prudential supervisory policy as regards significant banks to the SSM. The main areas of responsibility will therefore be responsibility for those supervisory tasks not transferred to the SSM, including conduct of business supervision, oversight of the supervisory processes required of the CBC by the SSM, the supervision of less significant banks, and operational issues such as budgets, banking operations, payment systems, internal audit, senior staff appointments and remuneration, management of the country's gold reserves, and the appointment of board committees. The board will need to be provided with access to the information necessary for the performance of these functions.

17.19 The arrangements would also make clear the responsibility of the executive for implementing policy through an executive committee where there should be a system of collective decision-making (except in areas deemed under EU law to fall within the Governor's personal competence) as this has been shown to produce the best results. The arrangements for the functioning of this executive committee should also be clearly specified.

17.20 The current management structure of the CBC is unusually flat, with most significant functions reporting directly to the Governor (we were told 14). This is particularly cumbersome given the Governor's Eurosystem and other responsibilities which require his absence abroad for large periods of time. This commitment will increase when the ECB Governing Council, of which the Governor is a member, assumes ultimate responsibility for the supervisory decisions of the SSM. The head of supervision will also need to be absent for large periods of time as the Supervisory Board of the SSM of which he will be an *ex officio* member is expected to meet twice a month in Frankfurt.

17.21 For these reasons we recommend that the Board of the CBC consider an executive management structure within the Bank under which considerable management responsibility is devolved to the two executive directors, who will need to have the skills and expertise appropriate for such responsibilities. Our own suggestion - though this is a matter for the Board - is that one executive director be assigned responsibility for banking supervision and the other for the Bank's operations. The Governor would have reporting directly to him the monetary policy function, because of his ECB Governing Council responsibilities, and the financial stability function because of the central importance of decisions taken on financial stability grounds.

17.22 **Frequency.** The board should meet monthly, and board committees quarterly.

17.23 **Independence of directors.** It is essential that the non-executive directors be independent, and be chosen for their personal qualities and qualifications. For this reason, we recommend that the board establish a nominations committee which would propose the appointment of suitably qualified non-executive directors for approval by the Council of Ministers, providing a stronger guarantee of their independence and of their capacity to make a constructive contribution. The individual board members would need to understand that their responsibility lay to the CBC and not elsewhere. The appointment process should be made more transparent by advertising vacancies, and appointments should be staggered to ensure balance and continuity. A similar process should be applied to the appointment of executive directors to ensure their independence.

17.24 **Directors' qualifications.** The qualifications of directors as laid down by the Central Bank Laws are that they "shall be citizens of the Republic of recognised professional qualifications, and/or recognised economic and business experience who are not disqualified for appointment…"

17.25 This definition is insufficiently precise and can leave open the possibility that directors have been chosen for their political affiliations. The qualifications should include knowledge and experience of banking, finance, risk management and audit. Also, we see no reason why a CBC board director should have to be a Cypriot citizen; indeed we believe that this is part of the wider cultural problem in Cyprus that we have already touched on. The CBC board would benefit from having directors with an international background who could bring a different culture and experience to its deliberations. It is increasingly the practice in Europe for central bank and financial supervision boards (and executives) to have a foreign component. Ireland provides a recent example where confidence was strengthened following the crisis by bringing in non-nationals at both the executive and non-executive levels in the face of widespread concern about the narrowness of the social base from which Central Bank officials were chosen.

17.26 We recognise that there are considerable practical difficulties in running the CBC in this era of change, particularly of communication and travel. Cyprus is the most far-flung member of the EU and the time taken in travel is already considerable with the Governor having to make frequent trips to Frankfurt. This will be increased when senior supervision staff have to make bi-monthly visits to the SSM supervisory board. Nor will it be easy for a non-Cypriot board member to attend frequent meetings in Nicosia. Greater use of teleconferencing is an obvious answer; however this may require changes to Cyprus' Administrative Law. We recommend that the necessary legal changes be made.

Conclusion and recommendations

17.27 Governance of the CBC has been deficient as regards the effectiveness of checks and balances on the role and power of the Governor, the method of appointment of board directors, and the strength of internal audit. The solution lies in having a stronger non-executive structure and clearly defined board responsibilities as well as a better structured executive. New legislation aims to correct some of these failings. We agree with its broad thrust though we differ on the detail of the composition of the CBC board. However, any changes will need to be consistent with the EU Treaty. The question of the role of the new executive directors and of the board more generally in the context of the SSM needs to be resolved urgently and the legislation reviewed if necessary.

17.28 **We recommend that the CBC have a policy-setting board chaired by the Governor, with two executive directors and four non-executive directors with clear decision-making powers in specified areas. The checks and balances on the executive would be provided by appropriately qualified, independent non-executive directors and effective board committees with the power to monitor the executive's performance and require corrective action if needed.**

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

18. Macro-prudential oversight

18.1 One of the causes of Cyprus' banking crisis was a failure by the authorities to adequately confront the risks which faced the banking system over this period, particularly the domestic asset bubble and the strains that were building up in world markets. Had these been dealt with promptly, it should have been possible to avoid some of the huge losses which subsequently materialised. Although functions existed at the time at the CBC to keep track of so-called "macro-prudential risk", these were under-resourced and given insufficient attention by top management.

18.2 Macro-prudential analysis is now well-established internationally as a component of the mechanisms used to monitor "big picture" banking risk, in particular systemic risks which could threaten the system as a whole, or groups of financial institutions simultaneously[26]. Macro-prudential units with a high level overview can also challenge the myopia and "group think" which tends to afflict the supervision process, and the banks and society more generally. However, as well as being properly resourced, effective application of macro-prudential analysis to operational supervision requires effective co-operation among financial supervisors and government.

18.3 The European Systemic Risk Board (ESRB) has recommended that EU countries designate a national macro-prudential authority to carry out these tasks. In Cyprus, this is to be the CBC. In addition, the new EU capital requirements framework requires EU member states to appoint a "designated authority" at the national level responsible for the application of macro-prudential policy tools. The Single Supervisory Mechanism also assigns specific macro-prudential powers and tasks to the European Central Bank and, consequently, a new macro-prudential policy framework is being set up that will involve close co-operation between the ECB and the national macro-prudential authorities in each member state in the deployment of macro-prudential policy instruments.

18.4 **Financial Stability Committee.** As we noted above, macro-prudential supervision requires effective co-operation among financial supervisors and government. Cyprus has a Financial Stability Committee consisting of the CBC, other financial regulators and the Ministry of Finance, chaired by the CBC to facilitate this work. This body, which was set up in 2007, is supposed to keep an eye on the big picture and co-ordinate the responses of its members. But it was under-resourced and failed to play an effective role in the crisis[27]. It met only infrequently, and then usually without the attendance of top personnel. Full information was not given to it because of

[26] See, for example, EU Directorate General for Internal Policies. Policy Department A: Economic and Scientific Policy. *Review of the New European System of Financial Supervision ("ESFS"). The Work of the European Systemic Risk Board – The ESFS's Macro-Prudential Pillar.*

[27] We were told, for example, that there was only one person in the Ministry of Finance watching over the banking system, and that the committee met only three times at the height of the crisis, and not once in 2012.

confidentiality constraints, and, possibly, tensions between members. If the necessary information had been available, this committee could have alerted financial supervisors to emerging risks and prompted action. It could also have brought the government's attention to the fact that banks might need help, and highlighted the implications of the deterioration in public finances in this context.

18.5 This Committee should be revived on a permanent basis with a clear mandate to monitor macro-prudential risk to financial sectors and government finances, and alert the appropriate authorities. Although it could recommend action, its role would be deliberative rather than decision-making, with each of the parties retaining their own formal responsibilities. International practice varies as to who should chair such a committee. In most countries it is chaired by the finance ministry to ensure its engagement in issues which are ultimately about the public purse and potential legislative change (as with the Financial System Oversight Council in the US). In any event, it should be supported by appropriate resources and trained individuals. There is also a need to update the applicable MoUs on financial stability to include the exchange of confidential information between the various parties and decision-making where responsibilities overlap.

18.6 **Financial stability in the CBC.** A Financial Stability Unit was set up in the CBC in 2004 to provide macro-economic information to alert and strengthen the supervisory process covering all aspects of the financial services sector including banking, insurance, investment and financial infrastructure. It also wrote the Financial Stability Report for the CBC's six monthly Economic Bulletin. In our Interim Report, we commented that the unit was under-resourced and failed to send out useful signals about threats to financial stability. Since then, we have been presented with evidence that the unit was indeed putting out impressively accurate warnings about emerging risks, but that these were treated as unwelcome higher up the line. In our view, this represented a major breakdown in internal communication and in accountability at a senior level within the CBC. The new governance arrangements at the CBC must ensure that unwelcome news cannot be suppressed or ignored.

