

# The Rebuilding of the Cyprus Economy

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## Abstract

Following the extra ordinary decision to bail in the unsecured depositors and restructure the two main banks and the near complete destruction of the country's economic business model as an International Financial Centre, the author considers the changes necessary to rebuild the economy of Cyprus on solid and sustainable foundations. The effort should revolve around the need to build a capability to source funds and appraise capital investment projects, reform the banking sector so that banks will begin to perform their primary function as prudent lenders, remove economic distortions and other controls and constraints in the free market economy and last but not least, take such measures as to gradually instil a learning culture in the working population. It is recommended that Cyprus should establish a National Development Finance Agency to undertake the lead in appraisal and financing of key developmental projects and Public-Private Partnerships.

**JEL classification numbers:** D61, G17, G21, G32, G33, H43

**Keywords:** Repayment capability, project evaluation, corporate lending, credit risk.

## 1 Introduction

The shattering shake-up emanating from the resolution and restructuring of the banking sector and the ripple effects of the austerity programme to be adopted will hit like a storming tsunami the very foundations of the Cyprus economy as it existed in the past few decades. It is a natural self-preservation reaction for everyone to respond to what is perceived as an impending disaster to run for cover. But after the initial shock and the unavoidable devastation that will bring, the field will clear up and will allow the rebuilding of the Cyprus economy on strong and sound foundations.

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There are four things to understand and get right in order to lay the foundations for rebuilding the Cyprus economy. First, we need to appreciate what is the vital role that banks play in a free market economy and how to ensure that our banks fulfil this crucial function. Second, we must recognize what is the role of the Government in a free economy and how it should introduce reforms so that it facilitates rather than impede the efficient and optimal allocation of scarce economic resources into their most productive uses. Third, we need to understand what economic development is and how it is advanced through economically viable projects and how special finance institutions such as a National Development Finance Agency can aid this process, particularly when a country is at the brink of economic depression. And last but not least, we need to overcome our fear for change and adopt a learning culture. This is how Cyprus can rise out of recession and build a competitive economy for sustainable and lasting prosperity.

## **2 The Role of Banking**

In a free capitalist economy, banks perform the key function of lending out the savings of depositors. Banks, however, have a duty to only lend money out in a strict and prudent manner. This in effect means that the risk of losing money through a lending operation should be confined only to the limits that can be covered by the capital put up by the bank's owners so as not to put at risk its depositors' money. Hence, if a bank can reduce the probability of default (through lending to those who have a capability to repay) and the extent of loss in the event of default (through taking adequate security cover), then it should be able to make more loans and consequently increase the return on the bank owners' capital.

So, where did things go wrong in the past twenty years or so in Cyprus? As illustrated in Figure 1, the rapid and abnormal blowing up of deposits from abroad has put too much stress on local banks' ability to position this excess liquidity in a small local economy through proper normal credit assessment and loan approval procedures. This had two negative effects. One was that all the Cyprus banks started lowering the hurdle for passing loan approvals to the point where it was too easy for anyone to receive a loan. The fact that a fair number of these loans will eventually end up as non-performing was not of immediate concern as long as the banks kept expanding their portfolio and showing an accounting profit. Profitability was not only important for justifying the huge salaries and bonuses of executives and directors but it was also vital to enable the banks to frequently issue new shares to the public and therefore restore their capital adequacy requirement (8% of total exposure, increased to 9% in 2013). A process which has also been accurately described as "blowing up the balance sheet". The Securities Commission was also at fault as it repeatedly failed to protect, or at least warn, potential investors who were lured by the reported false accounting profitability to buy the new issue of shares of these banks.

