Financial Stability Report

Executive Summary

In 2015 the Cyprus economy returned to modest economic growth after three years of contraction and is finally in a path of gradual recovery. Economic activity has turned out better than expected, with Gross Domestic Product (GDP) forecast to increase by 1.6% in 2015 and by 2.0% in 2016. Cyprus has made considerable progress in implementing its economic adjustment programme. New insolvency and foreclosure legislation has now been adopted. Access to market financing has improved, as reflected in the successful government debt issuance on international capital markets in April this year. The financial situation of the banks is gradually recovering, liquidity and solvency in the banking system has improved and it is encouraging to note that the slow pace of debt restructuring is picking up. Overall, a gradual economic recovery is envisaged.

While sentiment is improving, challenges still remain. The banking system has unprecedented levels of impaired loans – among the highest in Europe - and addressing these loans will take time; new lending is at a low level; households and non-financial corporations (NFCs) are characterised by elevated debt levels, unemployment – albeit falling – remains high and public debt as a percentage of GDP has improved significantly but remains high. Along with these financial risks, some delays are also observed in the passing of legislation such as legislation allowing the securitisation of loans by banks. Moreover, despite the reduced real and financial links between Greece and Cyprus, adverse developments in Greece could cause confidence effects. We are also observing many geopolitical developments in and around the European Union. Any of these could impact the financial stability of Cyprus.
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I. Main risks and vulnerabilities

The following vulnerabilities have been identified as representing the main sources of risk for the Cyprus financial system. The detailed analysis to this can be found in the report.

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<th>Overall assessment</th>
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<td>1. Asset quality concerns due to excessive exposure of the banking sector to non-performing loans</td>
<td>Decisive and efficient implementation of the newly enacted insolvency framework is expected to be conducive to resolution of non-performing assets.</td>
<td>Stable; expected to improve.</td>
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<td>2. Over-indebtedness of the non-financial corporations sector and of the household sector</td>
<td>At high levels of indebtedness households and corporates are more likely to encounter payment difficulties in the face of shock to incomes. Decisive implementation of the newly enacted insolvency framework should reduce the overall level of indebtedness and may bring about an acceleration of private debt restructuring.</td>
<td>Stable; expected to improve.</td>
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<td>3. Weak profitability prospects for banks and insurers in a low interest rate / low growth environment</td>
<td>Ongoing pressure on profitability, particularly for life insurers where low yields lead to high technical reserves.</td>
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<td>4. Real estate risks</td>
<td>Prices may be bottoming out and could modestly increase in the medium-term, given emerging signs of renewed domestic and foreign demand. However, the prospects for recovery of the property market are difficult to estimate with certainty. Close monitoring of property sector is required owing to its importance both for the asset position of households and for banks’ loan portfolios.</td>
<td>Stable</td>
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<td>5. Funding risks</td>
<td>Elevated since the bail-in of unsecured depositors and erosion of confidence. Access to medium-and longer-term funding at sustainable cost remains a challenge as central bank funding remains a significant proportion of the funding base. Banks have managed to decrease reliance on central bank funding and deposits have increased. The Central Bank of Cyprus’s claims on euro area credit institutions denominated in euro have been reduced from a peak of €11,4 billion in March 2013 to €4,9 billion in September 2015. Maintaining confidence is essential for financial stability.</td>
<td>Stable</td>
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<td>6. Liquidity squeeze and prolonged period of tight credit supply conditions owing to weak financial condition of non-financial corporations and households</td>
<td>Depositor confidence still vulnerable although deposit outflows have slowed considerably.</td>
<td>Stable; expected to improve.</td>
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II. Overview of financial sector developments and outlook

During the past year, strong policy action has been taken and the economic adjustment programme has been followed through - which has been an important factor to mitigate the impact of the high level of indebtedness and the vulnerabilities being faced in the financial sector. Cypriot banks are making headway in restructuring their non-performing loan portfolios. Recent improvements in the legal tools governing foreclosures may support the banks' loans restructuring, complemented by a modernised personal and corporate insolvency regime which should facilitate debt restructuring. Further, the country's return to modest economic growth after three years of real GDP contraction also helps the banks' restructuring efforts and reduces the risk of further increases in the level of non-performing loans.

Continued efforts are being made, such as the new legislation to expedite the transfer of title deeds which came into force in September 2015. Legislation to facilitate securitisation and the sale of loans is planned to be tabled in 2015Q4.

Recent developments

A key priority on the reform agenda has been addressing the high level of non-performing loans in the banking system and policy action has been taken to deal with this. The high level of NPLs reflects the severe recession. It also reflects the increasing number of strategic defaults according to anecdotal evidence from banks, especially given the positive asset position of households. However, latest available data indicate that NPLs may be reaching their peak.

While bank deposit outflows have slowed, non-performing loans have continued to rise, and credit remains impaired. Some signs of recovery have started to appear.

The new package of insolvency laws has been designed to help borrowers restructure their debt and should make it easier for banks to demand payment or seize assets. A debt-restructuring framework has been put in place, banks have put in place restructuring units, legislation to facilitate foreclosures was adopted in April 2015 and this has been complemented by a new modernised insolvency regime. More time is required to make a proper assessment as to whether there has been an improvement in the restructuring process due to the new legislation, however, the situation is being monitored. Implementing the measures effectively is a necessary condition for a sustainable stabilisation of the banking system.

The Central Bank of Cyprus (CBC) published an arrears-management framework (AMF) and the Code of Conduct in April 2015 to guide the loan restructuring process and developed a supervisory framework to monitor banks’ capacity and progress against operational and restructuring indicators. The AMF requires banks to implement efficient and effective structures, processes and tools to support arrears management and execute fair, adequate and sustainable debt restructurings. Incentives are now in place for banks to handle the excessive NPLs. Through this process, the pace of debt restructuring is expected to pick up.

Macroeconomic environment and public finances

The Cypriot economy has seen positive growth since the beginning of the year after almost four years of recession and economic performance continues to exceed expectations. Public finances remain on the upside exceeding initial expectations and there are some encouraging signs regarding the still very high level of non-performing loans in the banking system. Sovereign debt yields have declined, benefitting from purchases by the European Central Bank’s bond-buying programme that started in July. However, economic growth is still weak and high indebtedness levels remain a drag on economic activity. The unemployment rate remains elevated, but has stabilised at around 16% over the first half of 2015 and is forecast to steadily reduce.
Households and non-financial corporations sector
Domestic households and non-financial corporations (NFCs) continue to be highly indebted, with bank credit to the domestic private sector reaching the level of 280.2% of GDP at end-March 2015 and is significantly higher than the euro-area average. At high levels of indebtedness households and corporates are more likely to encounter payment difficulties in the face of shock to incomes. Households’ and NFCs’ debt-servicing capacity continues to be weak as reflected in the high aggregate debt service ratio and high non-performing bank loan ratios, especially in the case of loans to the broader real estate sector to which banks are highly exposed.

Despite the difficult outlook - the high levels of unemployment, declining household income as well as the very difficult operating environment for enterprises against a background of weak macroeconomic conditions - considerable progress has been made. Latest data indicate that NPLs may be reaching their peak, a modest recovery is beginning to appear and since 2014Q4 we observe a stabilisation in households’ and NFCs’ financial position. It is important that the new insolvency framework is efficiently implemented to help improve the high levels of indebtedness in the private sector.