18.7 The Financial Stability Report was dropped from the Bulletin in 2011 just as risks were reaching alarming proportions. The MoU suggests that this Report be resumed. We are doubtful about the value of this in isolation as a risk mitigation tool. Wider experience tells us that such reports usually veer on the side of caution, are a victim of their own timetable and constantly run the risk of handing hostages to fortune.

18.8 We support the work that the CBC is doing to strengthen the new macro-prudential oversight section drawing on intelligence from its supervisory work and the output of its Economic Research Department. This will provide a basis for macro-prudential policy decision-making as well as supervisory and other decisions. This function will deal, *inter alia*, with the interface between the financial system and the economy. In order to be able to give unbiased analysis it should be co-located neither with the supervisors nor the macro-economists, but rather report independently to the Governor.

18.9 The upcoming SSM will impinge on macro-prudential analysis and related policy decision-making. For example, the macro-prudential oversight section will work closely with the European Systemic Risk Board and the ECB to develop clear observable and quantifiable metrics, with associated thresholds which can become early warning indicators and allow the authorities to take prompt remedial action.

Conclusion and recommendations

18.10 The failure by high level authorities to heed macro-prudential warnings from the financial stability function about "big picture" risks, such as excessive credit growth and threats in the international markets, was an important reason why Cyprus lost control of its banks and plunged into a banking crisis. This is now being corrected. Steps have been taken to designate the CBC as Cyprus' macro-prudential authority and to create a macro-prudential oversight section in the Central Bank. These are welcome moves.

18.11 **We recommend that the macro-prudential oversight function be strongly resourced in the government ministries and the CBC, and that confidential information flows between them be improved and safeguarded. This function should have clear framework for identifying risks, and the CBC should have rigorous procedures for taking action in relation to such risks, and following it up.**

18.12 **We recommend that the existing Financial Stability Committee be revitalised to improve the CBC's working relationship with other areas of government, particularly the Ministry of Finance whose actions have a material impact on financial stability, and provide a top level forum for discussion of macro-prudential issues, including threats to the system as a whole.**

Managing "big picture" risk

Macro-prudential oversight is about more than keeping an eye on "big picture" risks to banks. It needs to have rigorous procedures to ensure that appropriate policy action is taken and followed up. It would need to include the following procedures:

- to identify, agree on and prioritise the key risks. As well as taking account of internal work this should include assessment of risks identified by the European Systemic Risk Board, IMF, BIS and other analysis;

- to take a formal decision on each of the risks as to how it should be addressed, including whether to take no action.

Follow up could include

- publishing an annual account of the risks identified,

- publishing macro-prudential policy decisions,

- issuing warnings to the public, perhaps through speeches or other media,

- targeted inspections of banks, especially systemically important ones,

- direct supervisory action in relation to individual banks or in relation to banks in general,

- ensuring that action that has been agreed is actually carried out,

- discussing legislative change with the relevant lawmaker to correct any shortcomings in the supervisory toolkit, and

- commissioning further internal research.

19. Prudential supervision and regulation

In this section we discuss the supervision of the Cypriot banking system, and make recommendations to raise its effectiveness.

19.21 Although we begin by analysing the failings of the past, we recognise that big changes are already underway at the CBC's own initiative and under the terms of the MoU (see box). We strongly support these initiatives: they are essential to bring supervision up to international standards. Our recommendations focus on the prioritisation of this work, on resourcing and management of the supervisory process, on aspects of international practice which Cyprus needs to introduce, and on areas for further consideration. In many of these, the essential message is that

Main banking measures in the MoU

1. "Carve out" of the Greek operations.
2. Resolution of Cyprus Popular Bank and the absorption of selected assets and liabilities by the Bank of Cyprus
3. Recapitalisation of the Bank of Cyprus through a debt to equity conversion and a deposit haircut, without the use of public money.
4. Maintenance of liquidity in the banking system.
5. Improved capital and liquidity buffers for banks.
6. Central Bank power to enforce capital requirements.
7. Better loan origination practices.
8. Concentration limits on lending.
9. Improved non-performing loan recovery rates: removal of obstacles to property seizure.
10. Better management of non-performing loans.
11. Creation of a credit register of all borrowers.
12. Implementation of best international practices on loan origination, provisioning.
13. Measures to strengthen bank governance.
14. Restrictions on directors' loans.
15. Better data reporting.
16. Stronger powers to combat money laundering.
17. Annual stress tests of banks.
18. Reform of supervision of co-operative credit institutions.
19. Restructuring of the co-operative sector.
20. Better monitoring of corporate and household debt levels.
21. Measures to deal with troubled borrowers.

clear processes need to exist to ensure that supervisory work is carried out regardless of subjective considerations, and that the process be dynamic, i.e. on the alert and constantly evolving.

19.22 The handling of banking supervision at both the macro- and the micro- levels in the run-up to the crisis and during the crisis itself was clearly deficient, as is evident from the devastating outcomes. We recognise that many of the failings have become more obvious with the light of hindsight, and that there may have been acceptable explanations for them at the time. But this broad conclusion is impossible to avoid.

19.23 **Comment.** After we published our initial views on supervisory failings in our Interim Report, we received a number of comments from present and former supervisory officials contesting our version of various events. These comments centred mainly on whether the CBC had adequate powers to restrain the banks in an environment where rapid growth was stimulated by loose fiscal policies and a generally low awareness of banking risk. These comments have not caused us to alter our broad conclusions about the inadequacy of supervisory outcomes over this period, though we qualify them by recognising that the supervisory function was under-resourced, that it was operating in extremely difficult, often unprecedented, conditions, and that many of its decisions were deemed to be correct at the time by other supervisors and international regulatory bodies. It is also true that Cyprus was not alone in experiencing a boom in bank credit which came to grief.

Cyprus' failures can be put in a number of categories.

19.24 **Failures of leadership.** We found a number of instances where line supervisors were attempting to correct the imprudent behaviour of banks, but were discouraged from following through because of negative attitudes higher up the line, and the prevailing view in government that the banks were doing a good job and should not be reined in.

19.25 **Challenging bank strategies.** The failure by the authorities to challenge bank strategies was critical because the safety and soundness of banks depended on their continuing to make money, which in turn depended on the soundness and viability of their business plans. When the largest Cypriot banks embarked on their overseas expansion in the mid-2000s, little attempt was made to question the prudence of these moves, even though they were new and very large, and took banks into potentially difficult markets such as Greece and Eastern Europe. Table 3 shows the surprisingly high number of branches that were opened by Bank of Cyprus in Greece with the approval of the CBC in the period leading up to Greece's crisis.

Table 3:
Bank of Cyprus branches in Greece

2007	135	Total existing
2008	25	New approvals
2009	10	"
2010	16	"

Source: Central Bank of Cyprus

19.26 The acquisition by Bank of Cyprus of Uniastrum Bank in Russia in 2008 also went unchallenged. We doubt that the CBC sufficiently appreciated the risks involved in foreign business acquisition, or effectively questioned the banks' strategies. The CBC's Financial Stability Report of December 2009 acknowledged that foreign expansion by the banks exposed them to "country risk" – which was new - but added that it "provides ample growth opportunities".

19.27 **Restraining imprudent lending.** There was no effective attempt by the supervisor to rein in the sharp rise in bank lending which took place in 2006-2008 and led to the funding of a real estate bubble in Cyprus and to a heavy exposure to bad debts in Greece. The CBC put the brakes on lending in 2007 by lowering the loan-to-value ratio for second home mortgages from 70 per cent to 60 per cent, but then raised this again to 70 per cent in 2008 because it believed the danger had passed. It made a further attempt to slow lending down in 2009 by raising capital requirements, but by then it was too late.

19.28 We accept that the CBC lacked monetary levers to contain credit growth, and that it warned the government about potential dangers, and that the authorities at higher levels did not, or did not care to, see the risks the banks were running. However we are left with the fact that credit growth in this period in Cyprus eventually reached the highest level in the euro area in 2011, and that this produced a devastating lending bubble.

19.29 **Follow through of regulatory concerns.** The purchase by Bank of Cyprus and Cyprus Popular Bank of Greek Government Bonds in 2010, despite Greece's rapidly worsening economic plight and the downgrading of these bonds by the rating agencies, was queried by the supervisors but not followed through because of inadequate powers. The comments we received focused on the fact that it is essentially up to the banks to monitor and manage "concentration risk", and for the CBC to ensure that the banks have adequate capital to manage that risk – which it did. It is also true that the risk of a devastating "haircut" on Greek Government Bonds was an unprecedented event in a class of securities which was "zero rated" by international standards so far as risk is concerned. The fact that the Cyprus government took no steps to exempt or shield its banks from the impact of the haircut was another major policy failing. However, again, we are left with the fact that these purchases (some of which were not adequately disclosed at the time) were totally exceptional and should have attracted stronger regulatory attention.

