Constantinos Herodotou: Address - Annual General Meeting of the Association of Cyprus International Financial Firms (ACIFF)

Address by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, at the Annual General Meeting of the Association of Cyprus International Financial Firms (ACIFF), Nicosia, 10 February 2022.

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It is my pleasure to address the open session of the Annual General Meeting of the Association of Cyprus International Financial Firms (ACIFF) today and present the current situation of the Cyprus and European banking sectors as well as the challenges ahead. I will also try to shed some light on the trends and developments in the banking industry.

Let me start with an update on the Cyprus banking sector. We are now almost a decade after the peak of the Financial Crisis in Cyprus and looking at our banks' key financials, we observe a significant balance sheet derisking and an improvement in their loss absorption capacity. This is despite the shocks caused by the on-going pandemic. Specifically, the capital position of our banks, measured through the common equity tier 1 ratio rose from 14,2% at the end of 2014 to 17,2% at the end of September 2021. This is well above the EU average of 15,7%. In addition, during the same period a noteworthy clean - up from non-performing loans has taken place, where troubled loans in the banking sector have been reduced from 28,3bln euros in 2014 to 4,3bln euros in October 2021. Nonetheless, the NPL ratio in the Cyprus banking sector is still high, ca. 15,2% as at October 2021. Although this has been drastically reduced from the peak of 48% back in 2014, it is still well above the EU average of 2,1%. Therefore the efforts for further deleveraging must be continued.

The liquidity position has also improved. The level of deposits is currently at the highest level ever recorded since 2014, amounting to 51,5b Euros with the reliance on domestic depositors climbing to 82% as opposed to 70% in 2014. This adds to the resilience of the deposits base since these depositors are associated with a more predictable and stable behaviour. The Liquidity Coverage Ratio, indicating the availability of liquid funds against deposit outflows over a 30 day stressed period, stood at the level of 313% in December 2021 which is more than 3 times higher than the minimum requirement of 100%, placing Cyprus amongst the most liquid banking sectors in the Union, where the average LCR amounts to 175%.

At the European level, including Cyprus of course, the banking sector faces a number of challenges. The profitability prospects of banking both in Cyprus as well as across the EU remain challenging.

But why is profitability an area of interest for regulators? A sustainably profitable banking sector is necessary to build buffers to absorb unexpected losses, like the ones we have seen recently due to the pandemic. It also enhances further the ability to provide viable lending to businesses and households alike, contributing to the efficient functioning of the real economy.

Under this light, banks' profitability is high on the agenda from a regulatory perspective. The level of Return on Equity of European Banks is shy on their cost of capital and below the respective level of other jurisdictions, like banks in the United States. A low Return on Equity compared to the Cost of Capital is a European structural issue and raises the need for formulating appropriate action plans, both by regulators and banks alike. If we want these actions to have an impact, we must first understand the factors that drive this weak performance.

Overcapacity of the banking sector is a dominant factor. According to most indicators there are too many banks in Europe relative to the size of the market. This implies that there is significant scope to benefit from consolidation without exacerbating the problem of "too big to fail" through the creation of mega banks. Moreover, the Banking Union which has ended a prolonged supervisory divergence enhances the capability of reaping these benefits in a more efficient manner.

Credit risk is inherent in banking and is considered a major challenge for the European banking sector. For countries that have a high level of legacy non-performing loans like Cyprus, this risk requires particular attention, despite the tangible improvement achieved in the last years. A weaker than expected economic environment may result in deterioration of asset quality. It is therefore important for our banks to continue the enhancement of the quality of the asset side of their balance sheets, bridging the gap with our European peers.

European Banks are also facing emerging risks beyond the traditional business model risks I just mentioned.

I will focus on the three I consider as the most prominent ones.

The first one is the exposure to climate-related and environmental risks, which will be one of the main concerns for both supervisors and banks in the years to come. The transition to a green economy comes at a cost and this will affect the banks through various channels, the most prominent one being their exposure to businesses that produce high carbon emissions. It is therefore of paramount importance for banks to develop appropriate strategies and risk management practises to alleviate the long-term, direct and indirect, effects of climate change. From the regulatory perspective, we are conducting for the first time a climate related stress test for the Significant EU bank Institutions and we are also planning to carry out both on site and off site inspections to assess the readiness of the banks to deal with this type of risks. Let me be clear; both banks and supervisors are still on the learning curve with regard to climate-related and environmental risks. However, we both need to adapt and we need to adapt as soon as possible.

The second emerging risk, is the IT and cybersecurity risk. The constantly increasing employment of digital strategies by banks which has been boosted further by the pandemic and the banks' increasing dependence on IT infrastructures raises the need and the requirement to constantly enhance their protection against cyber threats. According to the Bank of International Settlements as well as the International Monetary Fund the financial sector ranks high in frequency of cyber security events when compared to other sectors and these events have tripled over the last decade. The interconnectedness of the financial system means that a successful attack on a major

financial institution may spread rapidly through the financial system with potential adverse effects on the stability of economies.

In addition to the risks mentioned above, banks are also facing increasing competition emanating from new entrants in the market.

