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The banking sector of Cyprus : before and after he economic crisis

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THE BANKING SECTOR OF CYPRUS: BEFORE AND AFTER THE ECONOMIC CRISIS

MBA DISSERTATION

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Abbreviations:

BOC: Bank of Cyprus

CBC: Central Bank of Cyprus

CCB: Central Cooperative Bank

DPD: Day-Past-Due Loans

EBA: European Banking Authority

EC: European Commission

ECB: European Central Bank

ESM: European Stability Mechanism

ELA: Emergency Liquidity Assistance

EU: European Union

GDP: Gross Domestic Product

HE: Hellenic Bank

IMF: International Monetary Fund

NCB: National Central Bank

NPEs: Non Performing Exposures

NPLs: Non-Performing Loans

SSM: Single Supervisory Mechanism

TROIKA: is a decision group formed by the EC, the ECB and the IMF.

Acknowledgements

I dedicate this dissertation to my family, I am grateful for the unconditional love and support they have been providing to me.

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Abstract

The exposure of Cypriot banks to overleveraged local property companies, the Greek government-debt crisis, the downgrading of the Cypriot government's bond credit rating to junk status by international credit rating agencies, the consequential inability to refund its state expenses from the international markets leaded the island to the economic crisis.

The Cyprus banking system has undergone considerable transformation since the start of the crisis. The year 2012 was characterized by the continuing economic recession which led Cyprus to request the provision of financial assistance from other member states of the European Union and the International Monetary Fund.

In March 2013, Cyprus and the Eurogroup reached an agreement on a package of measures which, included the restructuring of the banking sector.

The aim of this research is to analyze and explain the Cyprus Banking Crisis, which hit the island in 2012-2013. Also, another goal of this research is to present reasons and consequences of financial crisis to avoid future failure in financial sector of the country.

1. INTRODUCTION

Chapter 1 – INTRODUCTION

1.1.1 Introduction

During the decade of 2010, Cyprus economy experienced major changes. Before joining the European Union, the economy of Cyprus used to be closed and tightly controlled. After Cyprus' accession to the Europe Union in 2004, the banking sector rapidly expanded due to a big amount of foreign capital inflows to the banks which led to a rapid credit expansion. The period 2005 to 2008 was characterized as easy bank credit period, households accumulated significant liabilities. "Huge capital inflows in the period 2004-2008 created an environment with abundant liquidity that led to excessive lending and risk-taking." (Clerides S.)

During 2009–2011, as the credit and housing market bubbles burst following the global crisis and growth declined, Cyprus' household saving rate rebounded sharply. Banks underestimated the risks they assume by investing the money of depositors. As the Cypriot banks had a high exposure to the Greek loans and Greek government bonds, it made things even worst. The economy of Cyprus downgraded by international credit rating agencies.

After the downgrade of the Cyprus economy, Cyprus has applied for accession to the European support mechanism. Troika delegation arrived in Cyprus on June 25 of 2012, and negotiated with the government of the terms of the loan.

The Cyprus economy entered into a deep recession in 2013 following the bailout agreement signed with the Troika. The agreement entailed the recapitalization of the two largest banks through the bailing-in of their uninsured depositors. These developments undermined the credibility of the entire banking system, stalled the credit cycle and made the imposition of capital control necessary. Amidst an extremely adverse macroeconomic and financial environment, domestic demand dropped steeply and real Gross Domestic Product (GDP) contracted by 5,4% in 2013. Unemployment rose steeply to 17% in the fourth quarter of the year, according to European Union statistics. (Annual Report of BOC, 2013)

On 25 March 2013 the negotiations between the Cyprus Government and Eurogroup have been concluded, and an agreement was reached for the provision of financial support towards the Cyprus Government of up to €10 billion and the development of a macroeconomic adjustment program. Out of €10 billion, €2,5 billion were used for the recapitalization of the banking institutions of Cyprus.

The main aims in accordance with the text of the economic adjustment program: (i) restore the strength of the Cyprus banking sector and gain the trust of the depositors and the market with the thorough restructuring and downsizing of the financial institutions, (ii) continue the current process of restructuring the public finances in order to correct the excessive government budgetary deficit, (iii) implement corrective reforms in order to support the competitiveness and a sustainable and balanced development.

In March 2016, the country successfully completed and exited the tree-year financial adjustment program agreed with its international lenders. While economic conditions are showing a clear improvement, challenges remain. Very high levels of NPLs are still present in the banking system and drastic reductions are needed in order to ensure the proper financing of economic activity.

Framework of the study:

This paper research explores the Banking Sector of Cyprus during the economic crisis. Includes an overview of the existing academic literature and consists of three main sections: (i) the banking sector in Cyprus before and during the Economic Crisis, (ii) analysis of major banks in Cyprus during the economic crisis and (iii) the financial sector of Cyprus after the Economic Crisis.

The first and second chapters introduce the financial system in general, the role of the banks and how they work. The second, the third and the fourth chapters are about the literature review, where in detailed way the main problems of the Cyprus economy are introduced. Besides, what went wrong in the financial system and brought the economic crisis to the island, will be examined.

In the fourth chapter the major banks of the country are introduced, with detailed explanation of problems that have been faced and how they were solved. The fifth chapter introduces the banking sector after the years of economic crisis, the outcomes of the economic program adjustment and the economy of island as it is at present years, as well. The last chapter is about the research analysis and conclusions of the author.

2. LITERATURE REVIEW

Chapter 2.2 – FINANCIAL SYSTEM

2.2.1 Financial System:

A good financial system of a country is a success key in the growth of economy. As its main functions are rational distribution of available funds, promotion of new financial products, reduction of risk by providing the right information and decreasing of transaction costs. It is not a coincidence that all developed economies of the world are characterized by highly developed financial systems.

The financial system consists of:

- *Financial Markets:* It is any marketplace where trading of securities including equities, bonds, currencies and derivatives occur. The most important function is to bring into contact the surplus units with deficient units effectively. It is divided into primary market (purchase and sale of new securities) and secondary market (purchase and sale of existing securities).

- *Financial Instruments:* Are assets that can be traded. They can be cash, evidence of an ownership interest in an entity, or a contractual right to receive or deliver cash. For example, bonds, shares, treasury bills, deposit certificates, currency etc. Financial instruments provide an efficient flow and transfer of capital.

- *Financial Institutions*: Are banks, trust companies, insurance companies, and brokerage firms or investment dealers. They provide financial services for members and clients. Banks are financial intermediaries that lend money to borrowers in order to generate revenue. Non-bank financial institutions generally do not have full banking licenses and they provide services like investment, risk pooling, and market brokering.

Figure 2: Modern Financial Intermediation (Casu, Girardone, Molyneux, 2015)

2.2.2 The Role of Banks:

Banks are necessary for a smooth flow of the economy and contribute to the growth of the economy, because they act as intermediaries between borrowers and savers. Banks collect funds from units in surplus and lend funds to unit in deficit. The efficiency of the process through which savings are channeled into productive activities is crucial for growth and general welfare. Also, banks can monitor the credit risk efficiently without too much cost, produce information without a cost as they use economies of scale, provide liquidity transformation and commitment mechanism.

Types of Banks:

- Central Bank: is responsible for monetary policy and may be the lender of last resort in a crisis.
- Investment bank: Gives letters of credit for sales of shares and securities and advising on mergers and acquisitions.
- Commercial bank: is the term used for a normal bank to distinguish it from an investment bank.
- Community development banks: are banks that provide financial services and credit to undeveloped markets or populations.
- Cooperative banks: are mainly local initiatives to strengthen for example local agricultural producers.
- Corporate Banking: The Corporate Banking has as object banking products mainly businesses and companies.
- Private Bank: deals with large customer accounts with great financial standing.
- Postal savings banks: savings banks associated with national postal systems.

Main functions of the commercial banks:

- Accept deposits
- Lend money
- Process payments
- Issue bank drafts and checks
- Offer safety deposit boxes for items and documents

2.2.3 Banking Services:

- *Payment Services:* Banks are offering to the customers the ability to make payments for goods and services or to make transactions, through bank payment system. Plastic cards (debit or credit cards) and cheques are widely used and they are preferred than cash, for any kind of payments.

- *Deposit and Lending Services:* Personal banking also includes deposit and lending services. For example, current or checking accounts (are used mainly for payments and pay no or low rates of interest), time or savings deposits (depositing funds for a set period of time for a pre-determined or variable rate of interest), consumer loans and mortgages (offered by banks to their retail customers).

- *Investment, pensions and insurance services:* Investment products are various securities-related products, such as saving bonds, that are offered to the customers. The pension services offered via banks are known as private pensions, usually there are tax advantages associated with pensions contributions. By insurance services people can insure their lives or properties through banks.

- *E-banking:* Because of technological progress there are a few categories of e-banking payment products. An online bank offers customers just about every service traditionally available through a local branch. Customers can have access to their bank accounts through internet and make transfers or purchases.

2.2.4 Liabilities of the Central Bank:

“The most important function of any central bank is to undertake monetary control operations. Typically, these operations aim to administer the amount of money (money supply) in the economy and differ according to the monetary policy objectives they intend to achieve.” (B. Casu, C. Girardone, P. Molyneux, “Introduction to Banking”, p. 127)

Central Bank of a country is the financial institution that coordinates domestic banks with regard to their general policy, and also has the power to issue new currency. Specifically, the central bank defines the rates of banks by fixing the interest rate, that the commercial banks are forced to act within defined frameworks. It is also the only bank authorized to issue and put into circulation banknotes in a country or fetter existing banknotes of the market. The central bank is one of the main organs of the country for the conduct of fiscal policy. Such acts have influence on inflation of a state.

But, as a country is a membership of a Eurozone, the central bank loses some of its properties like for example issuing of new currency, as all the rights automatically go to European Central Bank.

2.2.5 Monetary Policy:

"Monetary Policy is concerned with the actions taken by central banks to influence the availability and cost of money and credit by controlling some measure (or measures) of the money supply and/or the level and structure of the interest rate." (B. Casu, C. Girardone, P. Molyneux, "Introduction to Banking", p. 126)

It is the policy of the state, acting on the quantity of money in circulation in order to ensure price stability, interest rate stability, full employment, and the growth of real production. Cyprus and the rest countries of the Eurozone have to follow directives of the implementation of the the Eurosystem monetary policy. One of the primary objectives of the Central Bank of Cyprus is to ensure price stability.

2.2.6 Risk Management:

"Risk management is a complex and comprehensive process, which includes creating an appropriate environment, maintaining an efficient risk measurement structure, monitoring and mitigating risk-taking activities and establishing an adequate framework of internal control." (B. Casu, C. Girardone, P. Molyneux "Introduction to Banking", p. 352)

It is very important for an organization to methodically approach all the risks associated with their activities. Good risk management means identification and handling of this risk to achieve a profit in every activity.

