

# THE IMPACT OF FINANCIAL STABILIZATION POLICIES ON THE LEVEL OF NON-PERFORMING LOANS: PROBLEMS AND CONTRADICTIONS (THE CASE OF CYPRUS)

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**Abstract.** The relevance of the article stems from the current level of non-performing loans (NPLs), which remain very high and pose risks of financial instability in Cyprus. Further reducing the high level of NPLs is one of the main strategic objectives of the Cyprus Stability Program for the period 2019–2022. The purpose of this paper is to identify problems and contradictions in the current financial stabilization policy in the banking sector of Cyprus and to help policy makers of financial policy to trace the problems and contradictions in the course of its implementation. The object of the study is the financial and, in particular, the banking sector of Cyprus, which is largely concentrated within the two systemic banks. The methodology of the study is based on theoretical and methodological analysis of the scientific literature, statistical method, observations, comparative method and analysis, as well as analytical and comparative graphs, comparative and analytical approaches. The results of this study show that the profitability of the banking sector of Cyprus is still negatively affected by a long period of low interest rates, as well as the burden of increasing provisions for bad debts. The adoption of the accounting standard (IFRS9) will lead to a further increase in the amount of provisions for impaired loans and thus have a negative impact on the profitability of banks. In addition, the decrease in the loan-to-deposit ratio was mainly due to a significant reduction in the loan portfolio of Cypriot banks. The significant decline in total lending by banks is due to the high level of non-performing loans in Cyprus, accounting for 31.8% of total loans at the end of November 2018. Moreover, about half of all NPLs are NPLs of households. The ESTIA program was created to address NPLs in Cyprus. Overall, the results of the study also show that the launch of the ESTIA program in 2019 will lead to an increase in moral hazard. Significant growth in demand for real estate in Cyprus is due to government policy and is carried out through the Citizenship for Investment program. Increased demand causes prices to rise and forms a bubble in the real estate market. In turn, the formation of a housing price bubble is one of the pre-crisis conditions.

**Key words:** the financial system of Cyprus, non-performing loans, commercial banks, financial and stabilization policy.

**JEL Classification:** G32, G39

## 1. Introduction

The European Central Bank (ECB) defines financial stability as a state in which the financial system, including financial intermediaries, markets, and market infrastructure, is able to withstand shocks and financial imbalances. Financial stability mitigates the likelihood of financial intermediation failures (European Central Bank, 2020).

The Republic of Cyprus (Cyprus), in accordance with the provisions of the European Stability and Growth Pact, has developed and is implementing its Stability Program (SP) for the period 2019–2022, approved by the Council of Ministers of Cyprus on April 17, 2019.

The SP outlines the fiscal policy strategy for the period 2019–2022 in line with the macroeconomic scenario adopted by the government and formulates the main objectives enshrined in supporting and strengthening the sustainable growth of the Cyprus economy. One of the strategic objectives of the SP is identified to further reduce the high level of non-performing loans (European Commission, 2019, Ministry of Finance, 2019).

High levels of non-performing loans in the banking sector of both developed and developing countries are often associated with financial crises (Bernanke, Gertler & Gilchrist, 1999).

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Financial crises have historical roots through the ages (Reinhart, Rogoff, 2014; Reinhart, Rogoff, 2009; Reinhart, Rogoff, 2008).

The crisis arises from the interaction of various contributing factors and their combination: global economic development, politics, global macroeconomic factors, monetary policy, the rise of securitization, a fragmented regulatory structure, and other factors (Thakor, 2015).

In turn, Cypriot NPLs losses are due to corrupt bank lending and the government's resistance to reforms aimed at making the economy more competitive, despite the adverse global economic conditions of the period (Brow, Demetriou & Theodossiou, 2018).

Although the outlook today is positive, Cyprus still faces many problems and contradictions.

## 2. The aim of the study

The aim of the study is to identify problems and contradictions in the current financial stabilization policy in the banking sector of Cyprus and to help policy makers of financial policy to monitor the problems and contradictions in the course of its implementation.

The relevance of the topic of the study is due to the current level of non-performing loans, which remains very high and creates risks of financial instability in Cyprus.

