# The Performance of the Cypriot banking system during the Covid-19 pandemic

By Jordan Georgiou

# Table of Contents

## Abstract

The Covid-19 pandemic caused the biggest blow to the global economy since the Second World War. This situation led to a severe uncertainty in the economy as a whole. This paper will analyse the effect of the Covid-19 pandemic in terms of the banking system of Cyprus. The circumstances the world had found itself in meant that any prior predictions and forecasts would be obsolete for the years after the pandemic, as this was a situation no one had planned for or ever thought. This paper will analyse in specific the effects of the pandemic on loans, deposits, capital markets and in general the banking system as a whole. It will outline the measures that the government took to dampen the effect of the pandemic, but also the outcome of these measures. The findings of this paper reveal that Cyprus managed to maintain a satisfactory profile in economic terms, enabling the country to reduce the adverse effects on the banking system. More specifically, as of the first quarter of 2021, there has been no clear effect of the pandemic on asset quality. This was all a result of several years of a flourishing economic climate prior to the pandemic; thus, creating a financial climate that was in a position to tackle any economic repercussion the health crisis would bring. To be more precise, the banks were in a stronger position following a significant balance sheet clean up and deleveraging with a decline in the proportion of non-performing loans.

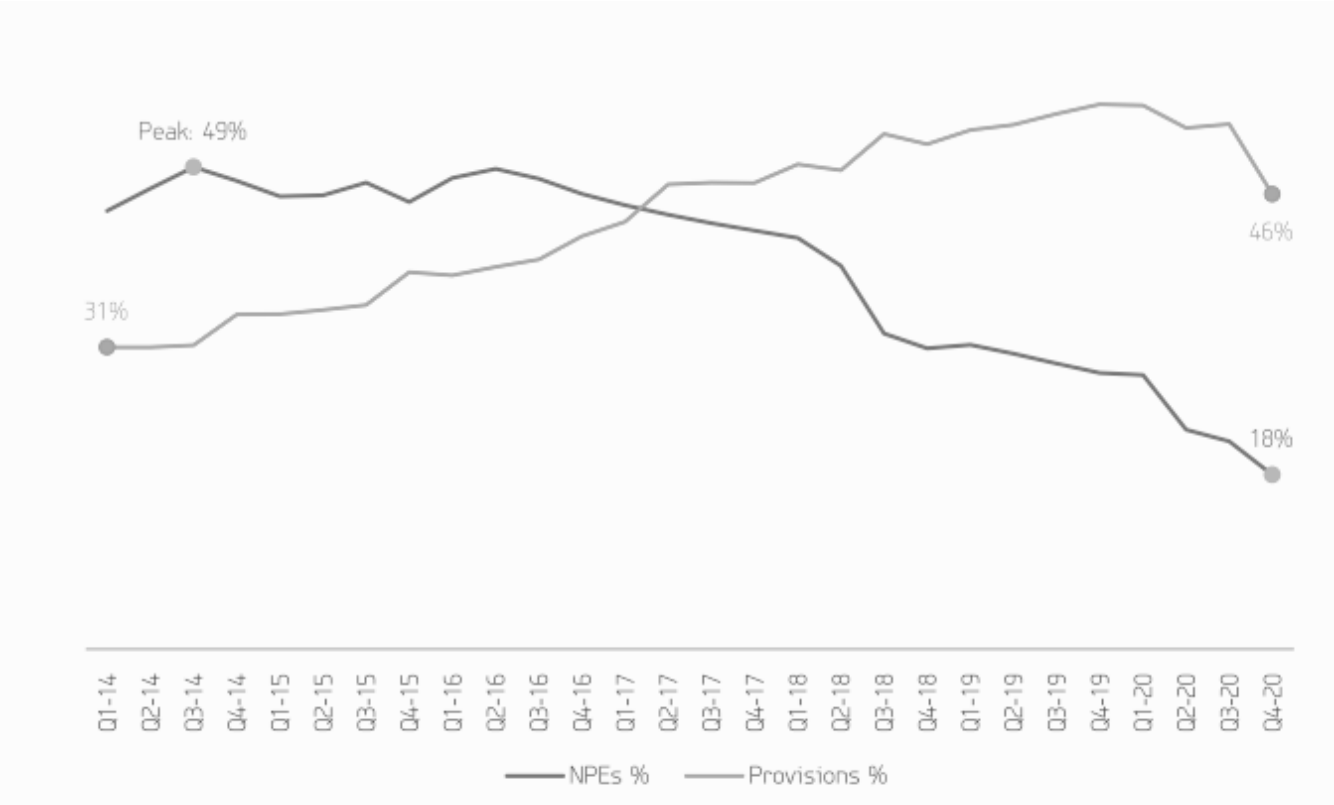
**Overview of the Performance of the banking system during the Covid-19 pandemic**