19.30 **Weak governance in banks.** Oversight of the banks' corporate governance structures and practices was deficient. The supervisor did not succeed in getting the banks to correct the serious weaknesses in the operation of their boards, in particular as they related to risk management, internal controls, and the role of the executive. This allowed the country's two largest banks to be run essentially as the fiefdoms of strong-willed chief executives. Although the CBC did obtain the removal of certain senior banking personnel in the 2010-2012 period, this did not avert the crisis.

19.31 **Credit origination.** As we noted earlier, loans are granted in Cyprus largely against collateral rather than ability to pay, which leads to poor credit origination and loan recovery practices. Little was done to encourage better practices in this area and introduce more rigorous control of collateral valuations, multiple guarantees etc.

19.32 **Poor enforcement.** Few actions were taken to enforce supervisory decisions, and no enforcement decisions were publicised, meaning that there were inadequate disincentives to bad behaviour.

Learning the lessons

The list of investigations into the global crisis is very long. The US, the UK, Switzerland, Spain and Ireland are among many countries which have published reports. The collective lesson for Cyprus from these is very salutary. Many of them contain common themes: a lack of supervisory rigour, failure to understand the risks at the macro level, poor governance in the banks, inadequate resourcing of supervision, human failing etc. The UK Financial Services Authority's investigation into the causes of the failure of the Royal Bank of Scotland contains conclusions which could be applied to many countries:

> "There was insufficient focus on the core prudential issues of capital and liquidity, and inadequate attention given to key business risks and asset quality issues. Too much reliance was placed on assessments that appropriate decision-making processes were in place, with insufficient challenge to management assumptions and judgements."

19.33 **The challenge.** If we summarise these failures, they lie in an overall lack of effectiveness on the part of the supervisory authorities for a combination of reasons including under-resourcing, lack of determination at senior level and the governance and internal control weaknesses that we identified in the previous section.

Risk framework

19.34 An effective supervision function needs to have a clear mission and objectives. It should operate within a framework in which risks to the banks and the supervisory process itself are clearly identified, prioritised and appropriately resourced accordingly. It is not clear to us that such a framework existed in the CBC at the time of the crisis.

We recommend that such a framework be developed, and that its priorities include:

19.35 **Credit risk**. Bad loans are high and will certainly go higher as the economy worsens. This places a priority on the identification and management of this problem, and the strict enforcement of the tighter non-performing loan regulations set down by the MoU, and now contained in a new CBC Directive. For the banks, this will require that they have the human and capital resources to deal with the problem. At the moment, their skills lie more in loan origination than in debt recovery.

19.36 However loan origination will also need to be more rigorous and less reliant on collateral and personal guarantees. "Multibanking" (taking loans from several banks at once) will need to be reduced by the use of the newly credit register. In the absence of monetary levers to control credit costs in the Cyprus economy, regulatory levers need to play a bigger role in keeping credit expansion under control such as loan-to-value and loan-to-income requirements, and capital and liquidity requirements.

19.37 **Bank governance risk.** The governance of Cypriot banks was weak, though it is now undergoing reform. We believe that regular monitoring and evaluation of the banks' governance practices and the competence of directors should become a key part of the CBC's supervisory programme.

19.38 We support the work the CBC is already doing in this area by vetting prospective directors, by applying stricter fit and proper tests, and updating its directive on corporate governance. Work is also proceeding to check banks' internal control systems, risk management practices and compliance procedures. Supervisors are scrutinising the minutes of board meetings, and challenging decisions.

19.39 The CBC needs to keep under constant review the corporate governance of the banks, and to require corrective action when warranted. It should also have the necessary tools and enforcement powers to address any problems arising from corporate governance weaknesses in a bank, and should use them.

19.40 In revising its directive on corporate governance, the CBC should stress the need to implement widely accepted sound corporate governance principles relating to

19.40.1 board practices (including the responsibilities of the board, the qualifications, training and performance appraisal of board members, the role of the chairman and board committees, potential conflicts of interest etc.);

19.40.2 senior management;

19.40.3 risk management and internal control functions;

19.40.4 compensation, and

19.40.5 transparency.

19.41 Cyprus has two corporate governance codes affecting banks (the CBC's and the Stock Exchange's) which could cause confusion. We recommend that they be aligned and that an authority be given the responsibility to keep them up to date.

19.42 One caution is that this work should strengthen rather than diminish the banks' sense of responsibility for their own actions: too much regulatory intrusion can result in the regulator becoming a "shadow director" and taking effective responsibility for a board's decisions.

19.43 **Systemic risk.** Although the size of the banking system will be much reduced, Cyprus will remain susceptible to systemic risk of a different kind because of the more concentrated banking structure which has resulted from the measures imposed by the MoU, and from uncertainties surrounding the recovery of Bank of Cyprus. The monitoring and control of systemic risk as well as resolution mechanisms for dealing with future crises will need to be robust.

19.44 There is a strong case for creating stricter frameworks for systemically important banks, such as more intensive supervision, higher loss absorption capacity, and higher standards of corporate governance. Many of these requirements are now contained in the EU's capital requirements directive. In Switzerland, banks with assets equivalent to more than 50 per cent of GDP are required, under the so-called "Swiss finish" rules, to have capital of 19 per cent consisting of 10 per cent equity and 9 per cent "CoCo bonds".

19.45 In the medium term, a clear capital framework will need to be established for the period when the Cyprus economy has recovered and the banks are back on their feet.

19.46 The MoU requires all Cypriot banks to raise their minimum core tier 1 capital ratio from 8 per cent to 9 per cent by the end of 2013. While Swiss-style measures will not be needed because of the smaller scale and simpler structures of Cypriot banks, we recommend that they be required to hold extra capital as a buffer against risk. This will be particularly important for counter-cyclical purposes should Cyprus return at some point to boom conditions.

19.47 The authorities may prescribe increased capital requirements within the following guidelines:

19.47.1 The 9 per cent minimum core tier 1 capital (as agreed in the MoU) should be maintained, including a 3 per cent capital conservation buffer. If a bank's core tier 1 capital falls below the minimum, the authorities should impose restrictions on payments of dividends, share repurchases and bonuses, and require more capital to be raised.

19.47.2 Systemically important banks should be required to have additional equity of at least 2 per cent. This stronger loss absorption capacity would reduce the likelihood of having to resort to government aid in times of stress. Systemically important banks would be defined in terms of their size relative to GDP.

19.47.3 Banks should be expected to build up their capital in good times to enable them to absorb losses in bad. The size of this countercyclical buffer may vary (for example between 2-3 per cent) and a higher capital requirement may be imposed in periods of emerging asset price bubbles. Thus this requirement may be used as a tool for economic stabilisation purposes.

19.47.4 By the same token, supervisors should consider lowering capital requirements on non-systemic banks to ease their cost burden and encourage competition.

19.48 **Operating risk.** In their weakened state, it is important that Cypriot banks have robust internal operating systems, for example in IT, accounting, personnel and compliance. The crisis exposed the fact that even basic IT security, including the recoverability of records, seems not to have been observed and there may be shortcomings in financial record-keeping and controls as well, given the difficulty in establishing the balance sheet of the new merged Bank of Cyprus. The CBC needs to have the skills and resources to examine such risks.

19.49 **Supervisory process.** A useful way to gauge the strength of supervision functions and objectives is to review them against the principles laid out by the Basel Committee on Banking Supervision in its report "Core principles for effective banking supervision" (September 2012) which provides a benchmark against which countries can assess the quality of their supervisory systems. This now a requirement of the MoU.

19.50 We think it particularly important that supervisory decisions be taken on the basis of sound due process. We recommend that there be a Supervisory Decisions Committee which would prepare recommendations with supporting arguments for decision by the Governor, and at a later stage by the SSM. This would ensure that recommendations were fully argued and documented, including the final decision. This body might be chaired by the head of supervision.

19.51 **Internal audit.** The CBC's supervision function needs to operate within a discipline which ensures that it is rigorous and under constant review. Until recently, this was not the case: the supervision department was not subject to the CBC's internal audit process, and its performance was not, therefore, independently assessed.

19.52 In our Interim Report, we expressed the view that this deficiency contributed to the supervisory failings in the crisis, and went on to recommend that it be corrected as a matter of urgency. Since then, an independent peer review of the CBC's internal audit arrangements also identified deficiencies, including the absence of an audit committee of the CBC board, and weak interaction between departments.