Real estate sector
Regarding the housing market, prices may be bottoming out and could modestly increase in the medium-term, given emerging signs of renewed domestic and foreign demand. However, the prospects for recovery of the property market are difficult to predict with certainty. Close monitoring of property sector is necessary owing to its importance both for the asset position of households and for banks’ loan portfolios. Particular attention to the sector will need to be given, by closely monitoring the evolution of house prices as well as the risk profile of banks’ mortgage portfolios.

Banking sector
Following the escalation of the financial and banking crisis in Cyprus at the end of 2013Q1, following the bail-in of unsecured depositors, depositors’ confidence deteriorated rapidly. The three largest banks continue on the path to normalisation. A range of challenges remain for domestic banks. While profit levels remain low (see Chart 28, p. 18), the return to profitability is a necessary step in the development of a sustainable and resilient banking sector capable of supporting an increase in lending to finance the real economy.

The overall level of non-performing loans (at over 47% of the loan book – see Chart 34, p. 20) remains very high. A large portion of impaired loans are to the real estate sector to which banks are highly exposed and a significant amount of impaired loans arises in the non-mortgage loan book. While bank deposit outflows have slowed, non-performing loans have continued to rise, and credit remains impaired.

Low levels of new lending and the limited scope to increase lending margins, are expected to constrain the ability of domestic banks to increase their income. Tackling non-performing loans remains a critical issue.

Some signs of recovery have started to appear. Confidence is in the process of being repaired and there has been an increase in shorter-term deposits. Progress has been made with the setting up of restructuring units at the banks following the enactment of the new insolvency legislation. The maturity profile of funding remains weighted heavily to the short term. Customer deposits are among those short-term funds and are a stable funding source. Nevertheless, the general funding profile leaves domestic banks susceptible to volatile foreign funding sources.
**Insurance sector**

Although the insurance sector has fared better than the banking sector, the weak macro-financial climate remains a key concern. Profitability is constrained by weak premium growth. Persistently low interest rates could pose a risk to the life sector in particular, due to the impact on profitability and the difficulties in generating adequate investment income, especially as insurers are diversifying their investments. Regulatory changes are looming, with Solvency II coming into force on 1 January 2016, whereby insurance companies will be required to operate in a new environment with more effective governance and increased compliance requirements. Insurers will be required to value their insurance liabilities on a market-consistent basis, to re-examine their risks and raise any additional capital to stand against these risks. All in all, the sector stands relatively well prepared for the impending changes, with no major recapitalisation needs in sight.

**Investment funds and investment firms sector**

Cyprus has recently modernised its regulatory framework for investment funds. This, along with an increasing appetite of investors and fund service providers for EU-regulated jurisdictions, has seen a significant increase in the size of the investment funds sector. Overall, while the industry is susceptible to external developments and changing investor preferences, it does not pose a significant risk to the domestic financial environment given its small relative size. However, as the sector is growing rapidly and links to both the economy and the financial sector exist, developments are being monitored closely. With respect to Cyprus investment firms, their operations are to a large extent outside Cyprus. Even though the domestic operations of these investment firms are fairly limited, due to the growing importance of their operations, close oversight is warranted with regard to risk mitigation measures, governance and internal controls.

**Capital Markets Union**

The European Commission’s Capital Markets Union (CMU) is a growth initiative proposed in 2014, to create deeper and more integrated capital markets in the 28 member states. Almost 80% of credit in Europe is intermediated through the banking system therefore policymakers are now focusing on capital markets as a way to improve access to financing in Europe, particularly for SMEs. The aim of the CMU is to increase and diversify funding channels with a view to maximising the benefits of capital markets and non-bank financial institutions to the real economy. Non-bank financial institutions operate in areas such as venture capital, private equity investment, public equity issuance, corporate bond issuance, corporate debt securitisation, and captures activities such as loan origination by investment funds.

The CMU though raises a number of potential financial stability issues. Increased credit intermediation through non-bank channels will require oversight and monitoring in order to assess fully the potential vulnerabilities of this sector. The sector’s interconnectedness with the traditional banking system will also need to be examined further. From a monitoring perspective, a fairly large number of investment funds are registered in Cyprus.

Regulators are hindered both by data gaps in the European shadow banking sector and by the lack of regulatory tools for some non-bank financial institutions that are engaged in credit intermediation. Sufficient attention should therefore be devoted in the CMU to safeguarding financial stability, such as in the area of shadow banking. An assessment of the financial stability impact of the CMU should require an action plan for the collection and analysis of all relevant capital markets data across the EU from which macroprudential policy conclusions would then be drawn.

The Commission’s Action Plan on the Capital Markets Union that was published on 30 September 2015 will have to be critically assessed to ensure the safeguarding of financial stability.
Summary
The domestic economic outlook has improved since 2013, while there have also been some positive developments in the banking sector. Despite a challenging external environment, economic recovery continues. There is positive evidence that loan restructuring is proceeding at a faster pace. The macroeconomic environment has been improving and progress has been made in reforming the insolvency and foreclosure laws which will further support banks’ efforts to tackle the high level of NPLs.

There are, however, issues weighing on the macro-financial environment. These include high debt burdens in the private and public sectors and a large stock of NPLs. Furthermore, many geopolitical issues could affect the Cyprus financial system and the macro-financial environment. It is important that the necessary reforms are followed through to ensure a stable and steady recovery.
III. The new additional responsibilities of the Central Bank of Cyprus with respect to financial stability and macroprudential policy

In line with the Recommendation of the European Systemic Risk Board (ESRB) on the macro-prudential mandate of national authorities\(^1\), the amendment to the *Central Bank of Cyprus Law, June 2014*\(^2\) officially appointed the Central Bank of Cyprus (CBC) as the macroprudential authority of Cyprus. This new mandate is now part of the CBC’s general mission of contributing to financial stability. This new Law confirms the mandate of the CBC as the institution in charge of the timely detection and monitoring of developments which could harm the stability of the financial system.

Within this new institutional framework, the CBC is responsible not only for the detection and monitoring of systemic risks but also for their follow-up, including taking policy action when deemed appropriate. This requires the development of a clear macroprudential strategy and operational framework, foreseeing adequate tools for systemic risk identification and assessment, as well as effective macroprudential instruments to address identified systemic risks. In view of the importance of the new macroprudential mandate, the CBC has an obligation to report to the House of Representatives of the Republic at least annually on the performance of its mandate.

Macroprudential policy is largely a new territory which has been put into place in the EU only in recent years, and it is still far from being widespread among all the member states. Its implementation entails, *inter alia*, the evaluation of potential interactions with other areas of economic policy which have been in use for many decades. The implementation of macroprudential policy is therefore work in progress.

On the operational front, the European arrangements set out a number of macroprudential instruments that can be used, and also prescribe detailed notification and authorisation procedures which entail an effective coordination with the European Central Bank (ECB) and the ESRB. It is necessary to devote further efforts and resources on the monitoring of indicators, the calibration of instruments, the taking of macroprudential decisions and the assessment of their effect.

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\(^1\) Recommendation of the ESRB of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3), OJ 2012/C 41/01

IV. Macroeconomic environment

Signs of economic recovery and a subdued recovery have begun to appear following the rapid deterioration of macroeconomic conditions in the previous years due to the Cyprus Sovereign debt crisis and to the crisis in the domestic banking sector, the consequent resolution of the two largest banks and the agreement for an economic adjustment programme with the Troika. Previous macroeconomic forecasts have proved to be more pessimistic than what has actually materialised and economic sentiment is recovering after the events in March 2013. However uncertainty still characterises the outlook – economic growth is still weak and high indebtedness levels remain a drag on economic activity.