At the start of the Covid-19 pandemic, Cyprus was in a resilient capital position with surplus liquidity; this was a result of years of economic prosperity which was encouraged by significant foreign investment in the county. Thus, Cyprus was on a stable economic platform at the start of the pandemic, having recently pushed through the previous economic crisis. The fact that Cyprus was in such a good position economically meant it had some flexibility in order to successfully avoid the transformation of a health crisis becoming an economic one that would inevitably destroy the country's economy for the years to come. But, it was inevitable for this to happen; the health crisis did become an economic crisis globally. For the years 2018-2020 the asset size of the banking sector remained constant at 280% of GDP. Even though this sounds as positive for the economy, it must be clarified that loans were and still are the largest asset category at 50% of the total assets. This figure is slightly lower than the European average which is at 60%; even though this is the case, a country such as Cyprus was in a unique position. In 2019, Cyprus remained as the country with the highest stock of non-performing loans (NPL), at 28.8% which is a far larger share compared with the other EU Member States. That being said, the Cyprus banking system had mass exposure which would evidently worsen as a result of the pandemic. During the pandemic, deposits remained stable as a whole; more specifically household deposits remained stable during the pandemic whilst corporate deposits fell. One of the key factors to why the corporate deposits had fallen was the negative interest rates imposed in most of Europe and Cyprus which would not make it worthwhile to save money in the banks as the return on savings was minimal. Therefore, as a whole, the banking system of Cyprus during the pandemic surpassed any expectations, with previous healthy growth rates prior to the pandemic Cyprus was in a position where it held some buffer to move and take the disastrous side effects the Covid-19 pandemic will inevitably bring about.

**The effect of Covid-19 on loans**

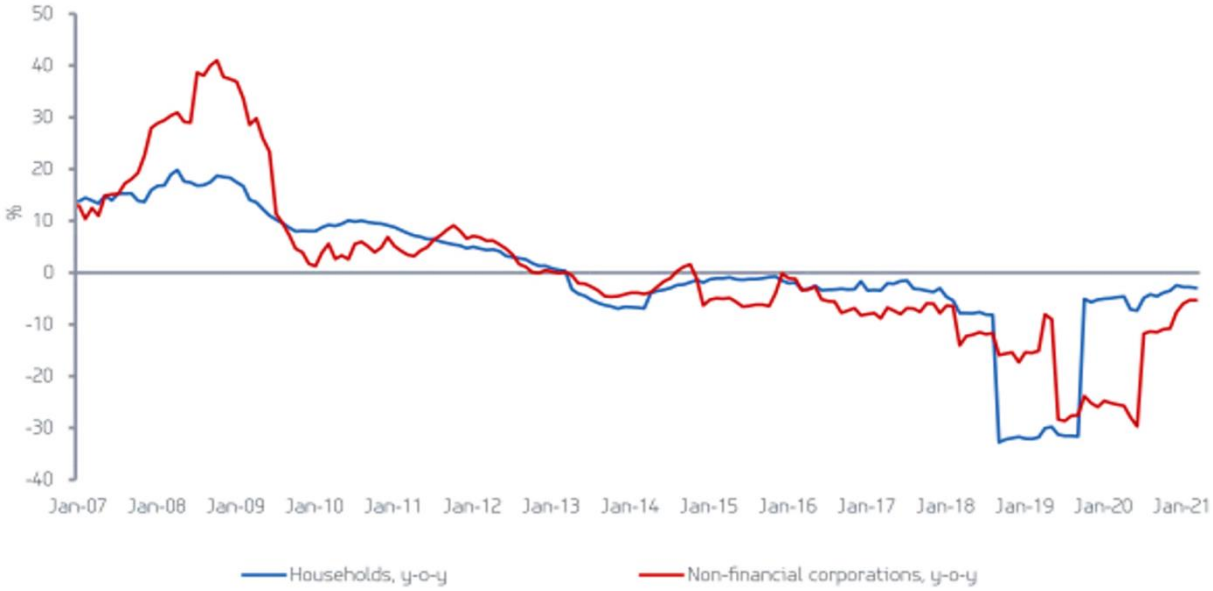
Analysing Figure 1 and Figure 2 below we can see that as a result of the Covid-19 pandemic loans outstanding began to rise from January 2019 till today. Also, loans for housing (mortgages) began to increase during the 1st quarter of 2020. The reasons for this increase in amounts outstanding in loans was mainly due to the measures implemented by the Cyprus government in order to diminish the effect of the Covid-19 pandemic on the economy. This is because, without a healthy and stable banking system in a crisis such as the Covid-19 pandemic, Cyprus would have experienced major financial pressure. This would inevitably cause the short-lived economic crisis to become one which is long-term and by far more serious.

