# ‘Shocked by Co-op’s fate, other banks may now act’

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By Stelios Orphanides

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THE supervisory decision to go hard on the Co-op, ultimately leading to the bank going out of business, may prompt other banks to deal with their non-performing loans faster and more decisively to avoid a similar fate, an academic has said.

Still, the island has a lot of distance to cover before it brings stability back to its financial system by reducing non-performing loans and restoring trust in its banks, tested thrice in six years and seen as the lowest Europe-wide, said Andreas Milidonis, who teaches finance at the University of Cyprus.

“Stability is an issue much broader than non-performing loans,” the associate professor said citing the findings of two recent academic papers. “We observe that Cyprus has the lowest score for ‘trust’ among European countries”.

“Non-performing loans continue to be a threat to the economy, especially given the recent aggressive changes in banking supervision guidelines.” Milidonis said in a reference to the introduction of international financial reporting standards (IFRS) 9 and new rules and a stricter European Central Bank’s (ECB) guidance speeding up the process of a non-performing loan becoming a provision. “I personally anticipate more changes with respect to non-performing loans”.

Non-performing loans in the Cypriot banking system stood at €20bn in March or 43 per cent of the total, compared to a 4.2 per cent EU average in September. Cyprus had the second-highest ratio in the EU, just behind Greece's 46.6 per cent and well ahead of Portugal, with 16.7 per cent.

"The forward-looking IFRS 9 standard, is a major challenge for banks in Cyprus for a few reasons," Milidonis said in reference to the new round of Europe-wide stress test lying ahead. "To be able to look forward, banks have to also consult their recent historical experience. However, the recent history of the banking sector in Cyprus, includes several shocks".

Andreas Milidonis, who teaches finance at the University of Cyprus says sStability is an issue much broader than non-performing loans

Such shocks which had the form of structural breaks include the bail-in five years ago and currently events unfolding around the Cyprus Cooperative Bank, which not only triggered changes in legislation but also changes in consumer behaviour, he said and added that as a result, "recent banking data in Cyprus not very representative of what will likely follow in the future".

The recent legislative changes already led to banks starting to pile the pressure on non-paying debtors, prompting a borrower protection group to complain that banks started informing customers that they would proceed to foreclosing properties.

The state-owned Cyprus Cooperative Bank is meanwhile the post-crisis first casualty in the battle against delinquent loans. Its failure to sufficiently reduce its bad loans and the subsequent impact on its capital adequacy, compelled it into selling its operations to Hellenic Bank. The European Commission made the approval of the transaction conditional to Cyprus making its foreclosure and insolvency framework more effective.

While this was a requirement of the 2013 bailout, the parliament only half-heartedly agreed to modernise legislation on foreclosures four years ago, before doing so with that on insolvency. Unsurprisingly, the result was a toothless framework which did not allow banks improve borrower discipline.

Hellenic Bank's agreement with the Co-op concerned the acquisition of the latter's healthy operations, including €9.7bn in deposits.

Still, five years after Cyprus punished savers in the bail-in, partly caused by a high volume of delinquent loans and compelled into turning a page, the island is also getting ready to reward borrowers not paying their debts.

Populist president Nicos Anastasiades could only forge a majority in the –otherwise hostile to reform– parliament and so satisfy the Commission's conditions, only after his government could present Diko a loan repayment subsidy scheme, dubbed Estia. The latter allows households and small and medium-size enterprises (SMEs) which have non-performing loans with primary residence worth of up to €350,000 as collateral, an annual income of up to €50,000 and net assets worth up to 125 per cent the value of their home, to benefit by having one third of their monthly loan repayment subsidised by the taxpayer.

With the island lacking a strong record in enforcing legislation, “reducing non-performing loans is possibly the reason the government is proposing Estia, which in my eyes at least, lacks long-term vision and implementation,” financial economist Milidonis continued.

Positive elements in the scheme are that it only covers loans that were already not performing in September last year and not those that became delinquent later and that the subsidy is conditional on borrowers not failing payments over 12 months, he said.

On the other hand, as the scheme rewards strategic defaulters and households whose financial situation does not justify benefiting from welfare schemes, Estia’s income and net asset criteria should be lowered, Milidonis said. In addition, it should also exclude politically exposed persons (PEPs) and strategic defaulters, whom he generally defined as borrowers otherwise ineligible for social welfare with a monthly net income of at least twice the monthly loan repayment.

The cost of strategic default “is in the range of €6,000 to €16,000 for each Cypriot voter,” the academic said.

With 550,876 voters eligible to vote in the past presidential elections, this would translate into a cost of up to €8.8bn, slightly exceeding depositor losses in the 2013 banking crisis.

Milidonis therefore proposed to reduce the income criterion to about €25,000, the primary residence value to €200,000, the average island-wide, and the value of additional households’ assets to less than €100,000.

“This suggestion is in line with the current scheme that the government has in protecting first residence properties,” he said. “Households that fall under the proposed criteria are more likely to be households in need”.

Furthermore, households whose assets exceed in value their primary residence, can use them to repay their non-performing loans which in turn would prevent strategic defaulters of taking advantage of the system, the academic continued. On top, this would help contain disappointment among households that have been honouring their obligations.

The financial economist said that while he hoped the completion of the deal between Hellenic and the Co-op could help stabilise the financial system, the Central Bank of Cyprus could also help maintaining calm and trust in banks by being “pro-active” ahead of crises and both “active” and “vocal” during crises.

“Trust in Cyprus is the lowest in Europe, hence more visible actions are needed by the central bank to improve or restore it, the academic said. “If need arises, then the ECB should step in”.

His comment could be interpreted as a swipe at governor Chrystalla Georghadji, whose term expires next year and who was widely criticised for remaining silent over the past months in which concerned Co-op depositors withdrew more than €2bn in deposits on fears they would be subjected to a new bail-in.

Milidonis said that a negative impact on private consumption, which in the past four years rose on average 2 per cent against a nominal growth of 1.5 per cent, is preferable to maintaining the current uncertainty in the financial sector.

“I am optimistic that borrowers will start paying more towards their loans, given the recent developments with the Cyprus Cooperative Bank and the subsequent legislation,” he said. “As implied, money that was previously either spent or saved, will now have to be directed towards loan payments”.

“It is possible that consumption may be affected but which is worse: decrease in consumption or more of the recent shocks to the Cyprus economy?” he asked.