The Future of Banking in Cyprus

January 2023

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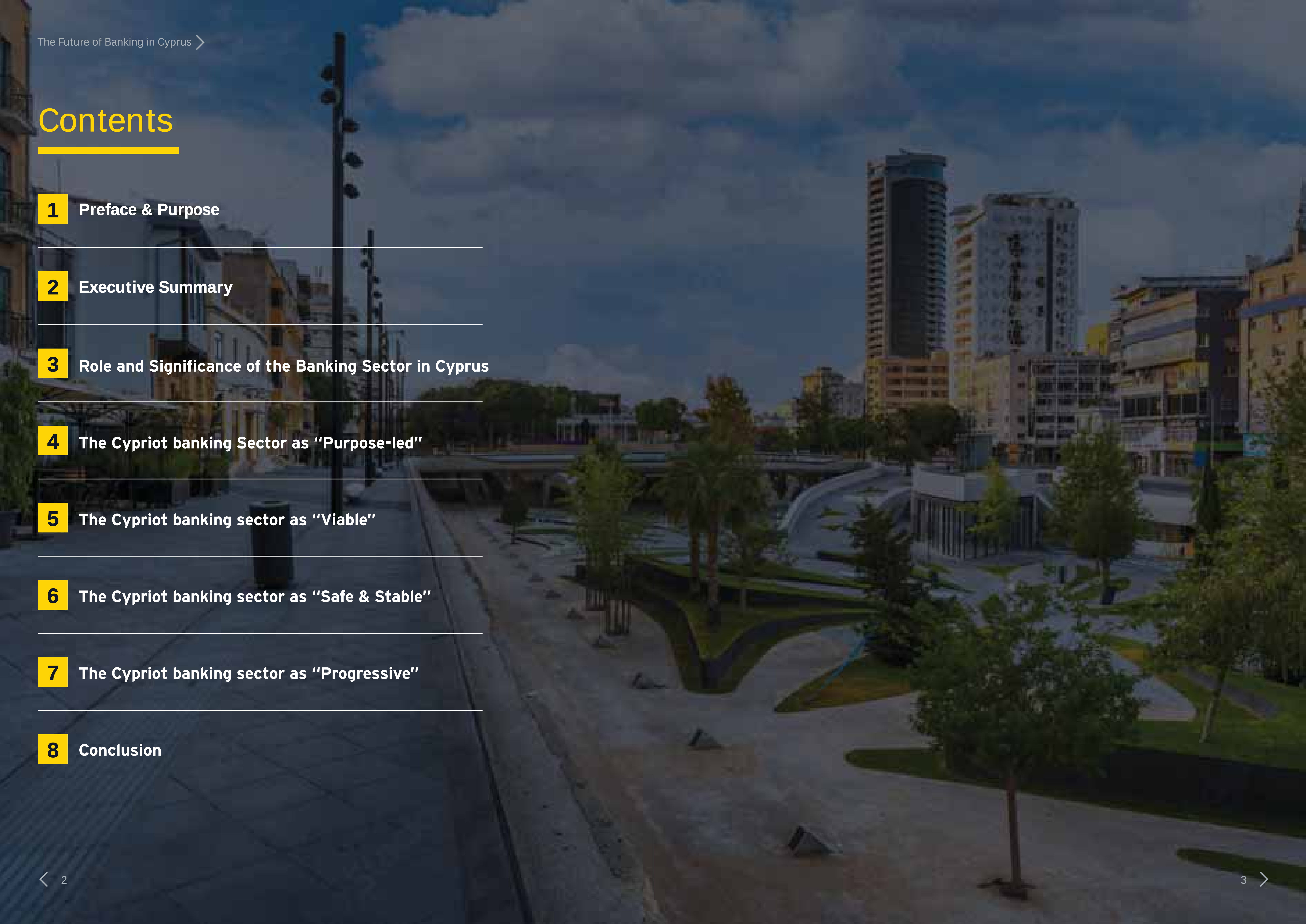

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1 Preface & Purpose

We have come a long way since the time banks acted purely as credit lenders and safekeepers of peoples' wealth. Nowadays, banks support us in most financial transactions we do, from paying for our coffee, to receiving our salary, settling suppliers, being paid by clients, managing our wealth. Banks support economic growth and prosperity in society through solutions to our needs.

The Cypriot banking sector is at an inflection point; technological advances, changing customer preferences, increasing competition from the rise of FinTechs, high cost-to-income ratio, growing importance of funding the green transition and record high inflation are some of the challenges that are already changing the landscape and shaping their future. Challenges usually hide opportunities, hence effective response and quick adaptation may unlock significant value for banks.

Transformation initiatives were already underway in the sector prior to global events, such as Covid-19 and the war in Ukraine. The pandemic, hand in hand with the Russia-Ukraine war, have resulted in an accelerated transformation pace and a new set of market developments altogether. Such developments endanger the sector's viability and stability threatening to offset the positive outlook created post the recent deleveraging efforts. Digitalisation, sustainable profitability and green financing, are currently at the top of the agenda for Cypriot banks.

Purpose:

This report by EY, supported by the Association of Cyprus Banks (ACB), showcases the importance and contribution of Cypriot banks to the wider economy and society, identifies current and upcoming challenges and opportunities, and ultimately conveys messages to banks and stakeholders to embrace change and progression framed against a set of four key pillars:

- A Purpose-led Banking Sector
- A Viable Banking Sector
- A Safe & Stable Banking Sector
- A Progressive Banking Sector

The report has been developed in consultation with local banking experts and senior industry representatives. It seeks to provide an overview of the sector as we know it today and to present a framework for collaborative and forward-looking discussion. There are many factors, challenges, and opportunities to reflect on as we debate and consider the future of banking in Cyprus.

2 Executive Summary

The Cypriot banking sector is a fundamental pillar of the country's economy with one of the highest Gross Value Added (GVA) contributions in the Eurozone (EZ); 6.6% compared to the EZ average of 2.8%. Banks (ACB members) employ more than 7,400[1] people and usually contribute approximately 4% of the state's annual tax revenues[2].

After almost a decade of deleveraging efforts, the credit to gross domestic product (GDP) ratio is approaching the Eurozone average (80% as of December 2021)[3]. However, despite offloading large amounts of NPLs to asset managers, these toxic exposures still remain as part of the economy

The banking sector emerged from the coronavirus pandemic relatively intact, supporting borrowers and the economy alongside impactful Government initiatives. The Russian invasion in Ukraine though, has shaken up economies and political relationships globally, causing disruptions in the production and supply chain of international trade with ripple effects on European economies.

Euro-wide sanctions against Russia have a negative effect on energy bills in Cyprus, as the island is heavily dependent on imported energy, highlighting the need for an accelerated green transition. Record breaking levels of inflation have moved markets and are anticipated to stress borrowers' repayment ability.

The rapidly changing socioeconomic environment in Cyprus signals the need for a thorough analysis of the local banking system's current state, to pave the way towards the future. The diverse needs and expectations of banks' stakeholders (i.e. regulators, shareholders, employees, customers, suppliers) are often conflicting. Cypriot banks need to balance their targets, requirements and contributions amongst stakeholders' demands, while at the same time improve core operations to run digitally and efficiently.

A framework of four pillars strives to shape the future of banking in Cyprus. These pillars aim to create a banking sector that is:

- Purpose-led: Balances the expectations of different stakeholders while it targets for long-term value creation to the society by respecting the environment and societal needs, promoting equality, and instilling trust.
- Viable: Ensures sustainable profitability and simultaneously delivers value to customers and shareholders to stay competitive.
- Safe & Stable: Acts in the best interest of the customer, is transparent and ensures financial robustness by surpassing regulatory compliance and consumer protection standards.
- Progressive: Is forward looking, adopts innovative technologies, embraces future trends and remains resilient to future challenges.

Key Findings based on the 4-Pillar Framework

Purpose-Led Banking Sector

A purpose-led banking sector places sustainability and societal contribution at the core of its operations and decision-making. A purpose-led sector is committed to advancing towards a greener future, meeting customer expectations and sustainably creating value other than monetary, for the greater benefit of society.

Green transition & ESG

In line with the Paris Agreement, Cyprus is committed to reaching specific environmental targets by 2030 and 2050. Cypriot banks, exploiting their gravitas in the economy and wider society, will play a pivotal role in the island's 'green transition'. The current energy crisis is boosting demand for green financing. Banks could contribute to the 'green transition' by designing green products whereby favourable lending terms are granted to borrowers pursuing environmental sustainability. Green banking products form a win-win situation for banks, borrowers and the society in general.

The framework of Environmental Social Governance (ESG) facilitates the essence of purpose-driven action; a banking sector with an ESG focus is one that seeks to be a leader in environmental sustainability, whilst also being socially beneficial and willing to take accountability for its actions.

An important step forward is currently being taken with ESG reporting. Regulators are working hard to establish standards of reporting. Regulatory pressure though, led banks to focus on ESG reporting first rather than ESG strategy.

A comprehensive ESG strategic plan is the key to achieving financial efficiency and growth goals. A strong ESG proposition links to value creation in top-line growth, cost reduction, productivity uplift and asset optimisation. Through an ESG strategic plan, banks can get quantitative information that measures the value they are getting back for their efforts, which would allow them to keep up with competitors, align with stakeholder interests and prepare for long-term success.

[1] EBF
[2] ACB, EY analysis; Tax Department annual Reports
[3] (CBC); (ECB); (ECB); (Eurostat)

For banks, the challenges associated with ESG may currently seem to be overwhelming compared to the visible benefits and opportunities. Internal cultural changes, short-term trade-offs over long-term benefits, and added risk management on top of the already high regulatory pressure are some of the challenges banks are (to be) facing.

Experts suggest that each bank has to establish a special ESG task force and develop tools that will enhance solid ESG data collection. As ESG reporting is expected to become a regulatory requirement, monitoring and assessment of ESG actions will be key in increasing the operating efficiency of Cypriot banks.

Instilling trust

Improving and repairing trust with the public should be a strategic priority for Cypriot banks. The 2013 events still echo in the public perception. Sector experts believe that trust can be restored. Data shows that this takes time but it's feasible. Being purpose-led can act as the compass to facilitate and expedite trust restoration.

A survey conducted by the ACB during the last quarter of 2021, measured the level of trust that individuals and legal entities place in Cypriot banks at 4.7 and 5.1 (out of 10) respectively. Internationally, financial services' trust levels hovered around 50% during the last decade, showing a relatively strong increase in the score during that time compared to other industries studied[4].

Bank executives suggested that acting with integrity and in a humane manner towards clients can have a positive impact on public trust and enhance customer satisfaction. Banks ought to practically demonstrate that they understand individual customer needs. Adhering to moral principles and demonstrating care at personal and exceptional circumstances can elevate the public perception towards banks in terms of trust and overall social contribution. Executives also stressed the importance of having the client at the core of their operations, in how banks act and invest for the future, by establishing a client centric model.

Culture in Banking

Culture is an integral part of banks' DNA, enabling or hindering the development of competencies. It acts as a catalyst towards value creation. Without the right culture, a purpose-led banking sector cannot exist. Banks need to carefully manage the various stakeholders, balancing out the incentives of shareholders and employees, which in Cyprus seems to be particularly challenging.

Banks' senior management should consistently reinforce and demonstrate core values, adopting them in decision-making processes and future planning. A fair and proper performance appraisal management system lies among the highest standards of conduct. Leading by example would strengthen the culture in banking and create a sense of unity in the workforce. In addition, banks need to encourage staff to take advantage of training and development resources to update their skillset, remain competitive, and ultimately be better positioned to keep up with the shifting demands of the market.

Undoubtedly, managing and improving culture involves many different stakeholders whose motives may differ and are often conflicting. Clashes between bank employees and employers give rise to labour conflicts, but it is up to the senior management teams to create a culture that is in position to resolve clashes before they escalate to conflicts and disrupt the business.

Labour conflicts between banks and and the Cyprus Union of Bank Employees (the Union) have a detrimental effect on all the elements constituting a healthy culture in the sector. The high degree of protection provided to employees by the Union hinders banks from implementing the right mechanisms to cultivate the desired culture. Evidently, best banking practices on remuneration, promotion and rewarding top talent are often effectively discouraged by a system which promotes tenure over contribution. A mutually agreed solution between banks and the Union on talent management and performance-based remuneration and promotion system is required to cultivate a competitive and progressive banking culture.

[4] Eldenman | Edelman Trust Barometer 2022

Viable Banking Sector

A viable banking sector is a prerequisite to a well-functioning modern economy and prosperous society. A viable bank is one that is well-positioned to serve client needs, is able to absorb economic shocks, comply with regulations and support the wider economy during recession and growth periods.

Sustainable profitability

Viability is largely associated with sustainable profitability. According to the ECB, a range of 6-10% return on equity (ROE) shall be the target. Over the past decade, European banks have struggled to generate the desired ROE. Prolonged periods of low bank profitability risk impeding intermediation in the economy with potential adverse repercussions for growth and welfare.

Profitability has been challenging for Cypriot banks as well, primarily due to high loan-loss provisions and non-performing loan (NPL) deleveraging efforts. As of Q4 2021, the Cypriot banking sector ranked last amongst European peers in terms of positive ROE.

Bank valuations have also been considerably low, with price-to-book (P/B) ratios constantly below one, indicating that investors have lost faith in the banks' ability to generate shareholder value. Sustainable profitability is one of the key factors driving bank valuations. A European bank priced at book value expects ROE of around 12.5%, which is admittedly very high for retail banks relying primarily on interest income. The recent interest rate hikes give a unique opportunity to Cypriot banks, not just to return to healthy profitability, but essentially to increase their market values.

Attaining a market capitalisation representative of their potential has been a long-standing effort of Cypriot banks which has not yet been achieved. While profitability in the coming years can elevate bank valuations, sustainable profitability can preserve them there.

Income

A significant drawback of the Cypriot banking sector is its heavy reliance on net interest income (NII) and the lack of income diversification. Although NII for the Cypriot banks is expected to increase in the years to come, banks need to diversify in commissions and fee-based services to increase their resilience towards market risk.

Investments in innovative technologies and collaborations with FinTech companies could transform a bank's business model and increase revenue generation. Banks should exploit advanced data analytics for tailored product offerings.

Sectorial expertise is also paving the way to income generation for banks. Being able to understand sectoral peculiarities, identify potential risks and develop banking products specific to key sectors, can diversify income and increase customer satisfaction.

Cost

Cypriot banks have been transforming their cost base gradually in recent years, focusing primarily on branch network, processes and workforce optimisation. Digital transformation initiatives are being implemented but there is still a long way to go. This transition is expected to be costly but ultimately rewarding.

The cost-to-income ratio of Cypriot banks remains significantly higher than the EU average, hovering above 70%. Despite efforts by Cypriot banks to reduce operating costs historically, inelastic staff costs continue to deplete a significant portion of operating income, absorbing c.40% of operating income in 2021. Reduction of staff costs is top of the agenda for Cypriot banks. In agreement with the Union, the largest banks have been offering generous voluntary retirement schemes (VRS) to incentivise highly paid employees to voluntarily leave. VRSs solve the high staff cost problem in the longer term, although they are costly at implementation and impact profitability.

In addition, digital transformation is key to sustainably operate at a lower cost base and ensure long-term profitability. Credit institutions recognizing the limitless potential offered by technology have actively integrated digital transformation into their operations, offering and using more and more digital services and processes.

Safe & Stable Banking Sector

Banks rebounded from the pandemic with higher margins and capital ratios, which provides an opportunity to optimise their capital positions by laying the groundwork for long-term growth. It is more important than ever for banks to build exceptional risk management practises and infrastructure that can be resilient in volatile times and sustain economic shocks.

Capital Adequacy

Cypriot banks maintain a strong capital buffer to sustain shocks with a common equity tier 1 (CET1) ratio of 17.5% (16.75% for banks designated as significant institutions by ECB) as at June 2022[5] which is higher than the EU average and one of the highest liquidity coverage ratios (LCR) across Europe at 344% as of Q2 2022. In terms of riskiness, risk weighted assets (RWA) are significantly higher than the European average and thus high capital reserves are mandated. Especially during crisis periods, high capital requirements can influence the cost of providing credit to customers.

Non-performing Loans

Maintaining a low non-performing loan (NPL) ratio is one of the greatest challenges for the Cypriot banking sector; back in 2015 it reached a record high of 48%. Since then, various actions have been taken to reduce the ratio down to 11% as of the end of 2022, which however is still the second highest in the EU. The current macroeconomic environment, characterized by high inflation and rising interest rates, increases uncertainty for the repayment ability of many borrowers and brings the NPL threat back to the surface before it is even gone.

Simple but usually effective measures could be adopted proactively. Maintaining good communication with borrowers, improving communication channels and being flexible in upcoming restructuring solutions to those in real need could be beneficial. Attempts should focus on preventing NPLs rather than managing them after they arise. Early detection mechanisms can be employed using advanced data analytics and predictive modelling.

ESG compliance

As banking regulators are tightening their grip on their ESG expectations in collaboration with European Law makers and several standard setting bodies that are issuing new standards around non-financial disclosures, banking institutions are increasing their efforts to make sure that future developments will find them in compliance. EU Taxonomy, the newly agreed Corporate Sustainability Reporting Directive, the Sustainable Financial Disclosure Regulation and the upcoming Pillar 3 ESG disclosures are some of the standards financial institutions are focusing their efforts on.

Cyber Security

EY banking sector survey 2021 found that cyber-security is among the most important issues to banks, according to the industry's chief risk officers (CROs), second only to credit risk[6]. Evidently building resilience to cyber risk is becoming increasingly important for banks.

Focusing on preventing cyber-crime does not merely imply taking steps to protect customers from falling victim to cyber-fraud, but also requires securing the banks' internal operations to prevent a cyber-attack against the bank that would have significant overall stability implications to all key stakeholders.

Banks need to develop digital and technological resilience, as cyberattacks remain a serious risk to data security. Cyber-talent hiring, personnel trainings, and future-proof infrastructure from international security providers are some of the steps Cypriot banks need to implement to build a cyberattack-proof network.

[5] CBC Key aggregate financial indicators for the Cyprus Banking Sector 2022

[6] EY/IIF Analysis

Progressive Banking Sector

A progressive banking sector is forward-looking, embracing future trends and utilising the newest technologies available to its best ability, in order to deliver maximum value to stakeholders and the society.

Digital Transformation

Globally, the banking sector experiences a major digital transformation with physical premises being radically replaced by digital options. Today, more than half of the Cypriot banking sector customers interact with banks via digital channels, a trend that has been accelerated by the pandemic.

Banks are called to quickly reshape their operations to address the new customer expectations and demands. Given the advanced digital skills of the youngest generations, such numbers are projected to rise in the years and decades ahead.

Despite the high implementation costs, digital transformation can offer invaluable benefits and potential to banks, allowing them to enhance customer experience, keep up with competition and step closer towards sustainable profitability. Some of the rewards of being digitally transformed could be the simplification of banking and transactions, streamlining of operational processes, increase of productivity, reduction of human errors, creation of a client-centric model, and delivery of tailor-made services.

Fintechs

FinTechs pose a threat to the traditional banking model. Estimates show that FinTechs have captured anywhere from 4%-8% of total banking revenues in the Eurozone area.

Their competitive advantage is generated by (i) their ability to maintain low operating costs (due to their virtual substance) and thus provide cheaper or even free solutions to customers, (ii) personalised service offerings, leveraging from innovative technologies and data analysis, (iii) user-friendly environment and easiness of transacting with peers.

Banks need to act fast in order to stay relevant. They must harness the power of technology and data analytics to become more client centric and improve their existing digital services.

At the same time, potential partnerships with, or acquisitions of FinTech companies may create synergies and gain a competitive advantage. Inorganic growth via acquisitions or partnerships with FinTechs could also be a win-win situation where FinTechs provide product design and tech expertise, whilst banks provide the funding, infrastructure, clientele, and distribution channels.

Human Capital

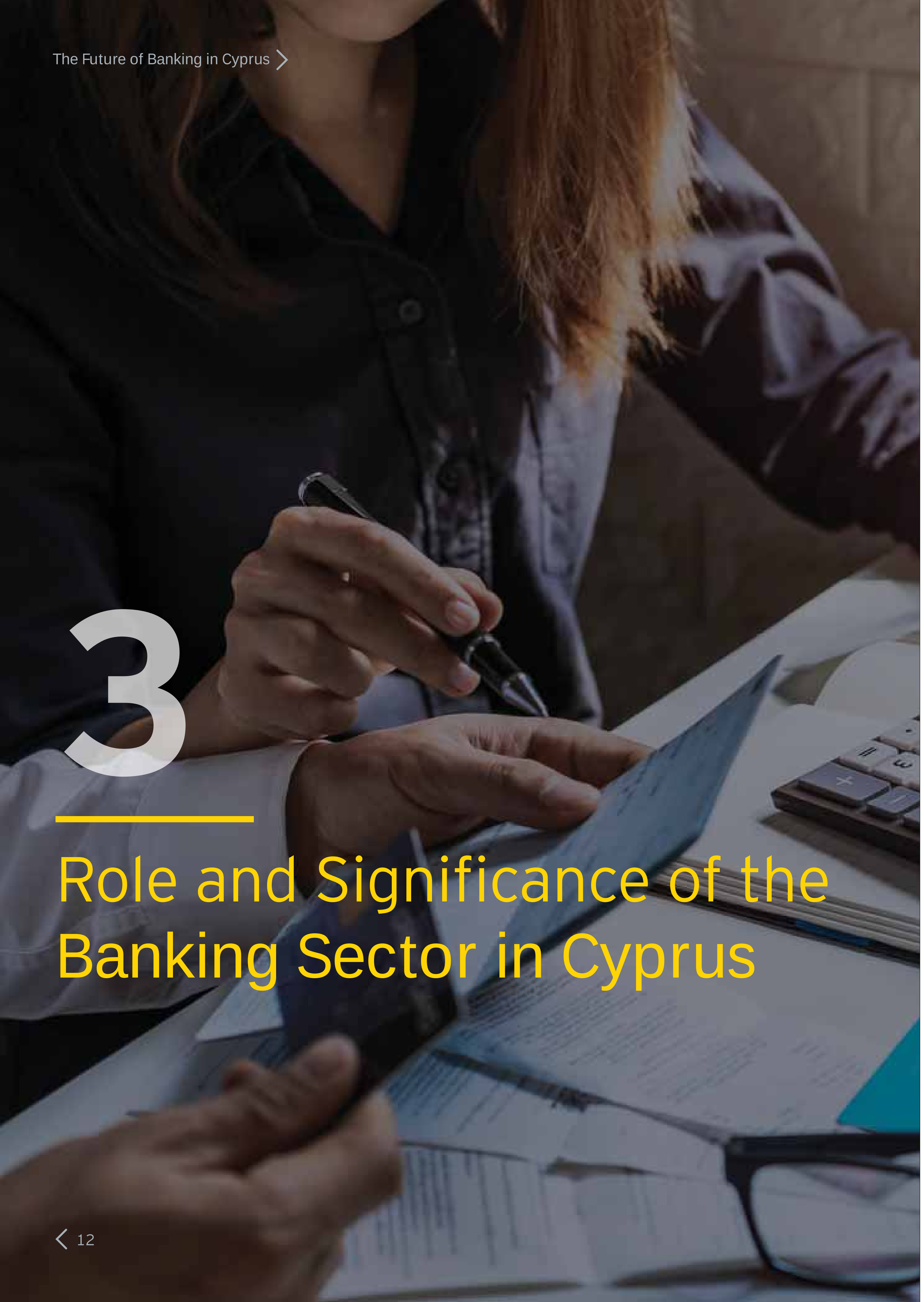
Succeeding in the digital era requires reskilling, i.e. new, transformed and developed employee skills. New skillsets are necessary to drive the change. Hiring Data analysts, AI specialists, data engineers and computer scientists will be key to digitising operations in line with customer and regulatory demands.