**Figure 1:** Non- performing loans




**Source:** Central Bank of Cyprus

**Figure 2:** Amounts Outstanding for Loans




**Source:** Central Bank of Cyprus

The Government, as a result of the Covid-19 pandemic had to take precise and immediate precautions in order to dimmish the effects on the economy. As Cyprus had only recently exited a financial economic crisis (2012-2013) and began to prosper again, the pandemic would test the economy with two possible outcomes; either destroying the economy and enter into years of financial crisis or overcome the pandemic and leave behind a more resilient economy which could limit any future economic exposure. In terms of loans, the government of Cyprus imposed a suspension of instalments for 9 months this would have two effects on the economy. Firstly, both households and businesses who are delaying their repayments would be able to spend this money elsewhere which in turn could lead to a greater multiplier effect. This is because the increase in spending, which is exactly what the economy needed during the periods of lockdown would help keep the economy moving, help pay salaries and increase consumption and investment within the economy having long lasting positive effects through the multiplier model. As well as this, by postponing repayments by 9 months this, in turn, would mean the banks could delay the classification of

loans into non-performing loans; meaning as non-performing loans are those which have not had an instalment paid for 180 days by delaying instalments Cyprus can in the short term keep non-performing loans at a more stable level.

However, one must point out that the delaying of instalments for loans could potentially in the medium to long run lead to a greater proportion of non-performing loans. This is because when it is time to pay the instalments a proportion of loan owners will inevitably be in a position where they are unable to. Thus, increasing the proportion of non-performing loans which is exactly the opposite of what the Cypriot banks have been trying to do following the 2013 crisis. In line with this measure, foreclosures were suspended; this indirectly would aid the economy. By avoiding foreclosing on a property, will in turn mean the owner of the house will potentially delay instalments which may help increase their economic activity. As rather than spending on loan repayments the individual could purchase goods and services or even invest which would have a positive effect on the multiplier, aiding the economy. This is because both these are components of aggregate demand, hence an increase in any of these will help keep the economy moving which is what was needed in times of lockdown and restrictive measures.

In addition, avoiding foreclosures helps keep the owners of the property maintain a satisfactory credit rating. To clarify, by not foreclosing and the loan owner being able to eventually repay the debt this would avoid the individual having their credit ratings fall dramatically meaning their economic activities will not be drastically affected. Therefore, these individuals who are potential foreclosures could if needed in the future borrow again or receive a mortgage. A further effect of not foreclosing on a property is stopping the prices of property from plummeting. This is because foreclosing on a property and having this property be empty would provide an investor with a larger amount of negotiation power to reduce the prices of other properties. This is closely associated with the ‘Estia’ Scheme. The ‘Estia’