The object of the study is the financial and, in particular, the banking sector of Cyprus.

The subject of the study is the impact of modern financial stabilization policies on the banking sector of Cyprus.

The practical significance of the study lies in the fact that the main provisions, conclusions, recommendations and methodological research approaches can be used to develop specific recommendations for improving the financial stabilization policy of Cyprus.

## 3. Methods

The research methods are based on theoretical and methodological analysis of scientific literature, statistical method, observations, comparative method and analysis, as well as analytical and comparative graphs, comparative and analytical approaches.

The chosen methods and techniques of the study allow to establish the impact of financial stabilization policy on the level of non-performing loans.

## 4. Results

Despite the developed institutional system of supervision and monitoring, the current stabilization financial policy of Cyprus, in the opinion of the author, has a number of problems and contradictions.

Thus, the profitability of credit institutions (see Figure 1) is still negatively affected by the long period of low interest rates (see Figure 2), as well as the burden of increasing provisions for doubtful debts (see Figure 3).

The main contradiction is that the introduction of the accounting standard (IFRS9), which will be gradually implemented over several years to regulate capital adequacy, will lead to a further increase in the amount of provisions for impaired loans and thereby negatively affect the profitability of banks.

This is extremely important because from 2011 to 2017 inclusive, Cypriot banks incurred annual losses and only reached marginal profitability by 2018 (see Figure 1).

In addition to the above, the overall deposit portfolio of Cypriot banks continues to shrink (see Figure 4).

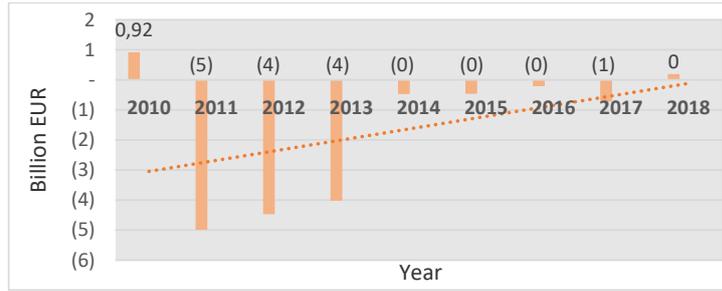
The total deposits of Cypriot banks amounted to €47.7 billion in April 2019, compared to €49.0 billion at the end of December 2016, thus the banks' deposit portfolio decreased by 2.7% from 2016 to April 2019. There was also a decrease in the loan-to-deposit ratio (see Figure 5).

The decrease of the loan-to-deposit ratio to 80% (as of April 2019) indicates the ability of Cypriot banks to cover withdrawals made by clients, if necessary. The contradiction of this situation is that the decrease in the ratio was not due to an increase in the total number of deposits in Cypriot banks, but due to a significant decrease in the loan portfolios of Cypriot banks (see Figure 6).

Total loans from Cypriot banks were €38 billion in April 2019, down from €62.7 billion at the end of December 2015, so total loans from 2015 to April 2019 declined by 39.4%. This decline occurred against the background of a long period of low interest rates. Thus, in theory, credit for businesses and individuals should have become more accessible due to lower interest rates in banks in Cyprus, but obviously this depends more on the credit policy of individual commercial banks rather than on the monetary policy of the ECB.