For example in Cyprus, there are currently 15 authorised electronic money institutions and 10 authorised payment institutions. But that number is likely to change dramatically. There are currently at the Central Bank of Cyprus 44 pending licencing applications (33 EMIs and 11 PIs), which is twice the figure compared to the applications pending only a year ago. Notably, this number is significantly higher than the 11 local and foreign authorised banks and subsidiaries in our country.

In the last few years, payments services regulation has allowed a number of payment institutions to make use of the banking industry's interfaces for accessing payment service users' accounts online.

These Fintech companies, which possess some advantages over traditional banks such as state-of-the-art technology and no legacy operating infrastructures, have taken advantage of the opportunities offered by payment services regulation and exert additional competitive pressure on banks. Licensed Payment Institutions and Electronic Money Institutions, are smaller (in terms of size and complexity), and have a competitive advantage in terms of cost structure and overheads. Moreover, due to the fact that they are not licensed to hold customer deposits, in other words they are not banks, they are not burdened by red tape. However, they cannot effectively operate without the existence of traditional banks nor can their business model be sustained without banks. Bank accounts and customer deposits are a basic pillar for the functioning of the payments ecosystem. Therefore, the co-existence of these institutions and traditional banks is at the same time competitive and dependent. Competitive because PIs/EMIs have gained market share from traditional banks with respect to payment services and dependent because they rely on traditional banks in order to provide these services.

In addition to the provision of payment and e-money services, a number of authorised PIs and EMIs in the EU are offering further (non-regulated) services such as peer-to-peer lending, data analytics, information and communication technology related services, consultancy services, in-game payments and other payment-processing products. As customers have become more willing to consume products online, they have also become more open to buying other services bundled with their payments provided by fintechs, which often have better ways than banks for leveraging customer data. This is particularly evident in the case of the "BigTechs", especially those which have acquired a Payment Institution or Electronic Money Institution license, and have challenged banks' traditional data gatekeeper role.

There are two schools of thought when one sees these developments from a traditional bank's perspective. One is that, a number of banks have been viewing PIs and EMIs as competitors, and have been avoiding any business relationship with them other than the minimum required by the legal framework. The other approach is the banks which have

viewed these entities as facilitators, an opportunity for growth and development. There are benefits to be reaped when combining the network reach and regulatory expertise of incumbent banks, with the versatility and innovative, agile operating model of fintechs.

A few weeks ago, we had an example of a global bank which views these entities as facilitators. In the European Fintech landscape, JPMorgan agreed to acquire a 49% stake in Viva Wallet, an EMI based in Greece. This is subject to Regulatory Approval. According to JPMorgan, this strategic investment sets the stage for expanding their digital payment offering to European SMEs.

So, What will be the landscape of banking in the near future.

Digitalisation in banks could be the solution to a number of issues, such as containment of costs and also keeping up with the new profile of consumers which are more technology-savvy and have less time to spend for making bank visits. Widely available digital innovations such as e-IDs, e-signatures and digital on-boarding solutions are available to facilitate the digitalisation of banks. To this I would like to note an initiative I undertook at the CBC to create a digital customer onboarding platform for banks in Cyprus. After a number of bilateral meetings with banks, a large number of them have confirmed they will join It. The technology we will use will be scalable. The Central Bank of Cyprus is aiming to publish the tender for the technology provision in the very near future.

EU-based banks should optimise their customer experience altogether, bearing in mind that the Single Market is borderless especially when it comes to digital services. For digitalisation to really deliver on efficiency, the digital strategy needs to be part of a wider reshaping of the business model and a streamlining of internal organisation. There aren't many examples of banks which have taken sufficient advantage of the Single Market opportunity, but, on the contrary, quite a few EMI's have done so and have acquired an important market share outside their home member-state, with the Cypriot market not being an exception.

Artificial intelligence and robo-advisory, distributed ledger technology and smart contracts, data analytics and cloud computing, are only some examples of the available technologies to build the digital bank of the future. Of course, as supervisors, we need to make sure that financial stability and prudential soundness are preserved, while at the same time allowing for technological innovation.

Dedicated interfaces (or Application Programming Interfaces as they are widely known), need not remain just a regulatory requirement for banks, built to "tick-the-box". These interfaces, could prove to be much more than just a regulatory requirement to serve payment institutions, due to their ability to seamlessly integrate banking services into an e-commerce experience, providing additional outlets for banking products and opportunities to enhance one's customer base. Their "open architecture" nature enables such services to become scalable and economically sustainable even when they are offered through small e-commerce sites with a limited sales volume.

In addition to rationalising the cost structure, banks need to identify avenues to enhance their income capacity.

Last, but no least, consolidation can further enhance efficiency through reaping cost-cutting synergies created through economies of scale. Nevertheless, this will be determined by market forces and the shareholders of credit institutions.

Let me now conclude.

The transformation of banks' business model towards digitilisation may give them the opportunity in the long term to enhance their profitability by rationalising their cost structure and providing more efficient, tailor - made services to their customers. Nevertheless, the underlying risks of this transformation should not be ignored. The competition from Fintech such as EMIs and PIs leaves no room for complacency to banks. They need to adapt to the demands of the new era regardless of which school of thought, which I mentioned earlier, they belong to.

Climate related and other emerging risks, like cybersecurity, must be taken into consideration during the transformation of business models in order to safeguard sustainable growth.

It might be pertinent to recall what Charles Darwin said: "It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change".