Scheme would provide socially acceptable and financially sustainable restructuring solutions to vulnerable borrowers who have mortgaged their primary residences as collateral and are having trouble repaying their debt. This scheme was extended during the pandemic in order to help those who are suffering financially; therefore this could in turn, help keep a healthy economy by reducing foreclosures and giving the chance to households to pay off their debt. Under the scheme €0.2 bn of non-performing loans were approved to be supported in order to avoid the seizing of collateral. Thus, the Cypriot government did provide measures to avoid further dampening the effect of Covid-19 on household struggling. However, it must be made clear that it was unrealistic for the government to accept all 6200 applications made since during times at which the economy was at a standstill excessive government spending would evidently leave long lasting effects on the economy.

By the government of Cyprus facilitating the opportunity to delay the repayment of loans this led to €11bn of loans being delayed. There was a more or less equal split between corporate and household loans. As well as this, €0.7bn worth of loans were considered non-performing loans. Hence, as a result of the emergence of new non- performing loans it was vital for the Cypriot government to apply pressure to credit institutions for them to undergo risk management. It is somewhat concerning that €11bn of loans were being delayed this is because it is logical to believe that a proportion of these will eventually become non-performing loans. Thus, a banking system which has been trying for years to clear up their balance sheets by selling off non-performing loans could potentially be at risk of a surge of non-performing loans as a result of the Covid-19 pandemic.

A final measure the government of Cyprus has implemented to avoid excessive exposure of non- performing loans, was the sale of these loans to PIMCO LLC. In August 2020, the Cypriot government sold €916mn (gross value) worth of these non-performing loans whilst in January 2021 €545mn (gross value) was sold to PIMCO LLC. The reduction

of non-performing loans on the balance sheet of the Cypriot banking system can be shown by figure 1 below, which shows that the proportion of non-performing loans is at the lowest from 2014 at 18%.

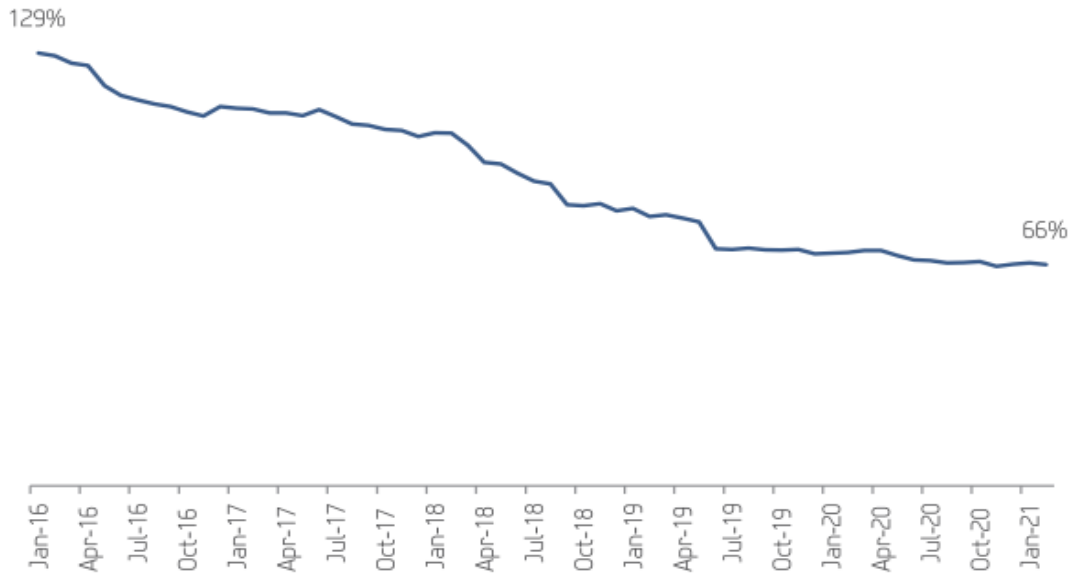
At present time the banking sector's biggest challenge is profitability, this is both within Cyprus but also the rest of Europe. By the pandemic causing very low interest rates and in some cases, negative interest rates this meant that in 2020 the banking industry began making losses. Another reason for these losses is the selling of non-performing loans at a loss to third parties. In terms of liquidity, the banks of the Cypriot economy hold coverage ratios and net stable funding ratios which exceed the minimum requirement. This is a sign that deposits within Cypriot banks are higher than the minimum requirement as the liquidity ratios mentioned above are considerate of deposits.