Domestic macroeconomic environment

During 2015 the economic growth in Cyprus was positive, with Gross Domestic Product (GDP) recording an annual increase of 0.8% in real terms in 2015Q2. This is lower compared to the euro area average increase of 1.6% (Chart 1). The outlook is positive and the latest forecast\(^3\) for GDP growth is 1.6% for 2015 and 2.0% for 2016.

Looking at the production and turnover indices of various sectors, it can be clearly seen that the sector which has been the most hardly hit is the construction sector, followed by the industry sector (Chart 2).

Focusing on the labour market, the unemployment rate remained high at 16.2% in June 2015 and showed a subsequent decrease since then having fallen slightly from its peak of 16.9% in October 2013, while the euro area average in June 2015 stood at 11.1% (Chart 3). Latest forecasts suggest the unemployment rate will fall over the next few years. From the perspective of the banking sector’s asset quality, the falling unemployment rate is expected to improve asset quality as households and corporates will be more capable to pay their loan instalments.

According to the Harmonised Index of Consumer Prices (HICP), inflation has decelerated considerably since late 2012 (Chart 4). Moreover, prices have entered into deflationary ground since December 2013. The year-on-year change in inflation rate of -2.1% is below the euro area average of 0.2%. Low energy prices are expected to keep HICP inflation in low territory in 2016.

As regards the balance of payments, the current account balance has been improving since September 2008 when an annual deficit of 19% of GDP had been recorded (Chart 5) and is at the level of 4.6% of GDP as at March 2015. In comparison to the euro area average which records a surplus at the level

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\(^3\) Central Bank of Cyprus forecast.
of 2.3% as at December 2014, the current account deficit is relatively large but is significantly improving. It is projected by the International Monetary Fund (IMF) that by the end of the year it will shrink further.

Economic sentiment in Cyprus has been improving considerably since 2013 reaching similar levels to that of the euro area (Chart 6). The Economic Sentiment Indicator (source – European Commission) shown in the chart is a composite indicator made up of five sectoral confidence indicators with different weights: industrial confidence indicator, services confidence indicator, consumer confidence indicator, construction confidence indicator, retail trade confidence indicator.

Further analysis on macroeconomic developments can be found in the Central Bank of Cyprus' Economic Bulletin which is published semi-annually⁴.

**Overall debt (public and private)**

The overall debt in the real economy as a percentage of GDP has been steadily rising, reaching 459.4% by the end of March 2015. Most of the increase during the last year is attributable to the general government (107% debt-to-GDP). However, non-financial corporations still have the biggest share in the overall debt (225%), followed by households (128%) (Chart 7).

**Aggregate private sector**

Debt overhang is still a problem for many households and non-financial corporations and the potential for adverse developments in the property market also exists. Downside risks remain with the high levels of private indebtedness and the large amount of non-performing loans leaving the economy vulnerable.

An upward trend in the bank credit to the domestic private sector has been witnessed over the past few years, due to the continuing fall in GDP, reaching the level of 280.3% of GDP at end-March 2015 compared to 272.4% a year earlier (Chart 8). The above developments are also reflected in the bank credit-to-GDP gap ratio, which is essentially the deviation of the bank credit-to-GDP ratio from its long-run trend. Both aforementioned ratios still remain substantially higher than the respective euro area averages.

Moreover, the private sector debt service ratio i.e. the ratio of debt payments to disposable income - which, in addition

to the principal payments, also captures the effect of interest payments and loan maturity, has followed a downward path since 2014Q2, reaching the level of 12.2% in March 2015 (Chart 9).

Loans to private individuals represented 40.4% of total outstanding loans to the domestic private sector at end-June 2015. As regards loans to NFCs, banks are significantly exposed to the broader real estate sector (i.e. loans to the construction sector, real estate activities and construction-related manufacturing activities), with loans to this sector of economic activity accounting for 24.7% of total outstanding loans to the domestic private sector at the end of June 2015. Loans to the wholesale and retail trade sector constitute the second highest exposure of banks to NFCs, amounting to 9.3% of total outstanding loans to the domestic private sector at end-June 2015.

Based on non-consolidated statistical data, the highest non-performing loans as a percentage of total outstanding loans concern loans to the construction sector at the end of June 2015. Looking at non-performing loans in each sector, the highest non-performing loan ratios in June 2015 were recorded in the construction sector (81.6% of total loans per category), mining and quarrying sector (77.2% of total loans per category) and agriculture, forestry and fishing (73.1% of total loans per category) sector.

Nevertheless, bank exposures to the last two sectors are relatively low in absolute terms. In contrast, banks are highly exposed to the construction sector. In general, non-performing loans to the broader real estate sector have been increasing, as the financial condition of land development and construction companies has deteriorated amid weak macroeconomic conditions and a very difficult operating environment.
V. Non-financial corporations and household sector

Domestic households and non-financial corporations (NFCs) continue to be highly indebted, with bank credit to the domestic private sector reaching the level of 280.2% of GDP at end-March 2015 compared to 272.4% a year earlier. High levels of debt can leave households and NFCs facing debt repayment challenges. Nevertheless, aggregate household and NFC indebtedness remained at a fairly stable level at 127.6% and 225.0% of GDP respectively, at the end of March 2015. At the same time, households’ and NFCs’ debt-servicing capacity continues to be weak as is reflected in the high aggregate debt service ratio and high non-performing bank loan ratios, which have reached unprecedented levels, especially in the case of loans to the broader real estate sector to which banks are highly exposed.

This section presents a concise analysis of the level of indebtedness and financial position of the main borrowers of the Cyprus banking system – the domestic household and non-financial corporations sector. It is based on the latest available data, mainly from aggregate statistics, monthly balance sheet data submitted by Monetary Financial Institutions to the Central Bank of Cyprus and from the quarterly financial accounts. In respect of the euro area comparisons, data is mainly taken from the European Central Bank Statistical Data Warehouse and from Eurostat.

Household sector

Bank loans

Based on the ECB methodology, total bank loans to domestic households fell annually by 1.2% in June 2015 compared with no change being exhibited in the respective euro area average in the same period (Chart 10). The decline is slightly larger when the annual percentage change of 1.4% in outstanding loan balances is considered.

The largest drop being observed is in consumer credit followed by loans for house purchase, the latter constituting the bulk of the loans (53.1%) granted to domestic households. Specifically, consumer credit and loans for house purchase recorded a year-on-year decrease of 3.0% and 1.8% respectively in June 2015, however we observe a decrease in the rate of reduction from the previous year.

Bank loans to households in foreign currency as a percentage of total lending have been showing a decreasing trend (Chart 11), but the share increased in 2015Q1 to 3.8%, primarily due to the Swiss franc and US dollar appreciation.

Non-performing loans

Based on non-consolidated statistical data, non-performing loans as a percentage of total outstanding loans to private individuals reached 55.7% at end-June 2015 (Chart 12), thus indicating that the financial position of households has been

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5 The calculation of annual growth rates for monthly Monetary Financial Institution balance sheet statistics is based on the ECB methodology, which takes into account net transactions but excludes reclassifications and revaluations. On the other hand, the calculation of annual percentage changes in outstanding balances includes reclassifications and revaluations in addition to net transactions.
deteriorating⁶. At the same time, loan loss provisions as a percentage of total non-performing loans to private individuals (coverage ratio) increased marginally to 19,5% in June 2015 compared with 19,2% in March 2015.

The latest available consolidated prudential supervisory data show that non-performing loans as a percentage of total outstanding loans to private individuals rose to 55,7% at the end of June 2015.