Cypriot banks may need to seek talent abroad, and likely have to compete against large multinational organisations and FinTech companies in hiring top talent. To attract such highly sought-after talent, who are likely to be young techie individuals, banks need to promote a package of incentives that includes competitive remuneration, improved working conditions with attractive benefits and career progression opportunities, a hybrid model of work and flexibility in working hours.

As certain core and supportive processes are being automated, human capital reskilling should also be a core part of a bank's strategy. There is an inherent challenge to reskilling as it is a lengthy, complex and intense process for both the bank and the workforce. Reskilling necessitates the collaboration of employees in the process, and sincere effort, which is something that is not always easily attainable.

Accessibility

As banks transit to a more digital business model, it is important to promote digital financial literacy to maintain and strengthen their offerings through digital channels. Allocation of banking agents in remote areas and simplification of digital platforms are ways to make digital offerings easily accessible by all customers. Having said that, it is vital not to exclude customers who confront difficulties to adapt to the new era of digitalization, such as elder populations.



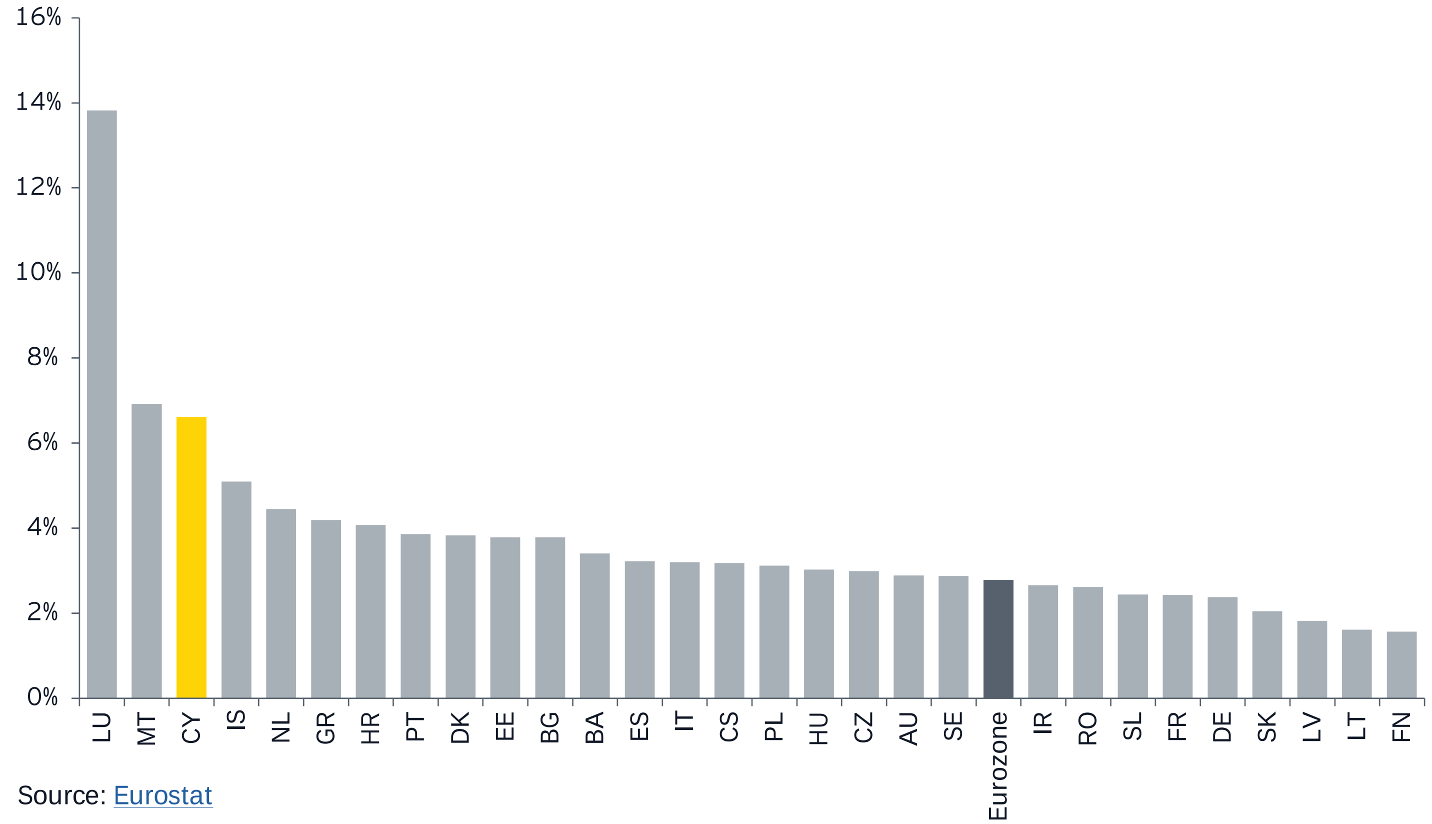
3

Role and Significance of the Banking Sector in Cyprus

3.1 Economic contribution

The Cypriot banking sector plays a critical role in the economy of the country as the supplier of credit and safekeeper of peoples' wealth. Financial services excluding insurance and pension funding (i.e. a proxy to "banking sector activities"), contributed €1.29bn to GVA in 2020 (6.6% of total GVA, compared to 2.8% in the Eurozone) [7].

Banking sector contribution to GVA across Europe (2020)

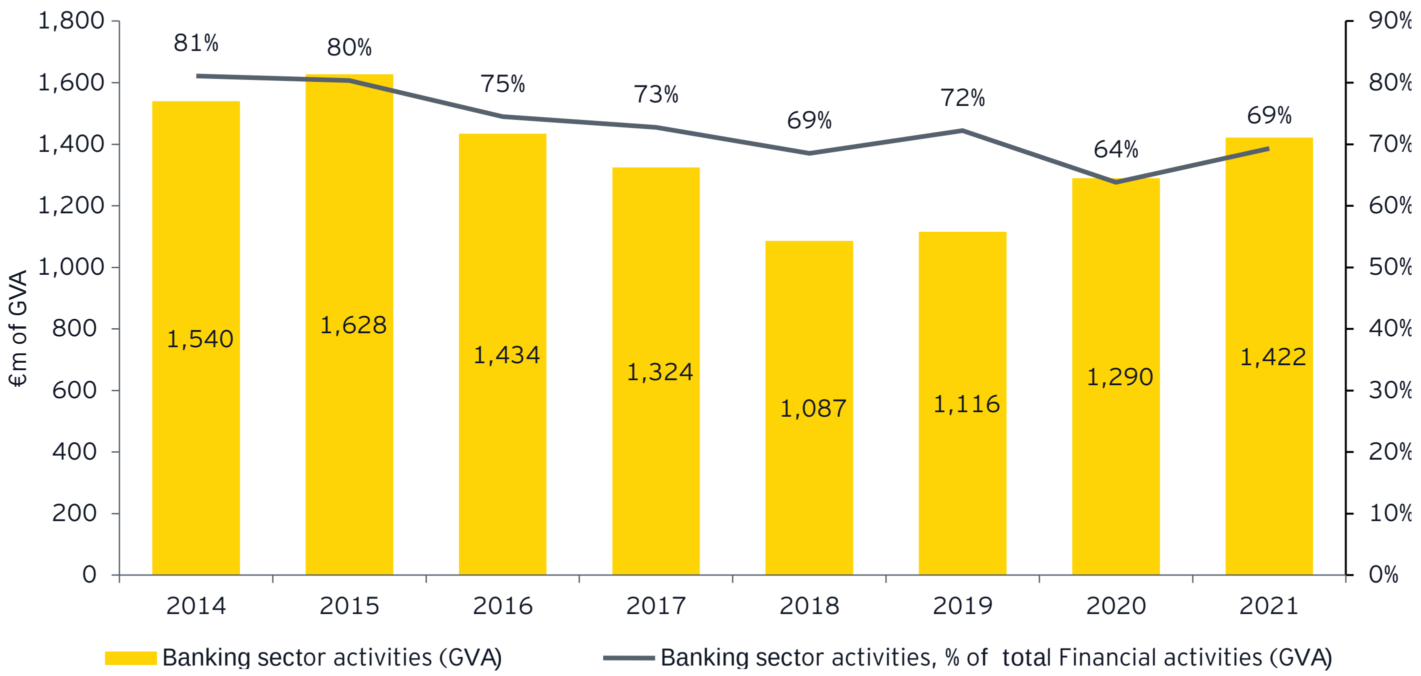


Source: Eurostat

The banking sector activities, constitutes 64% of the total nation's financial activities in GVA terms, which is a historic low. The growth of insurance, pension, and market related activities led to the reduction of the banking sector's contribution from 80% back in 2015 to 64% in 2020. Still, in relation to the EU, the Cypriot banking sector remains one of the key drivers of the economy.

[7] Eurostat

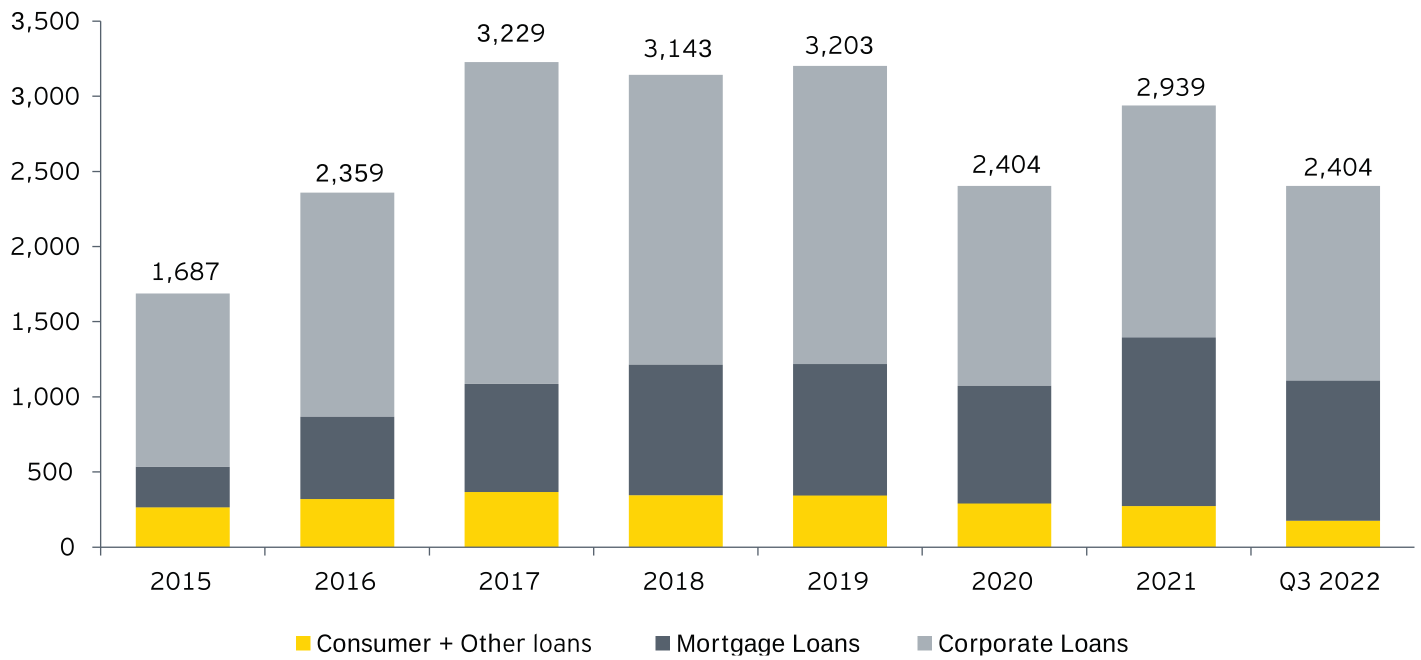
Cypriot banking sector contribution to total Financial Activities (GVA)



Source: Eurostat

Besides deposits safekeeping, Cypriot banks provide credit to the Cypriot households and businesses, recording growth in new lending volumes year-on-year from 2015 to 2019. Undeniably, the sector experienced a slowdown during the first two years of the pandemic. Returning to normality in 2022, Cypriot banks are on track to meet and even surpass previous highs of 2017 and 2019.

Annual new lending volume (€m)



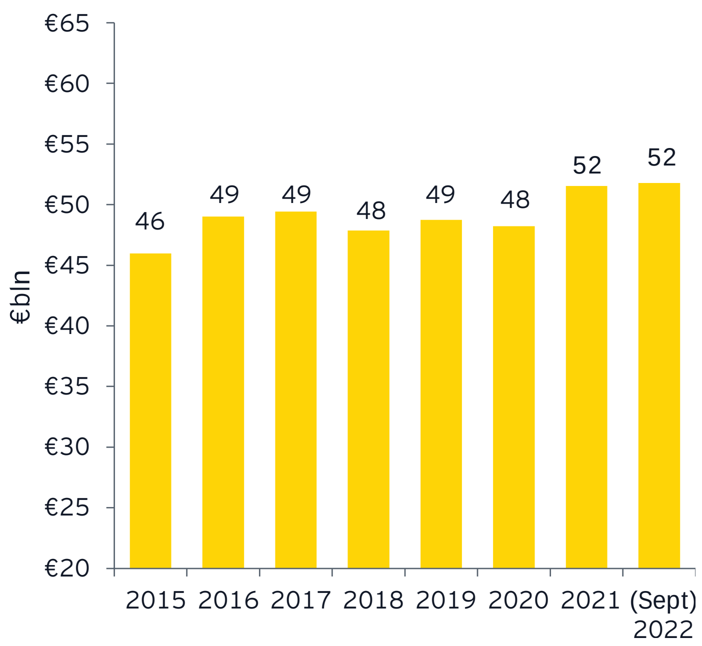
Source: Central Bank of Cyprus

The Cypriot banking sector constitutes the engine of the economy through its financial intermediary activities on a daily basis, money circulation, microtransactions, trade financing and trade guarantees.

3.2 Deposits and indebtedness

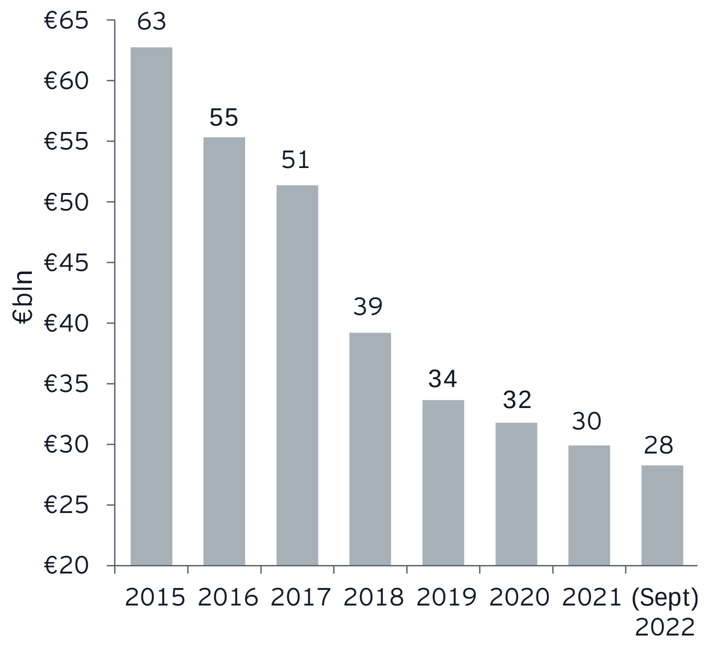
Deposits in Cyprus have been increasing in the last few years, surpassing loans in the summer of 2018. Since then, deposits have kept increasing, approaching to double the credit balance. As of September 2022, the country's financial institutions are holding 186% of the country's GDP in deposits amounting to €51,77bln[8]. Consequently, the debit to credit widening has resulted in excess liquidity.

Deposit Balance of Cypriot banking sector (year end)



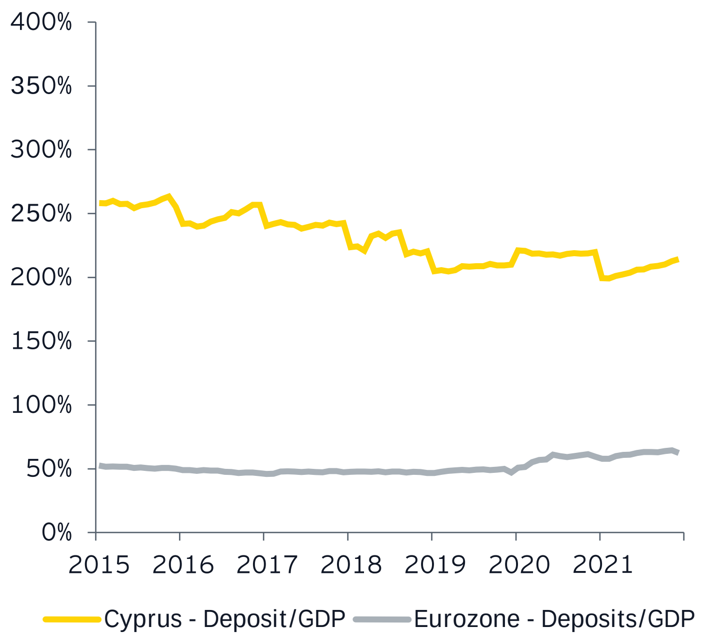
Source: (CBC); (ECB)

Loan Balance of Cypriot banking sector (year end)



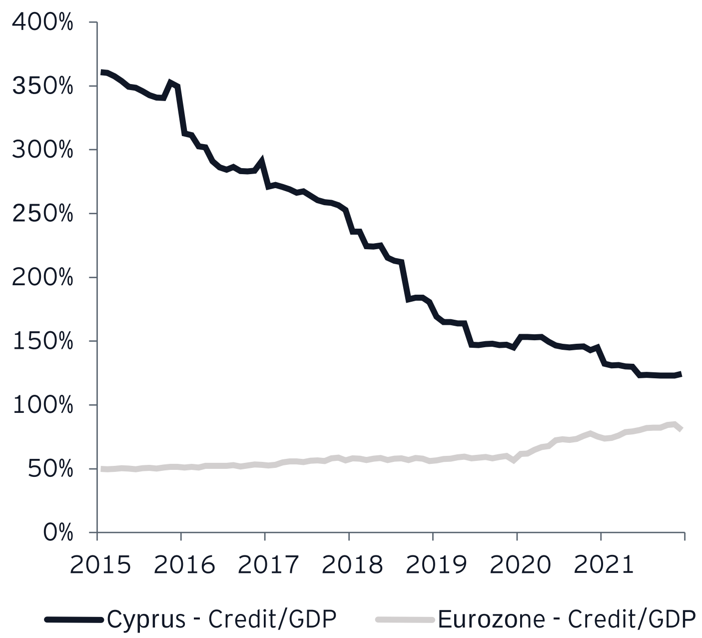
Source: (CBC); (ECB)

Deposits/GDP of Cypriot Banks and Eurozone Average



Source: (CBC); (ECB); (Eurostat)

Credit/GDP of Cypriot Banks and Eurozone Average



Source: (CBC); (ECB); (Eurostat)

[8] (CBC); EY Analysis

Deposits relative to Cyprus' GDP remained stable in comparison to the decreasing volume of loans relative to the nation's GDP from 2015 to 2021. This massive drop in loans relative to the country's economy is mainly due to the decrease of NPL balances in the Cypriot banks' portfolios. The Credit/GDP ratio, considering only the banking sector, has been reducing. The most recent figure estimates it at 125% which, although it is still far from the Eurozone's average (80% as of Dec.2021), the decreasing trend points towards normal levels of credit. However, despite offloading large amounts of NPLs to asset managers, these toxic loans still remain part of the economy. Upon completion of the already signed transactions, asset managers are estimated to hold €11-13 billions (as of mid-2022) of NPLs in gross book value terms. This denotes that the Credit/GDP ratio, considering the economy overall, is significantly higher than Eurozone's average and is a strong reminder that the issue of over-indebtedness exists in Cypriot households and businesses.

3.3 Impact of the Russian invasion in Ukraine

With one of the lower tax rates across Eurozone, Cyprus is an attractive market for foreign capital. Russian tourism, permanent Russian presence and material Russian investments in recent years have significantly developed the economy. It is thus necessary to assess the consequences of the Russia-Ukraine war on the Cypriot banking sector.

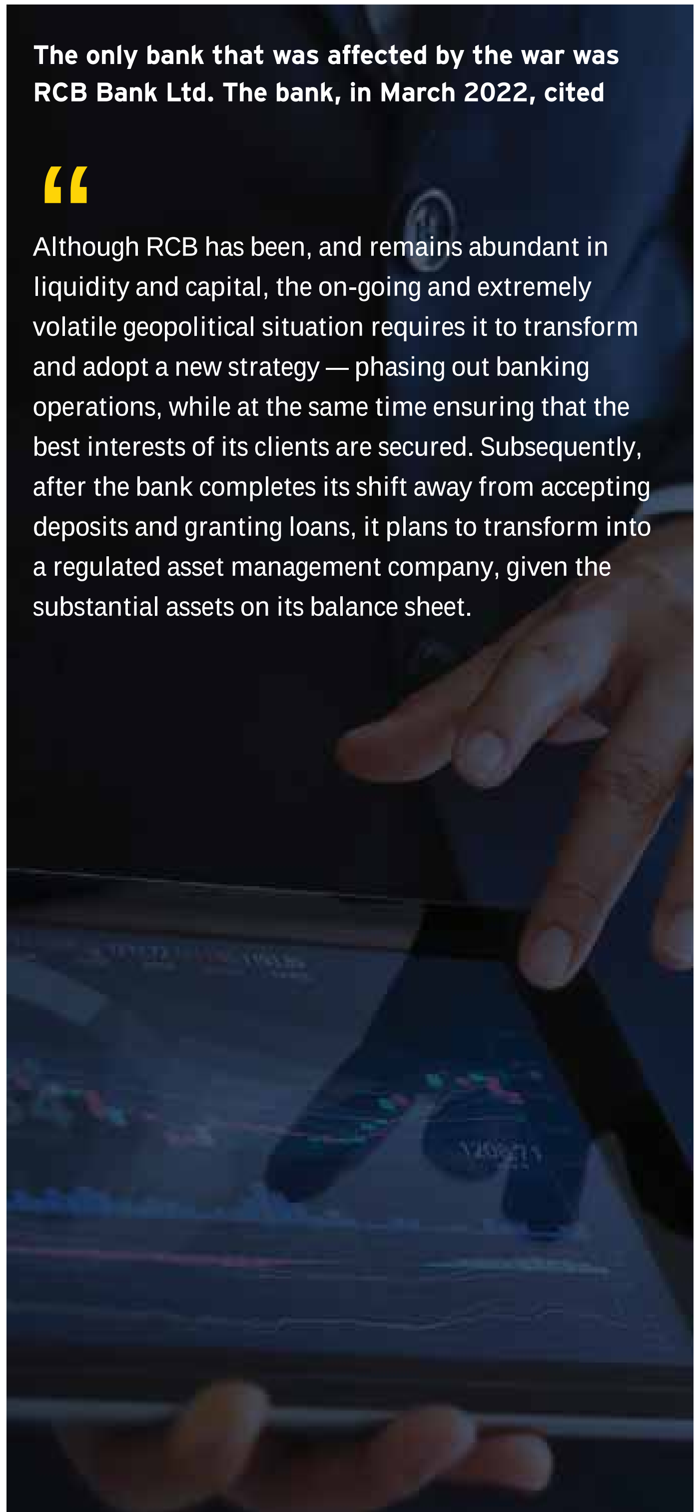
The direct effects of the war do not appear to pose a threat to the domestic banking sector, as exposure to sanctioned Russians (individuals and businesses) is low, both in terms of deposits and loans.