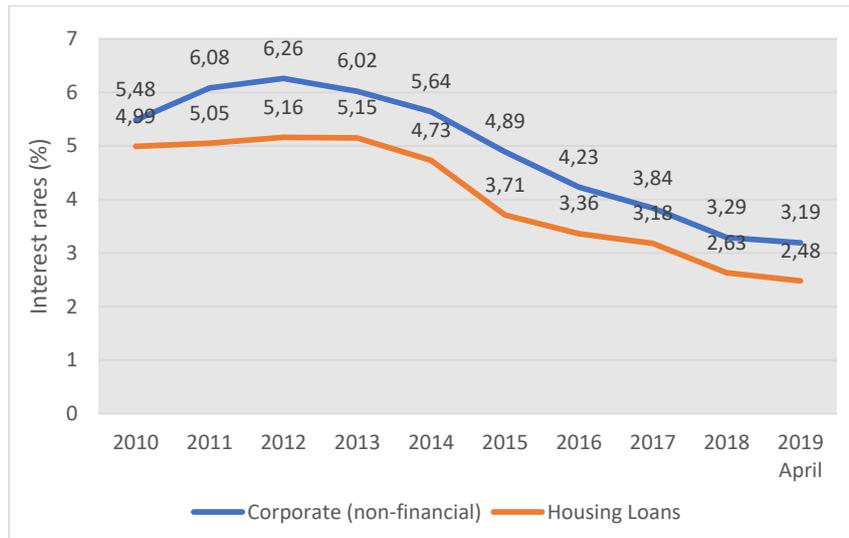
The significant decline in total lending by banks is due to the high level of non-performing loans in Cyprus. Addressing the high level of NPLs in the Cypriot banking system is a key priority (see Figure 7).

NPLs, excluding Cypriot credit institutions' overseas operations, remain high despite the progress being seen, at 31.8% of total loans at the end of November 2018, compared to a much higher figure of 42.5% at the end of December 2017. In nominal terms, total NPLs of all credit institutions (excluding their foreign operations) fell 46.1% to €11.2 billion at the end of November 2018, compared with €20.9 billion at the end of December 2017. Moreover, about half of all non-performing loans are non-performing loans to households (see Figure 8).



**Figure 1. Dynamics of profits (losses) in the banking sector of Cyprus, 2010–2018**

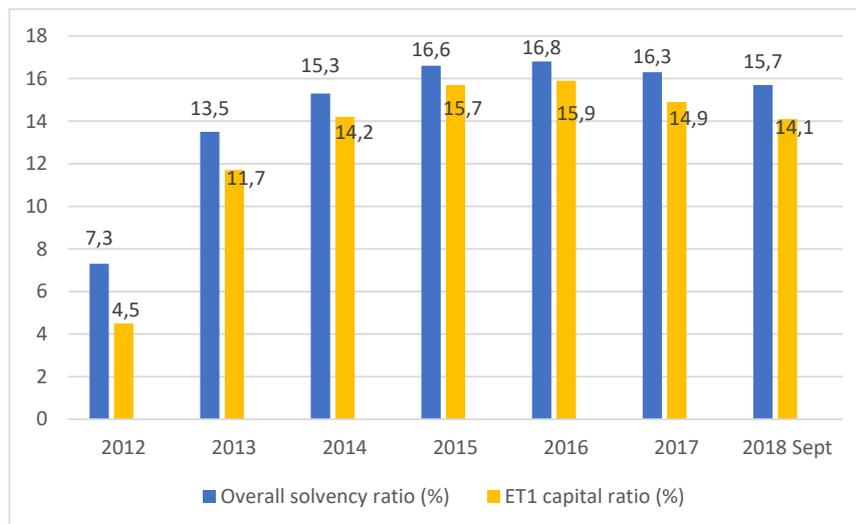
Note: compiled by the author based on data from the Central Bank of Cyprus (Central Bank of Cyprus, 2019)



**Figure 2. Average interest rates (for loans over 5 years\*) in the banking sector of Cyprus, 2010–2019 April**

Note: compiled by the author based on data from the Central Bank of Cyprus (Central Bank of Cyprus, 2019) and the Ministry of Finance of Cyprus (Ministry of Finance of Cyprus, 2019)

\* Non-financial corporate loans are loans to Cypriot companies which do not belong to the financial sector. The above interest rates correspond to the average interest rates for loans with a term of more than 5 years.