**Household debt**

At end-March 2015, household debt as a percentage of GDP reached 127,6% remaining fairly stable compared to the growth seen in previous quarters (Chart 13). This development shows that although domestic households remain over-indebted, especially when compared to the respective euro area average which is significantly lower at 61,2% of GDP, the trend is beginning to stabilise. Moreover, the changes in the ratio of household debt as a percentage of gross domestic income (GDI) have been more pronounced in recent years (the latest available data are for 2013) compared with those in the household debt to GDP ratio. However, in the last year this has fallen, suggesting an improvement in the debt servicing capacity of households over time.

**Financing conditions**

The Cyprus Monetary Financial Institutions (MFIs)⁷ average interest rates on euro-denominated loans for house purchase and consumer loans (new business) to euro area households has continued to reduce in 2015 with the convergence of consumer credit interest rates towards the euro area average. By June 2015, average interest rates amounted to 3,36% for house purchase and 4,57% for consumer loans compared with 4,4% and 5,74% a year ago, respectively. In comparison, the respective euro area MFI average interest rates stood at 2,02% and 4,88% in June 2015 (Chart 14).

**Net financial position**

Households’ net financial asset position (net worth) has been declining - to 109,9% of GDP 2015Q1 (Chart 15). This ratio continues to remain below the respective euro area average. It must be noted that an important contributing factor to the significant fall in the ratio in 2013Q3 had been the resolution of the two largest domestic banks and its effect on deposits as

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⁶ It should be borne in mind that data since September 2013 are not directly comparable with corresponding previous months due to the adoption of a new stricter definition of non-performing loans.

⁷ MFIs in Cyprus comprise of the Central Bank of Cyprus, all credit institutions operating in Cyprus, including Co-operative Credit Institutions (CCIs), and electronic money institutions
well as on net equity in life insurance and pension fund reserves.

On the same note, households’ financial liabilities as a percentage of financial assets has been increasing, reaching 57% in 2015Q1. At end-March 2015, loans still made up a significant proportion of all of the household sector’s financial liabilities (87.7%). Cash and bank deposits continued to represent the largest portion of households’ financial assets (63.8%), decreasing only marginally both in value and in share from the previous year (Chart 16).

**Deposits**

Based on the ECB methodology, deposits of domestic households recorded a year-on-year decrease of 5.2% in June 2015. The year-on-year drop in the outstanding balance of deposits was lower, reaching 1.4% in June 2015 compared with a decrease of 2.9% in March 2015 (Chart 17). A stabilisation in the level of deposits can be observed since 2014Q3.

**Residential property**

With regard to residential property, which is considered an important non-financial asset of Cypriot households, prices continued their correction, contracting by 6.5% 2015Q1 compared with the same period of 2014 (Chart 18). This was the twentieth consecutive quarter with a recorded decrease in residential real estate prices following the bursting of the property bubble of the previous decade.

**Non-financial corporations sector**

**Bank loans**

According to the ECB methodology, total bank loans to domestic NFCs increased by 0.5% year-on-year in June 2015 compared with an annual drop of 0.1% exhibited in the respective euro area average in the corresponding period. The outstanding balance of loans on the other hand fell annually by 6.6% in June 2015 (Chart 19).

Bank loans to NFCs in foreign currency as a percentage of total lending have been showing a decreasing trend (Chart 20), with this share increasing slightly in 2015Q1 to 9.4%, primarily due to the Swiss franc and US dollar appreciation, but decreasing again in the second quarter to 8.2%.
Non-performing loans

With regard to non-performing loans to NFCs, a significant upward trend has been exhibited since 2013 (Chart 21) with the first half of 2015 exhibiting signs of levelling. Based on non-consolidated statistical data, the ratio of non-performing loans to total outstanding loans to NFCs reached 67.0% in June 2015 compared with 62.7% a year earlier (June 2014) and 67.5% in March 2015, indicating a possible improvement of NFCs’ debt servicing capacity. In parallel, based on non-consolidated statistical data, loan loss provisions as a percentage of total non-performing loans to NFCs (coverage ratio) stood at 38.9% at the end of June 2015.

NFC debt

NFC debt as a percentage of GDP stood at 225.0% in March 2015 showing signs of stabilisation since the beginning of the year. Although domestic NFCs remain over-indebted, the upward trend may be levelling off. The NFC debt to GDP ratio is significantly larger than the euro-area average of 106.1%.

Financing conditions

The cost of financing for Cyprus NFCs has been reducing in 2015 compared to the peak levels in 2012 but continues to hover at high levels compared to the respective euro area average (Chart 22). The Cyprus MFI average interest rates on euro-denominated loans (new business) up to €1 million to euro area NFCs fell from 5.95% in July 2014 to 4.46% in July 2015. Nevertheless, the respective euro area average MFI interest rates stood at a considerably lower level in July 2015 (2.83%). At the same time, the Cyprus MFI average interest rates on euro-denominated loans (new business) over €1 million to euro area NFCs stood at 4.33% in July 2015. In comparison, the respective euro area average MFI interest rates stood much lower at 1.55%.

Net financial position

NFCs’ net financial liabilities remain high at 251.2% of GDP at end-March 2015 with a marginal decrease from last year’s level. Financial liabilities as a percentage of financial assets decreased slightly to 195.5% in 2015Q1 from 198% at the end of December 2014. These developments indicate that NFCs remain in a weak financial position, nevertheless we are seeing small signs of improvement.
Loans, equity and investment fund shares constitute the biggest components of the NFC sector’s financial liabilities (Chart 23). The share of equity and investment fund shares in financial liabilities remained stable at 42.6% in March 2015. Loans represent the largest part by a small margin, accounting for 43.8% of financial liabilities at end-March 2015. Equity and investment fund shares represented the greatest portion of the NFC sector’s financial assets at the end of March 2015 (59%).

**Deposits**

Deposits of domestic NFCs, following the resolution of the two largest domestic banks, recorded a significant decline. Following this, an increase was first recorded in June 2014, but this has not continued. Based on the ECB methodology, deposits of domestic NFCs exhibited a year-on-year decrease of 5.2% in June 2015. Similarly, the annual drop in the outstanding balance of deposits was 6.9% in June 2015 (Chart 24).
VI. Banking sector

Cyprus continues to recover from the crisis. Addressing the excessive level of non-performing loans in the banking system remains the number one priority. Steps have been taken to this end including approval of legislation to expedite the transfer of title deeds and new insolvency and foreclosure legal frameworks. Facilitating the sale of loans is planned for later this year. Implementing these measures effectively is a necessary condition for a sustainable stabilisation of the banking system.

One of the key objectives of the economic adjustment programme 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 of 25 March 2013.

Structural developments

The deleveraging process that was initiated as an end-result of the Greek sovereign crisis lead to a 52% reduction in the sector’s 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 end-June 2015 respectively (Chart 25) compared to 815% and 583% at December 2010 respectively.

At the same time, the number of credit institutions operating in Cyprus decreased from 150 (many of which were co-operative 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).

Market shares of domestic banks dominate at 64% market share of total consolidated assets (Chart 26). 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 (Chart 27) at 73%, followed by cash and cash balances with central banks (14%).

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8 The ‘domestic’ banks include the four domestically controlled banks plus the Co-operative Central Bank and the 18 co-operative credit institutions.
Financial condition

Earnings and profitability

Domestic banks returned to profitability in 2015Q1 (Chart 28). The first half of 2015 saw a reduction in impairment charges and provisions, as well as a reduction in net interest income.

