

First Steps

Positive measures will help restore banking confidence but others are needed to tackle unemployment



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Official statistics indicate that non-performing loans (NPLs) reached 30% of total loans in April 2013 and they will be significantly higher in September (the actual figures will be announced soon). Nevertheless, provisioning for loan losses stands at only 30% of total loans, well below the average ratio of 50% for EU banks. This suggests that Cypriot banks' profitability will be significantly affected going forward. As expected following the March crisis, the credit supply has contracted in the face of rapidly deteriorating loan quality and tight liquidity. As a result, corporate credit contracted by 9% YoY in June, with mortgage lending and consumer credit falling by 3% and 7% respectively.

To increase transparency, a new Central Bank of Cyprus (CBC) directive requires the reporting and classification of all loans in arrears for more than 90 days as NPLs, as well as all loans whose original terms have been modified! This is expected to lead to significantly higher officially-reported NPLs than those currently being reported. Also, the CBC has agreed to put in place a new regulatory framework on loan origination, requiring banks to consider affordability aspects in their lending decisions.

To allow banks to make better-informed loan decisions based on the creditor's history, while improving monitoring of credit quality, the authorities have decided to merge and expand the databases of the two existing credit registers for commercial banks and CCIs and to require lenders to submit data on performing and non-performing loans to the registers on a regular basis. The CBC, which will oversee the registers and the banks' contributions, will also develop tools to use the information for macro- and micro-prudential purposes.

Importantly, new steps have been agreed to facilitate corporate and household debt restructuring to address the high level of private indebtedness. Given the large number of existing and prospective loans in need of restructuring, the IMF has stressed the need for swift improvement in Cyprus's private debt restructuring framework

with a view to facilitating a reduction in NPLs and in private sector indebtedness. The Cypriot private sector is currently highly leveraged. The current private sector debt-to-GDP ratio is close to 280%, which is the highest in Europe and about double of the EU average. Corporate credit has been concentrated in the real estate and construction sectors. For households, housing loans account for more than half of the total, leading to high exposure of the banks to the decline in house prices that began in 2009.

Confidence in the banking sector is yet to be restored. The extent of the impact of the banking crisis on households and corporates, as well as on vital service sectors of the economy, will be larger than anticipated. These could result in a deeper and more prolonged recession, as well as in weaker long-run growth, with dramatic consequences for debt sustainability (IMF, 2013). On the external front, continued economic weakness in the EU could dampen demand for Cypriot exports. On the upside, tourism service exports could benefit from political turmoil in competing destinations and stronger non-EU demand (e.g. China and Russia). Development of the gas sector could also provide an upside to investment and growth over the longer term.

Unfortunately, unemployment has been taking the brunt of the adjustment, increasing from 11.7% in June 2012 to 17.3% in June 2013, the steepest increase observed in the EU the last few years. Much of this increase also takes into account the employees of Bank of Cyprus and Cyprus Popular Bank who took up the voluntary redundancy schemes. Also, the rapid increase in youth and long-term unemployment is particularly worrying, displaying a rate of more than twice that of total unemployment. The authorities should look for ways to promote employment in key areas within their limited policy space.

No-one can argue that Cyprus is suffering from severe economic dislocations, the full effects of which remain to be seen. The authorities are resolved to restore Cyprus's economic health and ensure its long-term sustainability. Cyprus has placed itself in a good position to prosper in the coming years but the island still faces tough days ahead.

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