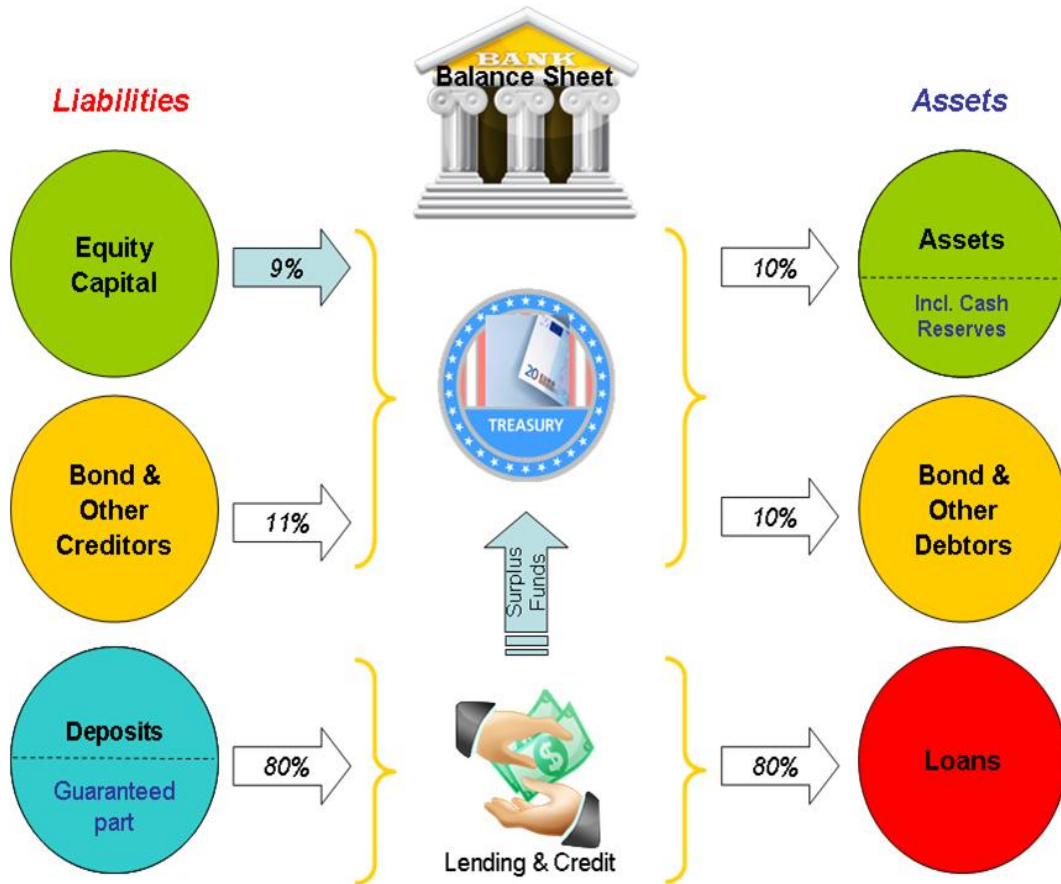


Figure 1: Bank balance sheet structure

The surplus of deposits that was not possible to give out in loans in the local economy was channelled through the Treasury or by Managerial decisions into the purchase of bonds (such as of the Greek and Cyprus Government) and the takeover of subsidiaries in other countries (Greece, Russia, Ukraine, UK, Rumania and even down under in Australia). Banks have also acquired assets or have expanded their Insurance subsidiaries. So, rather than having deposits on the Liabilities side of the Balance Sheet being turned into sound loans on the Assets side (typically representing 70%-80% of the total exposure of a bank), Cyprus banks ended up having a huge amount of bad or non-performing loans and many excess billions that had to be invested abroad in subsidiaries and Government bonds. Moreover, these crucial investment decisions, in most cases, were taken without a proper feasibility study, no well thought out strategic plan and with little transparency. This sad state of affairs was facilitated by an almost absent Central Bank which applied very little supervision and was unable to alert the banks and Government to the dangers and risks that such an unstable model of uncontrolled business growth was driving the country into.