Pre-tax profit of €285 million was recorded in 2015Q2. Although profitability has improved, it remains subdued and low levels of profitability in general are a concern for banks across the EU.

Improving asset quality is an important step in the recovery of 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 (Chart 29). In particular, measures were taken to constrain interest rates on loans with the consequent decrease in net interest margin. Net interest income stood at €1 billion as at June 2015 compared to €1.2 billion in June 2014, with decreases being recorded for both interest income and interest expense.

At the same time, net non-interest income recorded an annual increase of 27.5% in June 2015 compared to June 2014. Following the fall in lending rates and in interest margin, banks are focusing on increasing other sources of income, such as fees and commissions.

Net interest margin narrowed to 2.8% in 2015Q2, down from 3.0% in March 2015 (Chart 30), as the sector faced an increase in its cost of funding both through the slight increase in its deposit base but also through the regulatory measures taken by CBC to limit the level of interest rates on loans.

In fact, following a sharp decline in the net interest margin in March 2013 (1.7%), the indicator followed an increasing trend since then, due to the prudential intervention of CBC for the reduction of deposit interest rates in April 2013, and decreased again in 2014Q3 when lending interest rates were reduced. As such, lending margins are fairly stable but may come under even more pressure as a result of the low interest rate environment and flattening yield curves. Bank profitability might therefore be squeezed further if banks cannot compensate for this by increasing loan volumes and/or reducing credit risk, which is quite challenging in the current climate.
The majority of the credit institutions in Cyprus focus on traditional intermediation activities and derive the largest part of their earnings from net interest income. Consequently, the tightening of credit standards, in conjunction with the fall in demand for credit, has led to lower lending volumes and thus depressed credit institutions’ revenues. This trend is expected to continue in the medium-term as deleveraging is one of the key measures taken for the restructuring of the sector, adversely affecting revenue generation.

A decline in operating expenses was noted in 2015Q2 compared with the same quarter last year, with operating expenses and staff costs declining by 7.0% and 10.6% on an annual basis respectively, accounting for the reduction in the number of employees, salary decreases and branch closures as a result of the restructuring of the sector (Chart 31). Consequently, there was a slight improvement in the operating efficiency with the cost-to-income ratio for the banking sector decreasing to 35.3% at June 2015 (Chart 32). Domestic banks’ cost-to-income ratios remain significantly lower relative to the weighted EU average (62% as at mid-2014) and compared to ECB consolidated banking data one of the lowest in the EU, representing an additional positive outcome on future profitability.

The decrease in operating expenses outweighed the reduction in operating income with total operating profit recording a small annual increase of 0.4% at end-June 2015. Lower impairments of €672 million were recorded in the year to June 2015. This, along with lower operating expenses has resulted in a slight improvement in the profitability compared to last year’s results.

Banks’ profitability efficiency, measured by the return on assets and the return on equity, showed signs of improvement in 2015, with a slight reduction in 2015Q2. As shown in Chart 33, the annualised return on assets (ROA) (after tax) was 0.6%, while the annualised return on equity (ROE) was 5.2%.

Credit and asset quality
One of the most significant challenges faced by the sector is undoubtedly the acute deterioration in asset quality and the rising level of non-performing loans. During the second half of 2013, the worsening in the macro-economic environment and of the borrowers’ repayment ability was mirrored in the sharp increase in problematic loans, with non-performing loans calculated according to a new stricter definition. The quality of banks’ loans has continued to decline with non-performing loans representing 47% of the sectors’ loan portfolio as at June 2015 (Chart 34).
The introduction of the new definition of NPLs in September 2013 revealed the true magnitude of the problem. Although the definition of non-performing loans in the past excluded credit facilities that were fully collateralised by tangible collateral, the aggravation in the sector’s asset quality was evident from the trend of the non-performing loans and coverage ratios.

At the same time, the adequacy of loan loss provisions, measured as a percentage of total non-performing loans stood at 31.7% at the end of June 2015 remaining at a stable level since mid-2014.

The foreclosures legislation is an important catalyst in tackling the NPL situation, one which aims to bring customers to the negotiating table and allow the customer and bank to find a solution together.

**Funding and liquidity**

Domestic banks’ overall funding levels have stabilised following the increase in funding risk after the bail-in of unsecured depositors and the erosion of confidence in 2013. A number of positive developments since then are noteworthy. First, banks managed to decrease their reliance on central bank funding by €3,0 billion between September 2014 and September 2015 (Chart 35). The Central Bank of Cyprus’s claims on euro area credit institutions denominated in euro have been reduced from a peak of €11,4 billion in March 2013 to €4,9 billion in September 2015. Second, liquidity in the sector has benefited positively from the successful recapitalisation of the Co-operative Central Bank by the State for €1,5 billion in March 2014, as well as Bank of Cyprus and Hellenic Bank from private sources. Moreover, banks have regained access to unsecured and secured money market funding. Aggregate deposit outflows have been reduced substantially.

Negative developments, for example, geopolitical tensions, could trigger renewed deposit outflows however, we consider the developments and the outlook as positive against the backdrop of increased liquidity buffers and the recent stability of foreign deposits. Access to medium- and longer- term funding at sustainable cost remains a challenge for the Cyprus banking system as central bank funding still represents a significant proportion of the sector’s funding base (Chart 36), however this is steadily reducing.

**Capital adequacy**

The return to profitability, albeit at relatively low levels, provides a support to capital. Capital ratios are seen as an important indicator of banks’ resilience to potential future losses. Cyprus domestic banks’ common equity tier 1 ratio
averaged 15.1% in June 2015 compared to 12.9% in June 2014 mainly as a result of the capital increases at the largest banks and due to loan deleveraging (Chart 37). Ensuring their capital bases are sufficient to meet regulatory requirements remains a priority for domestic banks, given the high level of NPLs on their balance sheets.

As at June 2015, the overall solvency ratio increased to 16.2%, while the Tier 1 capital ratios stood at 15.5%, reflecting the sector’s successful recapitalisation and steps towards deleveraging that aid the reduction in risk-weighted assets, despite the deterioration in the asset quality of the sector.

Risk-weighted assets of the banking system have shown signs of stabilising following the sharp decline after the events of 2013 with the disposal of Greek operations and the resolution of Cyprus Popular Bank. The reducing trend has continued in 2015Q2 mirroring the deleveraging taking place (Chart 38). Overall, risk-weighted assets decreased by 5.4% on an annual basis as at June 2015.

Own funds and Common Equity Tier 1 capital have remained fairly stable after the large increase in March 2013 and the injection of new capital as a result of the ECB’s Asset Quality Reviews and the European Banking Authority’s EU-wide stress tests of 2014.

**Regulatory developments**

A number of reforms to supervision and regulation have occurred in the regulatory framework of credit institutions since 2013, in line with the terms and timeframe agreed in the Memorandum of Understanding (MoU) between the Republic of Cyprus and the International Monetary Fund (IMF), the European Central Bank (ECB), and the European Commission (EC).

The *Resolution of Credit and Other Institutions Law, 2013-2014* was introduced to include recovery and resolution of credit institutions; the supervision and regulation of the co-operate credit institutions was assumed by the CBC in September 2013; the maximum limits of the credit facilities to directors and qualifying shareholders were revised while internal governance requirements dictating that the majority of the Board of Directors of banks should be independent were introduced.

The internal governance of credit institutions has been enhanced through amendments to the existing framework, through the Directive on Governance and Management Arrangements in credit institutions in August 2014. This Directive provides, *inter alia*, for the composition,
organisation, functions and main responsibilities of the management body; for the remuneration, compliance and risk management frameworks, as well as for the system of internal controls.