Cypriot banks enjoy one of the highest liquidity coverage ratios in Europe at 314% as per ECB reports in Q2-2022[9], thus they should be able to absorb any outflows in liquidity. The exposure of the Cypriot banking sector to Russian nationals is also relatively limited; only 0.8% of total loans and 4.7% of total deposits come from Russian nationals[10].

Sanctions aside, the Central Bank reports that many Russian and Ukrainian nationals and businesses are seeking to immigrate to, and continue employment from Cyprus, amid the geo-political turbulence due to the war, thus creating new financing opportunities for Cypriot banks. Based on information received from authorities, there have been more than 17,000 applications for work permits from Russian and Ukrainian individuals in 2022 (200% increase compared to prior year), which is driven primarily by the war.

The only bank that was affected by the war was RCB Bank Ltd. The bank, in March 2022, cited

"Although RCB has been, and remains abundant in liquidity and capital, the on-going and extremely volatile geopolitical situation requires it to transform and adopt a new strategy — phasing out banking operations, while at the same time ensuring that the best interests of its clients are secured. Subsequently, after the bank completes its shift away from accepting deposits and granting loans, it plans to transform into a regulated asset management company, given the substantial assets on its balance sheet.



[9] ECB – Statistical Data Warehouse

[10] Central Bank of Cyprus, Speech by Constantinos Herodotou

The indirect effects of the war though, both to the banking sector and the economy in general, cannot be ignored.

i. The mainly energy-caused inflation and corresponding rise in interest rates are likely to stress the repayment ability of borrowers, turning some into non-performing.

ii. The EU-wide impact on GDP growth and to some extent in Cyprus' GDP following a hit in key sectors such as tourism and construction, signals a possible economic recession.

iii. The need to expedite green transition to reduce dependency on Russian energy sources and control inflation is at the top of EU's agenda.

Banks have a role to play in supporting clients overcome the upcoming crisis, support the wider economy and lead the way in green energy transition.

1. ECB Financial Stability Review shows risks increasing as economic and financial conditions worsen

Inflation (which rose to 10.6% in Cyprus in June 2022, the highest in 40 years[11]), as well as soaring gas and electricity bills, is hitting households, decreasing their purchasing power and potentially reducing their ability to repay loans. Lower-income households that generally spend a greater share of their income on energy and food are particularly affected.

Corporate sector challenges have grown amid higher energy and other input costs, with profits expected to decline as funding costs increase. If the outlook deteriorates further, an increase in the frequency of corporate defaults cannot be excluded, particularly among energy-intensive firms.

As firms and households find it increasingly challenging to service their debts, banks could face higher credit losses in the medium term. While the banking sector has recently seen a recovery in profitability as interest rates have risen, there are incipient signs of asset quality deterioration, which may require larger provisions[12].

2. GDP growth and possible economic recession

Fluctuations in GDP growth forecasts have painted an unsure picture of the actual growth for 2022. While the Central Bank projected a 2.7% growth of GDP in June, the forecast got readjusted to 5.8% in December, amid the positive tourism sector performance during the summer[13].

However, the impact of the Ukrainian war on the energy sector increases the uncertainty around the actual GDP growth of Cyprus, a nation dependent on imported energy[14].The GDP is expected to slow down to 2.5% in 2023 and grow by 3.1% in 2024 and 2025, according to the Central Bank's macroeconomic projects.

The European Commission, as well as economists working for the Financial Times and Bloomberg have all warned that if supply side disruptions do not cease by this coming winter, we are on course to face an EU-wide recession that will challenge the resilience of the very foundations of our financial system[15].

The uncertainty of how the war will unfold makes predicting a recession a tricky business and as such banks must be prepared for the worse. Proactiveness and adequate preparation is imperative. As per ECB guidance, banks should embark on conducting rigorous stress tests, constantly updating current expected credit loss (ECL) models and retesting assumptions, all within the context of hypothetical scenarios that account for significant loss of GDP and rising unemployment. This will ensure that banks' balance sheets can hold up under dramatic economic strain in case the possibility of a recession materialises.

To maintain profitability, it is also crucial that banks continue to re-evaluate the cost-effectiveness of all their operations, as well as seek out investment opportunities in emerging markets that will diversify their income.

3. Accelerating green financing is key to restraining an upcoming recession

At the root cause of the supply-chain inflation is Europe's energy reliance on Russian oil and gas. Historically, the oil market has been incredibly vulnerable to geopolitical changes, frequently causing disruptions in economic cycles. Reliance on limited output non-renewable energy sources causes both environmental and financial risks.

The bank's role will be pivotal in transitioning the Cypriot economy to green energy. Expediting green financing is key to helping industries and households switch to cheaper energy alternatives, limit the risks surrounding repayment ability and restraining an upcoming recession.

[11] StockWatch | Cyprus annual inflation rate at 10,60%, higher than Eurozone and EU average

[12] ECB Financial Stability Review shows risks increasing as economic and financial conditions worsen (europa.eu)

[13] CBC | Macroeconomic Outlook of Cypriot Economy (Dec'22)

[14] Irena | Energy Profile Cyprus (2022)

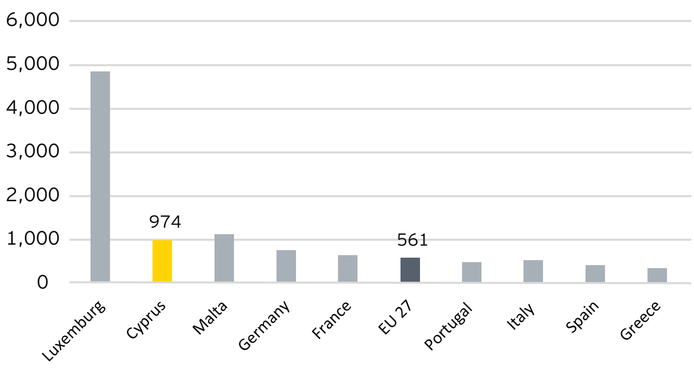
[15] Bloomberg | Gas Crisis Risks Euro-Zone Recession, 2023 Inflation at 5%

3.4 Social contribution

1. Employment, presence and compensation

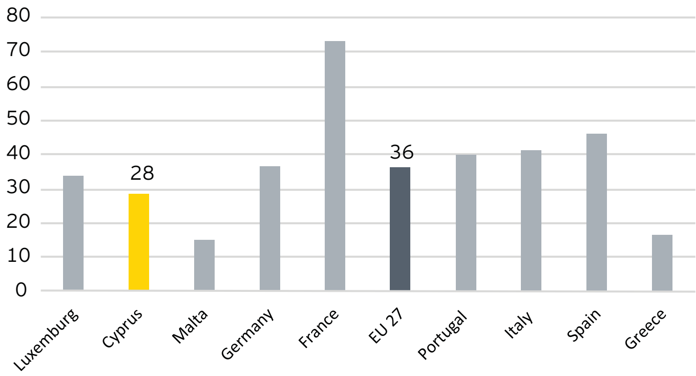
Cypriot banks employ approximately 7,463 people[16], which results in approximately 974 bank employees per 100,000 customers, the third highest in Eurozone, just behind Luxembourg and Malta[17]. The sector also accounts for 28 branches per 100,000 customers[18]. It is therefore evident that Cypriot banks are some of the largest employers on the island. Despite the size of the country and the population, they are contributing to the society by employing a material part of the country's workforce and maintaining good physical presence.

Bank Employees per 100,000 customers (2021)



Source: EBF; Eurostat; Eurostat;

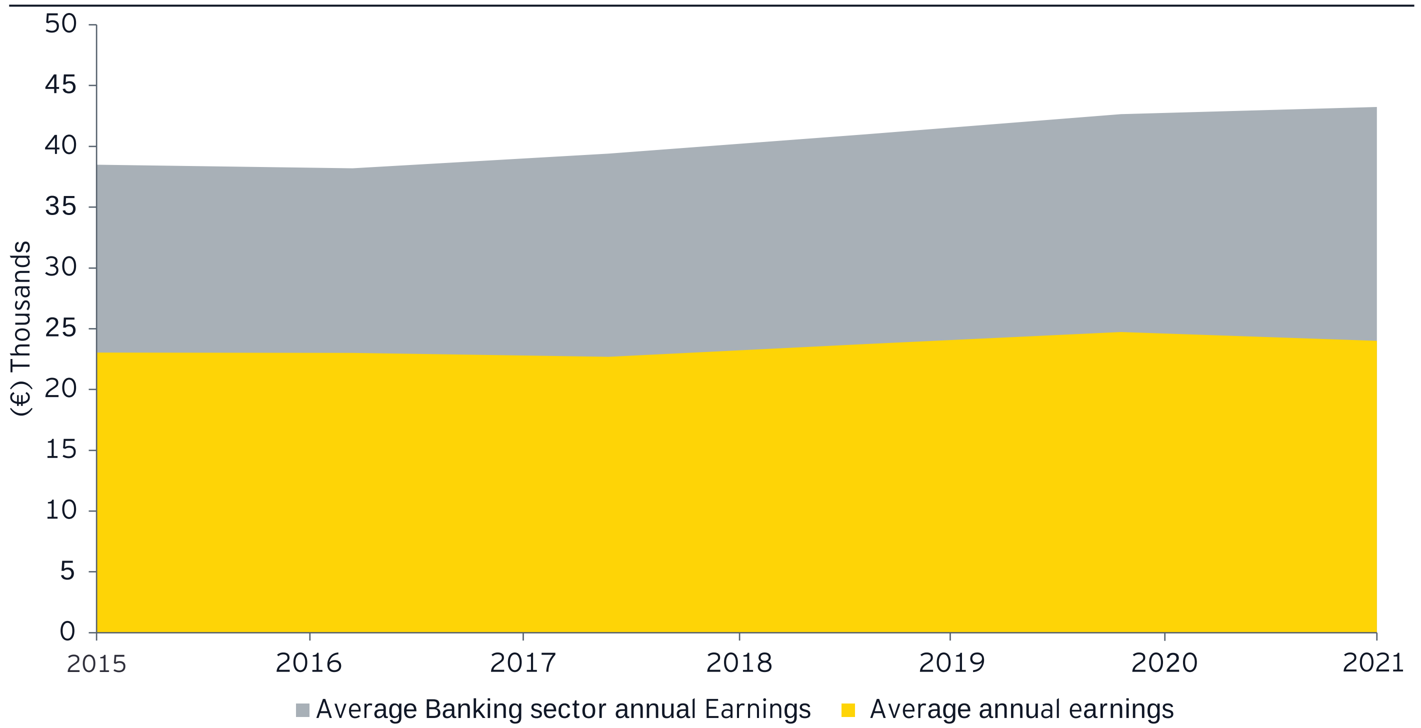
Bank Branches per 100,000 customers (2021)



Source: EBF; ECB; Eurostat; Eurostat;

Bank employees are also better compensated compared to the average salary in Cyprus. Since 2015, the average earnings in the banking sector had been around 1.8 times higher than the average salary across industries. At the same time, the average earnings in the government sector for the same period remain steady at around 1.4 times higher than the average salary across industries and lower than the average salary of banking employees.

Annual gross earnings of bank employees Vs average salary in Cyprus



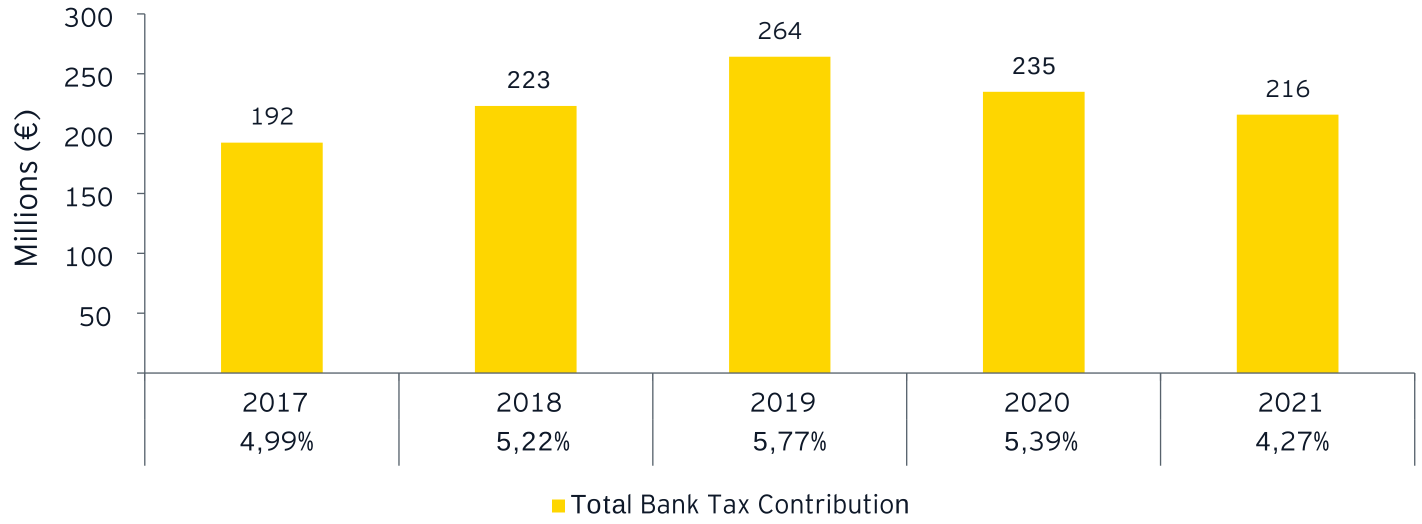
Source: Eurostat; Cystat

[16] EBF
[17] EY analysis
[18] Idem

2. Tax contribution

Despite the heavy losses sustained by the banks in Cyprus from the financial crisis of 2013 and in subsequent years as a result of high credit losses, the largest banks in the sector contributed c.€216m in 2021 to the national tax revenue, which amounts to 4,27% of the total tax contribution in Cyprus[19].

Total Bank Tax Contribution and [%] to Total Tax Revenue

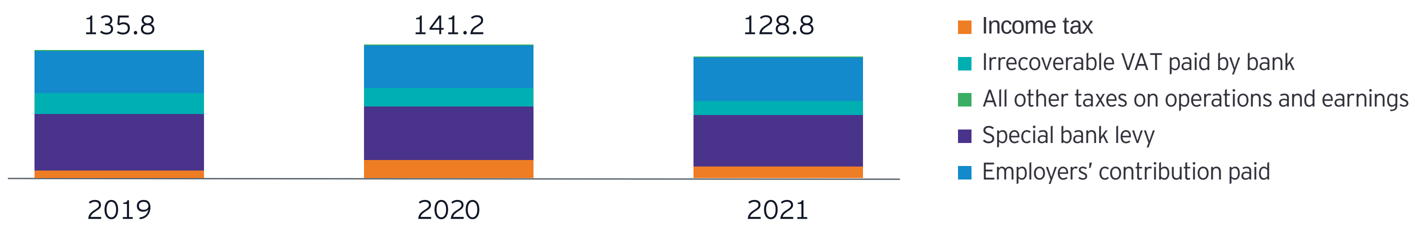


Source: ACB, EY Analysis, Tax Department Annual Report

The total tax contribution was derived from the taxes borne and collected by the Cypriot banks.

Taxes borne are a business cost and directly affect the bank's financial results; its main components are special bank levy, and employers' contribution paid, income tax, irrecoverable VAT paid and other taxes on operations and earnings. Total taxes borne amounted to c.€141mln in 2020 and c.€129mln in 2021. Income tax constituted 14% and 9% of total taxes borne for years 2020 – 2021 mainly because following the financial crisis the majority of the banking institutions in Cyprus were loss making. Income tax is expected to increase in the following years as bank tax losses are expiring and the banks are expected to return to profit generation in the upcoming years.

Tax Borne (€m)

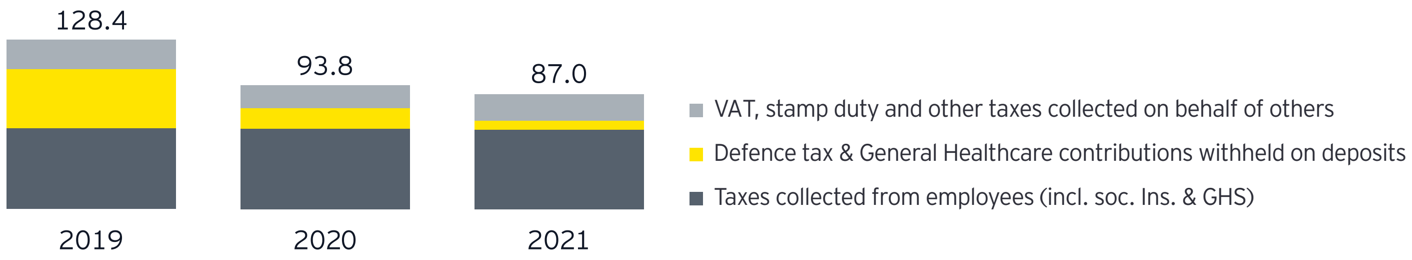


Taxes collected are those generated by the bank's operations but are collected from government authorities and reflect the wider economic contribution of the banking sector. The main components of the taxes collected relate to the taxes collected from employees, along with the defence and GHS contributions withheld on deposits and VAT and stamp duties. Total bank taxes collected totalled c.€94mln in 2020 and c.€87mln in 2021.

Please refer to the charts and table below for a detailed breakdown of the Cyprus banking sector's tax borne and tax contribution for the period 2017 – 2021.

[19] ACB, EY analysis; Tax Department Annual Reports

Tax Collected (€m)



Consolidated - Cyprus banking sector aggregate (€)	2017	2018	2019	2020	2021
Income tax	5,798,003	6,713,450	7,502,593	19,216,379	12,165,417
Special bank levy	40,242,149	47,155,528	60,698,406	56,702,768	54,253,717
Irrecoverable VAT paid by bank	8,937,265	12,410,333	22,265,641	19,392,946	15,373,526
Employers' contribution paid (1)	30,270,344	32,337,396	44,152,150	44,924,259	45,799,812
All other taxes on operations and earnings (2)	1,116,216	1,274,322	1,169,555	1,005,965	1,184,351
Total Taxes Borne	**86,363,978**	**99,891,029**	**135,788,345**	**141,242,317**	**128,776,822**
Taxes collected from employees (incl. soc. Ins. & GHS)	46,504,366	49,796,944	61,340,812	60,587,791	60,121,743
Defence tax & General Healthcare contributions withheld on deposits	46,213,657	52,993,137	44,616,520	15,729,070	6,817,263
VAT, stamp duty and other taxes collected on behalf of others	13,411,941	20,374,113	22,411,653	17,438,435	2,0,086,523
Total Taxes Collected	**106,129,965**	**123,164,194**	**128,368,985**	**93,755,296**	**87,025,529**
Total Bank Tax Contribution	**192,493,943**	**223,055,223**	**264,157,331**	**234,997,613**	**215,802,350**
Total tax revenue for the year ("total collection")	3,856,932,107	4,276,995,454	4,566,914,527	4,331,236,124	5,008,418,271
GHS destined payments to the Tax authority	-	-	11,486,397	26,300,000	50,600,000
Total (incl GHS)	**3,856,932,107**	**4,276,995,454**	**4,578,400,924**	**4,357,536,124**	**5,059,018,271**
% contribution of CY Banks	**4.99%**	**5.22%**	**5.77%**	**5.39%**	**4.27%**

(1) Social insurance, general healthcare contributions, redundancy fund, industrial training contribution, cohesion fund
(2) All other taxes, levies and special defence tax (except defence tax on deposits) that are part of bank expenses, including property tax, capital gains tax

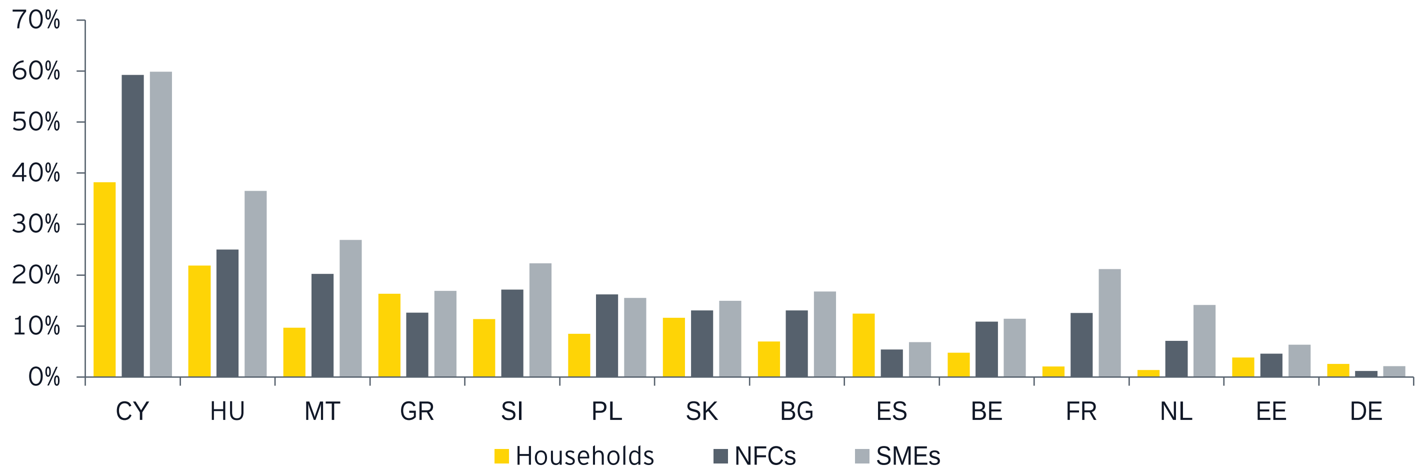
Source: ACB & EY Analysis

3. Supporting the economy

Small and medium-size enterprises (SMEs) are the backbone of the Cypriot non-financial business economy. Their contribution to total value added and employment is striking, at 76% and 84% respectively. Both are substantially higher than the respective EU averages of 56% and 67%[20].

Cypriot businesses have been widely supported by banks during the pandemic. Banks had shown great flexibility in repayment schedules and, along with Government initiatives, helped clients tackle liquidity problems. Loan payment moratoria were picked up by 60% of eligible businesses across the sector for 2020, the highest ratio in Europe.