Some of the important risks of banks are credit risk, interest rate risk, liquidity risk, market risk and lastly operational risk. Banks are using some techniques to manage these risks.

- *Credit Risk:* when bank borrower will fail to meet its obligations in accordance with agreed terms.

- *Interest rate risk:* derives from mismatching the maturities of assets and liabilities, as part of their asset transformation function.

- *Liquidity risk:* withdrawals are higher than normal and the bank is unable to meet its liabilities, lack of liquidity.

- *Market risk:* results from adverse movements in the level of market prices of interest rate instruments, equities, commodities and currencies.

- *Operational risk:* associated with the human error and it includes possible failure of a bank's system, control or other management failure.

Chapter 2.3- BANKING SECTOR BEFORE AND DURING THE ECONOMIC CRISIS

2.3.1 A short Review of Events of the Decade 2010:

Before 2000, Cyprus had self-controlled economy, with closed and tightly controlled financial system. In 2004 Cyprus became a member country of European Union and in 2008 a member of the Eurozone and adopted the euro as its national currency. The liberalization of the financial system and the EU integration created new prospects for the Cyprus economy. Today the economy is mainly built upon the services sector, including tourism, financial services and real estate, which accounts for over 80% of the island's total GDP and around 75% of employment.

Within a decade, Cyprus faced significant changes in the economy. Cyprus experienced large fluctuations in its household saving rate. During 2002–08, the saving rate declined steadily from a peak of 15.1% in 2003 to 6.7% in 2008, while growth averaged 3.6% per year, given a period of easy credit and a housing market boom.

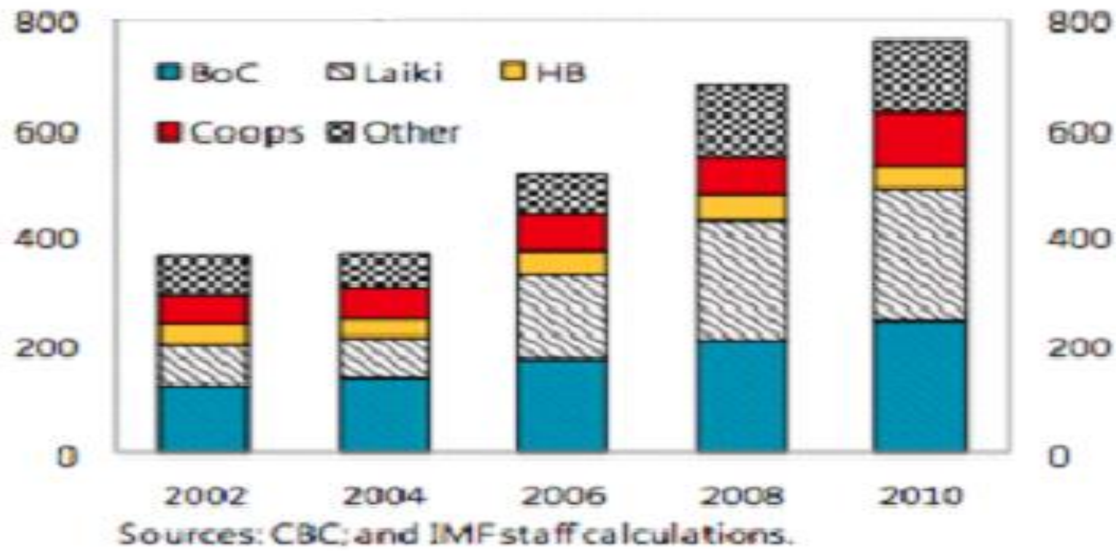
The period 2005 to 2008 was characterized as easy bank credit period, households accumulated significant liabilities, which increased by 9 billion or 33% of GDP. By end of 2012 household net financial wealth increased to 147% of GDP. This led to an increase in house prices, which boosted household's non-financial wealth, rising by an estimated 6 billion or 14% of GDP.

Graph1 shows how rapidly the banking sector of Cyprus expanded since 2000, reaching from about 360% of GDP in 2002 banking sector to 750% in 2010, of this, domestic banks represented over 600% of GDP. Two major domestic banks were the Bank of Cyprus (BoC) and Laiki Bank, constituting almost 500% of GDP by 2010.

The growth of banking sector was financed by a rapid increase in foreign deposits. Because of Cyprus' accession to the Europe Union in 2004, a lot of foreign capital began to inflow to the banks, this led to a rapid expansion of credit. The funds were channeled to domestic borrowing mainly by private consumption and construction. This helped to boost employment, especially in the construction sector, which relied on immigrant inflows to cover labor shortages.

Non-resident deposits in Cyprus increased by 50% during 2000–10. Banks expanded in Greece, where deposits increased by 75%. During 2000-10 domestic credit to private sector increased from about 212 to 284% of GDP. This fuelled a rapid boom in the property market in Cyprus.

Given banks large exposure to the real estate market, asset quality deteriorated as the real estate boom turned to bust and growth came to a halt. Cypriot banks came under pressure as the domestic economy started to falter and the Greek crisis intensified. The Cypriot banks had a high exposure to the Greek loans and Greek government bonds, amounting to about 130% and 40% of Cyprus's GDP respectively at the end of June 2011.



Graph 1: Banking System Growth (Percent of GDP)

The Greek crisis started in late 2009, triggered by the turmoil of the Great Recession which was a period of general economic decline observed in world markets during the late 2000s and early 2010s, the structural weaknesses in the Greek economy and revelations that previous data on government debt levels and deficits had been undercounted by the Greek government.

In 2009-2010 the biggest credit rating agencies downgraded Greece's long-term credit rating from A to A- increasing the borrowing costs of the country. This led to a crisis of confidence, indicated by a widening of bond yield spreads and rising cost of risk insurance on credit default swaps compared to the other Eurozone countries. The intensification of the Greek crisis led to an erosion of confidence in Cypriot banks. As a result, banks had to resort to ELA from the CBC.

ELA means the provision by a Eurosystem national central bank (NCB) of central bank money and/or any other assistance that may lead to an increase in central bank money to a solvent financial institution, or group of solvent financial institutions, that is facing temporary liquidity problems, without such operation being part of the single monetary policy. Responsibility for the provision of ELA lies with the NCB(s) concerned. This means that any costs of, and the risks arising from, the provision of ELA are incurred by the relevant NCB. (Source: European Central Bank)

2.3.2 Years During the Economic Crisis:

For Cyprus the real problem began in spring of 2012. As a result of the Greek debt restructuring, Bank of Cyprus and Laiki Bank suffered combined losses of 25 percent of GDP. Laiki Bank required public support of €2 billion (10% of GDP) in 2012 to meet capital requirements. At this point, after the downgrade of the Cyprus economy, the Cypriot authorities approached the International Monetary Found (IMF).

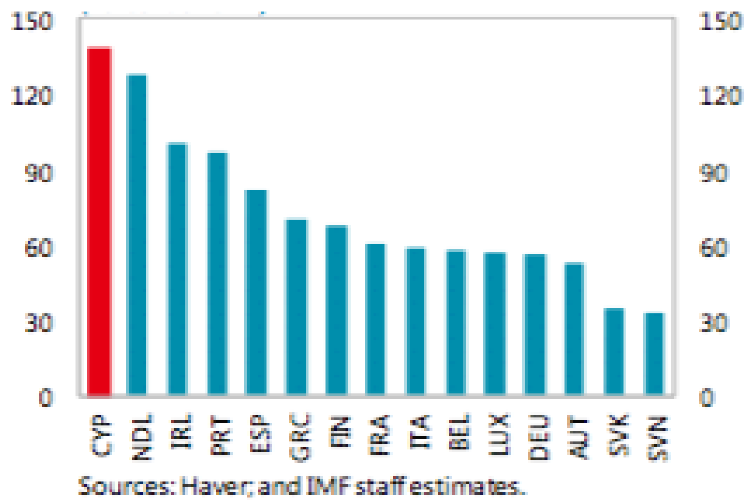
On the 13th of March of 2012, the country's credit rating was downgraded to the status of "Junk" by Moody's and on the 25th of June 2012, when Fitch slashed the ratings on bonds issued by the country to BB+ the government turned to the TROIKA for assistance.

Troika delegation arrived in Cyprus in June 2012 to negotiate with the government about the terms of loan. Troika is a decision group formed by the European Commission (EC), the European Central Bank (ECB) and the International Monetary Found (IMF). In March 2013, the agreement with the Government of Cyprus reached the amount of €10 billion.

The island was on the brink of bankruptcy in 2013 when it emerged as part of an international bailout that was being negotiated with the European Union and the International Monetary Fund that depositors with more than 100.000 euros in the top two banks faced losing a chunk of their money. To halt the outflow of cash from the island the government shut all banks for two weeks. The government imposed capital controls that allowed savers to withdraw a maximum of just 300 euros a day, it was the first such action in the European Union.

Companies accounts were restricted to daily withdrawals of 500 euros, cheques could not be cashed in at the counter and inter-bank transfers were limited. For companies of Cyprus was near impossible to pay suppliers or employees, particularly the first few weeks of the restrictions.

Graph 2: Financial Liabilities of Households 2013 (Percent of GDP)



The intensity in the financial economic crises brought household debt. Graph 2 shows that at the end of 2013, Cyprus' household debt was among the highest in the euro area, 140% of GDP at the end of 2013. Because of the rise in unemployment, an increasing share of households find difficulties to service their debt, therefore household non-performing loans reach 45% of total loans at end of June 2014.

The bottom-up assessment of banks loan books found that both Laiki and Bank of Cyprus were economically insolvent. Total capital needs of the sector were estimated at above €10 billion. Banks, supervisory authorities and the political system were not able to handle such a situation. The outcome was the haircut of deposits in above two major banks in March 2013. It was a big blow for Republic of Cyprus, as it was the second huge damage done on the island after the coup d'etat in 1974.

With public debt already high (close to 90 percent of GDP at the end of 2012), recapitalizing the banks with public support was not feasible, as it would have rendered debt unsustainable. Laiki Bank, considering the relatively larger capital needs, was split into a good bank and a legacy bank. The good bank was transferred to Bank of Cyprus. Bank of Cyprus was recapitalized through a deposit-to-equity conversion of uninsured deposits, after full bail in of equity shareholders and bond holders. Consequently, its uninsured deposits were frozen.

Banks opened in March 28, 2013 after almost two weeks of being closed. To protect the system from a potential deposit run, external capital controls and domestic deposit restrictions were put in place on withdrawals.