**Figure 3. Total solvency ratio (%) and capital adequacy ratio ET1 (%) of the aggregate banking sector in Cyprus, 2012–2018 September**

Note: compiled by the author based on data from the Central Bank of Cyprus (Central Bank of Cyprus, 2019)

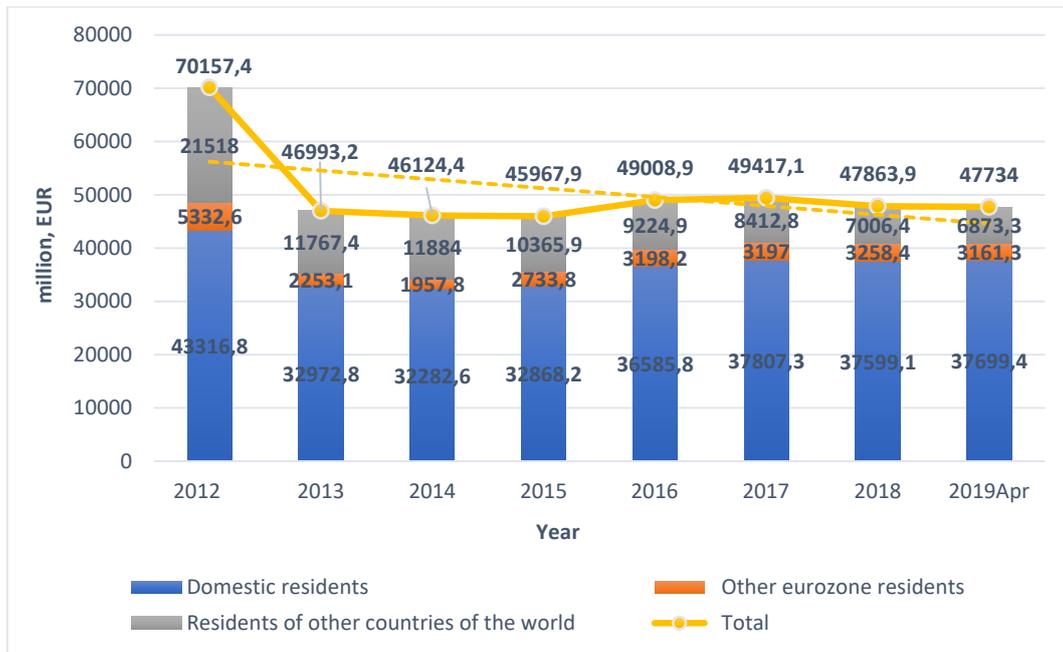


Figure 4. Total deposit portfolio of Cypriot banks, 2012–2019 April

Note: compiled by the author based on data from the Central Bank of Cyprus (Central Bank of Cyprus, 2019)

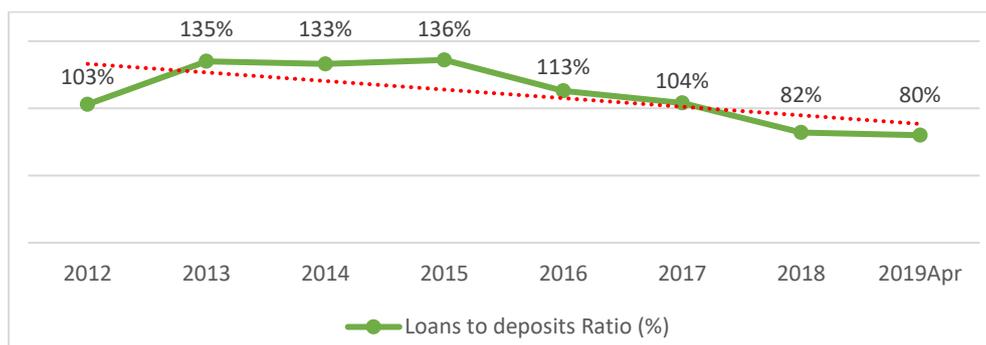


Figure 5. Dynamics of the ratio of loans to deposits in Cypriot banks, 2014–2019 April

Note: compiled by the author based on data from the Central Bank of Cyprus (Central Bank of Cyprus, 2019)