Loans granted moratoria as a % of total loans in 2020



Source: EBA | Thematic note on moratoria and public guarantees

[20] European Commission | Cyprus – 2019 SBA fact sheet

Amid the war, as the economy anticipates a new shock, and growth in the euro area slowing down, many enterprises have been and will continue to be impacted by the aftereffects of the energy crisis.

The banking sector needs to provide continuous support by easing access to financing, and relaxing terms where needed to allow breathing space to vulnerable businesses. Such initiatives would form the basis of building stronger relationships with clients. Advising clients with a view to help them overcome problems, will likely end up in a win-win situation. By adopting this stance, the client relationships will strengthen naturally, trust will be enhanced, and mutually beneficial opportunities could be created.

4. Financial Literacy

Financial literacy is the confident understanding of concepts such as saving, investment and debt that leads to an overall sense of financial self-trust. Financial inclusion, financial literacy and overall financial wellness continue to pose challenges for the Cypriot society. Advanced financial literacy is associated with adequate management of day-to-day financial issues, lower probability of over-indebtedness, better retirement planning, increase in employment opportunities and wages earned[21].

According to the World Bank, less than 35% of the population in Cyprus possesses a sufficient level of financial literacy. This ranks Cyprus in the middle bucket globally, far behind high achievers like Denmark with rates of more than 70%[22]. These findings are aligned with the Central Bank of Cyprus's (CBC) financial literacy survey performed in Q2-2021[23].

Financial literacy scores show that the most financially illiterate groups in Cyprus are young people aged 18-29 and those who have received lower level of education[24]. In 2021, a survey of the Youth Board of Cyprus shed light on the alarmingly low levels of financial literacy among young Cypriots. Only 2 out of 10 fifteen-year-olds showed satisfactory levels of financial knowledge, necessary to be able to responsibly manage their money. Additionally, most of the respondents stated that they were insufficiently educated on financial topics in school, highlighting the need for stronger financial education[25].

The Association of Cyprus Banks identified this issue and has been taking steps to address it; in collaboration with Junior Achievement Cyprus, the Cypriot division of the global non - profit organization dedicated to addressing social and economic challenges of young people. In this notion, two educational programmes have been set up in primary and secondary education, the 'More than Money' programme and the 'Economics for Success' respectively.

Educating students through the programs "More than Money" and "Economics for Success"

The 'More than Money' programme was launched in 2016 with the participation of five primary schools and c. 200 children. Within 6 years and by 2022, this programme increased its reach to 16 primary schools and more than 600 students. By emphasizing on teaching young students, the fundamental financial skills, 'More than Money' aims to familiarise them with the basic economic terms which relate to money management and company operation. The programme is comprised by 6 distinct themes which include interactive socio-economic activities dedicated to increase understanding of the significance of money management and raise awareness about the role of money within the society. The programme is being realised through the cooperation between schoolteachers and mentors who mainly come from members of the ACB.

The successful implementation of the 'More than Money' programme has led to the 2019 expansion of the collaboration between the ACB, the Ministry of Education, Sport and Youth and Junior Achievement Cyprus through the introduction of the 'Economics for Success' programme. This programme is currently being implemented in secondary education with the participation of c.600 third grade students in 20 schools under the delivery of volunteers coming from the banking sector. Aligned with the fact that at that age students are being called to identify, contemplate, and eventually select their career paths, 'Economics for Success' aims to support students to assess their personal skills and acquire further skills that would prove useful in their subsequent employment.

[21] Lusardi (2019)
[22] Klapper, Lusardi & Oudheusden | Financial Literacy Around the World
[23] CBC | Results from a sampling survey on financial literacy in Cyprus
[24] Central Bank of Cyprus | Results from a sampling survey on financial literacy in Cyprus
[25] Youth Board of Cyprus

Cyprus is definitely in the right path towards creating a more aware, conscious and financially literate society. The gap remains however, and we should rise up to the challenge. To further increase the level of financial understanding across age bands and society and to actually benefit from the implementation of such programmes more work is needed. Stakeholders have noted that this is a task that requires a collaboration between the financial services and banking sector and the government. These should work hand in hand towards structuring further educational programmes and setting the foundations for the inception of the right culture on this critical matter.

In this context, international financial institutions are also making effective efforts to educate financially the younger generations through their digital channels. Cypriot should be inspired by international examples to achieve an even more meaningful impact. The below example highlights the input of RoosterMoney to the financial education of NatWest customers.

NatWest's MoneySense web-portal and acquisition of RoosterMoney

NatWest makes great effort in increasing the financial literacy of its customers, mainly targeting the younger generations (5-18 years old) through games and online videos on their educational app, MoneySense portal[26]. They also offer resources for parents wanting to help their children with relevant articles on a vast range of basic finance topics. Moreover, they complement these efforts with educational material, targeting teachers spanning from lesson plans to activity sheets. Lastly, the bank offers volunteering opportunities to bank employees to help their local community by running workshops.

In 2021, NatWest acquired the FinTech company RoosterMoney as part of its strategy to help families and young individuals to manage their money more easily[27]. Working together with parents, RoosterMoney offers parental control on children's top-up debit card balances, setting limits on, or freezing a debit card and blocking selected merchants. In addition, integrated within MoneySense, its gamified educational app "Island Saver" aims to help children and teens to learn about money management and build financial confidence.

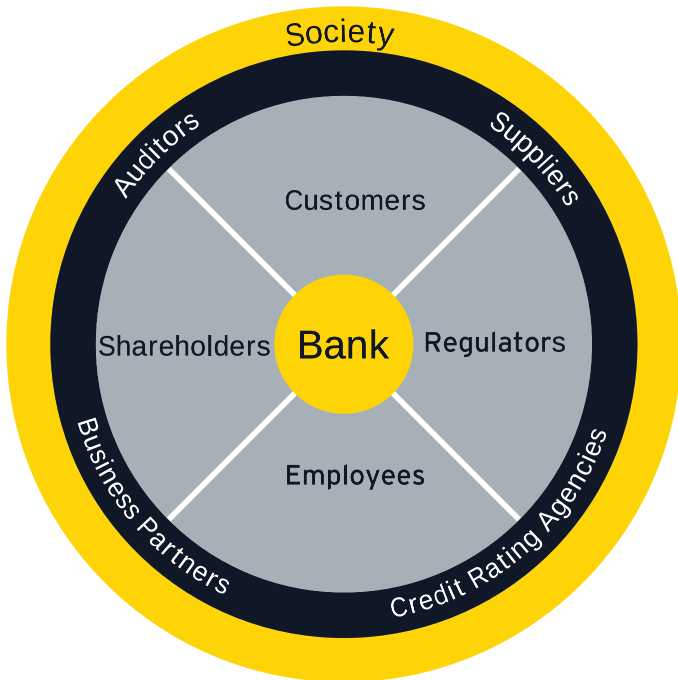
[26] NatWest | MoneySense
[27] NatWestGroup

3.5 Balancing stakeholder needs

Banks must run their core functions and remain competitive in their markets while meeting a diverse set of stakeholder needs. These stakeholders include primarily:

- **Customers**: seek trust, satisfactory service, and value. They look for fast, easy, and intuitive solutions to their finances.
- **Regulators:** demand transparency, resilience, customer protection, capital adequacy and compliance. Regulators are constantly adapting to new market entrants and to the transformative nature of banking in the 21st century.
- **Employees:** seek employment, job security and satisfactory benefits. Employees are the key representative channel of the bank's identity, shaping the public perception of the bank and how it delivers value.
- **Shareholders**: Demand consistent and strong return on investment. Shareholders are the lifeline for many banks and decide on the bank's future. Their interests are not always aligned with the interests of other stakeholders, namely employees, rendering their relationship management a difficult but important task.

Society, as a bank's all-encompassing stakeholder seeks a trustworthy banking system which supports its wider objectives including, but not limited to, educational projects, donations, and support initiatives through non-governmental organisations.



Interacting effectively with all the bank's stakeholders is crucial to the maximization of market value. A bank that generates sufficient funds to invest in all the interaction channels with stakeholders is likely to drive continuous and sustainable growth, stability, and profitability. Researchers have found that employee satisfaction is positively correlated with shareholder returns, but only in the long run. Thus, successfully meeting stakeholders' expectations can be a source of competitive advantage.

Banks in Cyprus are faced with the challenge of meeting their own objectives while satisfying all their stakeholders given their competing and diverse perspectives and interests. Meeting customer needs is crucial, especially for bank's operations as customer needs are their income driver.

In line with the best global banking practices, we see a progressive and all-changing future of banking in Cyprus through four key interconnected pillars:

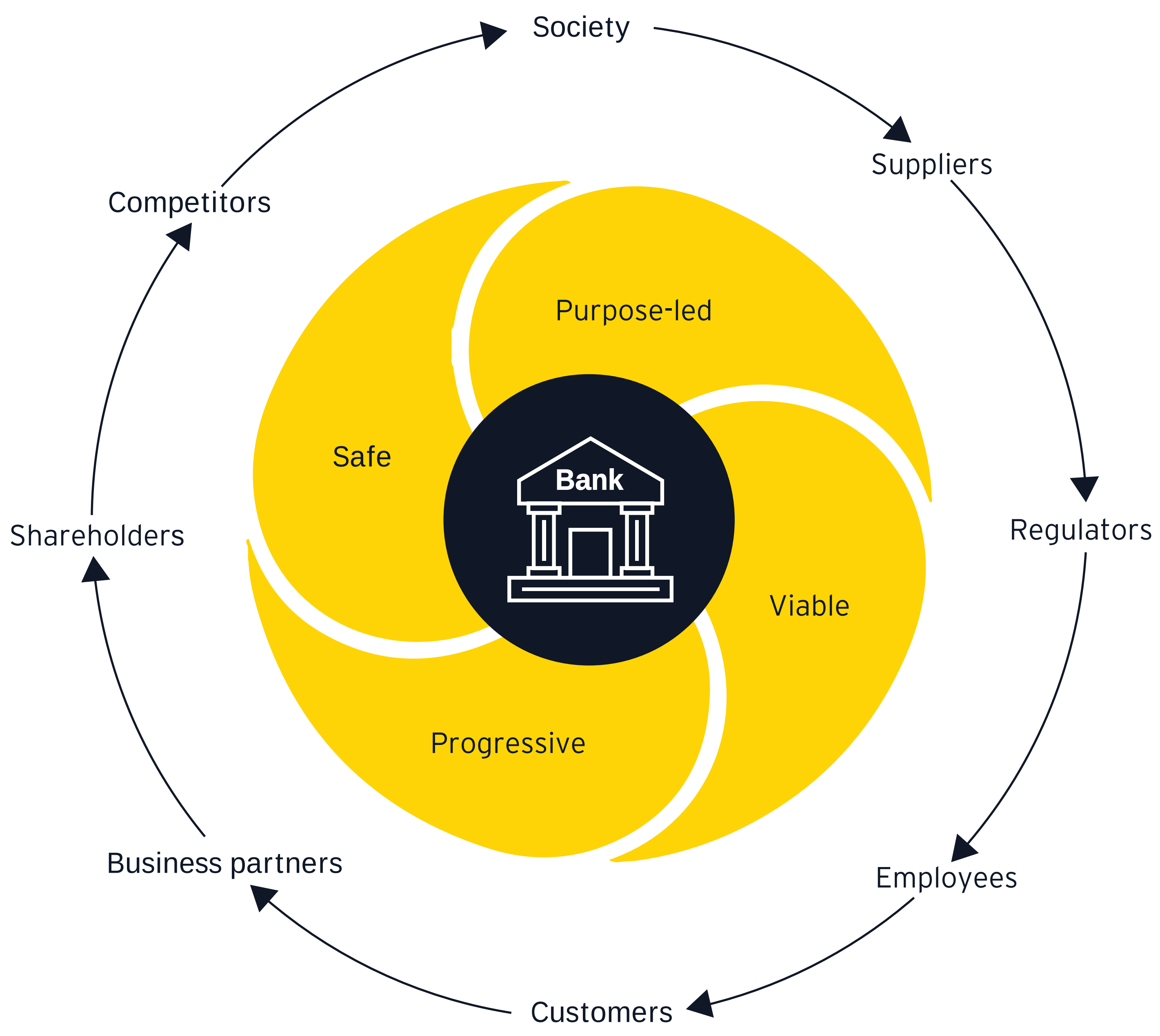
A **purpose led** Cypriot banking sector, places the customer at the centre of operations to create long-lasting relationships which aims to maximize both profitability and contribution to society.

A **viable** Cypriot banking sector ensures sustainable profitability, and simultaneously delivers value to customers and shareholders to stay competitive by inspiring trust and investing in future technologies.

A **safe & stable** Cypriot banking sector, which is transparent, secure and acts in the best interest of the customer, ensures financial robustness by surpassing regulatory compliance and consumer protection standards.

A **progressive** Cypriot banking sector, which remains forward looking, embraces future trends, and remains resilient to future challenges by planning and investing in innovative technologies.

We believe that this new set of criteria to meet all stakeholder needs is crucial for banks aiming to prepare for the future. They are also found to be of central interest in research conducted by the international monetary fund (IMF)[28], European banking authority (EBA)[29] and the Economist Intelligence Unit[30].



[28] Liu (2021); Tobias (2021)
[29] EBA
[30] EIU ; Temenos ; EIU

A new set of performance dimensions, balancing stakeholder needs to maximize value

	Purpose-led banking sector	Viable banking sector	Safe & Stable banking sector	Progressive banking sector
Description	A purpose-led banking sector places the customer at its centre to deliver value and maintain competitiveness	A viable banking sector is characterised by long term sustainable profitability by remaining future oriented through investments in technology	A safe and sound banking sector is transparent, secure and resilient to future challenges by maintaining capital adequacy	A progressive banking sector invests in increasing value to its customers through technology and continuously adapts to new conditions.
Why is it important?	Without purpose a banking sector does not ensure trust, loses competitiveness and long-term success.	Without sustainable profitability a banking sector cannot deliver value to shareholders and offer to the society	Without capital adequacy and regulatory compliance, a banking system is exposed to market shocks and endangers sustainability.	If banking services fail to keep up with the digital era and improve continuously, the banking sector will fail to preserve its existence.
How each performance dimension addresses all stakeholder needs	A purpose-led banking sector reassures to regulators, customers, and shareholders that customer and societal value outweighs short term gains	A viable banking sector balances costs and benefits to maximize gain while ensuring that all competing stakeholder needs and expectations remain satisfied.	A safe and sound banking sector protects customers with sufficient liquidity which also reassures shareholders the soundness of their investments.	A progressive banking sector will leverage its investments in technology to maintain customer loyalty and satisfy shareholders by staying competitive against disruptive market entrants.

4

The Cypriot banking Sector as “Purpose-led”

4.1 Introduction

We looked for the views of local banking sector experts on what it exactly means to be truly “purpose-led”. There is consensus that a purpose-led banking sector is one that places its organisational purpose, a meaningful and enduring reason to exist, at the core of everything it does and how it operates; using purpose as the compass to guide decision-making and deliver wider stakeholder long-term value generation.

The business case “For Purpose” made by the EY Beacon Institute, a community of global executives, entrepreneurs, academics, and thought leaders, revealed that in organizations where purpose had become a driver of strategy and decision-making, executives reported a greater ability to drive revenue growth and drive successful innovation and ongoing transformation[31]. The survey defined purpose as *“an aspirational reason for being which inspires and provides a call to action for an organization and its partners and stakeholders and provides benefit to local and global society”*.

Most executives believe purpose matters, as more than 80% of executives surveyed said a strong sense of collective purpose drives employee satisfaction, can affect an organisation’s ability to transform, and help increase customer loyalty. However, only a minority said that their company currently runs in a purpose-driven way, as organisations are trying to develop a strong sense of purpose.

A purpose-driven banking sector is one that measures success, not only in terms of profitability, but also in terms of sustainability and contribution to the society and climate change initiatives. It decides and acts in a holistic manner towards stakeholders’ changing demands, committed to advancing customer experience, enhancing value to shareholders, and sustaining the wider economy.

Research carried out by Harvard Business Review Analytic Services in association with EY revealed that organisations operating with a clear and driving sense of purpose, beyond the singular goal of generating profits, outperform the market. Developing a cohering purpose, such as community growth, poverty reduction or environmental friendliness at the core of business strategy influences decision-making, inspires employees and customers, and builds trust – an increasingly essential ingredient[32].

4.2 Green transition

Central banks and regulatory bodies globally are taking initiatives to ensure that banking institutions are prepared for financial shocks caused by climate change. These stress tests are aiming to test their counterparty risk exposure, highlighting the importance of being proactive facing climate risks[33].

Climate change is also a top priority for the Cypriot Government as it plans to allocate more than €500m by 2026 to policies addressing it. In line with the Paris Agreement, Cyprus remains committed to cut greenhouse gas emissions by 55% by 2030 and reach carbon neutrality by 2050[34]. Cypriot banks, exploiting their gravitas in the economy and wider society, will be asked to play a pivotal role in the island’s ‘green transition’. The EU has also decided to allocate as part of the recovery and resilience plan more than €490 million in grants and loans towards renewable energy production, decisively setting the tone on the national importance of greening the economy[35].

The current energy crisis is boosting demand for green financing, expediting the growth of the renewables and electric vehicles market, energy efficiency in buildings, rapidly altering the perception of people towards climate change[36].

[31] Harvard Business Review – EY | The Business case for Purpose
[32] Idem
[33] S&P Global | A global bank assesses its resilience to Climate risks
[34] Cyprus mail | Cyprus allocates €500m to address climate change, endorses forest pledge
[35] European Parliament
[36] Raconteur | Energy crisis causes more businesses to make the switch to renewables

Banks could contribute to the 'green transition' by designing green products whereby favourable lending terms are granted to borrowers pursuing environmental sustainability. To successfully launch green products and services, banks need to design adequate monitoring mechanisms that enable measuring a company's climate-related performance. In that way, borrowers that successfully operate within certain pre-determined sustainability criteria will be able to enjoy financial benefits, such as favourable interest rates. Furthermore, and most importantly, banks will ensure that product offerings ultimately achieve their goal, a positive impact to the environment and the economy in general. Green banking products form a win-win situation for banks, borrowers and the society overall.

Blackstone, one of the largest lenders of private equity globally, exemplify how financial institutions can promote and successfully blend sustainability and profitability together.

Blackstone

Arriving at a mutually benefiting solution of both promoting sustainability to borrowers and presenting revenue generating opportunities to lenders, seems to be a cumbersome task. A fine balance can be found in products such as the sustainability linked loans (SLL) offered by Blackstone[37]. The interest rates on their loans are linked to sustainability objectives, measured by key performance indicators, each specifically selected to fit the unique conditions of the borrower.

Recently, Blackstone financed a company offering sustainable and energy efficient solutions through an SLL, tying the loan's interest rate to the company's performance on three meaningful goals.

Goal 1: The borrower company is assessed on the extent they keep procuring energy on behalf of their clients, with a significant part of it being renewable energy, over the years of the loan servicing.

Goal 2: The levels of carbon emissions that the borrower's projects generate over the first three years after their completion, are also assessed.

Goal 3: The increase in representation of women within the borrower's workforce to a third of its workforce forms the last KPI.

Blackstone can also raise the interest rates on SLLs if the borrower fails to meet its targets. By doing so, the borrower is believed to be further energised towards attaining sustainability, which in turn can increase the value the company can generate for its investors. As such, the borrower has both ESG and bottom-line incentives to hit these sustainability targets. Flywheel effects can also arise as the lender can link targets with the capabilities of other companies within its SLL portfolio. This can strengthen the lender-borrower relationships, further increasing the value for banks. Ultimately, SLLs can be a means for banks to increase their green asset ratio, be compliant to increasingly greener future regulatory standards and remain competitive.

[37] Blackstone

4.3 ESG

Every business is deeply intertwined with environmental, social, and governance (ESG) concerns. The 'E' element in ESG, environmental criteria, concerns climate change primarily and specifically includes the energy consumption, waste discharged and carbon emissions.

Besides environmental criteria, the 'S' and 'G' elements, social criteria and governance, are equitably important. Social criteria address the relationships of a company and the reputation it fosters with people and institutions, the labour relations, diversity and inclusion. Governance is the internal system of practices, controls and procedures a company adopts in order to govern itself, make effective decisions, comply with the law, and meet the needs of external stakeholders.

ESG investing is driven globally by (i) accelerated consumer demand for environmentally friendly products and (ii) institutional investors shifting rapidly away from carbon-intensive industries. In essence, 'ESG, largely perceived as reputational, is now a financial risk'.

An important step forward is currently being taken with ESG reporting. Regulators are working hard to establish standards of reporting, aiming at comparable ESG data to facilitate the understanding around climate change risk management. In Europe the most anticipated standard is Corporate Sustainability Reporting Directive (CSRD) with its recent implementation in 2025 requiring all large entities (especially systemic banks) to regularly report on the social and environment impacts of their activities.

Regulatory pressure led banks focus on ESG reporting first rather than ESG strategy. An ESG strategic plan is the key to achieving financial, efficiency and growth goals. It's easy for a company to want to become more environmentally and socially conscious. It can be much harder though to know if companies are actually meeting these goals without a way to track them. That's where having a corporate ESG strategy makes all the difference; it gives businesses a framework for seeing progress toward reaching sustainability goals.

A strong ESG proposition links to value creation in top-line growth, cost reduction, productivity uplift and asset optimisation. Through an ESG strategic plan, banks can get quantitative information that measures the value they're getting back for their efforts, which would allow them to keep up with competitors, align with stakeholder interests and prepare for long-term success.

The framework of ESG facilitates the essence of purpose-driven action; a banking sector with an ESG focus is one that seeks to be a leader in environmental sustainability, whilst also being socially beneficial and willing to take accountability for its actions.

Solid ESG data will allow banks to improve how they price climate risks and then allocate capital accordingly. Right now, banks and investors are in the dark relative to their own exposure and a particular company's/client's exposure to climate-related risks[38].

Borrowers who are not yet cultivated to keep ESG information can be incentivised to collect and monitor "green" KPIs to benefit from favourable lending conditions. Banks benefit from ESG information collected by borrowers from both a financial and regulatory standpoint as it lowers their ESG monitoring costs and assures their regulatory compliance. Ultimately, by acting proactively there are benefits for both banks and borrowers, and an all-encompassing impact to preserve the environment by conducting business in a greener way.

[38] The Economist – Banking in 2035: three possible futures

S&P Global, Climate Credit Analytics model

Climate-linked credit analysis models have already been developed overseas. The "Climate Credit Analytics" model, an initiative from S&P Global, aims to link climate and credit risk through the modelling of climate scenarios into financial performance drivers. The model can evaluate the credit risk for both public and private companies and can even assess SMEs through extrapolation, by leveraging on its large databank of ESG related data. Evidently, such model necessitates the maintenance and upkeeping of a rich database, a feat very challenging and costly, especially for countries like Cyprus where ESG awareness is not very high. Nevertheless, through technological improvements and artificial intelligence (AI) enablement, such tools will be key in monitoring a bank's loan portfolio in the future.

Regulators, consumers, and investors are increasingly demanding from banks to embrace the green transition and abide by strict ethical standards. Embedding long-term socially and environmentally beneficial objectives at the heart of doing business is imperative for securing customer loyalty and investor confidence.