Furthermore, the definition of non-performing loans (NPLs) was amended through the issuance of the Directive on the Definitions of Non-Performing and Restructured Credit Facilities, 2013 to reflect international practices such that any loan that is in arrears for more than 90 days is considered as non-performing, irrespective of the value of the underlying collateral.

The Directive on Arrears Management, 2013 established the framework on arrears management, as well as a Code of Conduct between credit institutions and borrowers such that feasible, successful and sustainable restructurings are performed. Along these lines, the role of mediation service between credit institutions and their clientele has been expanded to attain fair debt restructuring. Credit institutions report quarterly performance indicators and targets to the CBC, enabling the latter to monitor the restructuring progress and management of non-performing loans.

The Directive on Loan Origination Processes and Processes of Reviewing Existing Loans, 2013 regulates aspects relating to the processes and practices followed by credit institutions in granting advances and loans to customers. Its aim has been to shift lending away from asset based criteria towards borrower’s repayment ability.

Additionally, loan provisioning and impairment practices are regulated through the Directive on the Loan Impairment and Provisioning Practices, 2014-2015, that sets out the procedures to be followed in the identification, assessment and measurement of loan impairments and the disclosure requirements of policies, valuation methods and analysis of the loan portfolio. The directive aims at ensuring prudent application of the relevant IFRS in this area and that credit facilities requiring provisions, as indicated by the existence of a trigger event of impairment, are correctly and timely identified and adequate provisions are recognised, either on an individual or collective basis. In the case of property collateral, prudent assumptions should be taken into consideration in calculating the value assigned to property for the purposes of measurement of the impairment amount. The directive also requires credit institutions to make appropriate and relevant disclosures in their financial statements that reflect the quality of their loan portfolio and their provisioning policies and levels to aid users to evaluate the nature and extent of the risks undertaken by them.
The Directive for the Operation of a Mechanism for the Exchange, Collection and Provision of Data between the Credit Institutions, 2013 establishes the setting up of a credit register that aids credit risk and large exposures monitoring as it enables participating institutions to identify the indebtedness and creditworthiness of each borrower.

Furthermore, stress testing has been integrated into regular off-site supervision.

The Directive on the Preparation and Submission of Recovery Plans prescribes the minimum arrangements and measures to be included in a resolution plan, which is required under the Resolution of Credit and Other Institutions Law, 2013-2014.

Moreover, the transparency and effectiveness of the anti-money laundering framework has been enhanced through the strengthening of preventive measures and the establishment of trust registers while the customer due diligence framework was improved.

A debt-restructuring framework has been put in place and banks have set up restructuring units. Recent legislation in April 2015 to facilitate foreclosures has been adopted and this has been complemented by a new modernised insolvency regime. This new package of insolvency laws has been designed to help borrowers restructure their debt and should make it easier for banks to demand payment or seize assets.

A new legislation that will allow banks to sell loans to third parties, which is part of Cyprus’s macroeconomic adjustment programme, is expected to be passed by the end of the year which will aim to assist banks relieve their balance sheets from non-performing loans.

**Risks facing the credit institutions sector**

In the medium term, credit institutions face a number of potential risks as they continue to operate in a subdued environment. Credit risk stemming from lending to domestic households and NFCs remains highly elevated, as witnessed by the rising non-performing loans ratio and its high level in relation to GDP, while the reduction in their debt-servicing capacity emanating from the prolonged economic recession could lead to a further deterioration in the sector’s asset quality. Rising non-performing loans, in combination with ongoing corrections in real estate prices, would result in high loan loss provisioning levels and thus exert significant pressure on credit institutions’ bottom-up results and capital levels. Should property prices continue to fall beyond the current expectations, banks’ would need to recognise additional impairments on non-performing loans, leading to a negative
impact on capital and profitability. However, we are currently seeing property prices bottoming out and if this trend continues, a positive outcome is expected.

Additionally, credit availability is already tight for borrowers, as also indicated by the results of the latest ECB Bank Lending Survey of April 2015. The credit institutions sector’s stressed liquidity and capital adequacy position, along with asset quality pressures and weak macroeconomic conditions, have resulted in the tightening of credit standards for loans to both households and NFCs. The resumption of the provision of satisfactory credit to the real economy is still a way away. Without access to credit, consumer consumption and domestic investments will remain subdued, inhibiting quick economic recovery. Initiatives taken by European organisations, such as the European Investment Bank (EIB) and the European Regional Development Fund (ERDF), in cooperation with domestic credit institutions, to finance new loans to eligible SMEs, are expected to have a positive impact on credit availability.

Inevitably, credit institutions have no option but to actively manage loan arrears, including the sale of loan collateral if needed. It should be highlighted though, that the sale of loan collateral should be undertaken with care as mass disposals would result to sharp reductions in real estate prices, creating feedback loops between the real economy and the financial sector.

While tensions over sovereign default have eased recently, there could be a risk of deterioration in the sovereign’s ability to meet its obligations due to weak public finances. However, the strong implementation of the MoU’s structural reforms so far seem positive.

The economic uncertainty in Greece and any potential political uncertainty could pose a downside risk for Cyprus credit institutions sector.

Concluding, addressing the high level of NPLs remains the key priority to restore credit and support growth. The new insolvency and foreclosure frameworks are a major step forward, significant progress has been achieved so far, however further efforts are required.
VII. Insurance sector

The domestic insurance sector has been subject to a period of weak premium income growth due to the operating conditions associated with a weak economy and low interest rates. While recent moderate improvements in the economic climate, if maintained, should serve to support the sector, the persistence of the low yield environment continues to present challenges to the profitability of both the domestic life and non-life sectors. Domestic insurance firms have extensive links to financial markets through their asset holdings, while adverse events that might emerge in the sector may impact economic activity.

Intense competition in difficult operating conditions has resulted in profitability concerns emerging in the insurance sector, with profitability becoming increasingly reliant on investment returns. Life insurance firms face challenges in generating profitable new business. The introduction of Solvency II on 1 January 2016 could pose implementation challenges for some firms in the sector and could see some mergers or acquisitions.

This section reviews the major developments in the domestic insurance sector and provides an assessment of the potential risks to which insurers are exposed. The analysis focuses on the 25 domestic business insurance undertakings that conduct all or the majority of their business in Cyprus and are supervised by the Insurance Companies Control Service (ICCS) of the Ministry of Finance. The assessment was based exclusively on data provided by the ICCS. The latest available data used for the assessment was as at 31st March 2015 using individual statistics submitted by companies along with the investment registers where data was available until June 2015.

Structural developments – size and concentration

Insurance companies operating in Cyprus are classified into life, non-life and composite companies, i.e. which carry out both life and non-life business.

The domestic insurance market is characterised by a persistently high degree of concentration, as measured by gross written premiums, with concentration levels being substantially higher in the life business. Specifically, the share of premiums of the three largest life business undertakings rose to 83% in March 2015, whereas the respective share for non-life business fell to around 42% (Chart 39).

Financial condition

Premium growth and production

Owing to the adverse economic environment, the insurance sector recorded a significant decline in premiums written in 2012, 2013 and 2014. The decline had been sharper in the life sector, reflecting both weaker demand and the lesser propensity of banks to sell bancassurance products, given life business’ sensitivity to the prevailing state of the economy.

Whilst gross written premiums remain muted, the situation has somewhat improved since the adverse events of March 2013. Specifically, total gross written premiums in March 2015 decreased by 3.3% compared to the previous year (Chart 40). The challenge for life-insurance companies is to attract new
business and income, which are key drivers of future profitability given the long-run focus of the sector.