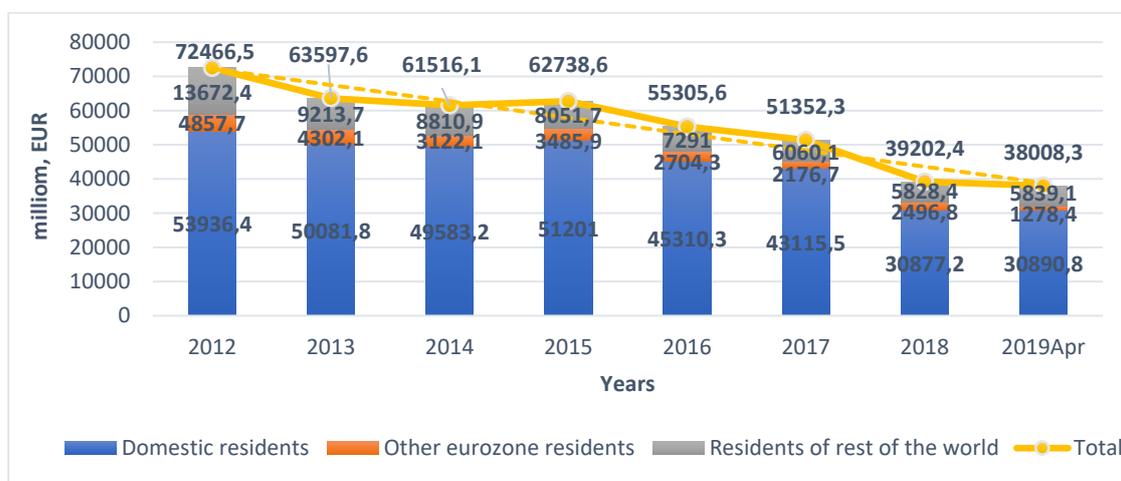
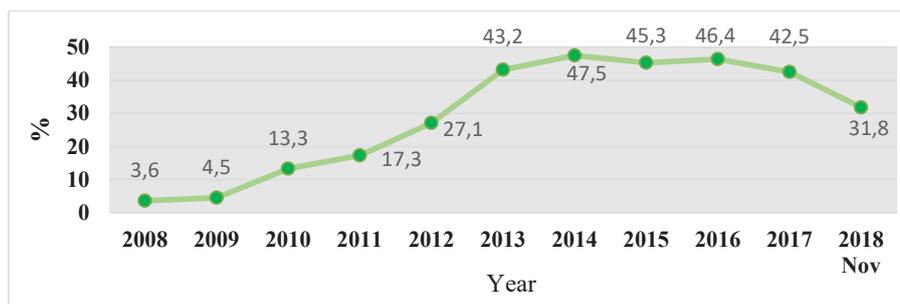


Figure 6. Total loan portfolio of Cypriot banks, 2012–2019 April

Note: compiled by the author based on data from the Central Bank of Cyprus (Central Bank of Cyprus, 2019)



**Figure 7. Ratio of non-performing loans to total gross loans in Cyprus (%), 2008–2018 November**

Note: compiled by the author based on data from the Statistical service of Cyprus (Statistical service of Cyprus, 2019) and Central Bank of Cyprus (Central Bank of Cyprus, 2019)



**Figure 8. Ratio of NPLs of households to total NPLs in Cyprus (%), 2014–2018**

Note: compiled by the author based on data from the Central Bank of Cyprus (Central Bank of Cyprus, 2019)

Figure 8 shows that NPLs for households, despite the progress observed, remain high at 49.8% of total NPLs at the end of 2018, compared to a much higher rate of 52% at the end of December 2017. In nominal terms, total non-performing loans to households across all credit institutions fell 47.1% to €5.17 billion at the end of 2018, compared with €10.97 billion at the end of December 2017.

To address the problem of NPLs in Cyprus, a federal ESTIA program has been created. According to Cyprus, non-performing loans with a total gross value of up to €3.4 billion as of September 30, 2017 are eligible to participate in the ESTIA program (ESTIA). Moreover, the Cypriot authorities estimate that the maximum total cost to the state if borrowers fully participate and comply would be approximately €815 million over 25 years (about €33 million per year) or 4% of GDP over 25 years (0.2% per year) (European Commission, 2019). At the same time, the authorities expect that ESTIA spending will not lead to an increase in public debt or violate the state's fiscal policy. ESTIA applies to households whose owners cannot repay loans for the purchase of a separate home, live in Cyprus and have real estate worth up to 350,000 euros, as well as meet other criteria set by ESTIA.