From a regulatory perspective, banks are required to maintain an ESG rating for customers. On the contrary, non-financial institutions have no regulatory pressure yet for green monitoring, and there appears to be an insufficient business response as the concept of a 'green transition' is well outside their priority lists. Therefore, it is imperative that banks raise environmental awareness of clients to minimise the existing sustainability gap between organisations, by:

- Relationship Managers (RMs) educating clients about the financial and non-financial benefits of maintaining ESG information in the long run;
- Banks demanding ESG disclosures from borrowers for new credit lending applications;
- Bank to establish mechanisms for effective monitoring the progress of green lending projects.

In the future, a domino effect is expected to happen within the market where ESG companies will exclude non-ESG players from their business operations. Thus, as time passes, SMEs will eventually have to go greener to survive the market conditions, a rather challenging task, necessitating planning, investments, and years-long effort. Banks can benefit from this situation with green banking products.

For banks, the challenges associated with ESG may currently seem to be overwhelming compared to the visible benefits and opportunities. Internal cultural changes, short-term trade-offs over long-term benefits, and added risk management on top of the already high regulatory pressure are some of the challenges banks are facing.

Experts suggest that each bank has to establish a special ESG task force, where in every department there is an individual responsible for the ESG trajectory of that department, supervised by a centralised ESG committee. Banks need to develop green financial products to both become more efficient in monitoring the loan balance and to smoothly transition into the greener economy of the future while meeting regulatory requirements and increasing lending.

4.4 Public Trust

Restoring trust with the public needs to be a strategic priority for Cypriot banks. Since the 2013 banking crisis, trust in banks has yet to be fully restored. There has been a slight improvement in public confidence during the pandemic as banks have shown flexibility and speed in supporting customers in need. Cypriot banks have demonstrated responsiveness and flexibility in supporting the community during Covid-19 lockdowns via the provision of c€8.6bn in loans approved to enter the country's moratorium scheme[39]. Cypriot borrowers had the highest participation in moratoria schemes across Europe, with 48% (Appendix A) of the loans accepted to the country's scheme.

A survey conducted by the ACB during the last quarter of 2021, asked individuals and legal entities to indicate on a scale from 1-10 the level of trust they place in Cypriot Banks. The average was 4.7 and 5.1 for individuals and legal entities, respectively.

Internationally, financial services' trust levels hovered around 50% during the last decade, showing a relatively strong increase in the score during that time among the industries studied[40]. It appears that the local results are aligned with the global trust levels of the sector, which suggest that public trust may be a sectorial, and not a Cyprus specific issue after all.

Bank executives suggested that acting with integrity and in a humane manner towards clients can have a positive impact on public trust and enhance customer satisfaction. Banks ought to practically demonstrate that they understand individual customer needs and be flexible in customising services and solutions according to customers' needs, striving to improve customer satisfaction. Adhering by moral principles and demonstrating care at personal and exceptional circumstances can elevate the public perception towards banks in terms of trust and overall social contribution.

Executives also stressed the importance of having the client at the core of their operations, in how banks act and invest for the future, by establishing a client centric model. Banks should maintain timely and response-driven communication with clients, acting genuinely to proactively address instances of financial struggle. At the same time, the customer experience needs to be improved by simplifying complex processes and relaying customer choices to clients in an effective way. Consistency by allocating dedicated bankers for customer communication creates a 'friendly face' that can build trust over time.

Sector experts believe that trust can be restored. Data shows that this takes time but it's feasible. Being purpose-led can act as the compass to facilitate and expedite trust restoration.

[39] Moratoria and Public Guarantees in the EU Banking Sector (2020) | EBA
[40] Eldenman | Edelman Trust Barometer 2022

4.5 Culture

Culture is the mechanism that delivers the values and behaviours that shape conduct and contributes to creating public trust and a positive reputation for banks among employees, investors and the wider public. Lack of culture and confidence in the banking sector could transpose badly to several aspects within society.

Cultivating a healthy culture in banking is imperative and to make it happen, it demands careful consideration, monitoring, and continuous efforts in managing its multiple facets.

(i) Leading by example

Core values should be well-defined and communicated to bank employees. Banks' senior management should consistently reinforce and demonstrate core values, adopting them in decision-making processes and future planning.

In Cyprus, banks should take big steps towards improving their culture. Senior management shall clearly set out where responsibility and decision-making lie within the organisation, if possible at an individual level, and provide a 'statement of responsibility' that will outline specific roles and responsibilities.

Transparency is arguably equally important. A fair and proper performance appraisal management system lies among the highest standards of conduct. Leading by example would strengthen the culture in banking and create a sense of unity in the workforce.

(ii) Promoting ideas and professional development

As banks are vital for a well-functioning economy, they are called to be at the forefront of constantly servicing the society. Evidently, in an everchanging economic environment, new ideas, innovation, creativity, and promotion of continuous learning must be a core part of a bank's culture to be able to fulfil its societal mission.

The rise of FinTech companies has increased competition and subsequently the pressure on legacy banks to be proactive to meet the increasingly higher customer expectations. Banks need to encourage their staff to take advantage of training and development resources to update their skillset, remain competitive, and ultimately be better positioned to keep up with the shifting demands of the market. Considering the alternative, hiring and firing a bank's staff to attract the desired talent is costly and, if abused, it can damage the reputation of the bank overall.

(iii) Collaborative leadership

Today's workers seek a trusted relationship with their employer and flexibility in the way they work. Increasingly more employees seek collaboration and teaming. Legacy management structures with strongly defined hierarchies have dominated the banking sector ever since and, in the spirit of transformation, a more collaborative leadership structure seems more appropriate.

Collaborative leaders will involve the entire team in discussing options, setting priorities and goals, and deciding on the best course of action. An example of this horizontal approach to leadership can be a brainstorming session where the flow of ideas moves from side to side rather than funnelling from top to bottom. For a culture of ideas and innovation to fully flourish, a collaborative leadership structure is necessary.

(iv) Communication

Communication in the workplace can be defined as the way an organization engages with its people, shares information, drives conversations, and encourages employees' voice. Voicing up is not easy and whistleblowing structures can greatly help raising awareness on internal professional misconduct, discrimination, harassment, and even criminal activity. Establishing whistleblowing mechanisms is a cultural matter and could be a great step forward for Cypriot banks in creating a freer working banking environment.

Undoubtedly, managing and improving culture involves many different stakeholders whose motives may differ and often collide. Clashes between bank employees and employers give rise to labour conflicts, but it is up to the senior management teams to create a culture that is able to eliminate clashes before they escalate to conflicts and disrupt the business.

(v) Labour conflicts

Labour conflicts between banks and the Union deteriorate all elements constituting a healthy culture in the sector. The high degree of protection provided to employees by the Union hinders banks from implementing the right mechanisms to cultivate the desired culture.

A performance-based appraisal system would promote, amongst other, organisational growth, higher productivity and progressive thinking. Such system would reward high performers and actively manage low performers who, through constructive feedback, would be allowed to develop and become more productive.

Horizontal promotion (i.e. increase in title and pay for an employee, but with little to no change in responsibilities) has been the norm for Cypriot banks. Any announcements for staff layoffs have been answered by union-wide action or were compromised by implementing voluntary retirement schemes, which are costly for the banks.

Consequently, high performers who have the potential and willingness to undertake more responsibility and move up the ladder quickly end up being demotivated and carried away by a culture which in essence encourages average performance. On the other hand, low performers do not feel any pressure to develop their skills and productivity as they enjoy the Union's safety net.

Evidently, best banking practices on remuneration, promotion and rewarding of top talent are effectively discouraged by a system which promotes tenure over contribution. A mutually agreed solution between banks and the Union on talent management and performance-based remuneration and promotion system is required to cultivate a competitive and progressive banking culture.

Culture is an integral part of banks' DNA, enabling or hindering the development of competencies. It acts as a catalyst towards value creation. Without the right culture, a purpose-led banking sector cannot exist. Banks need to carefully manage the various stakeholders, balancing out the incentives of shareholders and employees, which in Cyprus seems to be particularly challenging.

5

The Cypriot banking sector as “Viable”

5.1 Introduction

A purpose-led banking sector, as described previously, forms the basis for long-term viability. A viable banking sector is a prerequisite to a well-functioning modern economy and prosperous society.

Viability is largely associated with sustainable profitability. The traditional banking model of accumulating cheap financing from depositors, providing credit at a margin and charging fees for peripheral services is still the core of banking business globally but it has proved to be fragile over the last decade. It is largely prone to a decline in the asset quality, interest rate fluctuations and operating inefficiency. Challenger banks have also grown rapidly, initially supported by the tech savvy Millennials and Generation Z, threatening traditional banks’ viability to an extent, forcing them to redefine their offerings and business models and search for new ways to satisfy demand.

Sustaining healthy financial performance, to ensure viability, not only requires banks to quickly and effectively adapt to the changing market conditions and customer needs, but also to maintain and strengthen relationships with clients.

A viable bank is one that is well-positioned to serve client needs, is able to sustain and absorb economic shocks, comply with regulations and support the wider economy during both recession and growth periods.

In this section we put emphasis on the need to build sustainable profitability and touch upon its main drivers: income and costs.

5.2 Sustainable profitability

(i) What is considered sustainable ROE?

Over the past decade, European banks have struggled to generate the desired ROE as base interest rates hovered around zero. Despite the pandemic delaying the eventual return to profitability, it accelerated business model transformations.

The ECB has repeatedly highlighted that low bank profitability constitutes a key risk to the financial stability of the euro area. Prolonged periods of very low bank profitability, risk having healthy credit intermediation in the economy, with potentially adverse repercussions for growth and welfare.

The question is, what is the desirable level of profitability from a financial stability perspective? In fact, excessively high bank profitability could also pose the risks to financial stability. As vividly experienced in the period leading up to the financial crisis, such a situation may be predicated on high risk-taking, which could sow the seeds for future banking crises[41].

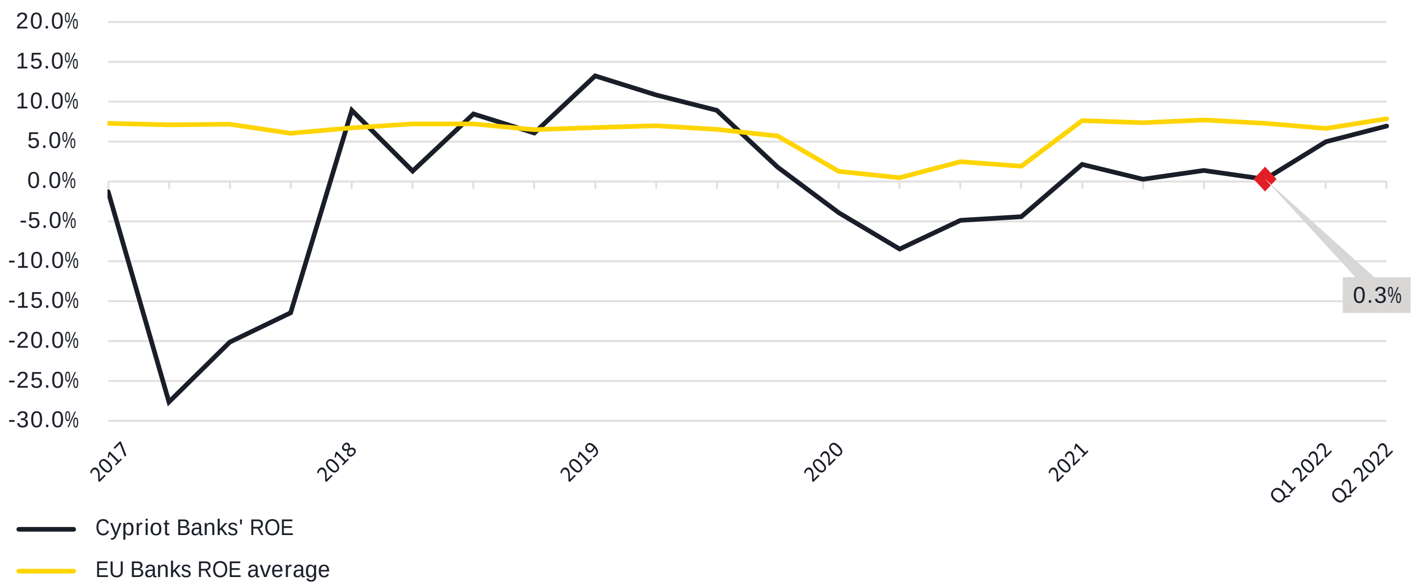
[41] ECB | How can euro area banks reach sustainable profitability in the future?

EU banks' average ROE increased significantly from a 10-year average of 3.0%[42] to 7.5% in 2021[43]. The recent hikes in interest rates by the ECB in an attempt to bring down record inflation in the eurozone, is positively affecting banks' profitability.

According to the ECB, a target range of 6-10% ROE for euro area banks is assumed and used as a benchmark. Realistic medium-term ROE targets acknowledge the fact that banks are currently much safer than before the outbreak of the crisis a decade ago[44].

Historically, profitability has been challenging for Cypriot banks primarily due to high loan-loss provisions and NPL deleveraging efforts. Compared to the euro area, Cypriot banks' average ROE was lower in the last 5 years. As of Q4 2021, the Cypriot banking sector ranked last amongst European banking sectors in terms of positive ROE.

Average quarterly ROE – Cypriot vs EU banks



Source: EBA Dashboard | Q2 2022

EU Banking sector – Return on Equity for the period ended Q4 2021

Source: EBA Dashboard | Q2 2022

[42] EBF | EBF Facts & Figures 2022
[43] EBA Dashboard | Q2 2022
[44] ECB | How can euro area banks reach sustainable profitability in the future?

(ii) Sustainable profitability can elevate bank valuations

In recent times, banks globally, but especially European ones have lagged the market significantly, with price-to-book (P/B) ratios constantly below one, indicating that investors have lost their faith in the banks' ability to generate shareholder value. Sustainable profitability, interpreted through the expected ROE metric, is one of the key factors driving bank valuations.

Our analysis shows that only 4% of the studied European banks have a P/B ratio above 2 and only one in five have a ratio above 1. With an average P/B ratio across Eurozone banks at 0.76, the banking sector remains unattractive to investors, and it is generally perceived as a risky investment.

According to our research, it is estimated that a European bank priced at book value expects ROE of around 12.5%, which is admittedly very high for retail banks relying solely on interest income. However, the recent rise of interest rates will certainly favour European banks' income statements.

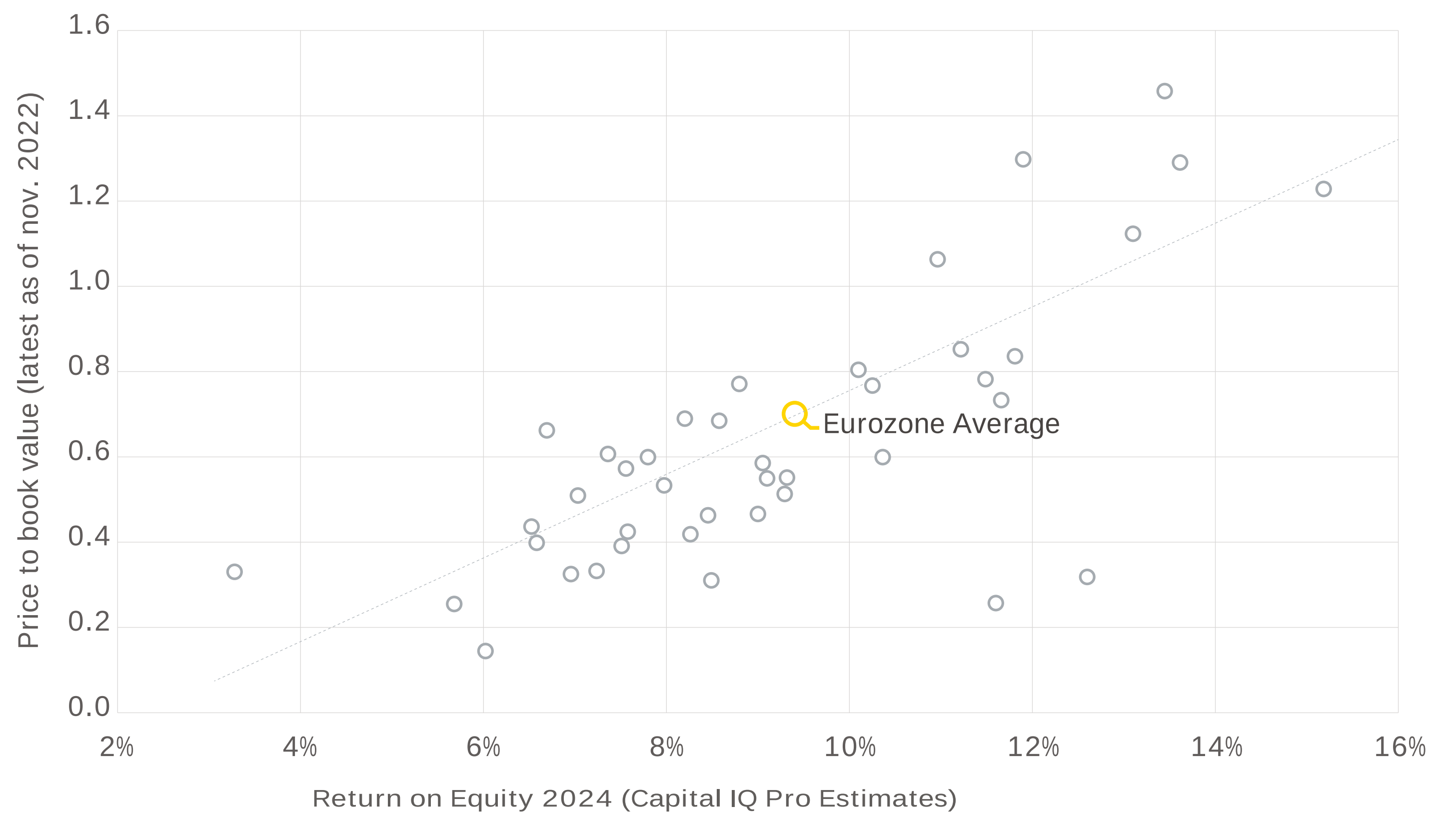
We estimate that the interest rate hikes will have a positive impact on NII of Cypriot banks in the order of €250-300m in 2023. The current market conditions and upcoming developments give a unique opportunity to Cypriot banks, not just to return to healthy profitability, but essentially to increase their values.

Cypriot banks have traditionally suffered from low P/B ratios due to a combination of factors: asset quality, low flexibility in cost reduction initiatives, small market size, and lack of exit options for investors. The determining factor though remains profitability and the ability to send a strong convincing message to investors that a sustainable ROE, as close to cost of equity as possible, is indeed achievable.

A simple regression between expected return and P/B ratio reveals that a bank generating ROE in the region of 6% would normally be traded at 0.35 of book value. Moving up to 9% ROE could double up market capitalisation.

Attaining a market cap representative of their potential has been a long-standing effort of Cypriot banks and has not yet been achieved. While profitability in the coming years can elevate bank valuations, sustainable profitability can preserve them there.

European Bank returns and valuations



Source: S&P Capital IQ Pro

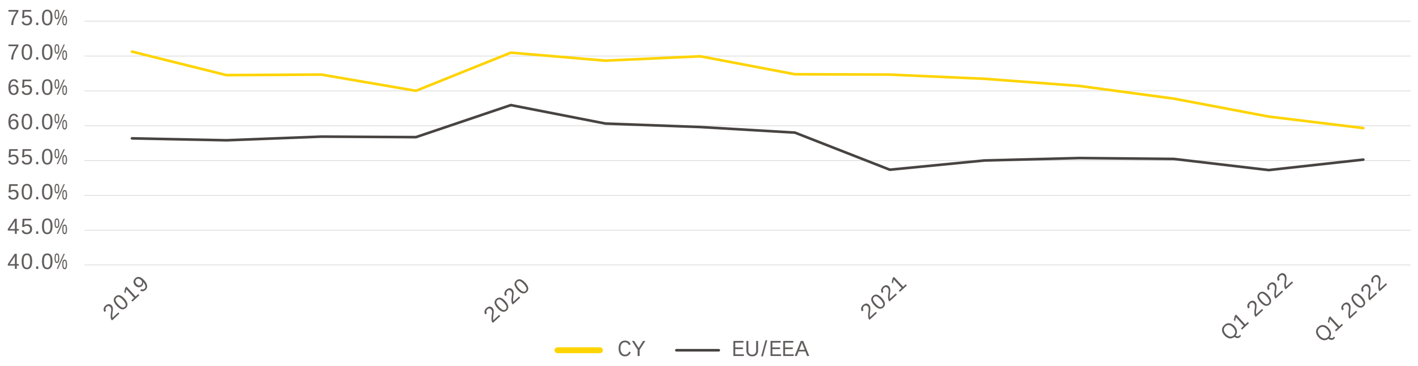
5.3 Income

Sustainable profitability requires a sustainable business model to begin with. Historically, lending volume was the target rather than asset quality. Traditionally, Cypriot banks' revenue was highly concentrated around interest income.

(i) Income diversification

The main income driver for banks across Europe is interest income. Net interest income to Total income ratio has been historically higher in Cyprus compared to the EU. In recent years, the ratio between the two converged, reaching 55-60% respectively.

NII to Total Income



Source graph : EBA Dashboard | Q2 2022

Research suggests that diversifying the banking operations can increase the resilience of individual banks to both systemic and idiosyncratic risk and allows for additional liquidity and investment opportunities to savers[45]. Ultimately, a more resilient bank, is a more viable bank that positively contributes to the stability of the country's economy.

Cypriot banks need to diversify their revenue streams through commissions and fee-based services to be better positioned for future unfavourable market conditions. Reducing reliance on interest income, by introducing alternative revenue streams, will enhance banks' resilience to changing market conditions, geopolitical situations and international decisions driving base interest rates.

We have seen banks which consult their customers on insurance, advisory or private wealth services gaining a competitive advantage over more indolent players, both in local and global markets. A swift way for banks to expand their service offerings and ultimately commission income, is through inorganic acquisitions of (or teaming up with) FinTechs.

(ii) Blending with a FinTech might be challenging but rewarding

FinTech companies have rapidly emerged over the last decade to set the scene of reshaping the banking sector, leaving little space for brick-and-mortar banks should they choose not to adapt to the new era. Globally, many of the largest banks have decided to grow inorganically by acquiring FinTech companies and start-ups, bringing new talent, valuable knowledge, and readily available products into their agenda.

Traditional banks still possess the option of engaging physically with clients, whereas FinTechs usually do not. To what extent should banks keep physical channels alive though? Physical interaction is still highly valued by some clients, especially the older ones who hardly use internet banking and mobile apps. Despite the surge of digital channels in recent years, accelerated by the pandemic, digital users are rarely found in older generations. By mid-2022, ongoing branch consolidation globally has resulted in a 20% reduction in the number of physical locations since 2017[46]. In Cyprus, more than 40% of bank branches have ceased operations during the same period. Worldwide, around 30% of customers continue to prefer their service needs to be met at branches. This share jumps to nearly 50% for sensitive and/or complex situations.

Can these two opposite worlds blend to create value for shareholders and clients? Can physical interaction be maintained, at least for high-value tasks, while at the same time transform and look into the future? The answer may be simpler than it seems, and integration of these two worlds might be achieved more naturally than one might think. Despite the differences in mindset, culture, aspirations and views, each must identify the other's strengths that would work synergistically, and step on them to grow.