Banks entered the races in everything financial, chasing more and more profit through a systematic expansion or “blowing up” of their Balance Sheet. Through this process, they have gradually replaced the diligent “in-bank” assessment of credit risk (through the

projection of cash flows that tests the applicant's repayment capability) with superficial reports that made it very easy to get a loan passed through a credit committee. This deterioration of standards was made possible in a banking environment where the regulatory authorities have in practice relaxed their normal checks and controls.

The problems were thus piling up for years. It was an accident waiting to happen. Under the rather lax supervisory conditions applied by the Central Bank and with some creative accounting, the banks were sweeping under the carpet all their sins for too long. It is therefore no big surprise that the Cyprus banking system has finally come to crashing end. Cyprus could not have sustained having a banking sector of 7-8 times its GDP where the risk of operating from Cyprus is internalised and carried over to the Cypriot tax payer. Cyprus never had the economy to absorb these funds while its capability to lend it out diligently and prudently into economically productive projects was limited. Moreover, the higher interest rates adopted by all the banks which were designed to attract foreign deposits made it harder to finance viable local enterprises in Cyprus. The push to loan out the surplus deposits results in bad and “liars” loans<sup>2</sup>, a great chunk of which inevitably end up as non-performing. In addition, the problem is exacerbated by the effort to position the excess deposits which were not possible to loan out, through the Treasury and by hasty Board decisions in bonds and acquisitions (such as the purchase of Greek Government Bonds or the highly questionable investments in subsidiaries in countries such as Russia, Ukraine and Romania).

Banks are the means by which savings are channelled into viable productive investments. This is how economic development and growth are bolstered. Hence, banks have a special role and mission to play in a free market economy. Banks should therefore be banks and not anything else. To fulfil this mission it is necessary to be able to do and diligently apply a proper credit risk assessment of the projects that are financed. When banks lose track of this role, inevitably, a misallocation of scarce economic resources ensues.

### **3 Repayment Capability versus Collateral Lending**

Traditionally, banks in Cyprus and to a large extent in Europe, have sought to assess credit risk when considering projects for corporate lending where risk was defined as just the possibility of the lending bank not being in a position to recover the loan. The accepted practice therefore was that given a “sound security” position the lender felt comfortable to grant a loan. Repayment capability was a further consideration, but it remained a secondary constraint given that the client can demonstrate that the bank has good recourse for recovering the loan in case of default. This code of conduct has made the banks in Cyprus collateral (or asset backed) lenders rather than business enterprise lenders. The emphasis was firmly on the applicant's balance sheet rather than on the projected income (or cash flow) from the project to be financed. It was more a question of “show me what you are worth rather than what you can do”. Moreover, credit risk was assessed by looking at the past (or history) of the applicant rather than the merits and risks

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<sup>2</sup>Liars or NINJA (No-Income-No-Job- or Assets) loans were terms used to describe the giving out of bad loans on purpose by credit officers of banks in the United States which created the conditions for control fraud by banks in the United States. See Black W. C. 2005

of the proposed business plan in the future<sup>3</sup>. The root of the problem is the wrong mentality and lack of training of credit risk officers, as Savvides 2011 points out:

“Why is it then that banks have relegated repayment capability to a role of secondary importance in credit risk assessment? The simple answer is that it is not easy to assess repayment capability and the risk profile of a project or business. The only way that repayment can be properly assessed is through meaningful cash flow projections. Credit officers should be trained in the methodology and tools of investment appraisal<sup>4</sup> and risk analysis and in addition understand the key success factors and aspects of competitiveness in a business enterprise. The fundamental question is what would it take for a business venture to be successful in the markets it competes in? This is not a matter of just putting down some numbers on a spreadsheet and calculating what money would remain available for servicing the loans.