19.53 Steps have now been taken to strengthen the internal audit function in the CBC and include supervision in its remit. Following recent legislation, an audit committee of the main board has also been set up to oversee the internal audit function. The internal audit function will have a dual reporting line to the Governor and the audit committee, ensuring that its reports are dealt with both managerially and by the board.

19.54 We strongly welcome all these steps. The importance of internal audit is that it will hold the supervision function to account by taking a view that is independent of the executive, and has the sponsorship of the board with the clout to make sure that management addresses its findings. The audit will not challenge the judgments made by supervisors, but will ensure that the procedures that have been laid down are adequate and being followed. The internal audit function will need to be fully resourced for this role.

Enforcement

19.55 It is one thing for a supervisor to have powers; it also needs to use them. The failure of the CBC to enforce its directives on a consistent basis during the crisis allowed banks to behave imprudently and diminished respect for the supervisor. In a banking community with Cyprus' recent record, the supervisor needs a big stick.[28]

19.56 The CBC has considerable powers: it can rule that a bank executive or director is not fit and proper for the job, it can place restrictions on a bank's operations, it can impose higher capital requirements to put a brake on certain types of activity, it can restrict dividends, and it can fine banks for breaches of regulations and procedures. The banking laws also empower it to issue guidelines and directives to banks to ensure financial stability. The MoU requires the CBC to use "mandatory supervisory

[28] In 2009, when the UK was tackling its own banking crisis, Hector Sants, the chief executive of the Financial Services Authority, said "Banks should be very frightened of the FSA".

action" when setting banks' capital levels[29]. We judge that the CBC's powers are adequate. But they need to be enforced, impartially, systematically, and regardless of a bank's financial condition and personnel consequences.

19.57 We learnt that there had been only half a dozen enforcement actions by the CBC in recent years, and these had remained confidential. This strikes us as a small number given the scale of the banking crisis and the defiance shown by banks towards the regulator. By keeping them confidential, the opportunity was also lost to set an example. Subject to the discretion of the CBC, taking into account the possible impact on depositor confidence, the decisions are now to be made public, a move which we welcome.

19.58 Enforcement needs to be directed against individuals as well as firms. This will strengthen individual accountability and hasten the cultural changes that we referred to earlier in this Report. However, there will always be resistance to enforcement, and the CBC needs to be equipped to meet it with appropriate documented processes.

19.59 Enforcement needs a strong platform because it is against the background of enforceable rules that supervisors make their judgments and their decisions. The enforcement function should be split out from the supervision department into a department of its own to give it greater independence and marshal the necessary legal expertise Clear and documented processes are needed to ensure that all decisions are properly taken and can be justified by reasoned evidence.

Resourcing

The resourcing of supervision needs to be measured in terms of quantity and quality.

19.60 The CBC's supervision department currently has a staff of 53 and consists of licensing, regulation and examination sections. The regulation department deals with the preparation of regulations, implementation of directives etc. A separate department handles licensing. The examination section consists of four teams of examiners who supervise particular groups of banks and conduct on site examinations.

19.61 Many improvements have been made to the department over the last two years. Staff rotation has been introduced to reduce the risk of supervisory capture. The range of skills has been extended beyond accounting to include risk assessment, banking and audit, though further specialist skills in anti-money laundering compliance and remuneration and, to the extent that banks go into trading, market risk may be necessary. It may not be possible for every supervisory team to embrace all these skills and many supervisory agencies use a matrix arrangement to make

[29] Memorandum of Understanding Para 1.10

sure that expertise is available from specialist teams to each line supervisory group. Supervisors must have the same skills as the banks they are dealing with.

19.62 The adequacy of resources for banking supervision is difficult to judge currently because of the large amount of additional work that has been created by the crisis, such as the administration of capital controls and handling the resolution processes.

19.63 Although the size of the Cypriot banking industry will be reduced by shrinkage and consolidation, the supervision department's work load will be increased by a raft of new regulatory measures, including responsibility for the co-operative sector, and the need to ensure that the shortcomings of bank practice in the past are corrected. The introduction of supervision by the SSM will, at least in the early stages, almost certainly lead to an increased workload rather than the reverse because of the creation of an extra layer of supervision, though this could be an area of future saving. We expect that the department will need additional resources in the not-too-distant future, and we therefore support the suggestion in the MoU that the hiring freeze be relaxed for the CBC's supervisory function.

19.64 However, given the size of the task, we also think the CBC should consider applying to the IMF or other organisations for technical assistance. This would provide a multi-year programme that would bring additional expertise to the CBC's supervisory work and ensure that it met current international standards.

19.65 We observe that regulation in Cyprus tends to be dominated by transposition of EU directives. There could be considerable benefit in issuing more guidance to the banks, for instance in areas where the Basel Committee on Banking Supervision has provided material for banks to incorporate in good practice. In turn such guidance could assist the inspectors in their assessment of bank behaviour.

Conclusions and recommendations

19.66 Much work is already underway to correct the supervisory failings at the CBC which contributed to the crisis, including the strengthening of the internal audit function to cover the supervision department. This will help restore confidence in the banks and reduce systemic risk. However further work needs to be done to make it more effective.

19.67 **We recommend that the supervisory function have a rigorous risk framework in which risks are clearly identified and prioritised.**

19.68 **We recommend that the CBC set up a Supervisory Decisions Committee to ensure due process in the preparation of recommendations for the Governor.**

19.69 **The CBC's enforcement function should have a department of its own to ensure its independence and marshal the necessary legal expertise. We welcome the decision to make enforcement decisions public.**

19.70 **We recommend that supervision be given more resources to support its enlarged role, but that it also seek long-term technical assistance from a body like the IMF to raise the level of expertise and ensure that it meets current international standards.**

19.71 **We support the recommendation in the MoU that the CBC undertake a review of its supervision functions and objectives against the principles laid out by the Basel Committee on Banking Supervision in its report "Core principles for effective banking supervision" (September 2012) which provides a benchmark against which countries can assess the quality of their supervisory systems.**

20. External audit

20.1 The role of the external auditors is important, as is the relationship with the supervisors, whose role they complement. This appears to have been neglected for a crucial period in the build-up of the crisis. Subsequent investigations have raised questions about the reliability of accounting and auditing in Cyprus. While we have undertaken no investigations ourselves, we have been told enough by those in a position to know to be sure that there is room for improvement.

20.2 **Judgment.** Choices of accounting treatments may sometimes have generated unhelpful information which may then have led to unwise outcomes. One example is the treatment of non-performing loans. It seems that where loans were rolled over at a penalty rate because of their poor status, the banks were able to accrue unpaid interest at the higher rate while maintaining the loan at full value so that it appeared that the banks' performance was improving when in fact it was getting worse. While banks in Cyprus report in accordance with International Financial Reporting Standards as adopted by the EU, the assessment of whether financial assets are impaired requires the exercise of judgment by management about the perceived ability of the borrower to repay over time, the extent of security and other support. Directors of Cypriot banks had to make such judgements when assessing uncertain future events - and continue to have to do so. The exercise of this judgment is critical, as is the willingness of the auditors to test those judgments. Much weight will rest on those judgements and the effectiveness of that challenge over the period ahead. Another example mentioned relates to the frequent switching of bonds between the "held to maturity" and "available for sale" accounting categories so as to present the bank's performance in the best possible light. Switching is permitted under certain circumstances, but there are reports that such switching may have occurred in circumstances which were not permissible.

20.3 **Partner rotation.** In relation to the practice of auditing, we also heard concerns about the rotation of engagement partner taking place in name only and with considerable influence played by a relationship partner of long standing. We understand that there is the intention to require banks to tender for both their auditor and legal adviser every five years under fully transparent procedures. There is considerable international discussion about the correct frequency of rotation of auditor, but we believe that compulsory re-tendering at relatively frequent intervals, in addition to rotation of audit partner, is desirable, particularly in a society where excessive dependence on relationships has been shown to have weaknesses in times of stress. This depends on there being an adequate supply of auditors in Cyprus with the necessary expertise and experience, and on the existence of well-functioning auditor oversight system.

20.4 **Cross-border auditing** issues have also been a matter of concern, though with the reduction of the banks' overseas operations, they have become of less overall significance while still of importance to the sound reporting of the remaining foreign entities.

20.5 **Auditor oversight.** In relation to auditing, it is worth noting that Cyprus is one of the last countries in the EU to adopt a system of direct inspections by the public oversight body of auditors of public interest entities: financial institutions as well as listed companies. It is important that the Public Oversight Board of Cyprus be strengthened as rapidly as possible and provided with the capacity, human and financial, to undertake direct inspections rather than outsourcing them to the accounting institutes. Given the importance of the financial sector to the Cypriot economy robust oversight of auditing should now be recognised as no longer optional.