A FinTech can leverage from a bank's immense client base and long-lasting relationships to swiftly extend its reach. A bank can exploit a FinTech's technological specialty to reduce costs, transform and enhance customer experience. A characteristic example of a win-win bank-FinTech deal is presented below, clearly indicating that both parties can benefit from such transactions.

Société Générale's acquisition of neo-bank Shine

In 2020, the French bank Société Générale acquired the neo-bank Shine which offers to Very Small Enterprises (VSEs), professionals and self-employed in France a solution that combines a full online bank account with a support in the administrative management for their daily activity (calculation of taxes and contributions, billing, accounting simplification etc). While maintaining its identity and autonomy, Shine took advantage of synergies with the bank's businesses, to broaden and distribute its offerings and to obtain approval as a payment establishment.

Despite being 100% acquired, Shine continues to develop their products independently, preserving the agility and flexibility that inherently FinTechs have. Within two years since its acquisition, Shine has doubled the number of its customers and employees and tripled its revenues[47].

(iii) Enhancing customer experience through digital transformation

Many bank processes are anchored to how their operations have always been; and this dynamic needs to be reversed. Advanced analytics, customer behavioural models and predictive algorithms can help advance service quality by predicting client needs before clients even think of such needs. Without a doubt, this would help banks build tailor-made value propositions for clients.

Recent survey results indicate that financial institutions aim to improve customer experience by setting customers' digital experience and data analytics enhancement as strategic primacies. In the era of digital transformation, automation can prove greatly beneficial to banks in an attempt to elevate customer experience. For example, digitalisation of loan application approval procedures can greatly shorten the waiting and time-to-cash for borrowers[48]. Another potential integration of automated processes can be in resolutions of disputes on credit cards which can alleviate employees from repetitive tasks, making time to help customers with more complex and demanding problems, ultimately enriching customer experience.

With the increasing integration of internet and mobile banking, banks have access to unlimited data points for a single customer. Micro-segmenting, even to the level of single customers, understanding behaviour, habits and predicting needs can unlock unlimited opportunities for banks to offer targeted products and boost their income.

Besides transforming how core business is conducted, innovation and technology can help with new product offerings. Robo-advisors in wealth management and automated product offerings specific to each customer profile will be standard practice in the near future.

[45] Acemoglu et. Al. (2015)
[46] Best of both worlds: Balancing digital and physical channels in retail banking | McKinsey
[47] Societe Generale
[48] Deninzon, Malik & Kapoor (2019)

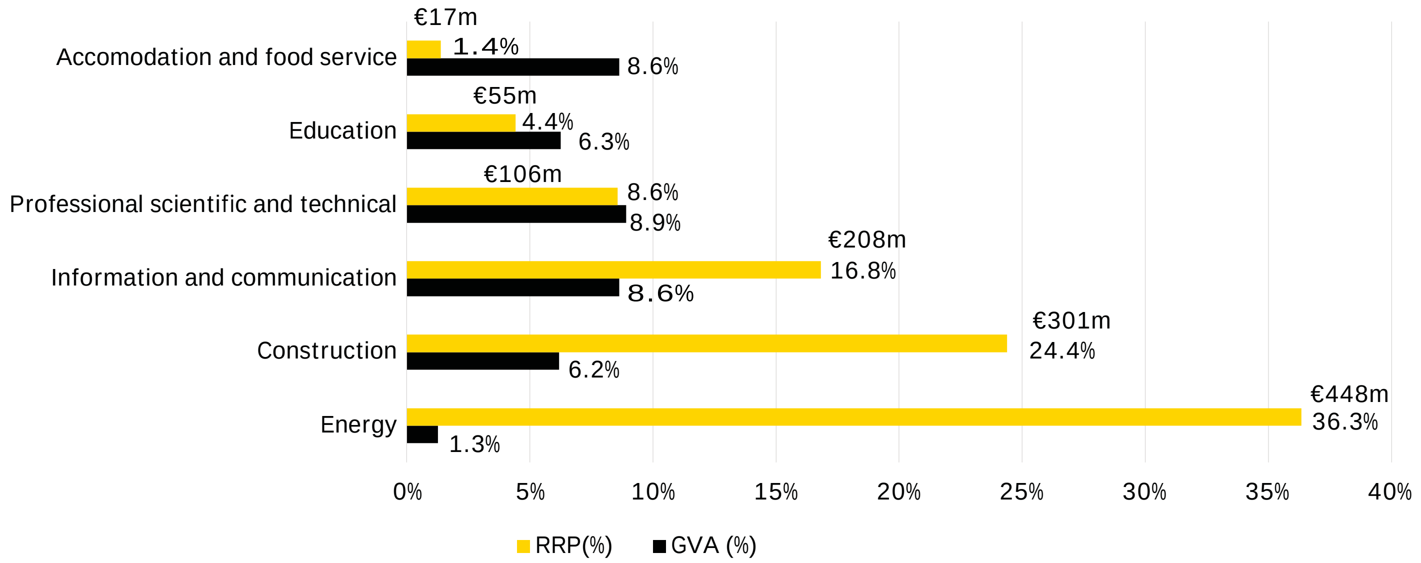
(iv) Sectorial expertise will be key to exploit future financing opportunities

Sectorial expertise not only amplifies customer experience, but also mitigates the exposure at risk. Deep industry knowledge implies better understanding of client peculiarities, risks, challenges but also upsides. In this way, a bank could transform its new lending and risk operating model to shift away from the blanket lending approach which largely ignores industry, developments and prospects.

Industry complexities and continuous transformation of markets make it difficult to maintain competitive knowledge and expertise across several sectors. Cypriot banks, primarily smaller ones that may not have the resources and capacity to develop expert teams across all key industries of the economy, could adjust their business models to develop deep knowledge and understanding on specific sectors and selectively offer customised products in these sectors.

Sectors with historically small contribution to the GVA of Cyprus could potentially turn into rising sectors and focus areas for new lending in the coming years, especially when taking into account the upcoming investments through the Cyprus Recovery and Resilience plan (RRP).

Sectors of interest % of RRP and % of GVA (2021)



Source: CyStat; Eurostat; EY analysis

According to EY analysis, the Cypriot recovery resilience plan is set to have a decisive impact on the GDP growth of the island. Specifically, funds earmarked for the transition to a greener economy are assessed to increase GDP by €239mln and create 6,330 jobs in the affected sectors until 2026[49].

The energy sector's turmoil in 2022 is setting a different pace in the green transition battle across Europe. As energy prices rise, enterprises and households are intensively seeking for greener solutions to reduce consumption and bills. Renewable investments and energy efficiency measures are expected to dominate the market in the coming years, and banks have a key role to play in financing this transition by working smartly hand-in-hand with clients. The Cyprus RRP is also expected to drive this change, as funding and grants linked to the country's green transition could contribute more than €450m (41% of total funding).

On the other hand, traditional sectors, such as accommodation and tourism, have been of the highest importance on the island's economy. According to the Cypriot deputy ministry of tourism, the direct and indirect-spill over effect that tourism has in the greater economy is estimated at 20%-25% of GDP[50]. Tourism is at the heart of Cypriot economy, and it constantly generates investment opportunities. Both the pandemic and sanctions imposed against Russia have adversely affected the sector since 2020, raising concerns about the viability of many market players. The sector proved resilient though, arrivals began to bounce back in 2022 reaching to more than 80% of 2019, which was a record year and is expected to keep offering substantial financing opportunities on an annual basis. It is up to the banks to evaluate and act upon them.

Another hot sector is shipping, with Cyprus having the third largest fleet under management in Europe[51]. The country's geographical position offers much more potential. The sector had traditionally provided opportunities for large tickets or syndications, but it is now at a turning point, trying to shift towards the "green era". Shipping companies are forced to transform and/or renew their fleet to meet environmental standards[52].

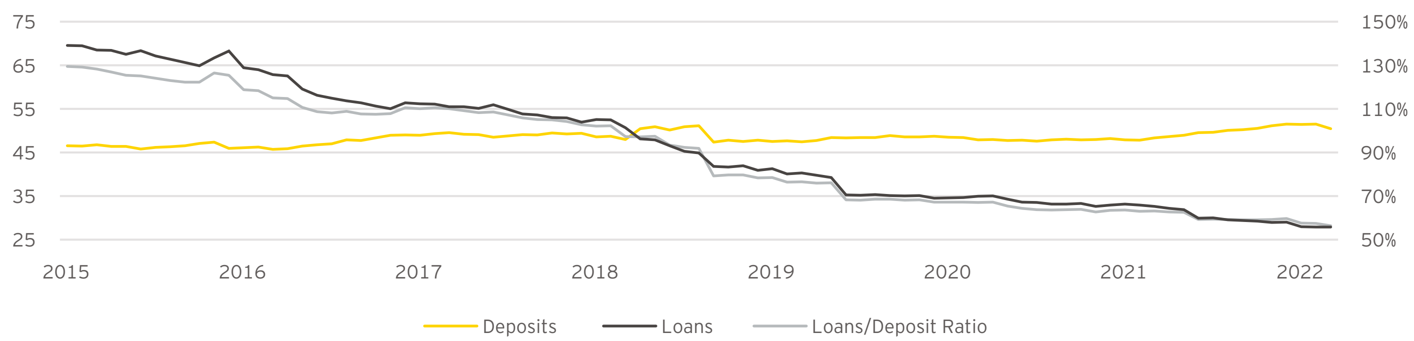
Banks are typically one-stop shops for people's and businesses' finances, hence should be able to advise and educate clients, not just lend them. Clients may lack deep understanding of specific industries and sectors, may lack skills needed in preparing a credible business plan and successfully implementing an expansion strategy, resulting in elevated execution risks which are usually harmful for both sides. Sectorial expertise can provide value-adding services from banks to clients and build stronger bonds on the basis of an advisory relationship rather than a cold financing relationship. Such expertise and culture can be cultivated through the recruitment of industry experts, dedicated and recurring trainings to bank employees, shift towards a client-centric model and change of processes.

(v) Leverage on excess liquidity

By Q3-2022, Cypriot banks accumulated over €24.5bn[53] of excess liquidity (104% of the 2021 national GDP). Deposit balances proved to be inelastic against the continuous reduction in deposit rates, probably because of limited investment options in the Cypriot market.

With a sector-wide liquidity coverage ratio hovering around 300%, Cyprus has one of the highest amounts of unused excessive funds across Europe whose LCR average is around 150%. Excessive unused funds create a suboptimal balance sheet position for Cypriot banks, who should seek for alternative ways to invest these funds as long as they are not being consumed by credit demand.

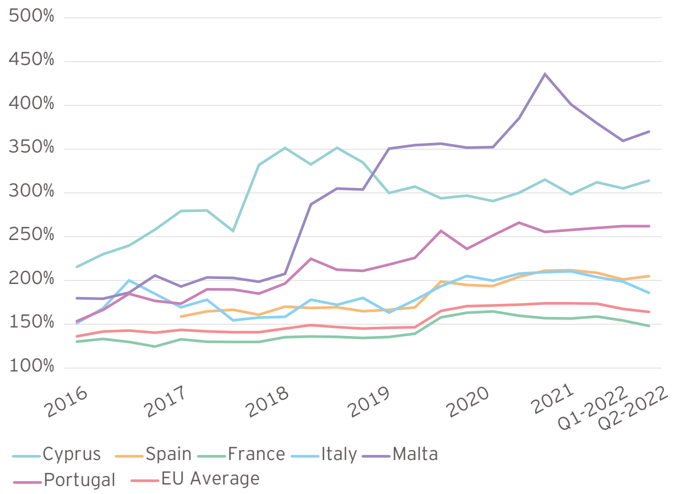
Loans and Deposits (€bn) of Non-MFIs held with MFIs – 2015-Q3 2022



Source: CBC

[49] EY analysis
[50] Deputy Ministry of Tourism | Annual Report 2019
[51] Cyprus Profile | Steering the World's Fleet
[52] Constantinou (2022)
[53] CBC | Aggregate Cyprus Banking Sector Data (Sep'22)

Liquidity Coverage Ratios

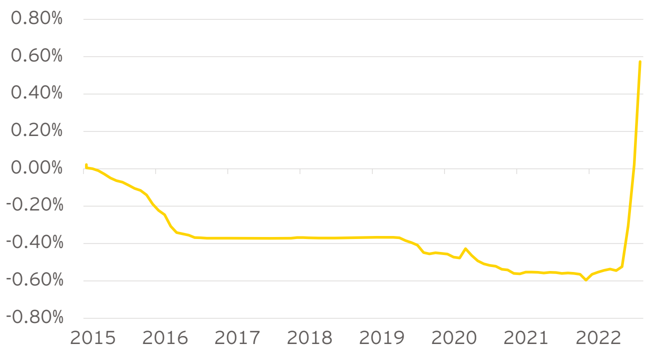


Source: [Statistical Data Warehouse]

Banks are having a hard time to convert excess funds into credit. Demand in the Cypriot market is being met, new lending is increasing, but not fast enough to effectively reduce excess liquidity to the European levels.

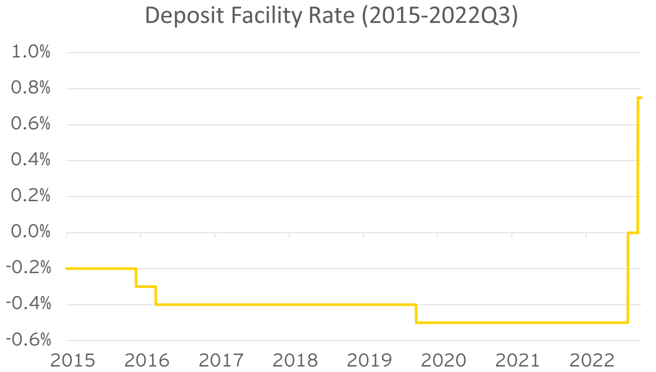
The hike of base interest rates by ECB has pierced to the positive territory after 6 years in the negative. This immediately turns an expense into income for Cypriot banks, who may benefit from either by depositing excess funds in the ECB at the deposit facility rate or lending excess liquidity to foreign banks at the interbank lending market.

Euribor 1-month – Historical close (2015-Q32022)



Source: [ECB Statistical Data Warehouse]

Deposit Facility Rate (2015-Q32022)



Source: [ECB Statistical Data Warehouse]

In addition, the excess funds could be redirected as international lending to foreign markets, leveraging on economies with better margins and larger financing needs than the Cypriot market. On the other hand, banks choosing this strategy may need to deal with different markets and regulatory issues outside Cyprus.

For instance, Greece poses as a great candidate for Cypriot banks to expand due to the close ties at cultural and political level, hosting many Cypriots either as students, entrepreneurs or businessmen. Greece is also a known marketplace for Cypriot banks as the largest ones had presence there until a decade ago, but eventually suffered as a result of the Greek sovereign crisis and the poor asset quality. Any international expansion initiatives will need to be strategically planned, articulated and methodically implemented to maximise probabilities of success.

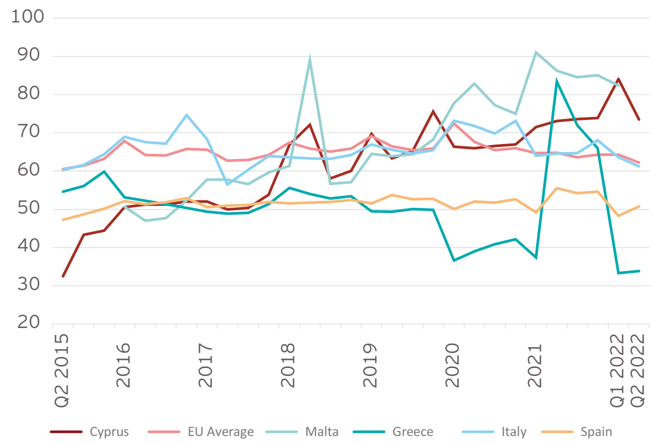
5.4 Cost

Sustainable profitability requires continuous evaluation and optimisation of a bank's cost base. Being in the digital era, banks ought to take advantage of the transforming technological landscape to digitise operations, streamline operational processes, reduce cost inefficiencies whilst also offer better customer experience. Cypriot banks' cost-to-income and staff cost-to-equity ratios are amongst the highest in Europe, thus reducing operational expenses imminently is vital to remain profitable.

(i) Cost optimisation is essential to sustain healthy financial performance

The cost-to-income ratio of Cypriot banks has followed an upward trajectory over the past years, and remains significantly higher than the EU average, hovering above 70% at the end of the second quarter of 2022. This increase is mainly due to the reducing operating income of the sector driven by the reducing net interest income, whilst operating costs remained relatively high. The outlook however is positive, as interest income is going to be boosted by the recent interest rate hikes, hence cost-to-income will be forced down. Nevertheless, cost optimisation is still essential to sustain healthy financial performance in the long-term.

Cost to income ratio: Cypriot vs EU banks

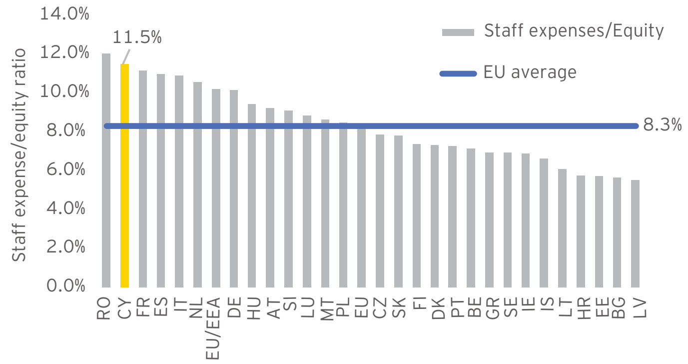


Source: [ECB | Statistical Data Warehouse]

Despite efforts by Cypriot banks to reduce operating costs historically, inelastic staff costs continue to deplete a significant portion of operating income, absorbing c40% of operating income in 2021 (36% in 2020). This is clearly visible from the staff cost-to-equity ratio, which for Cypriot banks (11.5%) is the second highest in Eurozone (average of 8.3%).

[54] [Retail Banker International]
[55] [SmallCapNews]

Staff cost-to-equity ratio of EU/EEA banks by member state (June 2022)



Source: [EBA Dashboard | Q2 2022]

Across Europe, the reduction in bank employees was sizeable during the last 15 years; 21% and 13% reduction since 2007 and 2014, respectively. Digital transformation coupled with the pandemic and pressure from shareholders to maintain returns forced banks to optimise costs.

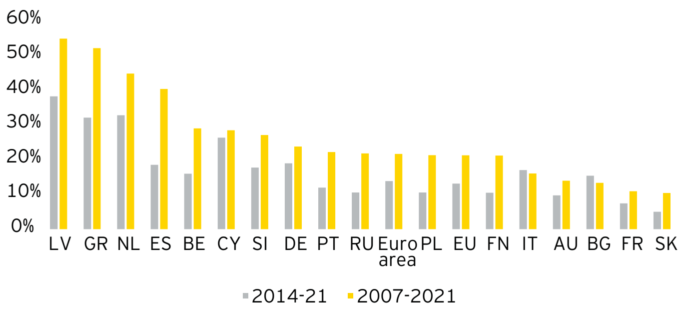
Santander's restructuring

A recent example of rather aggressive consolidation has been executed by the Spanish bank Santander. It made the headlines far back in 2019 with its restructuring plan to axe 14% of its total workforce and 1/3 of its branches in its domestic market, while since 2008 their branch network had nearly halved[54]. Employee layoffs and branch closures has followed the same trend in their global markets with downsizing being at the centre of their strategy. In Portugal and in the UK, during 2021, total Santander employees were reduced by more than 3000, while 134 branches closed in those markets within the same time period[55]. Apart from the fact that customers shifted towards the digital banking channels, and as such many branches became increasingly redundant/underperforming, these restructuring decisions have led to improved efficiency. While operating costs increased by 10% year on year (YoY), when adjusting for inflation they fell by 4%. Overall, Santander's efficiency ratio in Europe improved by 3.9% YoY.

(ii) Banks and Union should agree on modernising the remuneration and career progression framework for employees by implementing best industry practices

While European banks marched into organisational cost optimisation strategies since early 2010, Cypriot banks' reaction came in true effect much later. This is evident by the very small reduction of bank employees in Cyprus between 2007-2014. Effectively, Cypriot banks reduced bank employees only after 2014, in the aftermath of the Cypriot banking crisis.

Reduction in the number of Bank employees



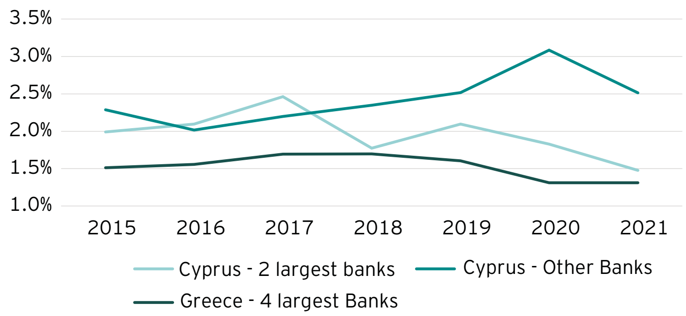
Source: ECB | Statistical Data Warehouse

Currently, reduction of staff costs is top of the agenda for Cypriot banks. In agreement with the Cyprus Union of Bank Employees, banks have been offering voluntary retirement schemes (VRS) in an effort to incentivise employees, especially the highest paid ones, to voluntarily leave. VRSs solve the high staff cost problem in the longer term, although they are costly at implementation and impact profitability as a lumpsum compensation is paid by banks upfront.

A notable reason behind the slow downsizing of the banks' workforce over the years is the resisting force of the Cyprus Union of Bank Employees. The Union has historically been one of the strongest in the Republic. The challenge for banks aiming to transform their business model, is to arrive at a mutually satisfying solution with the Union for modernising the remuneration, performance evaluation and career progression framework for employees by implementing best industry practices, incentivising employees and ultimately enhance productivity.

In Cyprus, the 2 largest banks by total assets are prominently more efficient than smaller banks, with cost-to-asset gap between them being 1.0% as of 2021. We expect this gap to continue increasing as digital transformation initiatives being implemented in the largest banks materialise.

Operating expenses/Total assets



Source: EY analysis

(iii) Digital transformation is key to sustainably operate at lower cost base and ensure long-term profitability

Changing market conditions and the rise of tech savvy generations put pressure on banks to go digital. Consumers look for ways to process their financial transactions in a simpler, faster and easier way.

Scale matters as banks compete on technological advancements. Technological and digital transformation investments in banking usually require high capital expenditure and advisory costs, placing smaller banks at a difficult position. Larger banks with a higher asset base and revenue generation can theoretically support easier high investments costs.

Inevitably profitability might be impacted in the short-term, but the long-term outlook will compensate banks day after day. It is not only a cost saving initiative, but rather an essential transformation to maintain competitiveness, keep up with the times, preserve existing clients and win the younger generations who value more a user-friendly digital interface over a branch at a suitable location.

In the digital world, the winners will be decided on marginal differences. Operating at low cost while ensuring profitability, necessitates economies of scale. However, this does not mean that all banks need to become large global institutions, but entails the need of scaling and pursuing efficiencies in the products and services they choose to compete with, either addressing them to the mass or to a niche market.