A credit officer without the proper training, not just in finance<sup>5</sup>, but also in marketing and management concepts would be at a loss at even asking the right questions let alone judging whether the assumptions made on market projections, prices and market shares are reasonable or not<sup>6</sup>. Moreover, any projection is usually assigned a 100% probability of occurrence. That is by itself an incredible assumption. When contemplating what may occur in the future for anything, not just for businesses forecasts, it is downright stupid to assume that any possible outcome would have but a very minute chance of happening as projected. Even when we are equipped to understand what we are dealing with, at best, we can only assign judgemental probabilities to each possible outcome for each variable in a financial model. But even so, it would be a daunting task to make sense of all scenarios that may arise from the combination of all possible outcomes between so many risk variables. Fortunately, by using Monte Carlo simulation software, it is nowadays easy to assess the impact of uncertainty and identify as well as evaluate project risks<sup>7</sup>. Projecting the cash flow within the margins of uncertainty shows how and when it is likely that loan default may arise (as illustrated in Figure 2). This in turn helps the credit officer arrive at an appropriate financing structure for the loan so that it reduces the credit risk and the impact on the Bank in the event of default.”

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<sup>3</sup> Savvides Savvakis C. 2011

<sup>4</sup> Harberger, Arnold C., and Jenkins, Glenn P. 2000

<sup>5</sup> Fischer, Charles C. 1997

<sup>6</sup> Savvides Savvakis C. 2000 and Savvides Savvakis C. 1990

<sup>7</sup> Savvides Savvakis C. 1994

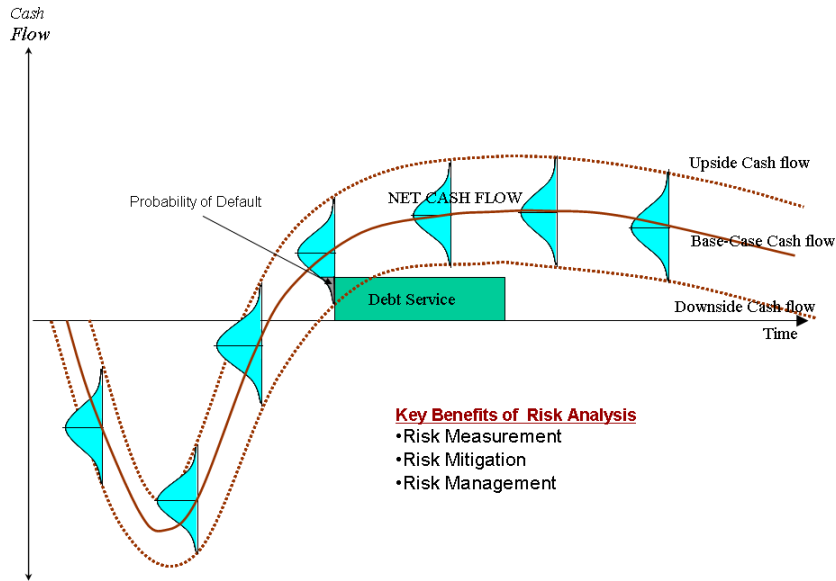


Figure 2: The impact of uncertainty on the projected cash flow

It is imperative that we build a totally new banking culture. We need to go back to basics and make paramount (as it should have always been) the viability and repayment capability of a project or customer to whom a bank extends a loan to. For this to happen, the current management of the banks should change. There is a good opportunity to do this with the two big banks that are currently being restructured. But there is also a need perhaps through better control from the Central Bank to make the other banks change their business plans and priorities as well as their top management.

#### 4 Equity to Loan Ratio

What happened the last few years with the quiet absence of the Central Bank is the granting of loans within a maximum allowed Loan to Value Ratio (LVR). For instance, the previous Central Bank Governor had increased by 10% the equity to loan ratio by introducing a loan to value ratio requirement for property development loans from 70% to 60%. However, the banks and loan applicants quickly found a way round this. The Value part of LVR is the Valuation of the security taken which in most cases was the asset that was actually the object of purchase by the new loan. External 'independent' valuations in many cases were overestimating the true value of the property, often a piece of land, so much so that the higher property values 'justified' the granting of loans without any actual equity from the loan applicant. For example someone who would purchase a plot of land for 100 would apply for a loan. The correct way is to lend, say 70% or even 60% and the rest to be paid as equity, in cash, by the buyer of the property (and loan applicant). In practice however, an 'independent' valuation would typically show the plot is worth 140. So, in order to have an LVR of 70% you can lend up to 100! So in this manner the bank would totally finance the project through loans with the borrower not paying any equity,

as his equity contribution was considered to be the difference between the actual loan and the market value of the asset itself (as estimated by the valuation)<sup>8</sup>.