20.6 The Board is currently resourced by the Accountant General's office, but it would be sensible to explore adopting the widespread practice in other jurisdictions of securing funding from the audit profession or other market participants such as listed companies. We recommend that, if found necessary, relevant legislation be brought forward.

20.7 Public reporting of the results of inspections of individual firms and networks, as is the practice in some EU countries, would help restore confidence in the reporting of the financial condition of banks. Audit committees should have access to the findings of audit quality reviews carried out on their banks. Such transparency will be particularly important as Cyprus seeks to attract financial services business, and indeed investment more generally, to replace that which has been damaged or discredited.

20.8 **Accounting enforcement.** The Cyprus Securities and Exchange Commission is responsible for enforcing accounting standards in the reporting of listed companies. Studies which have already been undertaken raise a sufficient number of questions about the quality of accounting in banks for it to be important that these be properly investigated. This would be done to take enforcement action where necessary, and also learn relevant lessons. This should be done as soon as practicable not just to put behind the question marks over the past, but also because the quality of accounting will need to be as robust as possible in the period ahead when the economy will remain under considerable stress. Sound accounting judgment will be at a premium as events unfold, and the public at large is unlikely to be forgiving either of the preparers or of the enforcers of financial statements which turn out to have been misleading.

20.9 **Trilateral meetings.** The trilateral meetings between the CBC, external auditors and bank boards were allowed to lapse and it is welcome that, in line with now standard international practice (c.f. guidance from the Basel Committee[30]), these have been resumed. It is also welcome that the banks' internal auditors are being included in these meetings as we have heard of cases where the external auditors were persuaded to side with management against the strongly held view of internal audit. A vigorous debate in these expanded trilateral discussions is to be welcomed, not least because the deterioration of the economy will lead to uncertainty as to proper accounting treatment.

20.10 **Bilateral meetings.** There also need to be regular bilateral meetings between the supervisors and the auditors so that auditors can convey any matters of concern to the supervisors and for the supervisors to indicate to the auditors any areas where they feel particular attention is warranted. If there are legislative obstacles to such discussions they should be removed.

Conclusion and recommendations

20.11 Questions have been raised about the quality of bank accounting and auditing in Cyprus. From the weaknesses we have identified, we recommend that

20.11.1 **Heightened emphasis be placed by bank managements, auditors and regulators on the importance of sound judgment when assessing asset quality within the parameters set by the accounting standards,**

20.11.2 **Cyprus' auditor oversight function be strengthened as soon as possible, that it be financed by the profession and/or listed companies, and that the results of its inspections be published, with inspection results of individual bank audits made available to bank audit committees,**

20.11.3 **the Cyprus Securities and Exchange Commission, through its enforcement actions, help ensure the quality of financial reporting by listed companies,**

20.11.4 **trilateral meetings between banks, the external auditors and the supervisors be re-established on a firm basis, that bilateral discussions between the auditors and the supervisors become routine, and that**

20.11.5 **audit partners be genuinely rotated.**

[30] BIS. *External audits of banks.* March 2013

21. Consumer protection

21.1 For full confidence to return to banks, consumers must be convinced not just that banks are safe but that they are getting a fair deal from them and, if not, that they can do something about it. We find that Cyprus needs stronger arrangements for regulating the conduct of banks and for putting things right when they go wrong.

21.2 **Conduct of business regulation.** The **c**onduct of business regulator is responsible for ensuring that banks deal honestly and fairly with their customers and comply with applicable laws and codes. Deficiencies in this area were exposed by the CoCos affair in 2011-12 when small investors bought so-called contingent convertible bonds from the banks in the belief that they were high yielding but safe savings instruments. The banks had a clear conflict of interest in advising retail customers to buy their own securities. When the banks subsequently converted the bonds into equity, the savers were wiped out. The CBC, which is responsible under the EU's Markets in Financial Instruments Directive (MiFID) for regulating the conduct of business of the investment services provided by banks, took insufficient action, leaving investors to seek their own redress in the courts.

21.3 Although the CBC has more recently imposed fines in the CoCos affair, the regulatory situation remains unsatisfactory in our view. The CBC is not specifically charged in the banking law with an overall responsibility for conduct of business regulation in banking services, meaning that other potentially controversial areas, such as the marketing of loans, mortgages, savings products, insurance and pensions, are not explicitly covered. (The regulation of non-banks' investment business comes under the Cyprus SEC.) We recommend that the CBC's role as conduct of business regulator be clarified in the relevant laws, and that the regulator be given the power to impose restitution.

21.4 An overall review of the adequacy of customer protection arrangements across banking, insurance, pensions and investment business would be a part of the process we recommend of moving towards an integrated financial regulator. Such a regulator could have an administrative unit which would oversee conduct of business regulation and co-ordinate work such as financial education. Much work is being done in this area by the European Banking Authority to identify issues and provide remedies[31].

21.5 **Financial Ombudsman.** We also recommend that urgency be attached to existing plans to establish a Financial Ombudsman to act on complaints against the banks. This should be done by the end of 2013. The Ombudsman will be an independent figure funded by the banking industry to mediate in disputes between customers, including private individuals and small businesses, and their banks based on the

[31] http://www.eba.europa.eu/regulation-and-policy/consumer-protection-and-financial-innovation

Banking Code of Conduct. In order to succeed the Financial Ombudsman will need to be adequately resourced and have the necessary legislative backing. Where banks do not accept the Ombudsman's finding, he should have the authority to escalate cases to the relevant supervisor.

21.6 **Banking Code.** The Cypriot banks have a Code of Conduct (based on an EU template) which sets standards of good banking practice for their dealings with personal customers. However, given recent events, we recommend that it be reviewed to see whether it is sufficiently comprehensive, and that it be more widely promoted. (It is only available in Greek on the Association of Cyprus Banks website which is unsatisfactory for a market with a large number of foreign customers.) Breaches of the Code should also be taken into account by the supervisors when assessing the adequacy of banks' systems and controls, and the fitness and properness of its executives and directors. Adherence to the Code needs to be monitored on an ongoing basis.

21.7 **Financial education.** One of the front line defences for a well-functioning financial system is an educated customer who can judge whether or not a product is suitable (which the buyers of CoCos evidently could not). We recommend that a more concerted effort be put into financial education in Cyprus to increase consumer awareness of financial risk and put pressure on banks to deliver a good service. This work could be sponsored by the banks, or the regulator (as in Malta), a combination of the two, or, as is beginning to happen in the UK, by including it in the standard school curriculum. This is an area where a considerable amount of work is currently being undertaken internationally. One example is the Money Advice Service[32] which was spun out of the UK's financial regulator, the FSA, as part of its statutory duty to provide financial education, and which provides comprehensive material on the internet to help consumers make financial decisions across a wide range of products in the light of their personal circumstances. Another source of material is the Personal Financial Education Group (PFEG)[33], a finance education charity in the UK which supports financial education at a variety of age levels, including the very young. It seems likely that much of the material produced elsewhere could easily be adapted for use in Cyprus.

Conclusion and recommendations

21.8 There are clear deficiencies in Cyprus' present arrangements for protecting consumers in their dealings with banks. Much could be done to strengthen confidence in banks by correcting them.

21.9 **We recommend that conduct of business regulation be strengthened by stating in the relevant law the CBC's responsibility for regulating the**

[32] https://www.moneyadviceservice.org.uk/en
[33] http://www.pfeg.org/

conduct of banks' investment business, as well as areas such as savings, mortgages, pensions, insurance and loans. We also recommend that the part played in these areas by the Financial Ombudsman and the Banking Codes be expanded, and that a more concerted effort be put into financial education to raise consumer awareness of financial risk.

22. What next?

22.1 Is it possible to imagine what the Cyprus banking sector might look like in five years' time? Using the analysis and conjectures we have made in this report, we put forward this vision of the future. It is optimistic but not, we believe, unrealistic.

22.2 The banking system overall would operate within a national strategic framework which recognised the importance of banking both as a financial service to the Cyprus economy, and as a potential source of foreign earnings. This framework would recognise that banking was about risk as well as reward, and would contain a commitment of resources to ensure its stability.

22.3 The essential components of the banking system would be the following. There would be a group of well-capitalised banks with experienced management and strong, independent governance. The focus of their business would be domestic retail and business banking, with a small number of branches abroad whose chief purpose was to serve their international clients. This would resemble Cyprus' pre-crisis banking model with the important difference that it would have the structural and governance strengths to operate in a liberalised marketplace.