ESTIA, on the one hand, aims to achieve a socially acceptable solution to the problem of over-

indebtedness of households to banks and, on the other hand, will help reduce non-performing loans in Cypriot banks. ESTIA is a one-time procedure which will start to be implemented in the next couple of months. Under the terms of the program, the government will fund 1/3 of households' monthly contributions after loans are renegotiated between borrowers and banks, and 2/3 of households will have to repay (European Commission, 2019).

ESTIA was originally approved by the Cyprus Council of Ministers in July 2018, and the ESTIA eligibility criteria were tightened in November 2018. The latest, but most important proponents calling for a change in the eligibility criteria for the ESTIA scheme are Cyprus' international lenders. Representatives of the European Commission (EC), the European Stability Mechanism (ESM), the ECB and the International Monetary Fund (IMF) called on the government to tighten ESTIA eligibility criteria to reduce moral hazard and equity risks. Thus, the main contradiction of this program is that, on the one hand, its goal justifies the means, but on the other hand, ESTIA risks exacerbating moral hazard and serves as a program to subsidize strategic non-payers.

Currently, the implementation of ESTIA and the introduction of electronic auctions in Cyprus are stuck in legal and procedural issues. It was planned that the

real estate of persons with non-performing loans would be auctioned off electronically, and the debtor's main house would be protected through ESTIA. However, nothing has been implemented so far, as the relevant online platforms are not yet ready. The predominant legal issues are related to the transfer of borrowers' personal data to the platform, through which applications for the scheme will be submitted electronically.

Another delay has to do with the Memorandum that the banks will have to sign with the government. The Memorandum is under legal service review, the provisions are reviewed one by one, and there are a number of legal ambiguities in the Memorandum.

The third reason for the delay appears to be how the thousands of cases included in ESTIA are handled. In particular, efforts are being made to simplify the application process. Interested parties must submit too many documents, as well as other loan restructuring and property appraisal data as collateral for a non-performing loan to be included in ESTIA.

Thus, the launch of ESTIA for vulnerable homeowners has been postponed again. The launch of electronic auctions has also been delayed. The two issues are interrelated because, on the one hand, the electronic auctions will auction off the property of a borrower who fails to pay the required fees to the bank. ESTIA, on the other hand, will provide a safety net for borrowers who cannot pay their loans.

The Cypriot Ministry of Finance prepared an action plan for the implementation of ESTIA with eight set schedules, none of which have been met. The delay was also due to a change in the scheme criteria by the European Commission Competition Network. Borrower applications were originally scheduled to begin on December 1, 2018 and end on February 28, 2019, which did not happen. It is worth noting that due to the delay in applications, the rest of the schedule will have to be delayed. Including the banks' evaluation of eligibility criteria and approval of applications by the appropriate state agency.

As for electronic auctions, the government originally planned to implement them sometime between June and September 2019, but they have now also been postponed until the fourth quarter of 2019.

The ESTIA program has detractors who argue that ESTIA promotes inequality before the law: the government and political parties encourage citizens to default on loans by protecting their primary residence and then reward them by forcing banks to give them discounts on the cost of the loan, while also forcing the taxpayer to indirectly pay a portion of it.

In addition, dealing with non-performing loans is complicated by inaccurate Cyprus Land Registry data and difficulties with asset valuation by banks. Neither households nor developers have incentives to repay loans, and banks are reluctant to go through lengthy procedures, preferring to wait for house prices to rise.

According to the Royal Institution of Chartered Surveyors, Cyprus Property Price Index, as of June 30, 2018, property prices in Cyprus were up 7.6% year over year, with homes up 4.8%, offices up 11.6%, and warehouses up 4.2%, while GDP growth in 2018 hovered around 4% (Royal Institution of Chartered Surveyors, 2019).