Moreover, the fact that the owner of a project is not therefore the real stakeholder (the owner does not in truth venture anything other than his time) while being burdened to repay a huge loan, made it more likely to use his position to extract as much money as possible for personal gain and leave the bank trying to recover from the resulting non-performing loan. This is a catastrophic model which destroys value and leaves the bank with enormous bad loans to recover from.

## **4.1 Central Bank Regulation and Supervision**

There are a number of problems and issues burdening the Cyprus Banking System that the Central Bank should undertake the lead to put right:

### **4.1.1 Enforcing prudent banking practices**

Central Bank employees lack the expertise to supervise effectively the banking sector which led to rather lax conditions within the banks. The Central Bank therefore should recruit experts and train their officers so as to execute their supervision duties effectively. The Cyprus Central Bank was presently absent from the credit and other key decisions that have been taking place in banks. It is imperative that the Central Bank acquires the required competence and starts supervising the banks effectively so as to ensure that loans are granted based on a proper assessment of repayment capability and not just security. Taking of collateral is not the prime criterion or the main purpose of a loan but rather a mere recourse for the bank in what should be rare loan default occasions.

### **4.1.2 Limiting the ability of banks to create new credit**

It is imperative that people understand that banks create credit/money through the fractional reserve lending mechanism. As such it is vital to limit the ability of banks to create new credit. To do that the Central Bank could impose higher reserve requirements. For example the Central Bank could increase the liquidity reserve requirement for EUR deposits from 20% to 30%. It should be noted that for foreign deposits (such as deposits held in USD and other non-Euro currencies), as was reported on the website of the leading Cyprus Law firm of Andreas Neocleous & Co. LLC<sup>9</sup>, a relaxation of the liquidity reserve requirement (from 75% to 70%) has been in place since 2008.

“The Central Bank of Cyprus has relaxed the minimum liquidity reserve requirement in foreign currencies for commercial banks operating in Cyprus. A directive issued in August reduces the reserve requirement in foreign currencies from 75% of total foreign deposits to 70%. The minimum liquidity reserve requirement in euro is unchanged at 20%. The change in reserve requirements will allow commercial banks to lend the equivalent of up to 30% of their total foreign currency deposits compared to 25% before

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<sup>8</sup>It should be noted that this over-valuation practice further created a security/collateral problem for the Bank as the forced sale of the asset (say 70% of its value) in truth was the market value and not what the asset will be worth under forced sales conditions in the event that Bank will try to recover by selling the property.

<sup>9</sup>Source: Relaxation of minimum liquidity reserve requirement in foreign currencies, <http://www.neocleous.com/index.php?pageid=49&pageaction=neo&modid=102&newid=1081>

the change, and is expected to release around €550 millions of additional liquidity into the market.”

However, the regulations completely missed that all foreign deposits should have had a higher than the lower reserve requirement. The biggest damage was done by allowing Euro denominated deposits from Russian and other non-eurozone origin to be under only a 20% reserve requirement. In addition, a lot of Cypriot passports were issued to Russians and other foreigners, thus allowing their deposits to be used at the lower reserve level of 20% which applied for locals. This alone and through the effects of the fractional reserve banking system largely contributed to the huge bubble that emerged. The Central Bank and Cypriot politicians as well as economists were, incredibly enough, not alert to the risk from this huge expansion of credit.

A way to correct this is to impose a high reserve requirement to all foreign deposits (irrespective of currency) and to apply to all foreigners in general irrespective of whether they were granted citizenship<sup>10</sup>. Limiting the ability of banks to create new credit is a very important measure in managing total exposure in order to avoid the risk of future asset bubbles. It will also enable the Central Bank to better control and manage the money supply.