Claims and lapses
Further to a significant increase in lapse rates in the life business during the previous years, primarily driven by the loss of confidence in the banking sector, lapse rates have begun to stabilise (Chart 41). While the effect was smaller for unit-linked policies where the investment risk is borne by the policyholder, substantial future fee income that covers expenses was forgone. Future revenues have now started to recover.

For non-life business, claims and expense ratios relative to earned premiums have remained stable reflecting insurers’ efforts to contain costs and foster operational efficiency. Although fraudulent claims are more common during periods of recession, reflecting economic and social conditions, this has not been witnessed. The combined ratio\(^9\) of 75% as at March 2015, still stands well below 100% thereby signalling profitable underwriting activity.

Assets and investments
Due to the economic recession, the total assets of the domestic insurance sector decreased significantly between 2011 and 2012, and by a further 8.6% between 2012 and 2013 to €2.5 billion. A small increase of about 1.1% and 1.5% was observed during 2014 and 2015 respectively. Investments constitute the largest asset item in the balance sheet of domestic insurers, accounting for 87% of total assets, as at June 2015. Own investment\(^10\) amounted to €1.29 billion, with life insurers having the largest share (66%). In addition to insurers’ own investment, €1 billion is held in unit-linked funds, where the policyholder bears the investment risk.

Cash and bank deposits constitute the single largest own investment category at around 29% of insurance companies’ own investment assets as at June 2015, followed by debt securities split between the corporate (23.7%) and government (9.8%) segments. This makes insurers important for the provision of financing to both governments and firms. As shown in Chart 42, since December 2013 we are seeing a shift in investments from government bonds to corporate bonds, a reduction in the proportion held in cash and deposits.

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9 Combined ratio is calculated as follows: Incurred claims plus expenses as a proportion of premiums earned. Relates the total cost of claims incurred plus expenses to gross premium earned and is an inverted measure of the profitability of the underlying insurance underwriting activities.

10 Own investments constitute the investments where the insurer bears the investment risk (unit-linked investments are excluded)
and a significant increase in the proportion held in investment funds.

As shown in Chart 43, in the life sector, investments are more widely diversified, with corporate bonds constituting the largest assets class, whereas for non-life insurers, a large proportion is held in cash and deposits followed by property and also corporate bonds.

**Solvency and capital adequacy**

Insurance undertakings supervised by the ICCS are required to maintain capital levels at least equal to the regulatory Minimum Solvency Margin\(^{11}\) or the guaranteed amount\(^ {12}\), whichever of the two is higher.

The average solvency position\(^ {13}\) of the insurance undertakings under review remained fairly stable (Chart 44), increasing slightly in March 2015, especially for life companies. It should be noted that the dispersion of solvency ratios on the individual insurer level was rather extensive, mirroring the wide discrepancy in the individual capital adequacy levels. On average, though, the insurance sector’s shock-absorption capacity remains satisfactory.

**Risk facing the domestic insurance sector**

**Low premium growth and new business:** The recent recession and the absence of economic growth has adversely affected the insurance business with a clear reduction in insurance premiums, mainly in the life business. Nevertheless companies continue to show positive revenue results, and their solvency coverage position remains stable.

**Liquidity risk:** The liquidity of insurers was negatively affected by the banking developments in 2013 and the restrictions imposed on bank transactions which led to an increase in the surrender of policies. In combination with the slow economic development and the reduced demand in real estate, the liquidity risk is expected to remain for insurance companies and even increase in some cases.

**Property investment risk:** The fall in property values, along with the illiquid aspect of this investment creates an additional burden on insurance companies who are big investors in the property market. Further reductions in property values could be expected following the recent approval of the foreclosure

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\(^{11}\) Calculated for every insurer individually, based on ICCS rules.

\(^{12}\) Based on ICCS rules, at the end of December 2012, the guaranteed amount for both life and non-life business increased to €3,7 million from €3,5 million.

\(^{13}\) Free available assets divided by minimum solvency margin.
legislation, which may create the need for additional capital for some insurance undertakings.

**Reduced profitability:** The increase in the surrenders and lapses of policies for life business and policy cancellations for non-life business exerts a downward pressure on in-force portfolios and on written premiums. Life insurance companies are facing challenges in generating new business which is profitable and the fall in in-force business will lead to the need for reduction of expenses.

**Credit risk:** Due to the adverse economic conditions, insurance companies are finding it increasingly difficult to collect the premiums due from customers and agents, and debtors’ balances are increasing.

**Concentration risk:** Following the imposition of capital controls in the aftermath of the events in 2013, restrictions in transactions affected the ability of insurance companies to reduce their high concentration in certain counterparties, mainly local banks. Due to the upcoming Solvency II risk-based requirements, the low credit ratings of local banks could create additional capital requirements for insurance companies. Following the removal of capital restrictions, insurance companies are moving deposits to banks with better ratings, locally or abroad, or to other types of investments which need lower capital requirements.

**Low interest rate environment:** The low interest rate environment which is a major concern in the European insurance market is now affecting Cyprus insurers as well. Interest rates earned on deposits and bonds have been falling, reducing not only investment income but also increasing life technical provisions due to the use of lower valuation rates.

Diversification of investments is key under Solvency II due to the high capital charge in the case where investments are not diversified adequately. Insurers are therefore turning towards investment funds and banks abroad despite the lower returns/yields. A shift of investments towards corporate bonds can also be witnessed (see Chart 42).

The life sector continues to face challenging operating conditions as the low interest rate environment impacts on the profitability of the guaranteed products previously sold by these insurance companies. New products with guarantees are not being sold anymore. Life insurers’ long-term liabilities means they will have to reinvest in new - lower-yielding in the current climate - assets when their investments mature.

**Solvency II requirements:** The new Solvency II Directive comes into effect on 1 January 2016. Insurance undertakings will be
required to operate in a new environment with increased regulatory and compliance requirements. Insurance companies are required to re-examine their governance arrangements and also their risk taking and raise additional capital against these risks.

Solvency II aims to increase the financial stability of insurance undertakings and enhance policyholders’ protection against the insolvency of insurance undertakings by setting capital requirements that better reflect the risks faced by insurance companies. However, its introduction may have implications for the financial stability of the insurance sector in Europe and in Cyprus, but also indirectly for other financial sectors with which insurance undertakings are interconnected, through their long term funding, such as to banks and governments.

The EIOPA Solvency II stress test of 2014, which tested the resilience of insurers throughout Europe, showed no cause for major concern for domestic insurers. Although the results showed that some small to medium non-life companies had a solvency deficit, corrective actions have been taken ever since, one of which being the reduction of their exposure to Cyprus banks.

Implementation of the Cyprus General Health Insurance Scheme (GHIS): Medical insurance constitutes a substantial component for a large number of life and non-life insurance companies’ premium income (€99 million for 2013 representing approximately 14% of their total premium income). The implementation of the GHIS without the participation of insurance companies would lead to a major reduction in their business.

**Overall assessment and outlook**

It has traditionally been recognised that insurance companies, given their role to mitigate risk and their often long-term investment horizons, often support financial stability. Especially in the case of life insurers, their investment policy is driven by the need to ensure adequate and predictable cash flows over time. Insurers’ balance sheets, unlike those of banks’, are composed of relatively long-term liabilities that protect insurers against the risk of rapid liquidity shortages that can and do confront banks. As a result, insurers tend to have a long investment horizon and can serve as a source of stable and secure investment during times of crisis.