CAPITAL AND DEPOSIT RESTRICTIONS

- **Cash:**
  - Withdrawal limit: €9,000 per month
  - Export of bank notes limit: €2,000 per journey
- **Checks, credit, debit:**
  - Cashing of checks prohibited
  - Use of credit card abroad limited to €5,000 per person per month
- **Wire-transfers:**
  - Business transfers: > €300,000 domestic; > €20,000 cross-border subject to approval
  - Individuals may transfer up to €3,000 to another domestic bank
  - Legal individuals may transfer up to €50,000 to another domestic bank
- **Prohibition to open new bank accounts**
- **Extension of term deposits**

Table1: Capital and Deposit Restrictions

A program supported with international financial assistance was approved in May. Under this program the authorities developed a comprehensive banking sector strategy. The strategy aimed at:

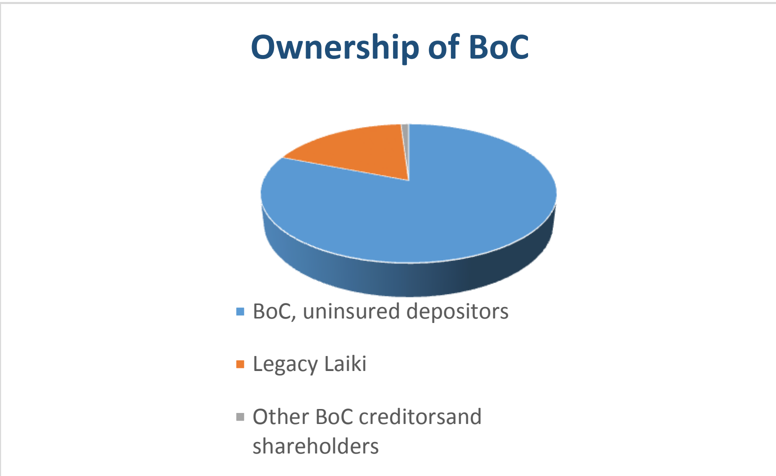
- Completing the recapitalization of the banking sector.
- Restructuring the sector.
- Developing a strategy to gradually lift payment restrictions.
- Strengthening regulation and supervision.

Recapitalization of Bank of Cyprus was completed through additional bail in of uninsured deposits. In accordance with the new resolution law, Bank of Cyprus, including assets transferred from Laiki Bank, was subject to a separate fair-value assessment.
As a result, the total share of BoC uninsured deposits that was converted into equity amounted to 47.5 percent. This allowed the bank's exit from resolution at end of July 2013.

End of March 2013:	End of July 2013:
37.5% converted into equity.	**47.5% converted into equity**
22.5% blocked as buffer for final bail-in.	**12.5% converted into 12-month time depos.**
30% blocked.	**12.5% converted into 9-month time depos.**
10% released.	**12.5% converted into 6-month time depos.**
	15% released

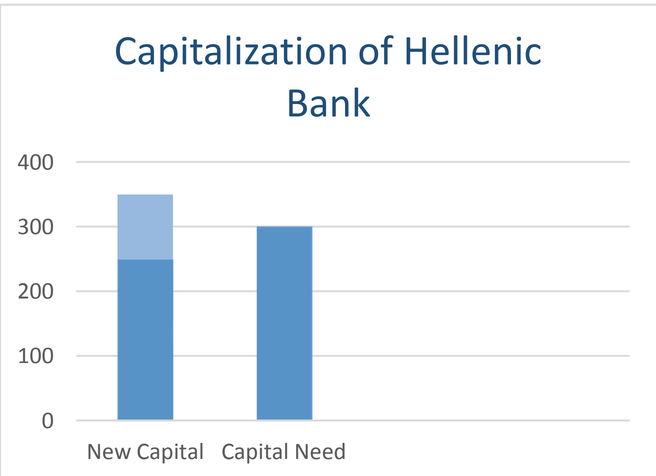
Table2: Conversion and Release of Uninsured deposits

Graph 3: Ownership of BoC (Percent of Total)



The ownership structure of BoC upon exit from resolution was heavily concentrated in its own uninsured depositors, that owned 80% of the bank. The rest was owned by Laiki's uninsured depositors, who were fully converted into equity and received an 18% stake in BoC in exchange for the assets transferred to BoC.

Graph 4: Capitalization of Hellenic Bank (Millions of euro)



Hellenic Bank was recapitalized using private means, and its capital shortfall identified under PIMCO's adverse scenario amounted to about €300 million. At the end of October 2013 the bank was fully capitalized through the sale of new shares €100 million to both domestic and foreign investors and conversion of junior debt €250 million.

The cooperative credit sector was fully recapitalized by the state. With the aim to preserve the sector, given its key role in the domestic economy, in March

2014, the state nationalized and recapitalized it by injecting €1.5 billion in the Central Cooperative Bank (CCB). Deposit outflows continued through 2013, with the system losing around 15% of the total deposit base. Deposits broadly stabilized in 2014.

2.3.3 Reasons of Banking System collapse:

The main reasons of banking system collapse according to Cypriot researchers A. Theophanous, Ch. Christoforou and K. Georgiou are:

- The failure of national policy to assess the risks involved in the operation of a large banking sector.
- Failed expansion strategies adopted by banks mainly in the second half of the decade 2000-2010 and inadequate supervision of the banking system by the Central Bank of Cyprus.
- Channeling of risk into the domestic banking system through the exposure of the Cypriot banks in Greece.
- The policy decisions made at the highest level and were about the second Greek bailout package in 2011 and the significant reduction of up to 78% of the Greek debt to private investors and the banks. This factor was enough to cause imbalances in banks balance sheets.
- The large government budget deficits of the last five years contributed to the exclusion of Cyprus from international markets (first half of 2011). As a consequence, lack of available resources to the banks took place when they were needed. The marginal adjustment in the Treaty of Maastricht had not adequately assessed the consequences of joining the Eurozone.
- The practice of concession loans mainly against property as collateral and personal guarantees without giving appropriate attention to the ability of debtors to repay loans.
- The large increase in total assets of banks led to a tendency for excessive and easy borrowing.
- Inefficient corporate governance of bank boards and poor functioning of risk and audit committees.
- The rapid liberalization of the sector after the admission to the EU in 2004 and the euro in 2008.
- The ongoing economic crisis at European and international level.

2.3.4 Consequences of the economic Crisis:

Since the outbreak of the European debt crisis, many countries embarked on strict austerity programs. Austerity resulted to a reduction in state budget deficits, but it also generated social tension, high unemployment and further economic slowdown.

Graph 5: Unemployment in Cyprus (in percentage)

Many businesses went bankrupt or were unable to employ the same number of workers, and also wages were reduced. The graph below shows the increase in unemployment during economic crisis. Unemployment increased from 5.4% in 2009 to 11.9% in 2012, and until 2015 unemployment reached almost 16,5% while from 2015 things got better and unemployment slowed down.

Reforms and reductions during economic crisis according to Christos Koutsampelas and Alexandros Polycarpou:

- Scale reduction in emoluments of public and broader public sector pensioners and employees from 1 December 2012 until 31 December 2013: 6.5% for €1,001-€1,500; 8.5% for €1,501-€2,000; 9.5% for €2,001-€3,000; 11.5% for €3,001-€4,000; and 12.5% for above €4,001 per month.

- Temporary contributions to the public, broader public and private sector on gross monthly earnings and pensions until 31 December 2014 at the following rates (levied on gross wages and pensions): 0% for 0-€2,500; 2.5% for €2,500-€3,500; 3% for €3,501-€4,501; and 3.5% above €4,500.

- Child benefit reform. Change in the definition of child and exclusion of one-child families having gross annual income higher than €49,000 and further reduction of the benefit as follows: 10% reduction for €39,000- €49,000 gross annual family income; 20% for €49,000-€59,000; 30% for €59,000-€69,000; 40% for €69,000-€79,000; and 50% for family income €79,000-€89,000.

- Student grant reform. The amount of the grant was reduced by: 7.5% for families with income between €30,000 and €40,000, 15% for income between €40,000-€50,000, 22.5% for income between €50,000-€60,000, 30% for income between €60,000-€70,000, 40% for income between €70,000- €80,000, 50% for income between €80,000-€90,000. PhD students are not eligible for the benefit, while Master students are, if their family income stands below €30,000.

- Single parent benefit. A new benefit was introduced in 2012 targeting mono-parental families. Lone parents with income up to €39,000 receive a monthly benefit of €200 for each child, which is decreased in a progressive manner; by 10% for families with income between €39,000-€49,000, 20% for income between €49,000-€59,000, 30% for income between €59,000- €69,000, 40% for income between €69,000-€79,000, and 50% for income between €79,000-€89,000.

- By 2014 implement a further reduction in emoluments of public and broader public sector employees and pensioners by a flat rate reduction of 3% on all wages.

- Increase the tax rate on interest income to 30%.

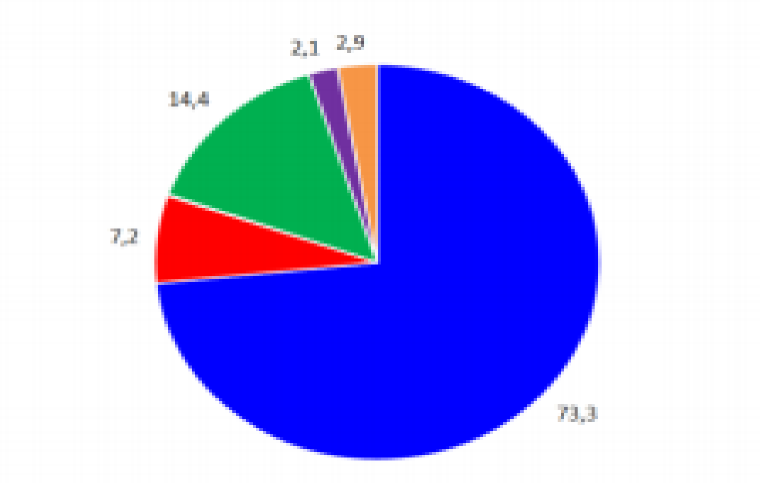
- Freeze of increments and general wage increase in public and broader public sector until 31 December 2016.

Chapter 4- ANALYZING THE MAJOR BANKS OF CYPRUS

2.4.1 Introduction:

The number of credit institutions operating in Cyprus decreased from 150 (many of which were cooperative credit institutions) in 2010 to 53, 19 of which comprise the co-operative credit institutions sector, four are domestically-controlled banks and 30 are foreign-controlled banks (of which seven are subsidiaries and 23 are branches of foreign banks). This chapter concentrates on some major banks which played significant role during and after the economic crisis.

Market shares of domestic banks dominate at 64% market share of total consolidated assets. There are currently four systemic credit institutions that are directly supervised by the ECB through the Single Supervisory Mechanism (SSM), representing 77,1% of the total banking sector's assets. Domestic banks' holdings of loans and advances account for the largest share of assets (Graph 6) at 73%, followed by cash and cash balances with central banks (14%).



73,3%: Loans and advances.

14,4%: Cash and cash balances with central bank.