#### **4.1.3 Externalisation of systemic risk**

The Central Bank should gradually revoke the licences of many foreign banks that operate in Cyprus as **subsidiaries** and which put the Cypriot taxpayer at risk. These subsidiaries and any new applications for new banks should only be granted a license as **branches** of their parent foreign banking corporation. This should be regulated by the Central Bank and/or through appropriate legislation.

The reverse should also be true for Cyprus banks operating abroad. Cyprus banks should be constrained from having branches in other countries as these create unmanageable risks on the shoulders of Cypriot tax payers. Unfortunately, Cyprus had the worst possible setup. Foreign banks in Cyprus were subsidiaries and Cyprus banks abroad branches. Luxembourg on the other hand has implemented the exact reverse set-up to externalise effectively systemic risk and away from the Luxembourgian tax payer.

#### **4.2 Lender of Last Resort/ELA & Moral Hazard**

Bankers have the wrong impression that in dire situations the Central Bank will always come to their rescue. The situation in which Laiki Bank found itself is evidence of what moral hazard can inflict to the creditworthiness of a financial institution. Prudent conduct of the applicant is a must prerequisite, before a Central Bank considers providing liquidity aid such as through making use of the Emergency Liquidity Assistance (ELA) programme through the European Central bank to a financial institution. Central Banks must strictly monitor Financial Institutions (including regular on-site auditing) to prevent unwanted situations which may jeopardise the survival of the State itself. On a more longer term, bank funding should gradually shift from deposits to equity and bonds.

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<sup>10</sup> It should be noted that there may be legal problems in applying such rule given that a foreigner has gained Cyprus Citizenship.



### **4.2.1 Valuation reforms**

The valuation of any asset is based on the most recent record of sales for similar properties (location and type of property). The proper way to value any asset however is not its historical price but rather the future cash flows of the asset (be it a plot, apartment, hotel and so on). Valuers in Cyprus who have participated and benefited greatly in this bank bubble) in most cases with the blessing of the Central Bank, reported security value of properties offered or held as collateral to loans as higher than their proper present value as this would arise from projecting a potential net cash flow stream from the asset. Historical values in the hands of professional valuers whose welfare depends almost totally on the business given to them by banks is a potential source of gross inaccuracy and irrelevance to the real world which, in combination with the desire of banks to grant as many loans as possible without due regard to a proper assessment of the ability of the client to repay the loan, made possible the granting of numerous bad loans. It also presented a way round the Loan to Value Ratio requirement as set by the Central Bank by overstating the value of the asset. Hence rather than having a 40% to 60% Equity to Loan contribution towards the financing of a project, the end result was that in effect the project was almost totally financed by loans.

There are many ways that a Central Bank can try to cure this problem, such as to require that the contribution of the borrower be in the form of cash as a condition precedent to the disbursement of the loan. The Central Bank should also issue a list of authorised/accredited Estate Agents to banks which will periodically revise based on the quality of valuations they produce. This will act as strong deterrent to professional valuers so as to prepare valuations which are realistic and not even marginally adapted to serve the needs of the customer.

### **4.3 Restrict the Use of Shares as Collateral for Loan Approvals**

The Central Bank should review and revise the directions to commercial banks regarding the use of company shares as collateral for the approval of new loans. The taking of such instruments as sufficient or partially satisfactory collateral to grant new loans is one of the main culprits that brought about the wasteful sanctioning of dubious loans from Cyprus banks in Greece and Cyprus (particularly from Laiki Bank). In particular, the taking in as countable collateral the shares of the company or related companies to the one that is receiving the loan, is a bad practice that should be stumped down.