22.4 There would initially be three main domestic banks: Bank of Cyprus, Hellenic Bank, and an incorporated co-op bank, plus three or four foreign banks. Later, this structure could change as a result of a number of possible events: a split of Bank of Cyprus to reduce its dominant position, a merger between Hellenic and a smaller bank to create a stronger competitor, foreign acquisition of a Cyprus bank, or a stronger push by foreign banks with an existing presence in Cyprus.

22.5 The delivery of banking services would be based on a leaner model. The dense branch network would have been substantially thinned down, and replaced by more electronic and remote delivery systems. The high level of personal service will give way to more automated processes, and more objective methods of credit origination and management. There would be greater labour flexibility to allow for adaptability and change. Domestic deposits, along with medium term funds raised in the capital markets, would be more than enough to meet local loan demand.

22.6 The Cyprus-based international banking business would survive, though in an evolved form. With the Cyprus economy once more stable and growing, confidence would have returned and with it foreign interest in Cyprus' service offering. Although tax would still be a driver of some of this business, this selling point would have been whittled down by an EU push against tax competition, and by Cyprus' understanding that it can build a more solid business by exploiting its professional skills and strategic location. This business would be pursued by the leading domestically active banks, while a number of foreign banks would continue to choose Cyprus as a base to focus exclusively on foreign clients.

22.7 The excess deposits generated by the international business would no longer be recycled into domestic and foreign lending expansion but redeployed, in an initial phase, into the international money markets in the form of fiduciary deposits. Later, as wealth management skills and the necessary infrastructure evolved, this would include the global securities markets. At this point, Cyprus could aspire to become a regional offshore wealth management centre for the Eastern Mediterranean and the Middle East. It could then move a stage further to develop global custody and fund administration capabilities within its banking system.

22.8 This model would have a strong, independent system of supervision based on the EU's new Single Supervisory Mechanism for large banks, and the Central Bank of Cyprus for smaller banks. This would ensure that banks were well run and capitalised. The culture surrounding banking would also be open and free from political interference.

22.9 Naturally, there are risks to this model. The main one is that it will take longer to restore confidence in Cyprus' banking system, and that healthy markets may not return soon. On the other hand, the model we describe is a relatively modest one which we believe to be achievable, particularly if there is improvement in the wider economic environment.

23. Cost/benefit analysis

Our Terms of Reference require us to provide a cost/benefit analysis of the recommendations in our Report.

23.1 In analysing the costs of our recommendations we should distinguish between the cost to financial institutions and the cost to the economy as a whole, - social costs. The first do not necessarily represent an increased burden on the economy.

23.2 The major costs lie in the additional capital requirements we recommend for systemically important banks. However these represent a redistribution of costs associated with the risks in the banking sector from the taxpayer and depositors to the banks' shareholders, bondholders and possibly borrowers if they result in higher loan rates. Thus, the net impact on the economy, if any, would be minimal.

23.3 There would also be additional administration costs, for example through the stronger resourcing of the supervision function at both the macro- and micro-levels, the establishment and staffing of the Financial Stability Committee, the Financial Ombudsman, a financial education programme, and international promotion activity for Cyprus as a business centre. None of these costs would be substantial.

23.4 On the benefit side, our recommendations would lead to the following:

- savings through the integration of Cyprus supervisory agencies;
- savings through the integration of co-ops into a single entity;
- bank cost savings through the increased use of electronic banking;
- an increase in Cyprus' competitiveness as a regional financial centre.

23.5 The most significant benefit would arise from a drastic reduction in the probability of a new financial crisis.

23.6 In order to put these recommendations into context we asked economists at the University of Cyprus to calculate the cost to the whole Cyprus economy of the crisis. According to their analysis[34], the loss of output, computed as the cumulative deviations of actual from potential GDP over 2012-2014 ranges from about -€8.4bn to -€5.3bn (between -56% to -35% of 2011 GDP). Over the period 2012-2020 losses lie between -€35.3bn and -€16.7bn (-233% and -110% of 2011 GDP). These are losses to the economy, and do not include the losses incurred by the banks which could well amount to a whole year's output.

23.7 We believe that, set against losses on this enormous scale, the cost of our recommendations represents a relatively small investment in the prevention of a recurrence.

[34] Pashardes, P. and Pashourtidou, N. , *Output Loss From The Banking Crisis In Cyprus*, Department of Economics and Economics Research Centre, University of Cyprus. June 2013. (See our website www.ICFCBS.org for the full paper.)

24. Summary of recommendations

National policy

24.1 We recommend that, given Cyprus' exceptionally high dependence on its banking system for financial services, and the potential of the financial services industry to generate foreign earnings, Cyprus adopt a national financial services strategy to ensure its stable development. There needs to be a clear understanding of the consequences of a high dependence on banks, and of the risks that accompany the rewards from international banking business. This requires a commitment of resources to monitoring these consequences and risks and ensuring that the country and its banks are equipped to manage them.

24.2 We recommend that Cyprus give priority to strengthening the independence of the banking system, and reinvigorating it with fresh people, new ideas, and international sources of advice. Cultural change of this kind would transform the banking industry in all the necessary ways, by delivering better governance, sounder banks, and greater trust internationally.

24.3 In the longer term, Cyprus needs to develop a more diversified financial system to reduce its dependence on banks. We recommend that Cyprus encourage the development of new sources of finance such as capital markets, particularly a local bond market, and investment funds. This can be based on local initiatives in the areas of tax and regulation, but also on wider moves at the EU level to complete the single market in financial services and improve access for EU member states to new sources of capital.

24.4 A flexible labour market is essential not just to the recovery of the banking sector, but also to Cyprus' wider economic prospects, particularly its ability to attract foreign direct investment. We recommend that labour market reform be treated as an urgent component of Cyprus' recovery plan.

Immediate steps

24.5 The restoration of confidence in the Cyprus banking system is the top priority. We recommend that this be achieved by removing capital controls on the banks and by issuing a state guarantee, backed by liquidity and capital support from the European authorities of all deposits in Cyprus' domestic banking system. Only this way will deposit leakage be staunched and recovery initiated within a reasonable time frame.

24.6 The re-launch of a new and strong Bank of Cyprus is the central objective for the banking sector, and we recommend that a clear timetable be set to achieve that goal. The priorities must be to establish a strong executive team, to secure the bank's liquidity position, to execute the merger and create a credible business strategy.

24.7 We recommend that non-performing loans be taken out of BoC and placed in a separately incorporated entity, to be owned by the same shareholders, funded by BoC and managed by private sector individuals with strong incentives to recover value. Apart from enabling BoC to pursue its recovery strategy more directly, this would also create greater transparency in the bank and raise depositor confidence.

24.8 Cyprus' reformed banking system must not be vulnerable to unpleasant surprises in the period ahead. The "cleaning up" process of the past must be thorough and swift, and arrangements must be in place to deal with further likely problems, particularly the management of bad loans.

Size and structure of the banking system

24.9 We believe that it is inevitable that Cyprus will have a larger than average banking sector in the longer term because of the absence of alternatives to banks for credit and savings, and because an international banking business could continue to be an important component of the Cyprus economy once confidence has been restored. However this underlines the importance of adopting policies to diversify the structure of the country's financial system.

24.10 The structure of the Cyprus banking industry that emerges from the present changes is likely to be unsatisfactory because it will contain a dominant bank with associated risks to competition and stability. We recommend that the new banking structure be kept under close watch, particularly as regards potential financial stability problems surrounding a bank that may be "too big to fail".

24.11 We recommend that this opportunity be used to combine the co-operative credit institutions into a single entity with a joint stock structure and a commercial culture to make them a stronger competitive force on the banking market.

Banking services

24.12 The structure of the new Cyprus banking industry will need to be closely watched because of the risk of over-concentration and loss of competition, which would damage service quality and the availability of important banking services such as business credit. We recommend that Cyprus adopt policies which strengthen competition in the banking markets through structural reform, by encouraging new entrants such as start-ups and foreign banks, and by fostering alternative forms of finance.

24.13 Changes in the Cyprus banking industry will have an important impact on the quality of banking services and the way they are delivered. We recommend that the government ensure that policies are in place to facilitate the transformation of banking service delivery from one based largely on physical contact to one using modern, electronic forms of delivery, by ensuring that high speed broadband services are available and affordable.

24.14 There are justified concerns about the cost and availability of credit in the coming recovery period, particularly for business. We recommend that the government consider means by which business lending can be stimulated to support economic recovery. These could include:

- the introduction of more sophisticated credit evaluation techniques in the banks aimed at high growth service companies;
- a requirement that banks have a pot of capital dedicated to business lending;
- a government support programme for business lending, and
- the entry of the co-ops into this segment of the market, though on a controlled basis.