7,2%: Debt instruments.

2,9%: Other assets.

2,1%: Tangible and intangible assets.

Graph 6: Banks' breakdown of assets as estimated in June 2015 (%)

Domestic banks returned to profitability in 2015. The first half of 2015 saw a reduction in impairment charges and provisions, as well as a reduction in net interest income. The banking sector and the return to profitability is a necessary step in building sustainability and resilience.

Total operating income was under pressure in 2015, recording an annual decrease of 2,4% in June 2015, mainly due to a significant fall in net interest income compared to the previous year.

In October 2016, the liquidity shortfall narrowed to €5.5 billion, the lowest value since February 2013, the month before the bail-in. Capital adequacy ratios have been attained and exceed minimum regulatory requirements, and the current banking sector has shrunk to two-thirds of its pre-crisis size, having shed 20% of its employees and 25% of branches.

The challenges for 2017 remain high, as in addition to domestic competition pressure, there is a need for more drastic, groundbreaking and multifaceted actions to address and reduce non-performing exposures.

2.4.2 Laiki Bank*:*

Laiki Bank, also named as Marfin Popular Bank was the second largest banking group in Cyprus behind the Bank of Cyprus until it was shuttered in March 2013 and split into two parts. The 'good' part was merged into the Bank of Cyprus including insured deposits under €100,000 and the 'bad' part or legacy entity holds all the overseas operations as well as uninsured deposits above €100,000, old shares and bonds.

From October 2011 onwards Laiki Bank requested Emergency Liquidity Assistance (ELA) from the CBC, with the consent of the European Central Bank (ECB), because of a severe liquidity problem. The above was caused by the continuous downgrades in the credit worthiness of the Republic of Cyprus by international credit rating agencies, which were mainly due to the exposure of the three largest Cypriot banks in Greece, and their subsequent downgrades.

Even as Greece's problem became clear Cyprus' two largest banks kept buying Greek government debt, as a result creating big losses as seen in the table below.

		LAIKI BANK	Bank of Cyprus
Total holdings of Greek government debt, in billions	As of... March 31, 2010	€2.94	€1.89
	Dec. 31, 2010	€3.41	€2.41
...eventually resulting in big losses.			
Total losses on Greek government debt, in billions	Sept. 30, 2012	€2.42	€1.87

Table 3: Losses on Greek Government debt by 2012

<u>Rescue Programme for Laiki Bank:</u>

Under the European Directive on Capital Requirements, and after supervisory review, the College of Supervisors set the shortfall in capital for Laiki Bank at €3,1 billion. The CBC asked Laiki Bank to cover this deficit and, to that end, Laiki Bank presented a recovery plan based on deleveraging and a capital increase of €1,8 billion from private investors. The effort to attract private investors began in late 2011 and continued until June 2012 without any result, so Laiki Board of Directors asked the government to cover a capital deficit of €1,8 billion and the government agreed to this request. Laiki Bank essentially became a state-owned bank, since the government acquired 84% of its share capital.

Loss of deposits in Greece amounting to €2 billion, downgrading of Greek covered bonds worth €1,2 billion and downgrading of Cyprus bonds amounting to €2,6 billion the ELA increased by €5,8 billion. As a result of the three above mentioned events, the total debt to the ELA increased from €3,8 billion in May 2012 to €9,6 billion on 3 July 2012.Consequently, the government, following the CBC Governor's suggestion and a decision by Parliament, applied to the EU Support Mechanism and negotiations with the Troika began in July 2012.

On 16 March 2013, the first Eurogroup decision for a general 'haircut' on deposits of all banks operating in Cyprus was rejected on 19 March 2013 by Cyprus' Parliament.

The second Eurogroup decision followed on 25 March 2013, whereby a support program for the Cyprus economy was agreed with Troika, which included 40% haircut on the deposits of Cypriot banks exceeding € 100,000 and the immediate resolution of Laiki Bank and the subsequent absorption of its operations by the Bank of Cyprus.

2.4.3 Bank of Cyprus:

Bank of Cyprus is the largest banking and financial services group in Cyprus, with significant market shares across all business segments. The group provides a wide range of financial products and services to personal and business customers. It also maintains two wholly owned insurance subsidiaries, General Insurance and Eurolife. The Group has a wholly owned subsidiary, Bank of Cyprus UK, which focuses on meeting the needs of entrepreneurs and owner-managed businesses. The economic recession that started in the third quarter of 2011 impacted the Bank of Cyprus.

Restructuring of the Bank of Cyprus:

- Uninsured deposits (i.e. deposits in excess of €100.000) in the Company remained frozen until the completion of the Company's recapitalization in July 2013. The Company has been recapitalized through a deposit-to-equity conversion of uninsured deposits with full contribution of equity shareholders and debt holders.

- As per the provisions of the Decree, 37,5% of the uninsured deposits at the Company as of 26 March 2013 were converted to Class A shares of the Company, 22,5% remained frozen and were subject to partial or total conversion to Class A shares of the Company, and 30% remained frozen and were subject to partial or total conversion to a time deposit.

- Bank of Cyprus combined with Laiki Bank on 29 of March 2013. The Company has been recapitalized through a bail-in (deposit-to equity conversion) of uninsured deposits. The holders of ordinary shares and debt securities as of 29 March 2013 have contributed to the recapitalization of the Company through the absorption of losses.

- On 30 July 2013, the Central Bank of Cyprus in its capacity as Resolution Authority, issued a decision whereby an additional 10% of the eligible deposits has been converted to equity, revising the total percentage of eligible deposits converted to equity to 47,5%. As a result of the bail-in, the Company issued new Class A shares of €1,00 each, and reduction of the nominal value of all Class D shares from €1,00 each to Class D shares of nominal value of €0,01 each.

- On 1 August 2013, the Company was reinstated as an eligible counterparty by the ECB for monetary policy operations. The combination of the restoration of counterparty status and the approval at the beginning of July 2013 for the use of bonds issued or guaranteed by the Republic of Cyprus resulting in a reduction in funding from ELA, as the Company has access to direct funding from the ECB for monetary policy operations.

Analysis of Key Elements of Results:

- ELA has been reduced by €720 mln to €8,78 bn on 30 June 2014, down from €9,51 bn on 31 March 2014 and €9,56 bn on 31 December 2013. ECB funding remained at €1,4 bn on 30 June 2014. Post 30 June 2014, ECB funding was reduced by €450 mln and ELA was reduced by a further €100 mln.

- Loans in arrears for more than 90 days (90+ DPD) declined by 1,3% during the second quarter of 2014, totalling €12.591 mln on 30 June 2014 (compared to €12.756 mln on 31 March 2014 and €13.003 mln on 31 December 2013), representing 49,8% of gross loans (90+ DPD ratio). During 4th querter 2015 loans in arrears for more than 90 days (90+ DPD) were reduced by €668 mln or 6% and totalled €11.329 mln on 31 December 2015, accounting for 50% of gross loans (90+ DPD ratio). In 2017 90+DPD reduced by 39% since peak of December 2013. (Graph 7)

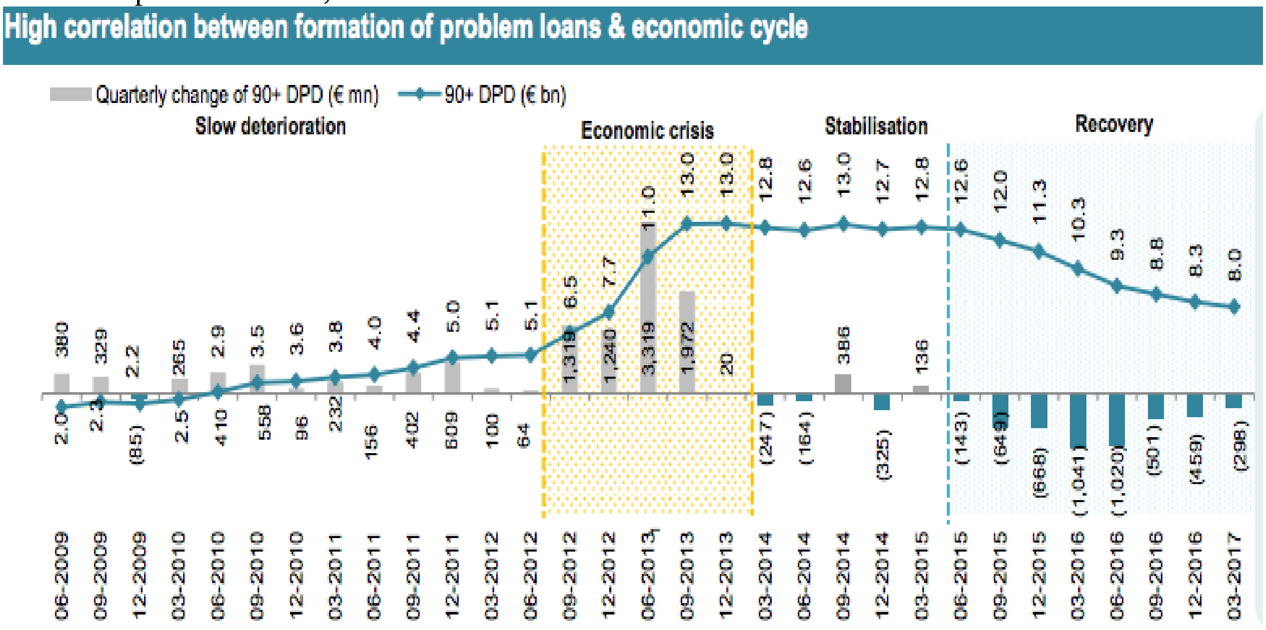
- Loans in arrears for more than 90 days (90+ DPD) were reduced by €3,0 billion or by 27% in 2016. The provisioning coverage ratio of 90+ DPD improved to 54,4% on 31 December 2016. When taking into account tangible collateral at fair value, 90+ DPD loans are fully covered. (Graph 7)

- NPEs as defined by the European Banking Authority were reduced to €11.034 mln on 31 December 2016, accounting for 55% of gross loans, compared to 62% on 31 December 2015. The provisioning coverage ratio of NPEs stood at 41% on 31 December 2016, up from 39% on 31 December 2015.

- Total income for 2015 was €1.040 mln. Total expenses for 2015 were €416 mln, and the cost to income ratio was 40%. Total expenses for 4Q2015 were €119 mln, compared to €102 mln for 3Q2015, with the increase primarily relating to higher nonrecurring advisory and professional expenses and increased provisions for litigations and legal settlements.

- Total expenses for 2016 were €397 million (2015: €408 million), and the cost to income ratio was 41%. Total income for 2016 was €963 million.

