Benoît Cœuré: Laying the foundations of the Cypriot recovery

Keynote speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the 10th Cyprus Summit "Current developments in the euro area", Nicosia, 4 November 2014.

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Ladies and gentlemen,

Today is an important day for the ECB and the euro area. The ECB has become the banking supervisor for the euro area, directly supervising 120 significant banks, including four banks based in Cyprus. This marks the single biggest step in European economic integration since the inception of the euro. We are ready for this step, but we are also very well aware of the important additional responsibility we will be taking on.

The economic and financial landscape is changing, not only in the euro area but also here in Cyprus. Since the start of the international financial assistance programme, important steps have been taken to stabilise and restructure the banking system, correct macroeconomic imbalances and create the conditions for a renewed economic recovery. My main message today is that a healthy and well-functioning banking system is crucial in this regard, both in the euro area and in Cyprus.

But let me begin by saying a few words on the economic situation in the euro area.

I ask for your understanding that my remarks on the economic outlook should not be construed as providing indications on the perspective monetary policy stance of the ECB, as we are in the so-called quiet period, during which the members of the Governing Council refrain from comments on the current outlook for monetary policy. The legacy of the crisis - weak demand, high debt and unemployment- continues to weigh on the pace of growth. Unless an adequate mix of monetary, fiscal and structural policies is in place to create confidence and sustain private consumption and investment, we once again run the risk of a self-fulfilling loss of momentum and a delayed recovery.

From our side, we are fully committed to play our part in this policy mix, which is to fulfil our mandate and bring inflation back towards 2%. But it is also clear that our monetary policy stance can only have its full impact on the real economy if the banking system is in good financial shape. Let me therefore turn to a key step we are currently taking which will support that process: the ECB's comprehensive assessment of bank's balance sheets.

The comprehensive assessment

The comprehensive assessment was one of the pillars of our preparatory work before taking over banking supervision. It involved over 6,000 experts at the ECB, national competent authorities, and private firms. The exercise comprised both the asset quality review, which harmonised the valuation standards and accounting practices, and the stress test, which measured the resilience of banks to adverse macro-financial shocks.

Nearly two weeks ago, the results of the comprehensive assessment were published. Let me recall here some of the key findings. The adverse scenario of the comprehensive assessment would lead to a capital reduction in the euro area banking sector by €263 billion, including a €25 billion shortfall for those banks that were found to be non-compliant with minimum capital requirements. The asset quality review found that euro area banks should increase their provisions and adjust the asset valuations by a total of €48 billion. And the total non-performing credit exposures under the harmonised definition employed in the asset quality review would increase by €136 billion in comparison to the banks' own definitions.

We expect that the rigour of the exercise and the unparalleled degree of transparency brought about by the public disclosures will improve public confidence in the banking sector.

Banks have already responded to the announcement of the ECB comprehensive assessment and strengthened their balance sheets by over €200 billion prior to the completion of the exercise. This includes €2.5 billion of capital raised by two Cypriot banks.

Looking forward, the comprehensive assessment confirms that the vast majority of euro area banks are already able to support the economic recovery. On average, the capital levels of the banking sector exceed the regulatory minimum requirements by a large margin. Those banks which face a capital shortfall have undertaken remedial action and will reach the required capitalisation levels. Banks are therefore on the whole well equipped to withstand a severe economic downturn. The ECB will now use the unprecedented amount of information that has been gathered on the directly supervised banks to enforce a strict and evenhanded supervisory approach across the euro area, and carry forward the harmonisation effort across member states.

Inadequate supply of credit should therefore no longer be the main constraint on viable businesses and good lending opportunities. The most recent results of the ECB bank lending survey, which were published last week, point to this direction. Euro area banks continued to ease their credit standards in the third quarter of this year for all loan categories.

Nevertheless, the repair of the banking sector is not sufficient by itself to bring about robust growth. Risk premia and the cost of borrowing for the private sector remain high in large parts of the euro area. There are remaining hurdles to a credit recovery emanating not only from subdued domestic demand, but also from the high level of corporate sector debt and, in many places, business environments and tax structures that stifle private investment.

Governments should therefore continue to build on the progress achieved in their budgetary position and implement structural reforms. Our experience with adjustment during the crisis – for example in the Baltic countries – shows that, on the whole, frontloaded reforms yield better results than a more gradual approach. If reforms are implemented rapidly, wages and prices can adjust quickly – without becoming entrenched in expectations and drawing out the disinflationary process – allowing growth to recover swiftly.

Such policies will help the real economy to overcome financing challenges and fully benefit from our very accommodative monetary policy. Growth in the euro area can also benefit from the completion of the single market in services. If the right policies are implemented, the euro area could significantly increase its growth potential. By raising permanent income, this can encourage consumption and investment, lift the purchasing power of households, and recreate fiscal space already today.

Benefits for Cyprus

These points are particularly important for Cyprus. Banks are an essential part of the service-oriented Cypriot economy. In fact, healthy banks are crucial to pass on the expansionary stance of monetary policy to the real economy via the provision of credit to households and businesses.