Cloud computing, for example, provides tangible benefits and productivity for banking IT as a whole, and particularly in areas like risk management or cash management. Another way to reduce costs, become more productive and scale gains is to build industry-wide utility platforms for executing common activities (for example, trading processing, KYC, Anti-money laundering (AML)) or networks like ATMs, even branches.

Credit institutions recognizing the limitless potential offered by technology have actively integrated digital transformation into their operations, offering and using more and more digital services and processes.

Cypriot banks have been transforming their cost base gradually in recent years, focusing primarily on branch networks as well as processes and workforce optimisation. Digital transformation initiatives are being implemented, but there is still a long way to go. This transition is expected to be costly but ultimately rewarding. Efforts to digitally transform should be intensified to sustainably operate at a lower cost base going forward, ensuring long-term profitability.

6

The Cypriot banking sector as "Safe & Stable"

6.1 Introduction

A safe and stable banking sector is characterised by financial robustness, with adequate capital and liquidity and the right mechanisms in place to proactively detect and assess risks that could lead to possible increase in NPLs.

Safety is safeguarded by a sector which is resilient against macro-economic shocks, such as abnormal fluctuations in inflation and GDP growth, and agile to make the necessary manoeuvres to cushion the negative impact of such effects on clients and shareholders.

Stability is ensured by complying with national and EU-wide regulations that mandate protection of consumers in areas such as financial crime, cyber-attacks and environmental risks.

Significant progress has been made in Cypriot banks the last decade in terms of improving anti-money laundering procedures. A vote of trust has been given by a number of correspondent banks, especially for the significant institutions of the island, which proves that the Cypriot banking sector has come a long way in improving past impediments and enhancing its connectivity with the international banking system.

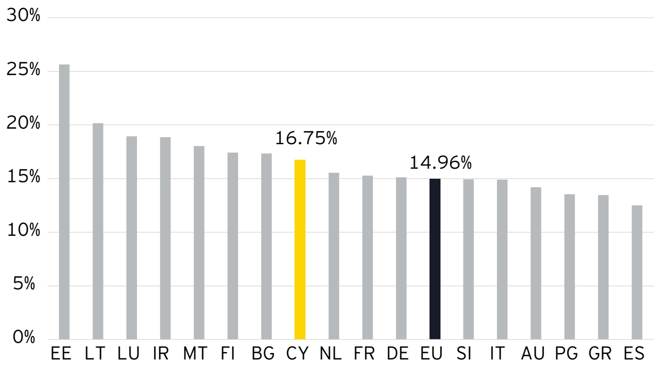
6.2 Capital adequacy

(i) Cypriot banks are amongst the best capitalised banks in Europe

Maintaining enough capital and liquidity is critical to ensuring effective risk management, as it enables banks to use own resources to absorb losses in the event of an economic shock.

The Common Equity Tier 1 (CET 1) ratio of Cypriot banks stands at 17.5%, and 16.75% for banks designated as significant institutions (SIs) by ECB as of the second quarter of 2022, above the European average which stands at 14.96%[56]. Cypriot banks also enjoy one of the highest liquidity coverage ratios (LCR) in Europe at 344%[57].

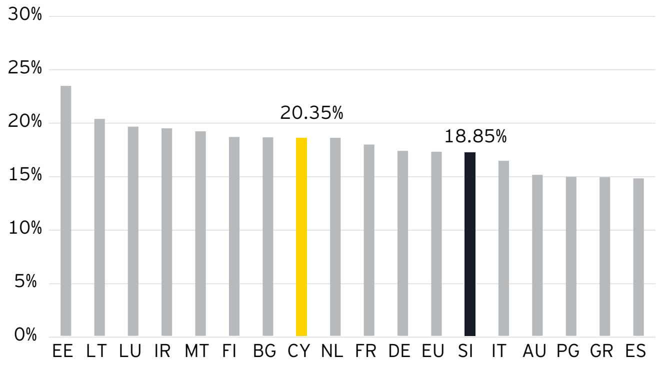
CET1 ratio across Europe (Q2 2022)



Source: ECB | Supervisory Banking Statistics (2022)

In comparison to other European countries, the Cypriot banking sector seems to be strongly positioned in terms of resilience towards sudden operating losses and customer withdrawal surges, with a total capital ratio of 20,35%, higher than the European average of 18,85%, as of June 2022.

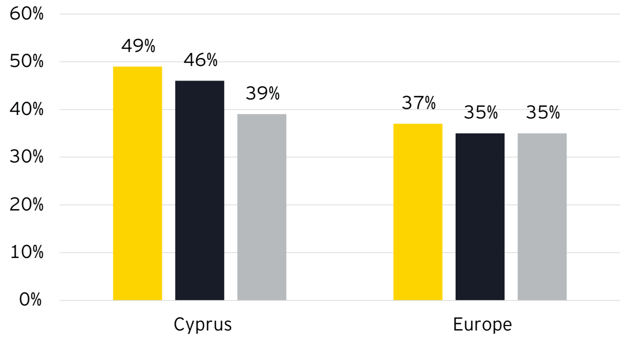
Total capital ratio across Europe – Q2 2022



Source: ECB | Supervisory Banking Statistics (2022)

Measuring riskiness, the RWA density of Cypriot banks historically exceeded that of European banks, primarily driven by the poorer asset quality and higher non-performing exposures. Higher RWA figures mandate higher capital reserves. While capital plays a critical role in the stability of the banking system, particularly at times of crisis, excessively high capital requirements can and do impact the costs of providing credit to customers.

RWA Density



Source: ECB

(ii) MREL is becoming a challenge for the banking sector

In addition to the above, regulators are always happier with higher capital, hence they keep increasing the barrier. The minimum requirement for own funds and eligible liabilities (MREL) is becoming an issue for Cypriot banks and probably for other European banks operating in markets with lower investor interest. Low investor appetite for MREL notes, driven by the reputation and the relatively small size of the Cypriot market, constitutes the issuance of MREL notes a costly business for Cypriot banks as investors require higher returns to be attracted and worth the risk.

56 ECB | Supervisory Banking Statistics (2022)
57 Central Bank of Cyprus | Speech by Constantinos Herodotou (2022)

6.3 Non-performing loans

Heading into an era of high interest rates, coupled with record inflation and unaffordable cost of living, the threat of new NPLs rising again in Cyprus comes to the surface. Looking ahead, banks need to proactively support existing customers, seeing through an upcoming crisis before it ends up in another recession, but also to maintain new lending growth. They need to strike the right balance between profitability (which might seem tempting after many years of drought) and preventing a new wave of NPLs from arising. Regulators also have a role to play by re-considering and/or relaxing some capital requirements, allowing banks to lo continue providing affordable credit.

(i) The threat of NPLs is visible again

Cypriot banks have suffered from unprecedently high NPLs the past decade. NPL ratio reached a record high of 48% in 2015[58]. Deleveraging efforts, NPL trades and dedicated organic servicing, have managed to reduce the ratio to 10.9% as of September 2022, but it is still the second highest in Europe[59].

The current macro-economic environment though, makes it likely that we will see a rise in NPLs again, which is one of the greatest threats to the stability of the Cypriot banking system. It remains to be seen how much NPLs will increase, nevertheless banks are well prepared and far more experienced to handle and tackle such crisis than a decade ago.

Simple but usually effective measures could be adopted proactively. Maintaining good communication with borrowers, improving communication channels and being flexible in upcoming restructuring solutions to those in real need could be beneficial.

Attempts should focus on preventing NPLs rather than managing them after they arise. Prevention requires early detection and warning mechanisms. Once higher risk is detected for a particular customer, or higher risk in the supply chain or clientele of the customer, immediate actions should be taken for effective and delicate handling.

Early detection mechanisms can be employed using advanced data analytics and predictive modelling. Banks constitute huge data centres nowadays. Transactions to and from a client's business, other internal data as well as publicly available information can collectively create a client ecosystem. Predictive modelling leveraging on the ecosystem's history can create a powerful mechanism for a bank, allowing automatic warning signals/alerts to pop up when risk for a client, its supply chain or even industry goes up. Artificial intelligence can also be used to enhance human expertise by identifying emerging threats and hidden opportunities within the data.

These new technologies are the future and aim to prevent rather than tackle NPLs. There are though legacy issues from the past which don't allow banks to tackle effectively existing or new NPLs.

(ii) Political interventions in banking-related laws endanger the vote of confidence by international investors

In 2020, the House of Representatives has voted for a freeze period in foreclosure procedures, prohibiting the sale of pledged properties for specific borrowers under certain criteria. Since then, the foreclosure moratorium has been extended a number of times.

The revised foreclosure framework voted in 2018 constitutes a powerful tool for banks against strategic defaulters. On the basis of this framework, Cypriot banks managed to successfully complete NPL trades and to speed up cleansing of their balance sheets. International investors gave a vote of confidence to Cyprus as a result of these actions.

Multiple suspensions of foreclosures and the continuous political intervention in banking-related laws, raise uncertainty to investors, create negative sentiment and endanger the confidence vote which has been given to the Cypriot banking system. The stability of the banking sector is also threatened as, going forward, similar interventions may extend to other matters in the political agenda.

58 The World Bank | Bank nonperforming loans to total gross loans (%) – Cyprus
59 CBC | Aggregate Cyprus banking sector data (non-performing loans data)

(iii) An efficient legal framework would boost safety and stability

The European Stability Mechanism ranks Cyprus as one of the slowest countries within the euro area in enforcing contracts, noting that insolvency proceedings are lengthier and more costly than the EU average. Lengthy and complex legal procedures, especially judicial ones, imply higher execution time which, in investors' eyes, translates into lower value.

An efficient legal framework, with specialised judges (or even courts) on financial and banking matters as well as faster resolution of legal cases would boost safety and stability perception regarding the banking sector and the wider economy, both in the eyes of domestic stakeholders but also foreigners.

6.4 | ESG compliance

How is EU Taxonomy implemented for banks?

The Taxonomy[60] sets a common set of definitions and thresholds and as such, the banking sector is subject to higher standards in terms of consistent, transparent and comparable reporting on green financial products and processes.

In that respect, it is undisputable that banks need to implement the Taxonomy regulation and the related disclosure requirements as this will assist banks to understand the possible impact on their business and how the engagement between banks and companies may evolve.

Additionally, the core business of credit institutions involves providing finance to other companies or private individuals to enable investment in the real economy. Therefore, a key figure must be defined that enables an analysis of the assets with regards to taxonomy compliance. For this purpose, the green asset ratio (GAR) is used as the main KPI for credit institutions for which relevant technical templates are available. This is intended to show how much of the financing of taxonomy-aligned activities is in relation to the total assets.

It is important to highlight here that in order to achieve this, banks should inform their clients to provide them with their EU Taxonomy disclosures for which they will constitute a set of KPIs of each sector as specified under the Article 8 Disclosures Delegated Act of EU Taxonomy.

As a conclusion, implementing the taxonomy alignment measurement will be a challenging exercise that will affect all activities of the banks and is not an easy feat as seen in practice. Banks should start implementing the screening and assessment criteria the soonest possible.

Corporate Sustainability Reporting Directive ("CSRD")

The proposed Corporate Sustainability Reporting Directive[61] aims to ensure that companies publicly disclose adequate information about the sustainability risks that they have and opportunities they face, as well as the impacts that they have on people and the environment (double materiality).

Also companies under CSRD scope are required to disclose sustainability information in accordance with the ESRS, the new European Sustainability Reporting Standards which are currently being developed by EFRAG.

The EU Corporate Sustainability Reporting Directive (CSRD) amends the current Non-Financial Reporting Directive (NFRD).

What does the proposed directive mean for companies?[62]

Businesses will be required to disclose more sustainability-related information than ever before, potentially including information about their business models, strategy and supply chains.

[60] EU-Taxonomy-Report-2022-3.pdf (ebf.eu)

[61] EY Press Release – How the EU's new sustainability directive ("CSRD") is becoming a game changer – Published 18 November 2022

[62] EY Corporate Sustainability Reporting Directive Brochure (PDF File)

Given the significance of the directive – and the time it may take to get ready for it – companies will want to start preparing for its implementation form the beginning of 2022 when the draft standards will be made available for public consultation.

Under CSRD companies will be required among others to disclose the following:

- Description of the business model and strategy (business model resilience, opportunities, business model compatibility with the transition to a sustainable economy; strategy implementation; stakeholders' interests and impact on the sustainability matters)
- Description of sustainability targets and progress to achieve the Paris agreement goals
- Description of the administrative, management and supervisory bodies with regard to sustainability matters
- Description of sustainability policies
- Description of the due diligence process; principle and adverse impacts and actions taken to prevent, mitigate or remediate those impacts
- Description of principle risks
- Indicators related to all the above

What is Sustainable Financial Disclosure Regulation ("SFDR")?

Moving on to the SFDR[63], the Sustainable Financial Disclosure Regulation lays down sustainability disclosure obligations for financial market participants and financial advisors.

EBA binding standards on Pillar 3 disclosures on ESG Risks

The European Banking Authority (EBA) published its final implementing technical standards (ITS) on Pillar 3 disclosures on Environmental, Social and Governance (ESG) risks[64]. The final ITS put forward comparable disclosures to show how climate change may exacerbate other risks within institutions' balance sheets, how institutions are mitigating those risks, and their ratios, including the GAR, on exposures financing taxonomy-aligned activities, such as those consistent with the Paris agreement goals.

How banks are affected?

Disclosure of information on ESG[64] risks is a vital tool to promote market discipline, allowing stakeholders to assess banks' ESG related risks and sustainable finance strategy. The EBA ESG Pillar 3 package will help to address shortcomings of institutions' current ESG disclosures at EU level by setting mandatory and consistent disclosure requirements, including granular templates, tables and associated instructions. It will also help establish best practices at an international level.

How does the EBA expect banks to capture environmental risks and activities that reduce those risks?[65]

The EBA is asking large institutions that have securities traded on a regulated market to disclose exposures to carbon intensive activities and assets that may experience physical risk as a result of climate change. In particular, it is asking banks to provide, among others, information with the following breakdown:

- Information towards fossil fuel companies excluded from sustainable climate benchmarks,
- Information towards other carbon-related sectors, as identified in the same sustainable climate benchmark Regulation.
- Information on GHG emissions financed by the institution and on alignment of metrics with 2050 Net Zero goals.
- These disclosures are aligned with those recommended by the FSB's TCFD, like e.g. exposures towards carbon-related sectors, although with a broader definition of which sectors are carbon-related. Banks are also encouraged to explain what measures they have in place to mitigate those risks such as reducing financing activities that reduce the carbon footprint of currently carbon intensive activities

[63] EY Sustainable Finance Disclosure Regulation Updates

[64] EBA Final Report – Final Draft implementing technical standards on prudential disclosures on ESG risks in accordance with Article 449a CRR

[65] EBA – Environmental Social Governance Pillar 3 Disclosures – Issues January 2022

What is Sustainable Financial Disclosure Regulation ("SFDR")?

Moving on to the SFDR[66], the Sustainable Financial Disclosure Regulation lays down sustainability disclosure obligations for financial market participants and financial advisors.

It imposes mandatory ESG disclosure obligations on asset managers and other financial market participants, including banks, in order to promote a systematic and transparent approach to sustainability within financial markets.

The aim of the Regulation is to direct private capital towards sustainable investments and prevent "green-washing" (when institutions spend more time marketing themselves as environmentally friendly rather than truly making necessary changes). To achieve this, the Regulation obliges banks and other investment advisors to provide investors with the necessary information on ESG risks related to investment products they offer, so that investors can make a choice based on their sustainability criteria. In addition, investment advisors need to inform investors on how they integrate sustainability risks in their decision-making. More specifically, banks and other investment advisors are required to disclose:

i. How their policies on the integration of sustainability risks in their investment decision-making and advisory processes;

ii. How they consider the adverse sustainability impacts of their investments (e.g. how the proceeds applied by borrowers have effects on ESG matters);

iii. The sustainability of their financial products;

iv. How environmental or social characteristics being promoted are met (e.g., if an index has been designated as a benchmark, then disclose information on how that index is consistent with those characteristics); and

v. Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, information as to how the index is aligned with that objective and, if no index has been designated as a reference benchmark for such objective, an explanation as to how that objective is to be attained.

To ensure compliance with such obligations, we recommend that Cypriot banks:

1. Governance and Strategy

- At the level of a department/unit/function of a bank, dedicated resource(s) should be appointed (adequately trained on ESG) to monitor progress on compliance. Centrally, a committee overseeing the overall compliance of the bank with ESG-related disclosures should be appointed, whilst also formulating the relevant strategy with clear objectives as to how ESG requirements will be met.

2. Monitoring through quantifiable metrics

- Banks should design and implement specific key performance indicators and metrics in order to quantifiably measure the progress of meeting ESG objectives. Such metrics will provide clearer view to both the bank's management and regulators.

[66] EY Sustainable Finance Disclosure Regulation Updates

6.5 | Cyber security

The US Federal Reserve identifies cyber threats as 'the single most important' risk to the stability of financial services today. The 2021 EY banking sector survey, found that cyber-security is among the most important issues to banks, according to the industry's chief risk officers (CROs), only second to credit risk[67]. Evidently building resilience to cyber risk is becoming increasingly important for banks.

Focusing on preventing cyber-crime does not merely imply taking steps to protect customers from falling victims to cyber-fraud, but also requires securing the banks' internal operations to prevent a cyber-attack against the bank that would have significant overall stability implications to all key stakeholders.

For customers, the enormous increase in the volume of transactions taking place electronically has brought a significant rise in internet fraud cases (under which fall crimes like phishing, impersonation, credit card and identification theft), with cyber-fraud claiming more than €6.9bn worth of assets in 2021 globally[68].

For banks, the multiple incidents reported on an annual basis of bank systems being accessed by hackers, should provide a stark warning as to the financially detrimental consequences of not prioritising cyber-security. The ECB has also warned that with Russian banks removed from the International Payments System (codenamed: "SWIFT"), the number of cyber-attacks by Russian hackers against Eurozone banks has risen considerably.

In response, the ECB Banking Supervision Committee has introduced a cyber-incident reporting framework that requires Eurozone banks to report to the Banking Supervision Unit and their respective central bank significant cyber incidents within two hours after having assessed the seriousness of the situation. In addition, the ECB through its Banking Supervision unit will also monitor banks' progress on Cyber-security by subjecting them to continuous off-site supervision and risk assessment as well as targeted on-site inspections[69].

Cyber-attack Singapore

Another example of a recent Cyber-attack is the An example of a recent Cyber-attack is the Singaporean multinational and financial services corporation, OCBC, which suffered a 13.7mn Singaporean dollar loss[70], due to an unprecedented 'SMS phishing attack impersonating the bank in December 2021'[71]. Even though the 'scam was not a cyber-attack on the Bank and the Bank's systems'[72] OCBC 'further enhanced [their] security measures' for their customers to 'prevent, detect and respond to scams'[73]. Following the incident, OCBC was determined to reduce the cyber security risk in the future.

To protect their customers, they implemented a '12 hr cooling off period for digital token provisioning' mechanism, joined the nation's SMS Anti-Spoofing Registry to have the Bank's registered SMS sender IDs protected, removed any clickable links in their emails and SMSs and implemented most of the measures as quickly as possible. Moreover, a "kill switch" solution was introduced at all OCBC ATMs enabling customers to freeze their accounts if deemed necessary.

Additionally, the bank engaged in training and reskilling of its staff to better manage risk and issues in social engineering, data protection and cybersecurity[74]. Additionally, a fraud hotline as well as a relevant customer service channel specific to fraud queries were set up[75].

[67] EY/IIF Analysis
[68] The Register | FBI: Cyber-scams cost victims $6.9b-plus worldwide in 2021
[69] ECB | What is cyber resilience?
[70] Channel News Asia
[71] OCBC Media Statement
[72] OCBC Annual Report
[73] OCBC Media Statement
[74] OCBC Sustainability Report
[75] OCBC Media Statement

We recommend the following for banks wishing to build cyber-resilience:

1. Close contact with EU and national bodies

- Bank executives should be in close contact with supervisors on both EU level and national level, engaging with the ECB as required by its reporting framework.
- In addition, multilateral agreements also allow for co-operation with Europol, Interpol and the European Network and Information Security Agency. Co-operation on an international level will allow banks to be informed of potential risks in the Eurozone area whilst also learning from counterparts as to how to best improve their cyber-security frameworks.

2. Human Capital

- It is suggested to banks to shift their focus towards attracting and retaining cyber-security talent, with digital, technical, governance and legal skills and background, who have expertise in cyber-crime.
- At the same time, banks should retrain existing workforce to be aware of potential cyber-criminal infiltrations, advise clients and be able to react swiftly and appropriately in the event of a cyber-attack.
- Setting up a cyber-security board within the governance structure of a bank could be beneficial in building and monitoring the strategy on cyber-resilience.

3. Budget and Spend Planning

- In the same way banks invest in a digital transformation roadmap and numerous initiatives to develop new digital services, supported by a clear and articulated budget, it is suggested that banks develop, document, and approve a clear cyber-security roadmap with the associated and committed budget
- Cyber-security investments should be assessed by analysing and defining both the value they will yield in safeguarding the bank's assets and the value created by providing secure and private services to customers.

7

The Cypriot banking sector as "Progressive"

7.1 Introduction

A progressive banking sector needs to be forward looking, willing to embrace future trends, resilient to future challenges, planning ahead of time, as well as agile and transformational in both outlook and mindset, to respond to changing trends quickly and efficiently.

7.2 Digital transformation

Throughout the world, traditional banking is becoming digitalised rapidly. The percentage of customers using digital banking services has skyrocketed from 25% in 2007 to over 70% in 2019. The use of cash is diminishing, from 38% in 2010 to just 13% in 2020. Banks across the EU are closing down physical premises and transforming to virtual or hybrid, as the number of bank branches in the EU has reduced by 31% between 2008 and 2019[76].

At a national level, 65% of consumers were using digital banking as of March 2022, compared to a mere 20% in 2012[77]. The pandemic accelerated demand for online services, causing the digital banking use to increase from 33% at the start of 2020 to 52% at the end of 2021.

Additionally, a recent study estimated that across post-covid Europe, 48% of people would consider moving towards cashless payments, while only 6.7% would move towards cash payments[78]. Given the advanced digital skills of the youngest generations, such numbers are projected to rise in the years and decades ahead.

Digital services and processes have the power to:

- Simplify banking and transactions, thereby allowing banks to offer faster and more efficient services to their clients, enhancing customer satisfaction.
- Streamline operational processes, increase productivity, reduce the level of human interaction (and error) in executing repetitive and simple tasks, lower costs.
- Create a client-centric model whereby, through AI and Data analysis, institutions can deliver tailor-made products and services to better cater customer needs.

WaFdBank, based in Seattle (US), offered digital-first banking and improved customer and agent satisfaction using AWS.[79]

In the past 10 years, the emergence of new financial technology and digital only banks has disrupted the banking sector. In an effort to adapt to the new reality WaFd bank enhanced the customer experience by incorporating conversational AI.

Following the upgrade of their online banking WaFd continued its digital upgrade by revamping its contact center using Amazon Web Services (AWS). The new contact center solution uses conversational AI and voice identification to improve the experience for both the customers and the agents. In January 2022 WaFd selected Talkdesk as its new cloud contact center platform which offered voice authentication and traditional call center routing, however when combined with conversational AI from AWS, it provided the desirable set of contact technologies.