- The Company has returned to the debt capital markets in January 2017 with the issue of €250 mln unsecured and subordinated Tier 2 Capital Note. The Note was priced at par with a coupon of 9,25%. The Note matures on 19 January 2027. The Company has the option to redeem the Note early on 19 January 2022, subject to applicable regulatory consents. The issuance of the Note is part of the Company's strategy to optimize the level and composition of its capital and liabilities, enhancing the Total Capital ratio to15,7%.



Graph 7: Correlation between formation of problem loans and economic cycle. (Source: BOC Annual Report)

Key Highlights for the quarter ended 31 March 2017

Asset quality improving

- Eight consecutive quarters of problem loan reductions
- 90+ DPD down by €298 mn or 4% since year end 2016; down by 37% since year end 2014
- NPEs down by €662 mn or 6% since year end 2016; down by 31% since year end 2014
- Total coverage including tangible collateral at fair value for both 90+DPD and NPEs at over 100%

Liability side normalising

- Full repayment of €11.4 bn ELA
- Loan to Deposit ratio at 95%

Strong capital position maintained

- Total Capital ratio at 15.6%
- CET1 ratio at 14.4% on a transitional basis and 14.0% on a fully loaded basis

Operating performance directed at faster de-risking the balance sheet

- Operating profits of €126 mn in 1Q2017
- Net profit of €2 mn in 1Q2017

Leading market position in a growing economy

- Market shares in loans and deposits maintained at 39% and 31% respectively
- New lending of €690 mn in 1Q2017

2.4.4 Hellenic Bank:

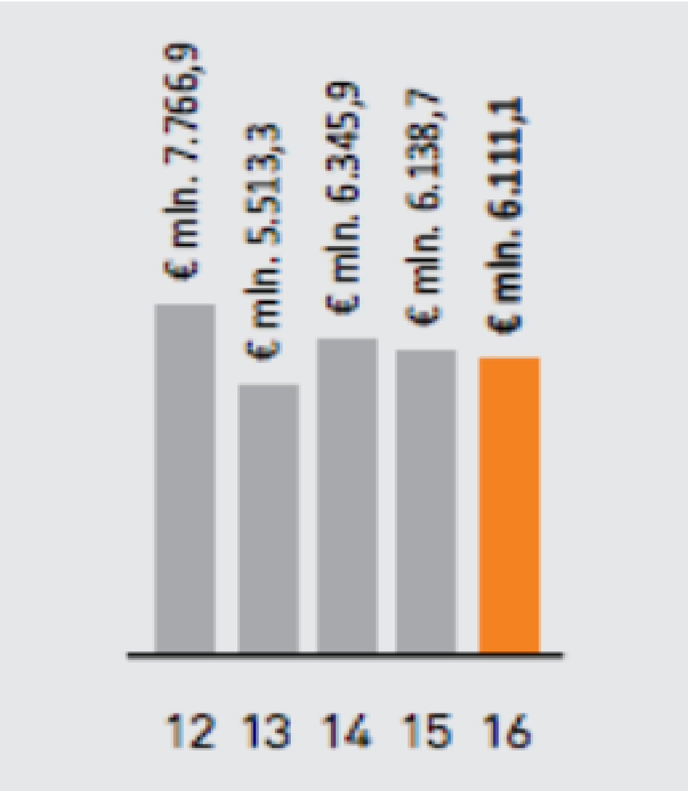
The Hellenic Bank Group commenced operations in 1976, is one of the largest banking and financial institutions in Cyprus. It provides a wide range of financial services that include factoring, brokerage services, insurance, portfolio management, investment banking, mutual funds, private banking and custodian services.

Hellenic Bank avoided Cyprus state bailout, raising €100 million through private funds from three major investors taking 75% of the share capital. Third Point and Belarus-owned Wargaming each takes a 30% stake and Demetra 15%. The Church of Cyprus, controlled about 25% of the bank' shares.

In 2013 the Cyprus Stock Exchange suspended the Hellenic Bank stock as investors were sought to raise the €36 mln shortfall in the recap plan.

New York-based hedge fund Third Point LLC, online gaming developer Wargaming.net and local investment house Demetra pumped €100 million by buying shares, bonds and rights that remained unexercised after the bank's €294 million issue to meet European liquidity rules.

Hellenic Bank was ranked the Safest Bank in Cyprus for 2014 in a survey of the internationally reputable "Global Finance Magazine". The rankings were based on the long-term credit ratings of the three ratings agencies Moody's, Fitch and Standard & Poor's, and the total assets of the 1000 largest banks in the world.



Total customer deposits in Cyprus amounted to €5,5 billion, decreasing by 23% from December 2012.

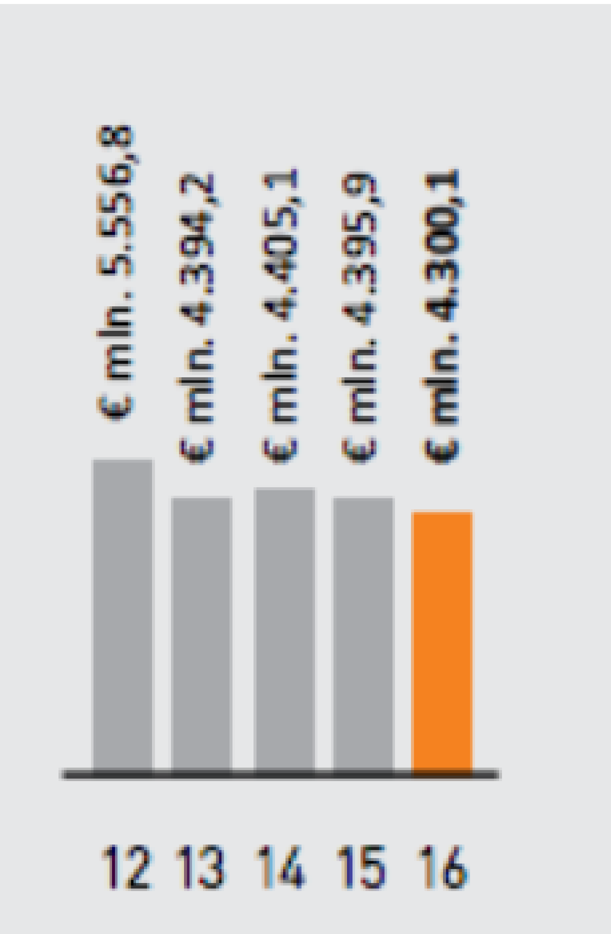
In December 2016 customer deposits amounted to €6,1 billion (December 2015: €6,1 billion).

They comprised of €4,6 billion deposits in Euro and €1,5 billion deposits in foreign currencies, mostly US Dollars.

Trends in customer deposits reflect the Bank' strategy to maintain a low cost of deposits taking into account its existing strong liquidity position.

The Bank' deposits market share in December 2016 was 12,6% (December 2015: 13,5%).

Graph 8: Customer Deposits and other Customer accounts (Source: HB Annual Report 2016)



The total gross customer loans and advances amounted to €4,4 billion in 2014, remaining at the same levels as in 2013.

Total new lending for 2016 reached €353,7 million (31 December 2015 €376,7 million). The Bank continued providing lending to creditworthy businesses and households while examining other growth opportunities.

In December 2016 gross loans amounted to €4.300 million (December 2015: €4.396 million) recording a decrease of 2% from 31 December 2015. A key driver in the reduction of gross loans is the increased restructuring activity including the debt to asset swap arrangements, loan repayments and customer efforts to deleverage.

During 2016 exposures of €160,5 million were written off (2015: €123,9 million). The Bank's loan market share as in December 2016 was 7,4% (December 2015: 7,0%). The net loans to deposits ratio stood at 47,9% as in December 2016 (December 2015: 50,4%).
Graph 9: Loans and Advances (Source: HB Annual Report 2016)

The Group's loss after recognizing impairment losses and provisions to cover credit risk and after taxation for the year ended in December 2014 amounted to €118,4 mln, compared to a loss of €158,4 mln for the year 2013. Loss attributable to the shareholders of the parent company for the year ended in December 2014 amounted to €118,6 mln, compared to €190,9 million loss for 2013.

Total expenses for 2016 amounted to €144,5 mln, were reduced by 5% compared to the €152,1 mln of 2015, due to lower administrative and other expenses.

Net interest income for 2016 was €147,5 mln, up by 1% compared to 2015. Loss before taxation for 2016 amounted to €12 mln compared to a profit of €3,5 mln reported for 2015.

The reported loss of 2016 was primarily due to increased impairment losses and provisions to cover credit risk.

Despite the challenging economic environment, the Group's operational profitability remained satisfactory.

2.4.5 Cooperative Bank:

The Cooperative Central Bank (CCB) was founded in Cyprus in 1937 and is engaged in the provision of a wide range of retail, commercial banking and insurance services. CCB is regulated by the Central Bank of Cyprus and supervised by the ECB. The Republic of Cyprus is the major shareholder with a 77,34% ownership, followed by the Recapitalization Fund with 21,88% ownership and the Cooperative Holding Company with 0,78% ownership, representing its Cooperative members. CCB is participating in international cooperative organizations and associated with cooperative movements across the world.

As part of Cyprus' bailout agreement, the Cooperative Central Bank received in 2014 a €1.5bn capital injection from the government and another €175 mln in 2015. Cyprus' second largest lender which is owned to 99% by the government and in turn has a 99% stake in the 18 cooperative saving banks it administers, is scheduled to start issuing new capital in 2018 in order to attract private equity and so gradually reduce the state's shareholding to 25%.

Cooperative Sector Restructuring Plan:

- On 14 June 2013, after a discussion with Troika, the Central Bank of Cyprus announced that the final requirements of the Cooperative Credit Institutions amounted to €1,5 billion.

- On 5 September 2013 the Parliament approved the legislation regarding the supervision and nationalization of the Cooperative Sector.

- On 27 September 2013, the European Stability Mechanism announced the deposit of €1,5 billion to Cyprus, an amount intended for the recapitalization of the Cooperative Credit Sector.

- On 4 October 2013, the decree for the nationalization of the Cooperative Sector was issued. According to the decree, the share capital of the CCB increased by €1,5 billion with the issue of new shares. The bond has a duration of 18 months, and it could either be renewed or exchanged at its maturity date with cash.

- The voting rights of the Republic of Cyprus in the ownership structure of CCB is 99% and of the existing shareholders of CCB is 1%. In this respect the Cooperative Holding Company of CCB is incorporated to which all existing shareholders of CCB are transferred with participation to its capital proportionally to the participation each shareholder had in the share capital of CCB. The nominal value of the shares equals to €1,28 per share. Also, according to the decree specific reductions were made to the payroll of the Bank.

- On 24 February 2014 the European Committee proceeded with the approval of the Cooperative Restructuring Plan and by March 24 of 2014 all merger procedures were completed.

Analysis of Key Elements of Results:

- Net interest income for the year 2016 decreased by 11,7% to €279,8 mln compared to 2015, when this income amounted to €317,0 mln, while the net interest margin was reduced from 2,37% in 2015 to 2,07% in 2016.