The growth in demand for real estate is due to artificial factors – specific government policies and the Citizenship for Investment Program the "Scheme for Naturalization of Investors in Cyprus by exception" dated September 13, 2016. The purpose of this program is to further encourage foreign direct investment and attract wealthy people to reside and do business in Cyprus. Thus, in 2017, 5,517 people were granted Cypriot citizenship, 18% more than in 2016, of which 23.8% were Russian nationals, 9.1% were British citizens and 8.7% were citizens of Ukraine (Cyprus Property News, 2019).

The purchase of real estate is one of the most popular criteria of the investment scheme among foreign investors interested in obtaining a Cyprus passport, while the Central Bank of Cyprus notes that the purchase of real estate is not financed by loans provided by the Cypriot banking system.

According to Christopher Pissarides, a prominent economist and winner of the 2010 Nobel Prize in Economics, Cyprus can blow bubbles in the real estate market thanks to the Citizenship for Investment program. He called the current economic policy in Cyprus unsustainable in the long term and pointed out that perhaps another bubble is being created in the real estate sector in Cyprus (Hazou, 2019).

Thus, the formation of a bubble in the real estate market creates significant preconditions for the beginning of the crisis in Cyprus and, consequently, the possibility of a new surge in the level of non-performing loans in Cyprus.

## 5. Conclusions

5.1. Further reduction of non-performing loans is one of the priorities of the current financial stabilization policy in Cyprus. It is important that problems in certain areas of the Cypriot economy do not lead to disruptions in the financial system, to large social costs in the form of financial instability or financial burden.

5.2. The level of non-performing loans at commercial banks in Cyprus was 31.8% as of November 2018, and about half of all non-performing loans belong to households.

5.3. The Cypriot banking system as a whole has sufficient liquidity, supported by the ECB, and at the same time it is heavily concentrated in the two systemic banks – Bank of Cyprus (BOC) and Hellenic Bank (HB). The loan portfolio of BOC and HB together accounts for 70% of total Cypriot bank loans

and therefore has the highest concentration of non-performing loans.

5.4. The profitability of credit institutions in Cyprus is still negatively affected by a long period of low interest rates, as well as the burden of increasing provisions for bad debts. Despite the fact that the aim of the cheap money policy is to stimulate the economy and the lower the interest rate, the higher the demand for credit, accordingly, the main criterion for lending by Cypriot banks is the solvency of the borrower, which has led to a significant reduction in the overall level of lending in Cyprus.

5.5. The introduction of the accounting standard (IFRS9), which will be phased in over several years to regulate capital adequacy, will lead to a further increase in provisions for impaired loans and thereby negatively affect the profitability of banks.

5.6. Cypriot authorities hope that amendments to the insolvency and collection laws passed in 2018, as well as the launch of the ESTIA program in 2019, under which the government will provide financial assistance to restructure household debt, will help reduce the level of non-performing loans more quickly.

Essentially, ESTIA means that banks will be able to build significantly less reserves on their balance sheets. The government will finance 1/3 of the monthly payments after loan renegotiations between borrowers and banks, which means that banks will receive a significant portion of the loans, while private funds buy bad loans for only 15% of their face value. But this

scheme creates the moral hazard of a high-ceiling on-income criteria and the value of mortgaged properties.

5.7. Risks to financial stability are mainly related to tighter financial conditions, weaker growth and a slowdown in the global economy due to trade wars between China and the United States, as well as political and geopolitical uncertainty. The UK's exit from the EU (Brexit) has the potential to disrupt the financial market and, consequently, the economy as a whole.

5.8. In addition to the above, there are a number of risks, such as the pressure on the Cypriot authorities from Brussels, which could jeopardize the "Citizenship for Investment" scheme, which is of great importance for the Cypriot economy. On the other hand, rapidly rising real estate prices and increasing construction activity are risky for the economy, which could lead to negative consequences in the future. With the help of the "Citizenship for Investment" program Cyprus is inflating bubbles in the real estate market, which may indicate the preconditions for the development of the crisis in Cyprus. The onset of the crisis could provoke a new round of growth in non-performing loans.

## 6. Directions for further research

Further research could be related to the analysis of the long-term effects of the ESTIA program. In this regard, it is proposed to use the construction of different versions of the implementation models of scenarios (e.g., bad, moderate, and good) and their analysis and evaluation.

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