Insurers are important for the stability of the financial system due to their large investments in financial markets, as large buyers of equities, sovereign bonds and corporate bonds, their

14 Source - ICCS
close links to banks and other financial institutions which can cause risks of contagion, and their importance in the safeguarding of the stability of household and corporations’ balance sheets by insuring their risks.

The insurance sector can, however, be a source of vulnerability for the financial system, and the failure of a large insurer may create financial stability concerns. Thus, a credible and effective recovery and resolution framework in the insurance sector is needed. The European Commission plans to table a proposal for the recovery and resolution of insurance companies which would be a positive factor towards further enhancing financial stability.

The outlook of the sector remains fairly challenging and risks remain on the downside. The recession in all sectors of the economy, the reduced trade and investment activity, the high unemployment and the reduction in salaries and household expenditure have significantly reduced new business volumes and have weighed on the earnings prospects and profitability of the sector. The main challenges for the sector include the muted economic growth and its impact on the ability of the sector to attract new business and retain existing clients. However, a revival of the insurance industry can be expected through the new amendment of the occupational pensions law which allows insurance companies to write group pension business.

With regulatory changes looming, namely Solvency II, significant additional challenges for the insurance sector are expected, not only in terms of the need for increased capital requirements but also in terms of more effective and formal governance arrangements. All in all, the sector stands relatively well prepared for the impending changes and there are no major recapitalisation needs in sight.
VIII. Investment funds and investment firms sector

The global investment fund industry has witnessed significant growth in recent years, a trend strongly anticipated to continue. The investment funds sector in Cyprus is also growing. In addition, experienced and established service providers, together with favourable conditions, mean that Cyprus’ investment funds sector has the potential of developing into a competitive fund jurisdiction. Cyprus offers both EU-regulated Undertakings of Collective Investment in Transferable Securities (UCITS) and alternative investment funds. The law on Alternative Investment Funds (AIFs) enacted in July 2014, provides for a framework similar to that of Europe’s main investment fund hubs like Luxembourg, Ireland and Malta. This legislation increases Cyprus’ competitive offering by modernising the existing legal framework and opening the market to the registration of new types of funds.

Investment funds do not guarantee the set investment objective will be met and the risk underlying their activities is borne in whole by the holders of participation units in them. Therefore, investment funds’ activities do not generate risk to financial system stability. A potential deterioration in the financial condition or capital position of the investment firms managing them should not negatively impact the assets accumulated in the investment funds they manage. The operations of the Cyprus investment firms are to a large extent outside Cyprus. Even though the domestic operations of these investment firms are fairly limited, due to the growing importance of their operations, close oversight is warranted with regard to risk mitigation measures, governance and internal controls.

This Section reviews developments in the Cyprus investment funds sector which are components of the overall domestic financial sector. The assessment was based exclusively on data provided directly by the investment funds to the CBC.

Key structural developments

The investment fund (IF) sector in Cyprus comprises of the Alternative Investment Funds (previously known as International Collective Investment Schemes) which are regulated and supervised by the Cyprus Securities and Exchange Commission, investment companies which are listed on the Cyprus Stock Exchange and Undertakings for Collective Investment in Transferable Securities (UCITS) funds resident in Cyprus.

Included within the definition of IFs are undertakings whose units or shares are, at the request of the holders, repurchased or redeemed directly or indirectly out of the undertaking’s assets; and undertakings which have a fixed number of issued shares and whose shareholders have to buy or sell existing shares when entering or leaving the fund.

As at June 2015, the domestic investment funds sector was composed of 78 reporting entities with total assets of €3 billion (Chart 45).

The resident investment fund sector has expanded considerably - more than doubling in size since 2008 - but remains very small compared to total financial sector assets (1.8% as at March 2015). The ratio of investment funds’ assets to GDP was approximately 17% as at March 2015.

However, this increase can also be attributed to the registration and entry of a number of funds over the last few years. Holdings of shares and other equity dominated, accounting for the majority of the
increase in assets and for approximately 75% of the total sector’s investment assets under management as at June 2015 (Chart 46). Non-financial assets (at 4%) include property investments.

Investment funds in Cyprus continued to be dominated by other non-financial corporations (NFCs) which owned over 38% of these funds, with other financial intermediaries\(^\text{15}\) (OFIs) also having a substantial share (33%) as shown in Chart 47.

There are two notable features regarding Cyprus investment funds that are important for macro-prudential risk analysis and systemic relevance; (i) the amount of resident funds held and (ii) the ownership of the holdings.

First, the dominant investors are non-euro area residents with holdings as at June 2015 of 45%, with euro area investors holding 11% of funds (Chart 49). Domestic investors own 44% of investment funds, as measured by the value of units/shares. A large fund entered the sector in September 2013 whose shareholders are domestic companies, which substantially increased the proportion of domestic residency in the sector.

Focusing on domestic investors, the largest share of holdings were by NFCs (62%) followed by other counterparties (19%) and by households (16%); for euro area investors the split was more spread mainly between NFCs (36%) and the OFIs (32%); and for non-euro area and non-domestic investors the largest share of holdings was by OFIs (65%). This is illustrated in Chart 50.

Second, the majority of assets are invested domestically and in the euro area i.e. the assets (e.g. securities, loans, deposits) of investment funds are predominantly located within Cyprus and the euro area (Chart 48). Holdings of equity were dominant; with a skew towards shares on the domestic stock exchange (44%), followed closely by shares quoted in the euro area (40%). In the domestic area, the funds were invested almost exclusively in shares issued by non-financial companies.

As such, direct links to the Cyprus economy exist; a significant proportion of assets are located domestically whereas liabilities, such as the ownership of equity shares in funds, are mostly located abroad (Chart 48) i.e. investors are foreign residents.

Risks to Cyprus’s financial stability from domestic investment funds remain limited. Direct linkages to the domestic financial system and economy exist but are not very significant due to the small overall size of the investment fund sector compared to total financial sector assets. However, the sector keeps growing in size so this is an area which will continue to be monitored.

In addition, there seems to be no or limited interconnectedness between the investment fund industry and the domestic banking sector, as the predominant domestic asset allocation is in shares.

\(^{15}\) OFIs are non-MFI financial intermediaries other than insurance corporations and pension funds that include for example, investment funds, financial corporations engaged in lending (e.g. financial leasing, factoring, consumer credit etc.), financial vehicle corporations, financial holding corporations and securities and derivatives dealers
issued by non-financial companies. Exposures to sovereign debt remained negligible.

The assets of these entities are fairly spread between Cyprus, the euro area and the rest of the world, with a predominance of assets within Cyprus, whilst their liabilities are located abroad, mainly outside the euro area.

The systemic relevance of the domestic investment funds sector remains limited since households hold only a small proportion of their gross household financial wealth in domestic investment funds.

The industry is susceptible to external and regulatory developments and at present, global and domestic funds and OFIs face a period of uncertainty owing to possible regulatory changes.

The recent financial crisis has shown that shadow banking could be a source of systemic risk in some countries' financial systems. Oversight continues to improve, with parts of the non-bank financial institution sector being subject to regulatory intervention through statistical data collection, disclosure rules (Prospectus Directive and Transparency Directive), market integrity rules (Market Abuse Directive) and funds regulations (UCITS Directive and Alternative Investment Fund Managers Directive).

Overall, while the industry is susceptible to external developments and changing investor preferences, it does not pose a significant risk to the domestic macro-financial environment given its small relative size. However, the sector is growing rapidly and some links to both the economy and the financial sector exist, warranting the continuous monitoring of developments.