- Non-interest income for the year 2016 amounted to €46,2 mln compared to €29,8 mln in 2015 as the Group benefited from profit arising on the sale of available-for-sale financial assets.

- Total net income for the year 2016 decreased by 6,0% to €326,0 mln compared to €346,8 mln in 2015.

- Total expenses for the year 2016 stood at €181,3 mln compared to €177,2 mln in 2015 due to the implementation of the second voluntary retirement scheme during the last three years. Cost to income ratio for the year 2016 amounted to 50,5%.

- The profit for the year 2016, after the increased tax burden due to the assessment of tax liabilities and deferred tax level, stood at €7,1 mln, compared to a loss of €176,4 mln in 2015.

- Total restructurings in 2016 reached €1.257 mln compared to €1.035 mln in 2015. Non-performing Exposures (NPEs) were reduced by €346,8 mln in 2016 (€7.563,5 mln on 31 Dec. 2015) and reached €7.216,8 mln on 31 Dec. 2016. The provisional coverage ratio of NPEs reached 45,34% at 31 Dec. 2016 compared to 45,60% in the previous year.

- In 2016, 90+ dpd loans decreased by € 794,6 mln. On 31 Dec. 2016 90+ dpd loans were €5.698,9 mln (47,31% of the total loans) compared to € 6.493,5 mln on 31 Dec. 2015 (51,05% of total loans). The 90+ dpd provision coverage ratio increased to 57,42% for 31 Dec. 2016 compared to 53,12% on 31 Dec. 2015.

€ million	31.12.2016	31.12.2015	Year on Year
Restructurings	1.256,7	1.035,0	221,7
Non Performing Exposures (NPEs)	7.216,8	7.563,5	-346,8
NPE to total loans (%)	59,91%	59,46%	+45Bps
NPE Provision coverage	45,34%	45,60%	-26 bps
Loans in arrears for more than 90 days (90+ dpd)	5.698,9	6.943,5	-794,6
90+ dpd to total loans	47,31%	51,05%	-374bps
90+ dpd provision coverage ratio	57,42%	53,12%	+430 bps

Table 4: Quality of Loan Portfolio

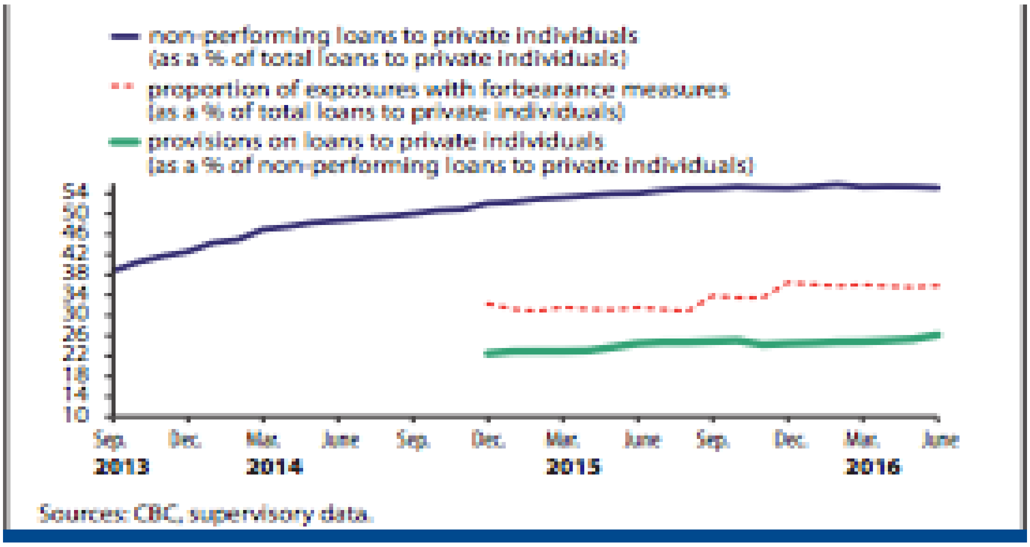
2.4.6 Managing Non-Performing Loans:

While significant progress has been made in addressing the crisis, important challenges remain. First, non-performing loans (NPLs) have risen rapidly, and standing at 54 percent of total loans or 143 percent of GDP at end of June 2014. Also, credit risk remains high and prospects for bank lending stay weak, reflected in high lending rates.

According to International Monetary Fund, "A loan is nonperforming when payments of interest and principal are past due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons to doubt that payments will be made in full."

Only a few countries have experienced such high NPLs ratios as in Cyprus. There are various strategies to deal with NPLs. They can be categorized under two broad approaches: (i) maintaining NPLs on banks balance sheets and (ii) transferring NPLs partially or fully to centralized agencies, often supported by the state. These have differing implications for risk-sharing between the private and public sector.

The cross-country evidence suggests that reducing NPLs takes time. It took time, 3–5 years on average, and in some cases longer, for NPLs to return to a downward path.



Graph 10: Non-performing loans to private individuals, forborne loans and provisions **(%)**

Based on non-consolidated statistical data, NPLs as a percentage of total outstanding loans to domestic households reached 55,2% at the end of June 2016, exhibiting a marginal reduction since March 2016 (55,3%), thus showing signs of stabilization (Graph 10). In absolute numbers, NPLs decreased by €0,6 billion between June 2015 and June 2016. In parallel, loan loss provisions as a percentage of NPLs to domestic households (coverage ratio) increased to 35,9% in 2016Q2, compared with 31,5% in 2015Q2.

The proportion of exposures with forbearance measures, i.e. restructured loans as a percentage of total loans to domestic households, has followed an increasing trend since the beginning of the year reaching 26,2% as at the end of June 2016 (Graph 10). A reduction in NPLs is expected through restructuring, as a result of the migration of loans from the category of non-performing to performing.

The rate of increase in loan restructurings has intensified since the second half of 2015. Taking into consideration the NPL definition, the reduction in their level due to the successful restructurings is anticipated to be gradual and smooth.

Chapter 2.5- BANKING SECTOR AFTER THE ECONOMIC CRISIS

2.5.1 Introduction:

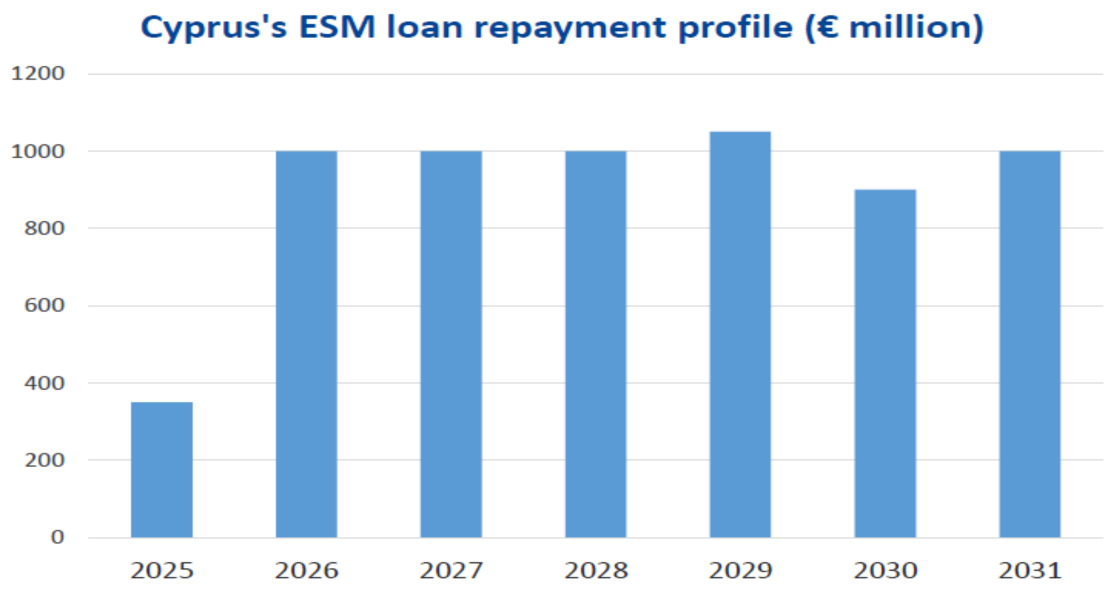
In March of 2016 Cyprus successfully completed the three-year financial assistance program. Klaus Regling, managing director of European Stability Mechanism, congratulated Nicosia and the Cypriot people, noting that "the country was able to return to economic growth and restore public finances more rapidly than expected."

The financial sector of Cyprus -which was the main source of the crisis- restructured, recapitalized and fell, and the legal and supervisory framework modernized. The country regained investor confidence and returned to the bond market, which continued to finance its debt to sustainable rates.

The end of the program is not the end of the reform agenda in Cyprus. More work is needed to reduce the level of non-performing loans in order to continue reforms in the labor market and to maintain fiscal discipline.

From a 10-billion-euro rescue package that European Stability Mechanism approved for Cyprus, Cyprus government used 7,3-billion-euros, as the country did not need the remaining of 2,7-billion-euros, as the macroeconomic adjustment program completed two months before the scheduled completion by the IMF.

The ESM paid 9 installments from May 2013 until October 2015. The loans will be repaid by Cyprus from 2025 to 2031, with an average repayment period of almost 15 years.



Graph 8: Loan Repayment Profile of Cyprus

2.5.2 Economic Adjustment Program and Outcomes:

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. Insufficient attention was paid to the fact that the banks were acting imprudently and that the international business was creating serious domestic imbalances.

The adjustment program that authorities put in place to restore the sustainability of public finances, targets a primary balance of 4 percent of GDP by 2018 to put the debt on a downward path toward 100 percent of GDP by 2020.

The key objectives of the program are:

- To restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions, strengthening supervision and addressing expected capital shortfalls, in line with the political agreement of the Eurogroup on 25 March 2013.