International financial centre

24.15 Although the shock to Cyprus' ambitions as an international financial centre has been severe, it is possible to identify the steps that would need to be taken to bring about its recovery. We recommend that Cyprus seek to raise the quality and scope of the present skill base of its international financial centre business so that customers choose to use it for its breadth and sophistication, not just the tax breaks, and that the banks develop their product range to include higher class wealth management and off-balance sheet services, and later custodian services and fund administration. Supervision will also need to be improved, possibly by drawing on outside assistance to give confidence to users of these services, and anti-money laundering controls will have to be strictly and visibly enforced. If concerns persist about the risks that the foreign banking business pose to the domestic economy, supervisory means should be used to contain its growth.

Corporate governance

24.16 The weaknesses in corporate governance in Cyprus' banks were severe, and a crucial cause behind the banking crisis. In order to raise the standard of governance in the banks and the co-ops, we recommend that measures be taken to

- instil a new culture of independence in the boardroom, and raise the status of boards,

- improve the quality of directors by appointing on merit, and raising the number with international experience,

- increase the non-executive component of boards to counter-balance the executive,

- provide training for directors, and carry out regular evaluation of board performance,

- strengthen board procedures to ensure that board members are fully informed of the bank's affairs,

- strengthen board committees, particularly in the areas of audit and risk, to provide independent checks and controls,

- devise incentive schemes which commit executives to long term objectives and allow for claw back depending on performance,

- encourage shareholders to play a more active role in holding the banks to account by means of greater transparency.

24.17 Stronger internal audit functions in the banks could have played a significant role in averting the Cyprus banking crisis. We recommend that boards of banks and the CBC ensure that internal audit functions operate to the highest standards. The key benchmark for assessing the adequacy of internal audit functions is the International Internal Auditing Standards published by the Institute of Internal Auditors.

Financial stability

24.18 The current structure of financial supervision in Cyprus is fragmented, which leads to inefficiency and exposes it to the risks of political influence and regulatory capture. Although a number of different models are in use around the world, the integrated structure is, in our view, the best for Cyprus because it is the most efficient and streamlined.

24.19 We recommend that the four components of Cyprus' financial supervision system be combined into a single entity and placed within the CBC which has the legal and financial independence to handle this role, and whose supervisory competence and governance is in the process of being strengthened.

24.20 The highly charged political atmosphere surrounding Cyprus' banking system has led to tension between the government and the CBC, which is harmful. It is important for the effective discharge of the CBC's monetary and supervisory duties that the central bank's independence be recognised and respected, but that this also be balanced by clear accountability. We recommend that the CBC's accountability for financial stability and banking supervision be made more explicit in the relevant laws.

24.21 There are weaknesses in the arrangements governing relations between the Central Bank and other areas of government. We recommend that the Memorandum of Understanding between the CBC and the Ministry of Finance be reviewed to ensure that it establishes a clear understanding of the role and responsibilities of the parties involved. It should also incorporate formal arrangements for top level regular meetings between the Governor of the CBC, the Minister of Finance and the heads of other supervisory authorities, and their respective staff.

Governance of the Central Bank of Cyprus

24.22 We recommend that the CBC have a policy-setting board chaired by the Governor, with two executive directors and four non-executive directors with clear decision-making powers in specified areas. The checks and balances on the executive would be provided by appropriately qualified, independent non-executive directors and effective board committees with the power to monitor the executive's performance and require corrective action if needed.

24.23 We recommend the establishment of a nominations committee to oversee a transparent process of board member selection and to propose suitable candidates for Council of Ministers approval. We also recommend that the qualifications for non-executive directors be widened to allow non-Cypriots to sit on the board. The law permitting, teleconferencing should be introduced.

Financial supervision

24.24 The failure by high level authorities to heed macro-prudential warnings about "big picture" risks was an important reason why Cyprus plunged into a banking crisis. We recommend that the macro-prudential oversight function be strongly resourced in the government ministries and the CBC, and that information flows between them be improved and safeguarded. This function should have clear framework for identifying risks, and the CBC should have rigorous procedures for taking action in relation to such risks, and following it up.

24.25 We recommend that the existing Financial Stability Committee be revitalised to improve the CBC's working relationship with other areas of government, particularly the Ministry of Finance whose actions have a material impact on financial stability, and provide a top level forum for discussion of macro-prudential issues, including threats to the system as a whole.

24.26 Much work is already underway to correct the supervisory failings at the CBC which contributed to the crisis, including the strengthening of the internal audit function to cover supervision. This will help restore confidence in the banks and reduce systemic risk. However further work needs to be done to make it more effective.

24.27 We recommend that the supervisory function have a rigorous risk framework in which risks are clearly identified and prioritised.

24.28 We recommend that the CBC set up a Supervisory Decisions Committee to ensure due process in the preparation of recommendations for the Governor.

24.29 The CBC's enforcement function should have a department of its own to ensure its independence and marshal the necessary legal expertise. We welcome the decision to make enforcement decisions public.

24.30 In terms of resourcing we recommend that supervision be given more resources to support its enlarged role, but that it also seek long-term technical assistance from a body like the IMF to raise the level of expertise and ensure that it meets current international standards.

24.31 We support the recommendation in the MoU that the CBC undertake a review of its supervision functions and objectives against the principles laid out by the Basel Committee on Banking Supervision in its report "Core principles for effective banking supervision" (September 2012) which provides a benchmark against which countries can assess the quality of their supervisory systems.

Audit

24.32 Questions have been raised about the quality of bank accounting and auditing in Cyprus. From the weaknesses we have identified, we recommend that

- Heightened emphasis be placed by bank managements, auditors and regulators on the importance of sound judgment when assessing asset quality within the parameters set by the accounting standards,
- Cyprus' auditor oversight function be strengthened as soon as possible, that it be financed by the profession and/or listed companies, and that the results of its inspections be published, with inspection results of individual bank audits made available to bank audit committees,
- the Cyprus Securities and Exchange Commission, through its enforcement actions, help ensure the quality of financial reporting by listed companies,
- trilateral meetings between banks, the external auditors and the supervisors be re-established on a firm basis, that bilateral discussions between the auditors and the supervisors become routine, and that
- audit partners be genuinely rotated.

Consumer protection

24.33 There are clear deficiencies in Cyprus' present arrangements for protecting consumers in their dealings with banks. Much could be done to strengthen confidence in banks by correcting them.

24.34 We recommend that conduct of business regulation be strengthened by stating in the relevant law the CBC's responsibility for regulating the conduct of banks' investment business, as well as areas such as savings, mortgages, pensions, insurance and loans. We also recommend that the part played in these areas by the Financial Ombudsman and the Banking Codes be expanded, and that a more concerted effort be put into financial education to raise consumer awareness of financial risk.

25. Implementation

25.1 Given the far-reaching nature of our Report, we believe that a disciplined approach is needed for its implementation. Although we were commissioned by the Central Bank of Cyprus, many of our recommendations range more widely, for example to other regulators, financial services firms, professional and trade bodies, different branches of government, the House of Representatives, and EU institutions, etc.. In this section we lay out a detailed plan for project organisation, prioritisation of recommendations, and allocation of responsibilities.

25.2 We recognise that there will be practical obstacles to implementation. These are exceptionally busy times for the financial establishment in Cyprus, and capacity is stretched. Also, there will be resistance to change: some of our recommendations affect the powers and territories of institutions and individuals who will not be willing to give them up. This reinforces the need for a disciplined approach.

25.3 We recommend that implementation be overseen by a Steering Committee chaired by the Governor of the Central Bank of Cyprus. It would consist of the principal organisations we identify below as responsible for addressing our recommendations, for example the Ministry of Finance, the Association of Cyprus Banks, and the House of Representatives. It should also represent users of the banking system, such as business and consumer lobbies. A member of our Commission might be added. The Steering Committee would agree on the recommendations to take forward and would put in place processes for their implementation.

25.4 Implementation would be driven by an Implementation Committee, perhaps led by one of the newly appointed executive directors of the CBC. This would consist of a core of permanent members representing the relevant departments and organisations, plus co-opted members dealing with specialist areas. This Committee would assign tasks to individuals responsible for their achievement and set deadlines. The Committee would meet weekly to review progress and escalate issues requiring the attention or support of the Steering Committee.

25.5 The two Committees should be supported by a project management office staffed by an external consultant experienced in change management. This office would track the execution of each task and supply staffing where the line departments or organisations did not have the capacity to execute.

We recommend that the priorities and responsibilities be allocated as follows.

Immediate

25.6 Confidence building

25.6.1 Consideration of a state guarantee of deposits: Ministry of Finance, Central Bank of Cyprus, EU Commission (DG ECFIN), European Central Bank, IMF.