The new contact center uses voice biometrics for authentication and auto-populates customer information to assist agents. It also includes self-service virtual agents for common call requests, such as checking account balances, reducing the time of execution by 90% (i.e. from 4.5 minutes to 28 seconds). The call and chat systems are now interoperable, and chats can be escalated to live agents when needed with the full chat record and tone analysis provided by the agent.

The system uses AWS data lake to store and analyze conversational data, which has helped the bank improve its customer satisfaction and boost its net promoter score from 12 to over 50, reflecting its commitment to clients. In addition, the bank expects a 30% reduction in agent call volume and transition to lower-cost, higher-efficiency channels, such as chatbots. WaFd sees the implementation of conversational AI and voice biometrics as the beginning of its innovation journey.

[76] EBF | Banking in Europe: EBF Facts & Figures 2022
[77] Trading Economics | Cyprus – Individuals using the internet for internet banking
[78] Kotkowski & Polasik (2021)
[79] WaFd Bank Transforms Contact Centers Using Conversational AI on AWS

HSBC – Robotic Process Automation (RPA) – Overcoming Challenges to add day-to-day value[80]

While front office digital solutions (e.g. ibanking) is an area where HSBC is heavily investing in, back-office automation is also deemed crucial as it enables frictionless servicing and zero contact resolutions. In the past, to increase the servicing channels of banks, new departments needed to be added in their business model which often led to operational inefficiencies.

Thanks to digitalisation, HSBC as a leading European bank has employed many RPA solutions, strengthened by AI implementation to complement the human touch to each service line. The bots are placed in the middle of the process, taking on the monotonous day-to-day tasks which are not adding value to the customer experience, consequently freeing up bank employees to handle the exceptions, to focus more in-depth analysis and to work more closely with clients.

An example of RPA implementation to increase customer satisfaction can be the inbound customer service query system (codename "BOLT"). Instead of employing human capital to interrogate inquiries, machine learning and RPA software track a query as it moves around the bank. This way, when a similar enquiry comes in again, HSBC can immediately direct the query to the end point, where the answer/solution lies. This leads to faster customer servicing which significantly increases servicing performance and ultimately satisfaction.

Cypriot banks have collectively spent over c€230m on technology and digital transformation programmes over the past three years. To date, Cypriot Banks have oriented their efforts and funding towards transforming their processes internally but also developing and improving their digital channels used by clients, thus improving customer experience.

Internal process transformations

- Digitalising the internal operations of the bank through the use of IT infrastructure to streamline, automate and digitalise operations.
- Enhancing cyber-security at a time of unprecedented rates of reported cyber-theft incidents.
- Migrating services to the cloud and use of AI to enable banking systems to process large volumes of data faster, shortening processes.
- Restructuring; reducing number of branches and employees when going from physical to virtual.

External services transformations

- Development of digital solution to enable online transfers of money, checking current balances etc.
- Smartphone payments (e-wallet).
- KYC verification techniques allowing customers to digitally prove their identity to prevent cyber fraud.
- Digital account opening for new customers (digital onboarding).
- Expanding the digital footprint of individual banks and building online channels to communicate with customers in a personalised and efficient manner in an effort to drive the digital economy.

[80] HSBC | Robotic Process Automation – Overcoming Challenges to Add Day-to-Day Value

7.3 FinTechs

FinTech poses a threat to the traditional banking model. More than 30% of customers in Western Europe use non-traditional players for digital banking services. Estimates show that these non-traditional players have captured anywhere from 4%-8% of total banking revenues in the Eurozone area, reducing both the profitability and the market share of traditional banks at a rapid pace[81].

It is worth mentioning that even though non traditional players such as Revolut have not yet generated profit, though estimates show that they are on track to do so.

But how are FinTech services different from those digital services currently offered by traditional banks? Since FinTechs are primarily virtual in their operations, they enjoy much lower overheads and can therefore afford to charge lower (if any) transaction fees compared to traditional retail banks, which still tend to rely on charges and fees as a primary source of revenue.

Revolut, a FinTech company which currently has over 160,000 customers in Cyprus, allows users to transfer funds from anywhere in the world with any national bank without fees charged. Users can also exchange currencies without any fees charged if transferring to other Revolut users wherever they might be in the world.

FinTechs in the banking sector tend to offer 24/7 engagement services and use the latest developments in AI to better understand the needs and personal preferences of clients, providing catered solutions accordingly.

At the same time, such firms also offer a range of ancillary services that maximise customer satisfaction. Such services might include budget optimisation and transaction tracking, contract for difference (CFD) trading facilitation and robo-advisory services on trending investments, peer-to-peer lending offering lower interest rates bypassing traditional credit score related limitations and international money transfer facilitation with low-to-zero fees.

How should traditional banks respond to maintain their competitive advantage? To maintain profits, traditional banks must digitally reimagine the products they offer to clients rather than simply taking existing operations online; they must offer faster and more efficient services that use technology to provide catered solutions that maximise customer satisfaction.

In short, they must harness the power of technology to become more client-centric. To do so, we recommend:

- Operationalize digital transformation to become part of the culture rather than an acceleration program.
- Expand digital transformation activities to focus on embedded banking services in the digital economy.
- Optimise existing digital services to maximise customer experience; this includes being cost-efficient and seeking alternative revenue streams to enable cutting transaction fees, increase the speed of service and engage with clients regularly.
- Diversify digital services to include the range of asset management, currency trading and investment advice that FinTechs currently offer.
- Inorganic growth via acquisitions or partnerships with FinTechs, to leverage the expertise of both sides can be considered where applicable for the local market. FinTechs can provide product design and tech expertise, whilst banks can provide the funding, infrastructure, clientele and distribution channels. A recent example in the global arena is the partnership between Goldman Sachs and Apple to issue a credit card. Such ventures must be designed to primarily apply to the local market by addressing existing market gaps in customer needs and untapped value.

[81] McKinsey Global Banking Annual Review 2021

7.4 Human capital

Succeeding in the digital era requires reskilling, i.e. new, transformed and developed employee skills. New skillsets are necessary to drive the change. Hiring Data analysts, AI specialists, digital engineers and computer scientists will be key to digitising operations in line with customer and regulatory demands.

Cypriot banks may need to seek talent abroad, and likely have to compete against large multinational organisations and FinTech companies in hiring top talent. To attract such highly sought-after talent, which is also likely to be young techie individuals, banks would need to promote a package of incentives, such as:

- Competitive remuneration closer to international levels and linked to performance.
- Improved working conditions with attractive benefits and career progression opportunities.
- Hybrid model of work and flexibility in working hours.

Such incentives are also vital in retaining existing talent as well. Besides new hiring, research suggests that redeployment of existing staff with effective reskilling can be 20% more cost-effective than "hiring and firing", as it reduces the associated turnover costs[82].

As certain core and supportive processes are being automated, human capital reskilling should also be a core part of a bank's strategy, aiming to develop technical and digital skills, as well as social, inter-personal and emotional ones, related to managing customer experience, creative problem solving, empathy, leadership and emotional-social intelligence.

Cross-training and upskilling of employees will allow banks to become future-proof. Through this approach to learning, banks can acquire agility and flexibility in how they manage their operations, by deploying staff where and when needed.

Learning and development enhances the bank's reputation and employer brand, by positioning itself as an organisation which invests in people, and which provides new and exciting career paths and opportunities.

There is an inherent challenge to reskilling as it is a lengthy, complex and intense process for both the bank and the workforce. Reskilling necessitates the collaboration of employees in the process, and sincere effort, something not always easy to attain.

Bank of America: providing pathways to new opportunities and reskilling

Internationally, large banks operate their own education departments, investing in their workforce and providing the tools for career development. For instance, at all levels of Bank of America (BoA), there are opportunities for employees to follow new career paths. In 2019, the intracompany career tools, resource and programs helped more than 21,000 employees to find new roles within BoA, which accounts for more than 10% of its staff. Additionally, the bank's employee turnover is decreasing from 15% in 2014 to 7% in 2020.

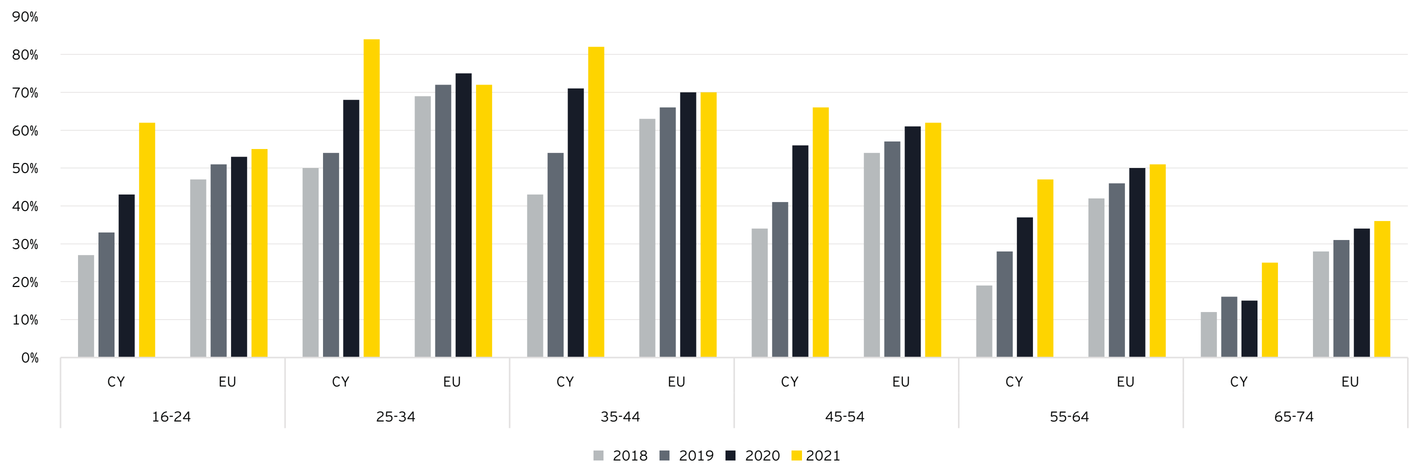
The bank invests in reskilling and continuous learning with its one-stop portal tool, its own self-directed and virtual instructor-led training program, and with its own onboarding, coaching and development organization "The Academy". The latter is accessed by more than 45,000 employees annually, which represents approximately one fourth of its workforce.

[82] McKinsey | How banks can build their future workforce – today

7.5 Accessibility

At a time when banks are digitalising operations, it is also vital to make sure that they do not leave customers who lack access to the internet behind. The challenge for the Cypriot banks is to remain competent and increase the user friendliness of their online service channels as clients of higher age groups remain hesitant to use internet banking channels.

Users (% of customers) of Internet Banking by age in EU and CY



Source: Eurostat

Cypriot banks were well equipped in addressing the rapid spike of internet banking usage, mainly driven by the pandemic. Customers of Cypriot banks demonstrated great adaptability in switching to digital channels as the internet banking usage has doubled across all the age groups over the past years. A better response was observed by the younger generations who outperformed EU averages in 2021, with internet usage surpassing 80% of customers. On the other hand, older age groups lag behind EU averages, highlighting the adaptability and accessibility challenges that banks need to face in addressing this age group.

Elder citizens in Cyprus have limited knowledge and familiarity with technology and online banking. In fact, only 58% of those over 65 are technologically literate[83]. Cyprus pensioners union warned that the closure of branches has already been very problematic for this age group; especially if family members are not around, it's hard for them to use digital banking services.

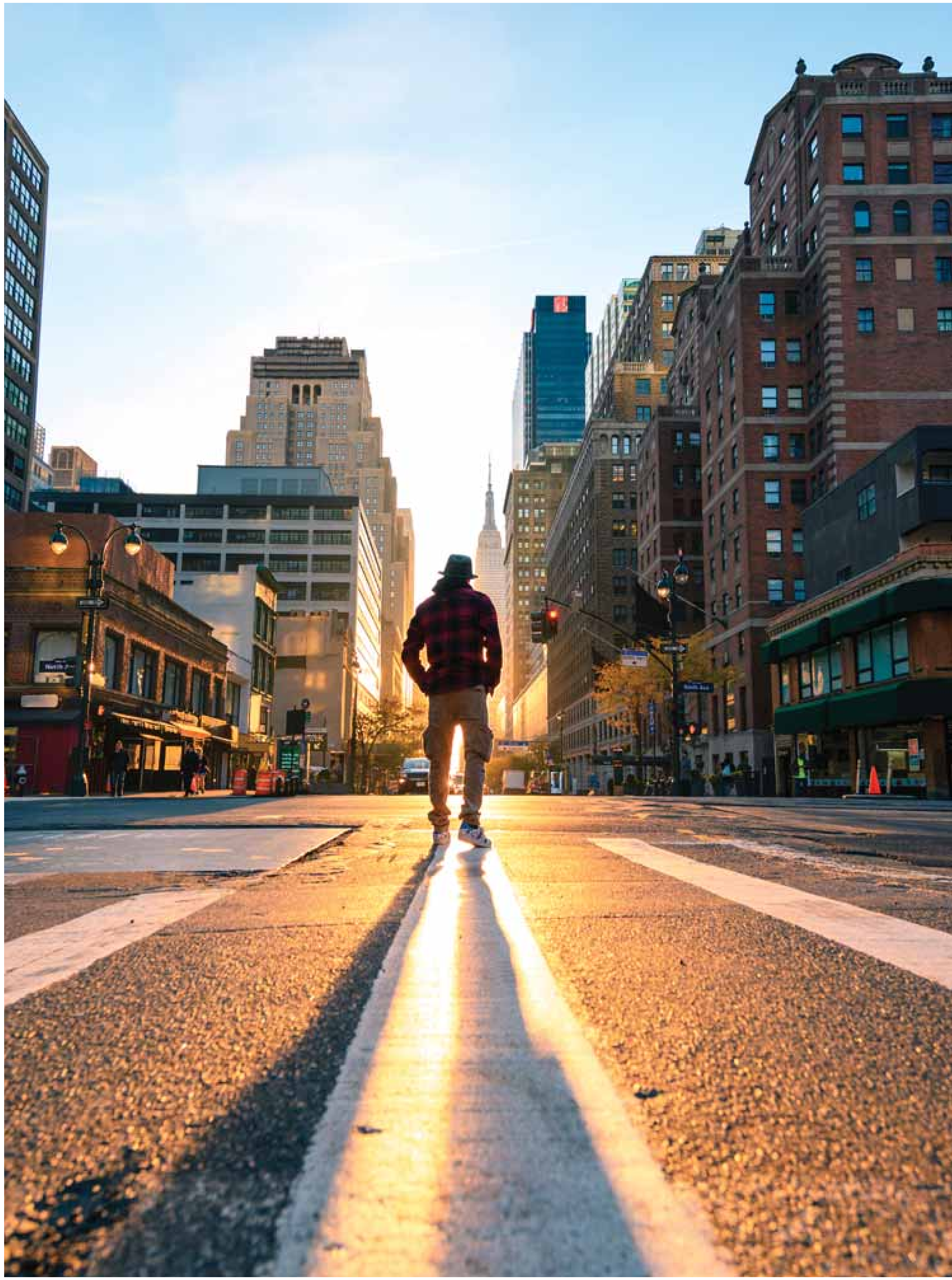
Aside from age, other customer demographics form barriers to accessibility. There is a significant proportion of rural areas where reduction in physical branches might significantly increase the distance to the nearest branch.

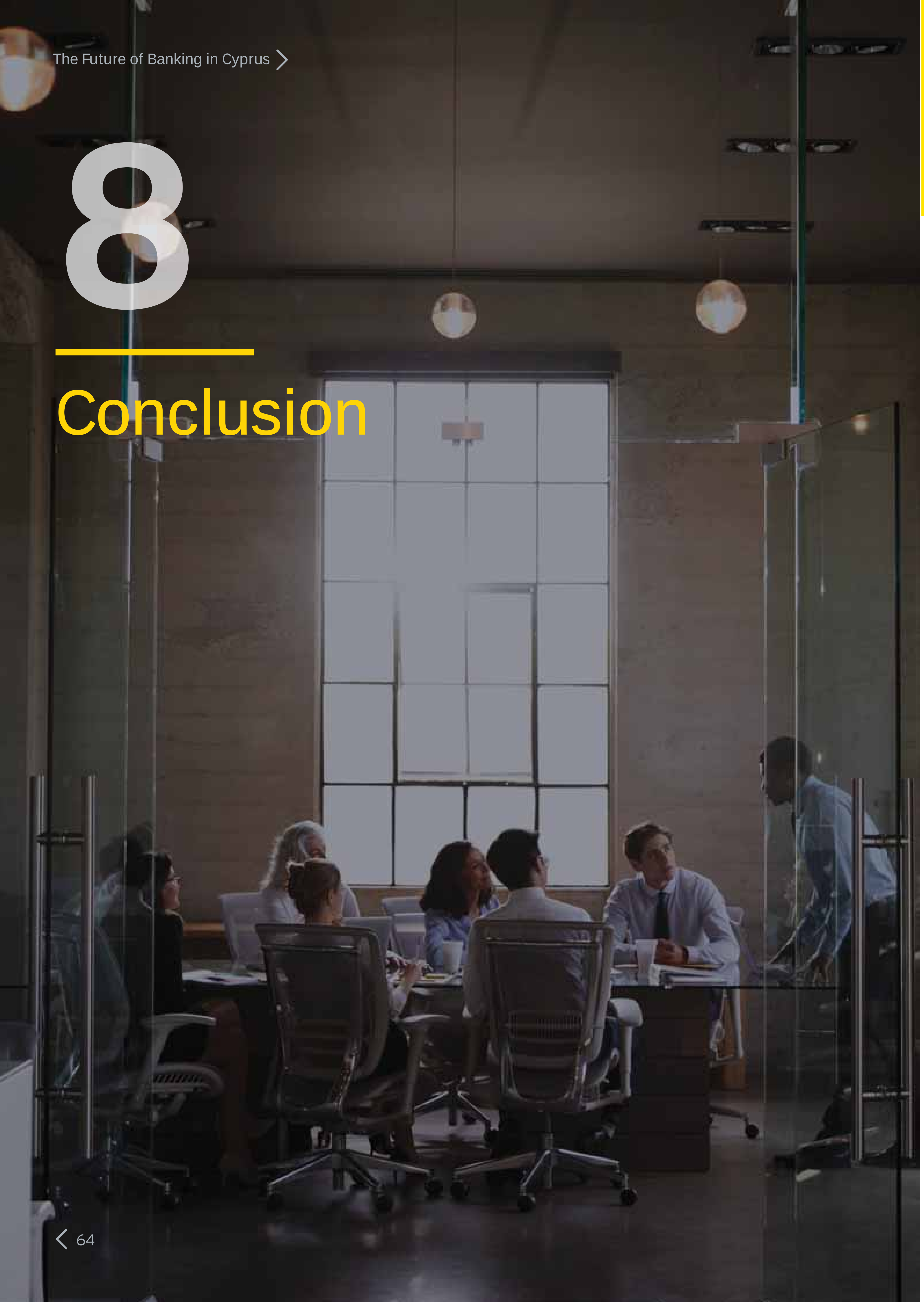
The promotion of digital literacy through funding, trainings, or other form of education to elders could significantly minimise the issue. Banks can address these challenges by integrating e-tutorials on their digital apps or providing on-call service guidance. Seniors should have someone they could reach out to and help them step-by-step through various processes, albeit that a technophobic senior would most probably prefer the bank's employee to conduct their transactions for them. It is also recommended to streamline and simplify digital apps/services so that access is as easy as possible for those technologically challenged and provide a point of contact to those finding difficulties to reach out for instructions.

For those without access to the internet, banks should focus on enabling bank transactions to be made through other non-physical services that don't require the internet, such as over the phone transactions using smart verification ways.

For rural areas, banks can also strategically locate banking agents, which are micro, medium and small enterprise (MSME) partners (small shops, pharmacies and supermarkets) offering basic cashier services (e.g. cash withdrawal).

[83] Eurostat





8 Conclusion

Purpose of the Report

This report by EY, supported by the ACB, showcases the importance and contribution of the Cypriot banking sector to the nation's economy and society and identifies current and future trends, challenges and opportunities. It aims to convey messages to bank executives and stakeholders to embrace the everchanging future, marked by transformation and progress through the four key pillars: purpose, viability, safety & stability and progressiveness.

Role and significance of the banking sector in Cyprus

The Cypriot banking sector is of key importance for the island's economy, providing one of the highest GVA contributions in the Eurozone while at the same time employing a significant workforce size and contributes more than 4% to the country's tax revenue. Admittedly, the prosperity of the banking sector is of high importance for a well-functioning modern economy as well as for the prosperity of the greater society.

The sector faces unprecedented challenges and is found in the midst of ground-breaking transformations. Balancing stakeholder needs and expectations, which are often conflicting, will be the key to successfully unlocking the new era. The future of banking in Cyprus, along with its challenges and prospects, is examined and discussed through four key pillars.

Purpose-led

A purpose-led banking sector is one characterised by a strong and clear sense of direction, valuing sustainable development and contribution to the society and the environment. Cypriot banks should aim to instil public trust via a more client-centric operating model, by being flexible and responsive to customer needs, and by cultivating a healthy culture in which employees and employers align to deliver the highest possible value to the society and wider economy.

Viable

Viability entails sustainable profitability. The Cypriot banking sector remained resilient throughout the pandemic and is now at a strong position to face the upcoming challenges. Diversification of income and targeted cost optimisation are essential to achieve sustainable profitability. FinTechs are growing and chipping away the legacy banks' market share. Banks will need to elevate their digital capabilities and advance their technology, or even partner up with FinTechs to remain relevant in a tech-savvy world.

Safe & Stable

Cypriot Banks remain some of the most secure in Europe in terms of capital adequacy, partly mandated by their higher NPL ratio. Despite the near decade-long efforts of decreasing the sector's NPL ratio, it remains the second highest in the EU. This issue could surface again given the recent interest rate increases and the record inflation. Banks need to act proactively in identifying and preventing new NPLs from arising. ESG compliance is expected to bring compulsory disclosures and banks will need to be proactive in setting-up the relevant ESG structures and staff across their organisation. Lastly, digitalisation of banking operations could attract an increasing number of cyber-attacks, thus it is essential for banks to develop the skills and invest in the right infrastructure that would keep customer data privacy and safety intact.

Progressive

Digitalisation of banking operations was rapidly accelerated during the pandemic and banks are expected to continue transitioning into a more automated business model to improve efficiency and increase customer satisfaction. Digitally accustomed customers in a way exert pressure to banks as they turn towards FinTechs, which provide faster, easier and more personalised solutions. To compete with FinTechs, banks will need to offer more ancillary services or integrate the existing capabilities of FinTechs through partnerships, producing synergistic effects. To continue being progressive, banks need to train, reskill and redeploy their staff along with hiring new talent to line up with the requirements of future banking.

Foundation for a debate

This EY report, supported by the ACB, provides an opportunity to initiate a wider discussion among bank executives, regulators, industry leaders and the wider public on the current and future state and trajectory of the Cypriot banking sector. In this report, a range of challenges and issues faced by the sector are being analysed as well as views on the upcoming banking trends that are expected to dominate and shape the sector in the coming years. A comprehensive approach was followed, using data provided by the ACB, consultation with a panel of local banking experts and senior industry representatives, desktop research and EY analysis.

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