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Woes of our banking sector: What are the underlying reasons?

As we are all aware, our banking sector is facing considerable challenges with our two largest Cypriot banks seeking state aid to achieve the desired Core Tier 1 capital ratio, set by the European Banking Authority (EBA).

The main problems started late last year with the infamous Greek PSI (Private Sector Involvement) and the overnight loss of about €4b from the sector and our economy.

Furthermore, the banks' huge exposure to the Greek economy (estimated at around €25b) as well as to the real estate sector here in Cyprus, led to a substantial climb in their non-performing loans following the rapid deterioration in the economies of both countries. Someone could also argue that the expansion in foreign markets (mainly the Balkans and Eastern Europe), although profitable in the boom years, proved risky and expensive in the late recession years.

As a result of all these problems, the banks have continuously been downgraded by the credit rating agencies, which automatically implies loss of confidence from investors and increase in the cost of borrowing.

I need to point out though here that the reasons for the banks' or sovereign downgrades (as expressed in the rating agencies' reports) is not solely a result of the banking crisis, but also due to the fiscal problems faced by our government and the structural problems that our economy is facing and need to be resolved.

But why did the banking sector end up in this unfortunate situation? What are the underlying reasons?

One factor is certainly a rather "loose" regulatory supervision that allowed individual banks, as well as the overall banking sector, to increase to such an extent that it dwarfs the GDP of the country (is approximately eight times its size), and take excessive risks without properly diversifying their portfolio.

Unfortunately, and as it was pointed out many times in the recent past, we created institutions that are "too big to fail" but also "too big to save"!

It's ironic that people kept praising the regulatory authorities for protecting the banking sector from toxic products (asset/mortgage-backed securities, collateralised debt obligations (CDO), credit default swaps (CDS) at the height of the global banking crisis of 2007-2009, products that led to the collapse of banking and insurance giants all over the globe, such as Lehman Brothers, AIG, or Bear Sterns.

Then, in a few years, we find out that the simplest of the securities and "supposedly" the least risky (sovereign bonds) were to prove so fatal that they brought our banking sector to its knees.

Another underlying reason for the crisis is certainly the excessive risks that banks have taken, either in the form of cheap credit given out to real estate developers without properly assessing the risks involved, or the overexposure to the Greek economy and Greek government debt, without properly diversifying their investment portfolio.

Buying risky securities (even from the secondary market) is acceptable given that the organisation properly assessed the risk and hedged the exposure (using credit default swaps was certainly one way).

Here of course is the classic example of moral hazard, i.e. bank executives taking risky investments knowing that in case of a negative outcome the burden would not fall on their shoulders. Obviously in case of a positive outcome, they would be the ones to reap the rewards with big bonuses.

One could also argue that the lack of proper and effective corporate governance practices was also a prime determinant for the crisis.

Good corporate governance practices can create shareholder value through transparent disclosure of the organisation's activities to its shareholders, holding directors accountable, and creating an effective two-way communication between the board and the shareholders.

There are internal and external mechanisms that organisations can utilise to achieve these objectives.

Internal mechanisms include the establishment of independent board of directors with non-executive directors and the establishment of specialist committees (audit, risk, and compensation).

External mechanisms can include legal duties imposed on directors, listing rules of exchanges that have to be adhered to, honest reporting of financial performance, and external audit of financial and other statements.

Unfortunately corporate governance has failed in this situation, and this should prove an important and useful lesson not only for the two main banks, but for a number of other organisations in Cyprus.

Finally, the global financial crisis that started from the US in 2007 and eventually spread to Europe in the form of a sovereign debt crisis is certainly a major underlying reason behind our country's problems.

This highlights the impact of globalisation and how contagion effects can propagate financial crises from one region or country to another.

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