25.6.2 Completion of the reorganisation of Bank of Cyprus: Central Bank of Cyprus, Board of the Bank of Cyprus.

25.6.3 Separate incorporation of non-performing loans at Bank of Cyprus: Central Bank of Cyprus, Board of the Bank of Cyprus.

25.6.4 Completion of the crisis "cleaning up" and enforcement process: Attorney-General, Ministry of Finance, Central Bank of Cyprus, Cyprus Securities and Exchange Commission.

Near term

25.7 National policy

25.7.1 Organisation of an inter-governmental group to prepare a national financial services strategy: Ministry of Finance, House of Representatives, Central Bank of Cyprus, Cyprus Economic Policy Council, regulatory agencies, Association of Cyprus Banks, Cyprus Investment Promotion Agency.

25.7.2 Measures to encourage cultural change in the financial sector and strengthen corporate governance in banks. Ministry of Finance, Central Bank of Cyprus and other corporate governance enforcement agencies, the boards of Cyprus banks, professional and trade organisations.

25.7.3 Reform of labour practices to bring greater flexibility to the banking market: Ministry of Commerce, Association of Cyprus Banks, House of Representatives, Bank Employees Association, ETYK.

25.7.4 Measures to stimulate the availability of credit to support economic recovery: Ministry of Finance, Central Bank of Cyprus, Association of Cyprus Banks, the banking industry, Ministry of Commerce, Cyprus Chamber of Commerce.

25.7.5 Measures to support the recovery of Cyprus' international financial services business. Ministry of Finance, Central Bank of Cyprus, Association of Cyprus Banks, Association of International Banks of Cyprus, Cyprus Investment Promotion Agency.

25.8 Financial stability

25.8.1 Reform of the governance of the Central Bank of Cyprus: Ministry of Finance, House of Representatives, Board of the CBC.

25.8.2 Revival of the Financial Stability Committee and review of the Memorandum of Understanding to strengthen relations between the Ministry of Finance and Central Bank of Cyprus: Ministry of Finance, Central Bank of Cyprus, regulatory agencies.

25.8.3 Measures to strengthen and resource the conduct of supervision of the banking system at both the macro and micro levels: Ministry of Finance, Central Bank of Cyprus.

25.8.4 Measures to raise the quality of auditing in Cyprus: Accountant-General, Cyprus Securities and Exchange Commission, Institute of Certified Public Accountants of Cyprus, Central Bank of Cyprus.

25.9 Consumer protection

25.9.1 Necessary amendments to laws relating to the allocation of responsibility for conduct of business regulation. Ministry of Finance, House of Representatives, Central Bank of Cyprus, regulatory agencies, Cyprus Consumers Association.

25.9.2 Advancement of plans for a Financial Ombudsman. House of Representatives, Association of Cyprus Banks, Cyprus Consumers Association.

25.9.3 Advancement of plans for financial education. Ministry of Education, Ministry of Commerce, Association of Cyprus Banks, regulatory agencies, Cyprus Consumers Association.

Medium term

25.10 Reform of the banking system

25.10.1 Although reform of the size and structure of Cyprus banking is a long term objective, work needs to be initiated soon to begin the process.

25.10.2 Assessment of the optimal structure of the banking system and adoption of appropriate measures to sustain it: Ministry of Finance, Central Bank of Cyprus, Cyprus Economic Policy Council, academia.

25.10.3 Policies to support the transformation of the banking sector to a more electronic form: Ministry of Finance, Ministry of Communications, Central Bank of Cyprus.

25.10.4 Transformation of the co-operative bank sector into a single joint stock entity: Ministry of Finance, Central Bank of Cyprus, Co-operative Central Bank.

25.10.5 Policies to advance diversification of the financial services sector and create new sources of finance: Ministry of Finance, Central Bank of Cyprus, Cyprus Economic Policy Council.

25.10.6 Measures to encourage new entrants into the Cyprus banking market: Ministry of Finance, Central Bank of Cyprus, Cyprus Investment Promotion Agency, Association of Cyprus Banks.

25.11 **Financial stability**

25.11.1 Integration of financial supervisory agencies into a single supervisor: Ministry of Finance, House of Representatives, Central Bank of Cyprus, regulatory agencies.

People and institutions interviewed

Accountant General, Treasury
Alvarez & Marsal
Association of Cyprus Banks
Association of International Banks
Bank for International Settlements
Bank of Cyprus
Bank of England
Barclays
Basle Committee on Banking Supervision
Commissioner of the Authority for the Supervision of Co-operative Societies
Co-operative Central Bank
Co-operative Savings Bank, Limassol
Cyprus Chamber of Commerce
Cyprus Consumers Association
Cyprus Economic Policy Council
Cyprus Investment Promotion Agency
Cyprus Popular Bank
Cyprus Securities & Exchange Commission
Cyprus Shipping Chamber
Cyprus Stock Exchange
Deloitte
Director, Social Insurance Services
Directorate General, Competition (DG COMP)
Directorate General, Economics and Finance (DG ECFIN)
Ernst & Young
ETYK
European Banking Authority
European Central Bank
Financial Ombudsman
Financial Stability Board
Georgiades H., Minister of Finance
Hellenic Bank
HSBC
IMF
Institute of Certified Public Accountants of Cyprus
Lojevsky, Igor
Ministry of Finance
Morgan Lewis & Bockius
Papadopoulos N., Chairman, House of Representatives Finance Committee
PIMCO
Piraeus Bank
Present and former directors of the Central Bank of Cyprus
Present and former members of the staff of the Central Bank of Cyprus
Present and former officials of the Central Bank of Ireland
Prudential Regulation Authority (UK)
Russian Commercial Bank
Sarris M., Minister of Finance
Superintendent of Insurance

Numerous individuals in a private or professional capacity

CENTRAL BANK OF CYPRUS

EUROSYSTEM

Independent Commission on the Future of the Cyprus Banking Sector

Revised Terms of Reference

Context

The crisis in the Cyprus banking sector requires solutions which deal both with the immediate consequences of the financial agreement with the EU, the ECB and the IMF (the Memorandum of Understanding, MoU) and with the longer-term implications for the role of the banks in the Cyprus economy.

The Central Bank of Cyprus (CBC) will be working closely with the relevant authorities to ensure that the banking system is restructured in an orderly way, and that a return to normality can be achieved as soon as possible. However urgent thought also needs to be given to the longer term implications of the restructuring agreement and other requirements in the MoU which will affect the future of the Cyprus banking system.

In November 2012, the CBC established an independent Commission of experts to examine the banking sector with a view to making concrete and practical recommendations about its future. In light of subsequent events, the CBC has revised the terms of reference to focus the Commission's work more directly on the longer term consequences of the MoU for the banking sector.

Scope and objectives

Under the Revised Terms of Reference, the Commission will make recommendations regarding:

- the optimal size and structure of the Cyprus banking sector in the longer term;
- the strengthening of prudential regulation and supervision of the banking sector, including the governance of the Central Bank;
- the improvement of corporate governance in Cyprus banks;
- the improvement of levels of banking competition and service quality for the benefit of consumers and businesses.

  In particular, the Commission will focus on the following issues:

- Reducing systemic risk and moral hazard in the banking sector;
- Reducing both the likelihood and impact of bank failures, including in terms of the cost to taxpayers; and
- Ensuring competition and consumer choice so that the needs of banks' customers (both individuals and businesses) are efficiently served.

In developing its recommendations, the Commission will take into account of

- the causes of banking sector problems in Cyprus (as described in available documents) and relevant lessons of experience from other countries;
- relevant reforms agreed by the Cypriot authorities in the context of the MoU;
- the need to rebuild public confidence in Cyprus banks, both domestically and internationally;
- good international practice as well as ongoing EU and international policy work in this area; and
- legal and operational requirements (including consistency with EU rules) as well as the impact (costs-benefits and trade-offs) of any policy measures.

Approach and process

The Commission will consult widely with public and private sector entities as well as individuals in Cyprus and abroad in order to collect information and to develop a comprehensive picture of the Cypriot financial system. The Commission will also have access to all reports and documents that are necessary to its work. It will prepare an interim report laying out the main findings and potential recommendations being considered which it will publish in order to solicit public feedback from stakeholders. After considering this feedback, the Commission will publish its final report.

The Commission will be supported by a Secretariat, housed within the CBC, which will collect information and make logistics arrangements.

Governance

In carrying out their tasks, Commission members will act with due care and diligence in a personal capacity as subject matter experts. The chair of the Commission, in consultation with the other members, will design the work plan and maintain overall responsibility for the write-up of the report.

The Commission will report its findings and recommendations to the CBC Governor. Both the interim and final reports will be published on the CBC's website.

Timetable

The Commission will produce an interim report by mid-2013, and a final report by the end of November 2013.

Nicosia April 2013

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