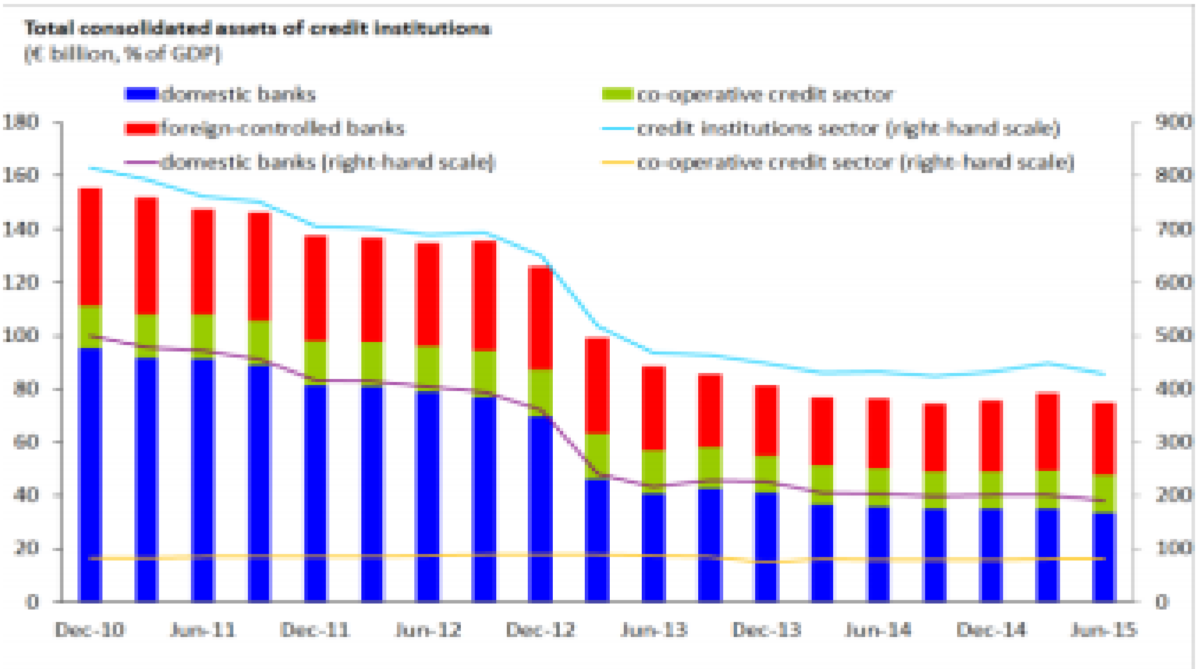
- To continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit as soon as possible, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector.

- ➢ To implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

The 2013–14 fiscal consolidation was broadly balanced between revenue and expenditure. Expenditure measures targeted the compensation of employees and social transfers. Revenue measures focused on raising tax rates and broadening tax bases. Nominal salary cuts of 9–15 percent (depending on the salary level) were implemented. The VAT and reduced VAT were increased by 2 and 1 percentage points. The corporate tax rate was increased from 10% to 12.5%, property tax rates were also raised.

Cyprus returned to growth in 2015 after three years of recession. The banking sector' fundamentals improved further. An injection of additional capital in 2015 strengthened capitalization, but excessively high NPLs weighed on profitability and the outlook. Although the NPL stock remained overly high in international comparison, it is expected to decline.

One of the key objectives of the economic adjustment program of Cyprus has been to restore the soundness of the credit institutions sector and to rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions and strengthening supervision, according to the terms of the Eurogroup agreement on 25 March 2013.



Graph 9: Total consolidated credit institutions assets (€ billon, % GDP)

The deleveraging process that was initiated as an end-result of the Greek sovereign crisis led to a 52% reduction in the sector' total consolidated assets over the period December 2010-June 2015. Specifically, the assets of the overall credit institutions sector and domestic credit institutions (on a consolidated basis) represented 428% and 273% of the country's GDP at the end of June 2015 respectively (Graph 9) compared to 815% and 583% in December 2010 respectively.

In October 2016, the liquidity shortfall narrowed to €5.5 billion, the lowest value since February 2013, the month before the bail-in. Capital adequacy ratios have been attained and exceeded minimum regulatory requirements, and the current banking sector has shrunk to two-thirds of its pre-crisis size, having shed 20% of its employees and 25% of branches. Exposure to foreign economies has also been significantly reduced.

2.5.3 List of Affected Credit Ratings by Moody's:

Moody's Investors Service is one of the "Big Three credit rating agencies", the other two being Standard & Poor's and Fitch Ratings. They are American financial services companies internationally recognized, which publish financial research and analysis on stocks, bonds and commodities.

Moody's expects the banks to be profitable in 2016-2018 after five years of losses. Moody's forecasts real GDP growth of 2.7% in 2017 and 2.5% in 2018 as tourism revives, consumer spending rises and the country's large business services sector maintains a strong performance and the conclusion of its economic adjustment program in March 2016. These factors have partly restored depositor confidence and banking system deposits are growing modestly.

➢ ***Bank of Cyprus Public Company Limited:***
Long term local currency deposit rating: Affirmed at Caa3, outlook changed to positive from stable
Long term foreign currency deposit rating: Affirmed at Caa3, outlook changed to positive from stable
Short term local and foreign currency deposit rating: Affirmed Not-Prime

Short term commercial paper rating: Affirmed Not-Prime
Adjusted Baseline Credit Assessment: Affirmed at caa3
Baseline Credit Assessment: Affirmed at caa3
Counter party Risk Assessment: Long term upgraded to Caa1(cr) from Caa2(cr). Short term affirmed at NP(cr)
Senior Unsecured EMTN program: Affirmed at (P)Caa3
➢ ***Hellenic Bank Public Company Ltd:***
Long term local currency deposit rating: Affirmed at Caa2, outlook changed to positive from stable
Long term foreign currency deposit rating: Affirmed at Caa2 outlook changed to positive from stable
Short term local and foreign currency deposit rating: Affirmed at Not-Prime
Commercial Paper Rating: Affirmed at Not-Prime
Adjusted Baseline Credit Assessment: Affirmed at caa3
Baseline Credit Assessment: Affirmed at caa3
Counter party Risk Assessment: Affirmed at B3(cr)/NP(cr)

Table 5: Credit Ratings by Moody's (June 2016)

The positive outlook on Hellenic Bank and Bank of Cyprus, Caa2 deposit ratings reflects the progress the banks are making in restructuring stock of problematic loans. These positive developments are balanced against the vulnerability of Hellenic Bank and Bank of Cyprus capital buffers, owing to the still high stock of NPLs.

	2015 (€ million)	2016 (€ million)	Change (%)
EXPENDITURE			
Intermediate consumption	691,8	673,3	-2,7
Compensation of employees	2.224,7	2.211,4	-0,6
Social transfers	2.467,8	2.563,2	3,9
Interest	495,4	464,7	-6,2
Subsidies	71,5	97,2	35,9
Other current expenditure	463,3	383,3	-17,3
Gross fixed capital formation	337,5	429,7	27,3
Other capital expenditure	152,7[1]	88,0	-42,4
Total expenditure	**6.904,7**	**6.910,8**	**0,1**
Total expenditure as a % of GDP	**39,1**	**38,5**	
REVENUE			
Taxes on production and imports	2.601,2	2.670,0	2,6
Current taxes on income, wealth, etc	1.719,1	1.719,2	0,0
Social contributions	1.482,9	1.528,5	3,1
Other current resources	316,6	279,4	-11,7
Sales	525,0	527,0	0,4
Capital transfers received	0,0	5,3	-
Property income	238,5	190,5	-20,1
Total revenue	**6.883,3**	**6.919,9**	**0,5**
Total revenue as a % of GDP	**39,0**	**38,6**	
Surplus (+) / Deficit (-)	**-21,4**	**9,1**	
Surplus (+) / Deficit (-) % of GDP	**-0,1**	**0,1**	

Sources: Cystat, CBC.
(1) Excluding the recapitalisation of the Cooperative Central Bank amounting to €175 million.

2.5.4 Economy of Cyprus as it is according to Central Bank of Cyprus:

Public revenues registered an annual increase of 0,5% in 2016 (Table 6), mainly owing to a 5,9% increase in VAT receipts, a result of the positive developments in the economy.

It is worth noting that the improvement in public revenues occurred despite a 29,2% reduction in the category 'other current taxes', due to the 75% discount on the immovable property tax, and the deterioration by 20,1% in property income due to the reduced CBC dividend.

Public expenditure (Table 6) recorded a marginal increase of 0,1% in 2016 compared with a decrease of 0,9% in 2015, owing to fluctuations in various expenditure subcategories.
An improving labor market and buoyant investment will fuel resilient growth in the year 2017.

The projections for the Cyprus
Table 6: Accounts of General Government

economy covering the period 2017-2019 were revised slightly upwards compared with the previous CBC forecast, despite the deterioration in the international economic climate.

An annual growth of 2,8% is expected for 2017, while further growth of around 3% is projected for each of the next two years. The envisaged economic growth path partly reflects the positive trend in fixed investments already underway in tourism, construction and other business activities.

HICP is expected to rise to 0,9%, 1,5% and 1,6% in the years 2017, 2018 and 2019, respectively, driven mainly by continued domestic economic growth and increased in the price of energy.

However, structural impediments to a stronger recovery and a balance of risks that remains tilted to the downside, especially over the medium term, remain important challenges.

Chapter 3.6- THE RESEARCH ANALYSIS

3.6.1 Introduction

This research has fulfilled the aim and objectives of the dissertation giving the author the opportunity to develop communication, observation and analysis skills and improve qualities such as vision, courage, confidence, integrity, wisdom, determination and passion.

The results of this research correspond to the expectations and answer the research questions. The critical success factors identified through the literature review are very well validated through this case study.

3.6.2 Research Analysis:

What went wrong and eventually led to the great economic crisis? So far there is not a clear answer on this question, since many parameters contribute to this in different ways. But all agree that the occasion for the outbreak was the bubble created in the housing and mortgage market. The Cypriot economy has been adversely affected over the last couple of years by the Eurozone credit crisis, especially with respect to the economic conditions in Greece and the instability in the global financial markets. The recession that started in the third quarter of 2011 continued, with the economy contracting in 2012 by 2,4%. The financial sector was particularly hit by losses on investments in Greek government bonds, as well as loan losses on Greek and Cypriot operations.

The unprecedented global economic crisis, which has created a credit crunch in the financial services system from 2007 up to now, largely influenced the functioning of international financial institutions. The destabilization of traditional lending pattern of banks from the markets led to question the credibility and solvency. Cyprus was not an exception.

At the enterprise level, this crisis is manifested by a series of adverse conditions such as drop in demand for products and services, pressure for lower prices and more credit, and presented bold debt collection problems and payment obligations while problematic and inadequate funding from banks took place.

The banking sector is one of the most important parts of the economy and the prosperity of a country depends a lot on the banking sector. Cyprus, before joining the European zone had self-controlled economy. Banks were doing very well as the system was controlled by Cypriot governance.

The current economic crisis is an important moment for the future of global governance.

Since Cyprus joined the Eurozone lost its prospect of economic autonomy, as it has to follow the rules of European Union. Country lost the opportunity of having its own currency as all the members have one common currency. This means that the Central Bank of Cyprus cannot print money when needed as the European Central Bank decides when and in what amount the currency will be printed. Therefore, when some currency difficulties may arise the country will not be able to solve it by itself and the interaction of European Committee will be necessary.

Besides, as a member ship of European Union, Cyprus had to compete countries with huge industries. This was another difficult part for Cyprus economy as Cyprus is a very small and introvert country and now it had to deal with globalization and big countries with economy of scales, such as Germany and France.