Balance Sheet financing cannot use both the Asset and Liability side of the Balance Sheet as collateral for a loan. Company shares, as a rule, should only be taken for the purpose of giving the bank granting the loan some leverage in situations of default or near default and in order to prevent the problematic client from stripping down any remaining assets. Consequently, at the time when one may need to use the "notional" collateral value of shares, these will probably be practically worthless. One has only to consider the number of loans that have been given out by using the shares of the Bank of Cyprus and Laiki Bank in the past 10-15 years and what the current near total destruction of value of these shares will do on the quality of the portfolio of loans remaining with the Banks in Cyprus. The practice of the banks in Cyprus of watering down the security adequacy requirement through poor valuations and by taking in shares as collateral substitutes, both of which went rather unnoticed under the lax conditions allowed by the Central Bank for many years is what really brought about the current catastrophe in the loan portfolio quality.

To sum up, as was pointed out above, commercial banks had become "pure" collateral lenders and practically abandoned their duty to diligently test for and reject any loan applications of projects that do not meet repayment capability conditions. And then, they did not even do that right, by failing to take in adequate collaterals in their loan approval processes.

#### **4.4 Bank Governance and Accountability**

New internal bank regulations should be put in place to address the conduct of bank executive officials (Board of Directors/Executive management). It is critical that the right incentives are created for people managing Banks. Board of Directors and top/senior management in Banks are not up to standard. Bonuses and profit related rewards should be linked long term success. Credit risk officers, for example, should be rewarded based on the quality of loan portfolio they have produced over the years rather than on the number and amount of loan approvals passed.

##### **4.4.1 Auditing and realistic provisions**

The firms auditing Cypriot banks bear their own share of the blame for the dire situation the country now finds itself in. Beyond a general obligation for keeping a "good accounting practice" auditing firms have failed in providing a fair and accurate picture of the true economic situation of banks. In particular, bank auditors have helped their customers cover and perpetuate bad loans on their books.

If auditing firms performed their duties, as they were supposed to, Cyprus would have avoided waking up to the very bad state of the loan portfolio of its banks that has been revealed recently (such as by the PIMCO survey). In the future, the firms auditing banks should be held accountable for their work by appropriate legislation and/or through possible ramifications from their professional Institutes.

## **5 The Role of Government**

The role of Government in a free market economy is to create an economic climate that encourages investment and to lay the foundations for private industry to undertake in a climate of confidence and economic stability entrepreneurial risks. In order to attain this, a number of reforms should be made which are designed to remove the economic distortions that currently plague our economic model and the free price and market mechanism in general.

A number of necessary Government reforms designed to reduce the bloated public sector in Cyprus and to make the market economy more efficient have already been agreed and are included in the Memorandum of Understanding reached between Troika and the Republic of Cyprus. These include measures relating to the labour market (such as the conditional freezing of the automatic adjustment of wages to compensate for inflation and the privatisation of State-owned monopolies). In addition, it is imperative that Cyprus removes some self imposed economic distortions some of which are remnants of a protection mentality which existed prior to the country's joining of the European Union

and which unfortunately still seriously impede and constrain economic development. These should include the following.

### **5.1 Removal of Licensing and Permit controls**

A sweeping reform is necessary that will completely **liberalise the practice of any legal business** without the need for applying and acquiring license and permits as are currently being required by the State in some business activities.

### **5.2 Removal of Controls on Opening Hours and Price Restrictions**

Appropriate law should be passed to **remove restrictions regarding the control of time of work** and the right of a business to decide when to open for work or **when to embark on a Sales campaign**.

### **5.3 Removal of Restrictive Trade Practices and Special Privileges**

The Government should ban by law any kind of **monopoly power or privilege** granted to any public private company, or individual, which may restrict and impede trade, as for example, where there are still special privileges and restrictions of trade still being granted and in force to aid Cyprus Airways.

### **5.4 Tax Reform on Aligning Corporate and Personal Income Effective Taxes**

A **tax reform** which will aim at bringing closer together the Corporate and top bracket Personal tax rates, thereby containing the possibility for tax avoidance and evasion.