The comprehensive assessment concluded that the two largest Cypriot banks, which have raised €2.5 billion of capital this year, are resilient to an adverse macro-financial scenario. The third one, Hellenic Bank, is undertaking measures to improve its capital position and address the shortfall.

The conclusions of the comprehensive assessment come after a period in which the Cypriot banking sector has been facing major challenges. Following EU entry in 2004, significant foreign inflows led to a rapid expansion of the banking system, with its total assets peaking at seven times GDP. Easy credit fuelled a housing boom and an increase in private sector debt to over 300% of GDP, which stretched private sector balance sheets. The challenge now is to restore the financial intermediary function of the banking system in support of Cypriot households and companies, while it restructures and becomes less leveraged.

Since the start of the financial assistance programme, Cyprus has achieved a lot. Responding to the seriousness of the economic situation, the Cypriot authorities took unprecedented measures. For example, two systemically important banks were resolved and the resulting institution was recapitalised. Domestic and external payment restrictions were imposed. And the government has started implementing a sizeable fiscal adjustment, and is carrying out some important structural reforms aimed at improving the functioning of the economy in a durable way.

Those measures were painful and they have imposed a large short-term cost on the economy and Cypriot society. But they have started to pay off.

The restructuring and recapitalisation of the banking sector have led to a significant improvement in the health of the financial system. Payment flows have normalised, while the domestic payment restrictions have been gradually lifted. The current account deficit of the balance of payments has almost been eliminated, from a peak of 15.6% of GDP in 2008. The general government deficit has fallen by around half from a peak of close to 6% of GDP in 2012, consistently over-performing the fiscal targets in the programme. Those achievements are impressive and command respect from the rest of Europe. They have helped Cyprus to regain access to international capital markets earlier in 2014.

Looking forward, the successful completion of the comprehensive assessment should not be seen as the end of the efforts to put the banking sector in the best position to serve the Cypriot economy. Overcoming the legacy of the crisis requires further crucial steps.

The quality of bank assets continues to be a cause for concern. *At more than half of the total loan portfolio*, non-performing loans (NPLs) are the highest in the euro area, and among the highest following any recent banking crisis. Addressing the high level of NPLs is critical. NPLs are a major hurdle to the provision of credit to the economy, as the attention of banks is diverted to the work-out of legacy problems instead of looking forward to profitable business opportunities. Exposure to the fragile property market remains in banks' balance sheets.

The new foreclosure framework is necessary for the resolution of the high levels of NPLs. Taking into account last week's decision of the Supreme Court, it is now time to make a major push in this regard. Fundamental drivers do not fully explain the NPL levels observed in Cyprus. Under the legislation prevailing before the recent reform, there were insufficient incentives for borrowers and lenders to find solutions to restructure debt. The foreclosure process in Cyprus could take 10 to 15 years, much longer than in most other countries. In the absence of a credible perspective of the collateral being seized, borrowers' payment discipline has been adversely affected.

What follows is that there is an urgent need for implementing legislation that speeds up private sector debt restructuring. This does not necessarily mean that this legislation will lead to a widespread increase in foreclosures. What matters is that sufficient incentives are in place for borrowers and lenders to collaborate in case of repayment difficulties and to work out solutions acceptable to both borrowers and lenders.

In addition to a strong private sector debt restructuring framework, banks will also have to step up their efforts to reduce their NPLs in other ways. For example, banks will have to further enhance their operational capacity to manage NPLs, and to become more alert in identifying prospective NPLs.

Addressing the high levels of NPLs needs to be embedded in a broad structural reform strategy, building on what has already been done under the programme. Regarding property markets, there is an urgent need for stepping up the reduction of the backlog of title deeds and streamlining their issuance process. This is a very important area given its significance for restoring demand for property and reducing the cost of credit. Securitisation could be used to offload the risk to specialised investors, if the legal framework is established to facilitate the transfer and work-out of bank assets.

In addition, fiscal policy should continue on the path of consolidation, which is needed to ensure fiscal sustainability, consolidate access to international capital markets and further restore confidence in the Cypriot economy. This should be complemented with measures to make the economy more efficient and attractive to domestic and foreign investors, such as reforming public administration, improving corporate governance and privatising state-owned enterprises. Experience shows that reforms pay off. And other euro area countries that have implemented reforms in recent years are now starting to reap the benefits.

Conclusion

Ladies and Gentlemen, a healthy and well-functioning banking system is indispensable for a sustainable economic recovery. Unprecedented steps have been taken to strengthen the banking sector, both in the euro area and in Cyprus.

The successful completion of the comprehensive assessment creates the potential for credit supply constraints to diminish, supporting the economic recovery. The ECB will play its part by enforcing a strict, fair and harmonised supervision of euro area banks. It is, however, essential that the progress achieved so far in the restructuring of the banking sector is accompanied by the completion of legislation that would facilitate incentives for borrowers and lenders to cooperate.

This means reforming the legal framework for private debt restructuring, coupled with further implementation of the measures agreed under the programme. We should not expect to see a notable decline in NPLs, a pick-up in credit and a sustainable recovery in Cyprus unless this issue is addressed forcefully.

Cyprus’ achievements command respect and are starting to pay off. It is time to build on them and make a decisive step forward.

Thank you for your attention.