Whilst the banking industry was severely strained as a result of the Covid-19 pandemic, the non-performing loans were reduced from €9bn to €5.1bn throughout 2020. As previously mentioned, the reason for this major reduction in NPL was the sales of the loans to third parties, but also writing off these loans as bad debts. Despite the significantly reduced level of non -performing loans, the figure still remained high compared with the euro area average and has the potential as a result of the pandemic to escalate rapidly.

**The effect of Covid-19 on Deposits**

Despite the Covid-19 pandemic, Figure 3 below indicates that domestic deposits have been resistant throughout 2020 in surviving through the pandemic. One must clarify that the increase in household deposits compensated for the decline in corporate deposits.

**Figure 3:** Deposits into Cypriot banks




**Source:** Central Bank of Cyprus

A key reason why companies would avoid the deposit of money into banks was to have cash on hand in order to deal with any unexpected liquidity problems which could have come about throughout the lockdown periods. This avoidance to deposit by companies was further heightened by the implementation of negative interest rates; these would discourage saving as it was no longer worthwhile to deposit into banks due to the fact that return on savings was minimal if not zero.

Throughout the ongoing pandemic, deposits from non-residents of Cyprus declined this could be due to the measures set up by banks in order to reduce their risk and exposure. However, one may also add that a further reason for the reduction in deposits could have been the 'Golden Passport' issue which occurred at the end of 2019. This issue would destroy the high reputable image Cyprus has created over the years as a key player in the corporate climate.

During the pandemic, interest rates on deposits of household's loans with a maturity of up to one year was at around 0.09%. This figure is extremely low compared to that of around 0.62% in 2018; thus, discouraging households to deposit money into banks which may in fact play a vital role in the liquidity of the Cypriot banking system. Therefore, throughout the pandemic Cyprus saw a reduction in deposits as a whole as individuals would look for other investment opportunities such as Stocks, Property and even Cryptocurrencies; all of which may potentially provide a higher return than money in the bank.

Interest rates for non-financial corporations throughout the pandemic were around 0.13%. This figure is particularly low in comparison to that of 2018 which was at approximately 0.80%, this would again discourage companies to deposit their money into the Cypriot banking system which reasons for the slight decline of deposits by corporations. Therefore, as a whole, the pandemic brought about little change to deposits in the Cypriot banks due to the increase in household deposits which cancels out the decrease in corporate deposits. Analysing Figure 3 we can clearly see that from the final quarter of 2019 the percentage of deposits compared to GDP was at 66% even though this was lower than previous years it was more or less stable throughout the pandemic.

**The effect of Covid-19 on Capital Markets**

Capital markets is the part of the financial system concerned with raising capital by dealing in shares, bonds and other long-term investments. Even though the Cypriot economy was facing severe uncertainty due to the global Covid-19 pandemic, the Cyprus Securities and Exchange Committee (CySEC) experienced an increase in supervised entities of 42 entities; most of which were in the fund management industry.

The Investment firms based in Cyprus surprisingly did not experience a large effect from the Covid-19 pandemic. The number of investment firms in Cyprus remained the same at 242. In comparison, the fund management sector saw an increase in authorised management companies of 56 firms from 2019 to 2020. Hence, the fund management industry within Cyprus saw a growth of 26.7% in the number of companies during the pandemic.

The Asset Management industry did not only increase in terms of the number of firms in the industry but also the size of the market as a whole has increased from 2019 to 2020. During the first year of the pandemic, the assets under management had increased by €0.3 bn. A large proportion of funds within Cyprus are invested in private equity or real estate, sales of property increased by 27.6% from 2020 to 2021 (Comparison of first quarter of each year). Therefore, the pandemic did not adversely affect the Capital markets or the real estate industry in Cyprus to a great extent.

