



Financing the New Economy



By George Theocharides

**Cyprus International
Institute of Management**

One of the biggest obstacles to kick-start our economy and return it to growth is obviously the lack of sufficient liquidity in the market to finance consumers and businesses. This is a natural phenomenon given the fact that almost all financing comes from the banking sector, and we all know the problems that they face and their need to leverage. This will take some time and in the process the banks will be reluctant to give out new loans. So how can we deal with this pressing issue? Can something drastic happen with the banks that will allow them to provide liquidity to the market? Could we discover or develop alternative forms of financing, i.e. non-bank financing?

The fact that Bank of Cyprus recently raised ?1 bln of new equity from foreign investors is very important as it will increase its capital ratio, allow it to pass the upcoming ECB stress tests with ease, and thus bring back confidence to the system. I hope that Hellenic Bank will also find ways to raise its share capital prior to the stress tests (by issuing more shares, or converting contingent convertible bonds into share capital), and that the Cooperative Central Bank will also manage to pass the stress tests without any extra government support. Furthermore, the legal framework in relation to foreclosures and the forced sales of mortgaged property will need to be put in place, mainly to put pressure on the loan holders that can, but are reluctant now to service their loans, to start doing that. Unfortunately, there is no other way. If these things happen, I expect that by the beginning of the next year the situation can improve with at least more effective restructurings happening on problematic loans. It's also important in the restructuring process for the lending rates to gradually drop as it is very difficult for individuals/businesses to service their loans. But as I have already pointed out, I don't see many new loans being issued as the deleveraging process will have to continue.

Therefore, since the banking sector will not be able to finance adequately the new economy, we will need to find alternative ways. This is a trend that we will see not just in Cyprus, but across the whole of Europe. As capital requirements have become stricter following the recent bank failures, bank financing will gradually be replaced by other sources. Recent statistics showed that in the US, bank lending constitutes only 25-30% of the available financing, with the rest coming from the capital markets and the shadow banking system.

SHADOW BANKING

But what is a shadow banking system? A system that provides bank-like activities through non-bank financial intermediaries, such as hedge funds, money market mutual funds, and securitisation vehicles. These entities receive funding through short-term borrowing and use these sources to provide leverage for corporations, or for securities trading. They have the benefit that they are not subject to the same strict regulations imposed on the traditional banking system.

In Europe though (including of course Cyprus), it's the reverse, with the majority of financing coming from the traditional banking sector, but this trend will gradually change. If we had a well-functioning capital market, we would not be in such a difficult situation right now.

We will also need to turn to innovation in order to help the financing of our small and medium enterprises (SMEs), which form the bulk of our economy. What could be such an innovation? "Peer-to-Peer" platforms, such as MarketInvoice, or SME Markets that operate in the UK could be such an innovation. MarketInvoice brings together small firms with investors through an electronic marketplace, whereby small firms sell their unpaid invoices at a discount. Small firms receive the liquidity they so badly need, while investors get a rate of return for the services they provide. SME Markets is an online marketplace that brings together and matches borrowers and lenders, and operates as a facilitator offering expert financial assistance. The benefit is that it makes lending more accessible to companies in need, but also more cost efficient.

We also need to utilise more foreign structural funds. The recent interest in Cyprus of institutions such as the European Bank of Reconstruction and Development (EBRD), the European Investment Bank (EIB), the International Finance Corporation (IFC - a member of the World Bank), or KfW (a German government-owned development bank) is in the right direction and we need more of that, if we want to kick-start our economy.

Finally, in order for these alternative forms of financing to have an effect, there needs to be the right legal framework, companies in Cyprus need to start providing reliable and timely financial statements for lenders to assess, and the new economic model that is envisioned by the government needs to incorporate other industries (apart from the traditional ones, such as energy and technology) to give choices to foreign investors where to lend.

**George Theocharides is Associate Professor of Finance
and Director of MSc in Financial Services at the Cyprus International
Institute of Management (CIIM), www.ciim.ac.cy**