From the moment that someone becomes a member of a group, automatically creates a domino where each country influences another. This happened with Banking Sector of Cyprus. The problem started in the USA with housing and mortgage market and often spread to other countries due to globalization. Bankruptcy of international financial institutions in America was one of the causes of global economic crisis.

Another reason of Banking Sector collapse was exposure to Greek bonds. Impairment of Greek government bond debt by 75% in real terms, led the Cypriot banks to huge losses due to the installation of large sums in Greek bonds with consequent huge losses and impact on the Cyprus economy.

Cyprus in the summer of 2011 was excluded from the international markets due to negative evaluations by international rating agencies and therefore could not refinance public debt. The fiscal deficit increased sharply and was difficult to keep the economy on a growth path and because of the increasing public debt unemployment rose to high levels, and the development
stagnated at threshold levels.

How Cyprus Banking Sector managed to revert in a short time:

As Cyprus is a small island with a strategic geopolitical location, its banking sector recovered from the global economic crisis sooner than it was expected. Proper management of government is also an important part of increase in arrivals of tourism.

Measures taken by authorities called “Austerity measures” aim at reducing public spending in an attempt to decrease the country’s deficit and eventually regain in primary surplus. Also, reform policy is a way of improving and encouraging competitiveness.

The above played an important role in recovery of Cyprus from global economic crisis.

Future of Banking Sector:

Financial innovation like the implementation of “new markets” would help the country to get the economy in high levels as it would allow the economy to create liquidity.

In addition, the existence of large natural gas deposits in the Cyprus Exclusive Economic Zone is a vital new promising development, which in correct handling of the state will substantially enhance the long-term development of the country, greatly increasing the living standards of the people in Cyprus.

John Fitzgerald Kennedy once said “our problems are man-made, therefore they can be solved by men” (Kennedy, 1963).

Cyprus can make a full recovery, if all the appropriate directives are applied in a space of 5 years. This would include coming out of this crisis with strong solid external and internal economical and political systems.

3.6.3 Future Prospects and Challenges:

Future Prospects:

- The discovery of significant natural gas resources in Cyprus could be enough to power all electricity on the island for 210 years. All indications are positive that in the sea of Cyprus there are more wells of gas and oil, securing the economic future and rapid development, given that the GDP of the country is only 17 billion euro per year.

- Number of companies from different parts of the world have shown an interest or have bought the results of research carried out by the Republic of Cyprus in its exclusive economic zone. According to informed sources known petroleum industry giants and smaller international players have expressed interest, including, Brazil’s Petrobras, ExxonMobil of American interests, British BP, Dutch interests firm Shell, Petronas of Malaysia and Russian Gazprom.

Challenges:

- Non-performing loans are still high. Dealing with NPL problem effectively not only has an impact on the balance sheet and the capital of the banks but it also has broader implications for the economy. By lowering NPLs, banks can increasingly extend new credit to families and corporations on better terms, thus supporting investment and jobs. Banks improved lending capacity especially affects SMEs that are more dependent on bank financing.

- Public sector debt is still too high. Controlling the growth of the public sector wage bill and increasing the efficiency of the public sector through promotion and mobility across the civil service is a critical step.

- Action plan of growth by improving the business environment. The privatization of state owned enterprises allows better and less expensive services for the population and attracts foreign direct investment, which can bring jobs and increase liquidity in the economy.

Cyprus in 2017:

- Since exiting the IMF program, Cyprus' economic recovery has gathered momentum, banks liquidity has improved, restructuring of nonperforming loans has accelerated, and the fiscal primary surplus has increased.

- GDP growth is forecast at around 2.5% on continued support from foreign demand and external financing.

- Continued very high levels of private sector indebtedness, nonperforming loans and general government debt remain vulnerabilities.

3.6.4 Conclusions:

"A financial crisis is any of a broad variety of situations in which some financial assets suddenly lose a large part of their nominal value." (Wikipedia) The economic crisis can be caused not only by human mistakes, but by circumstances that human being can not control. For example, natural disaster or terrorist attack etc. In case of Cyprus, human mistakes led the economy to financial crisis.

Cyprus as a small and introvert island suddenly became part of a huge industry of European Union. Without having the necessary knowledge and experience, the government and the financial institutions made huge mistakes that led the economy of the island to a deep recession.

Over-lending, investments in Greek government bonds and bad management led the Cyprus banking financial system to collapse.

To restructure, the Cypriot banking sector followed the adjustment program of European support mechanism that recapitalized two major banks through the bailing-in of uninsured depositors.

Perhaps if better measures had been taken by the government, the consequences of the economic crises wouldn't have been so destructive, like for example the shut down of Laiki

Bank, deposit haircut and huge unemployment. But, the most important is to learn from mistakes to avoid them in the future.

However, Cypriot banks have already demonstrated their resilience and most industry professionals believe the current overhaul of the sector and increased European supervision has produced a more agile and secure banking sector to boost the economy. In July of 2016, the Republic of Cyprus accessed international capital markets for the first time after the economic adjustment program.

New opportunities are springing up in the wake of rebuilding the Cypriot banking sector. Cyprus can offer new investment opportunities in the areas of commerce, services, energy, development projects, shipping, education, health, technology and tourism.

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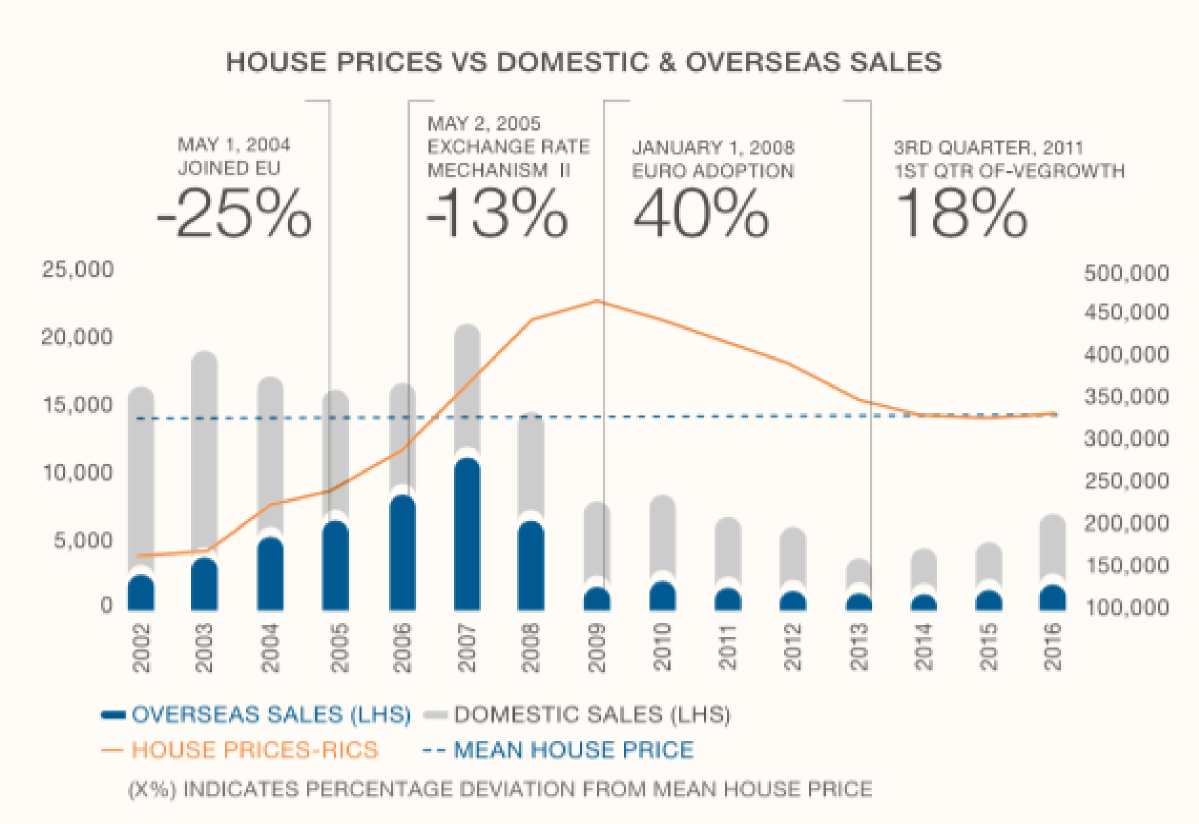
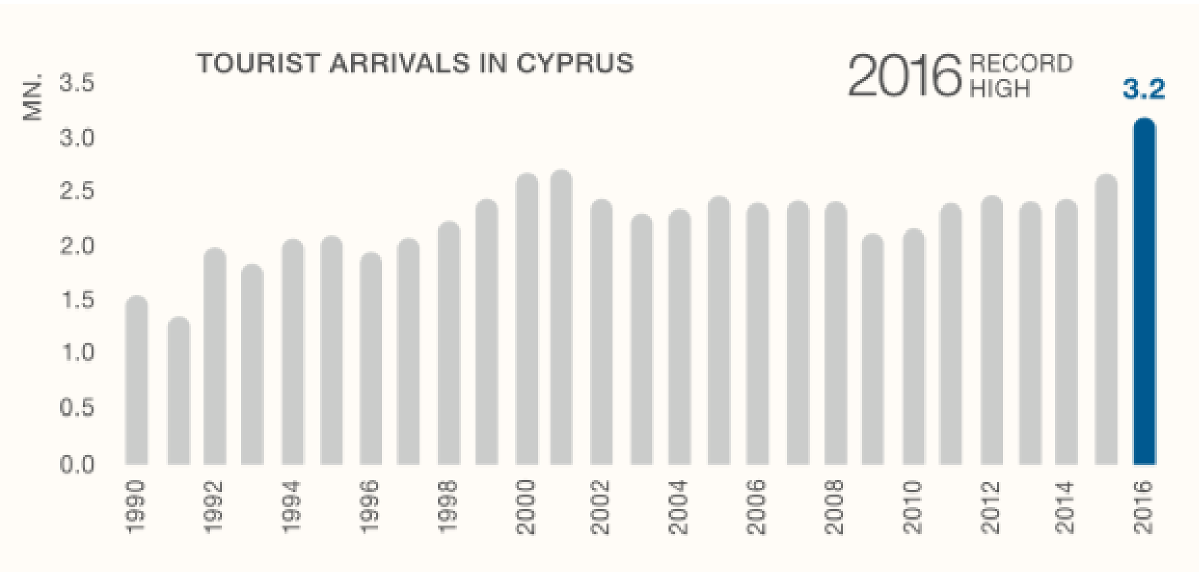
APPENDIX A:



Resource: HB/Economic Review 2nd half of 2016

APPENDIX B:



Resource: HB/Economic Review 2nd half of 2016