**Way forward**

At the time of writing this report, it is impossible for one to know exactly the way forward during these circumstances we are living in. The Covid-19 pandemic is still in full swing with countries delaying their easing of restrictions this is mainly due to the development of new variants of the disease such as the Delta variant. These variants will continue to develop if citizens avoid being vaccinated hence delaying further the return to normality. In Cyprus, we are hopefully expecting a period of recovery from 2021 onwards, circumstance dependent. Real GDP is forecast by MoF to grow year on year at 3.8% in 2022, 3.2% 2023 and 2.8% 2024[1]; this will only be possible with the encouragement of private spending and investment within the economy which will bring about positive effects on the multiplier as both investment and consumption are components of aggregate demand.

However, the government will hold a vital role in the recovery process of the economy as it will have to increase government spending in the short run in order to support small and medium size businesses who may struggle to live through the pandemic which will then lead to more unemployment and fewer taxes.

More precisely regarding the banking sector, the main focus should be the percentage of non-performing loans and how this will be affected by the pandemic. As non-performing loans are projected to increase throughout the pandemic, but also during the years to follow after the end of the pandemic where the economy will still be absorbing the whole negative effect the pandemic brought. Banks in Cyprus should continue to reduce the levels of non-performing loans from their balance sheets in order to reduce any excessive exposure, which could lead to severe liquidity issues.

The banking system is in a satisfactory position in the current economic climate which means the initial aim of the banks would be to continue on the same path they are

[1] Stability Programme 2021-2024, April 2021

following but to prepare for the worst-case scenarios in order to guarantee that the banking system in Cyprus will exit the pandemic stronger and more robust.

The termination of the Cyprus Investment Program (CIP) will put Cyprus partly in a more difficult position when trying to attract foreign investment which would help drive the economy and allow for a greater injection of money into the Cypriot economy for the next couple of years. If the program was still operating under more strict legislation and monitoring systems then Cyprus would potentially have reduced the effects of the pandemic since foreign investment would continue to be encouraged which in turn would lead to more job opportunities, greater spending, and a more active economy. This all would allow for Cyprus to recover from the pandemic at a faster pace, as the economy as a whole will see a growth in investments.

**Concluding Remarks**

The uncertainty in the duration of the Covid-19 pandemic is one of the most significant risks the banking system among others is exposed to, and this is because it is simply impossible to predict the longevity of the effects this pandemic will bring to our banking system but also to the economy as a whole. As we do not know how long the pandemic will continue in the future, we are unable to confidently predict when the country will go back to a period of economic prosperity.

The Cypriot banking system should have as main focus reducing their vulnerability to the high non-performing loans, this because the deferral of loan repayments will further expose the banks to new non-performing loans which is a burden to the financial performance of the economy. Whilst at the same time, the economic effects of the pandemic such as the rising unemployment and closing of businesses could worsen the economic environment by increasing non-performing loans.

The final year of the pandemic and the year following will be two of the most crucial years for the economy, as the way in which the government will conclude its actions at the end but also the way it will return to normality; meaning the incentives and aid which will be given to all the different sectors in the economy will determine the path of the economy for the near future.

Cyprus at this point of time, is in a satisfactory position economically whilst at the same time the vaccine roll out within the country is surpassing other EU countries; both of which are hopeful. However, it is too soon to conclude on the economic effects the pandemic brought about as this health crisis is ongoing. The Cypriot government should focus on the economic stability of the country, but also on the task of improving the image of Cyprus domestically and abroad.

**Bibliography**

Covid-19 Industry Pulse Report: Banking. EY. Demetriou S. https://www.ey.com/en_cy/covid-19-updates/pulse-report-banking

Post-Programme Surveillance Report-Cyprus, Spring 2020, European Commission. https://ec.europa.eu/info/publications/post-programme-surveillance-report-cyprus-spring-2020_en

Stability Programme 2021-2024, Ministry of finance (April 2021) http://mof.gov.cy/assets/modules/wnp/articles/202104/880/docs/stability_programme_21_24_en_final.pdf