### **5.5 Removal of Labour Market Restrictive Practices**

A reform of **labour market** regulations and restrictions aimed at increasing labour mobility (such as the freedom of bank employees to seek employment from one bank to another) and in order to reduce labour conflicts.

### **5.6 Obligatory Balanced Budget Requirement**

Limit the ability of the Central and Local Government as well as other Public Sector Institutions to borrow without control. There should be a legal requirement to make it obligatory to have a **balanced budget**.

### **5.7 Restructure and Reduce Local Government**

Cyprus has 39 Municipalities of which only 30 are currently active (as 9 relate to areas in the occupied territories). These thirty Municipalities employ many tens of thousands of people and have a combined budget which is many times higher than that of European Municipalities with similar or even greater number of citizens. This means great economic inefficiency which sooner or later is carried over to the tax payer. The over fragmented system of local authorities in Cyprus leads to duplication of fixed costs such

as basic administration and computer systems and is a source of potential conflicts impeding the implementation of co-operative projects between Municipalities such as roads, recycling/waste plant locations.

The Government should pass a law where there would be only one Municipality per District (as it was prior to the 1974 Turkish invasion) which means a total of 6 where Kyrenia would be operationally inactive until a solution to the Cyprus problem is achieved. The current municipalities within each district should be represented by their current Mayors (who would become Representatives of their localities) in their respective District wide Municipalities. A very basic and much reduced administration for each wound down municipality can remain operational to cater for the administration needs of its local community. The savings in efficiency, economies of scale and the ability to negotiate better contracts and financial arrangements would be a huge boost to the country and aid the rebuilding of the economy effort. The Economy will further benefit from the release of economic resources which will, eventually, be more productively employed in other value-adding economic sectors.

## **6 Economic Development**

### **6.1 Cost-Benefit Analysis**

The methodology of cost benefit analysis which involves the careful projection of cash flows (inflows and outflows) expected to arise from a capital investment project is the accepted and widely used practice for promoting economic development. The cash flow projections of any investment project or business enterprise can be compiled with respect to different project stakeholders; the "Owner" of the project which includes the loans and other inflows and outflows relating to the owners of the project, the "Banker" (or Total Investment view) where it is assumed that the project is all equity financed in order to show how good the project is in supporting the repayment of its obligations (including the loans it may wish to raise), and last but not least, the "Economy's View" where the basic cash flow is adapted and the prices adjusted to reflect the net benefits and costs arising to the Economy in general. Economic value (which is the building block of economic development) occurs when the net present value arising from the costs and benefits cash flow of a project from the Economy's perspective is positive. The academic foundations and methodology for this type of analysis are well documented<sup>11</sup> and applied worldwide successfully for many years.

Economic development therefore comes from funding economically viable projects. It does not come because a foreign or local investor decides to venture millions, or even billions, on fancy or heroic projects. Non-viable investment projects inevitably only drag the economy even further into recession. The need to identify, appraise and finance developmentally strong projects is even more acute when there is a need for restructuring and to get the economy out of recession (or even depression). Many of the projects will be financed by loans to the private sector through normal banking while a number of other projects will be in the form of Public-Private Partnerships (PPP) with the participation of local and foreign banks (such as the European Investment Bank).

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<sup>11</sup> Harberger, Arnold C., and Glenn P. Jenkins 2000, Jenkins, G.P., 1998

### 6.2 Public Sector Project Development and Procurement

Cyprus should be ready to make the necessary reforms and put in place the changes necessary mechanisms to facilitate this critical process for spearheading economic development. The need to change the banks including the shift of focus and the retraining necessary to enhance the capability to assess credit risk in giving out loans is necessary but not sufficient to bring about the required change when the country is at the brink of economic depression. It becomes imperative that immediate steps are taken so as to secure the necessary long term funds to finance a new development initiative and to start building the institutions and the capability to independently and professionally evaluate the returns and risks from such projects and in managing the project development and procurement process (illustrated in Figure 3).

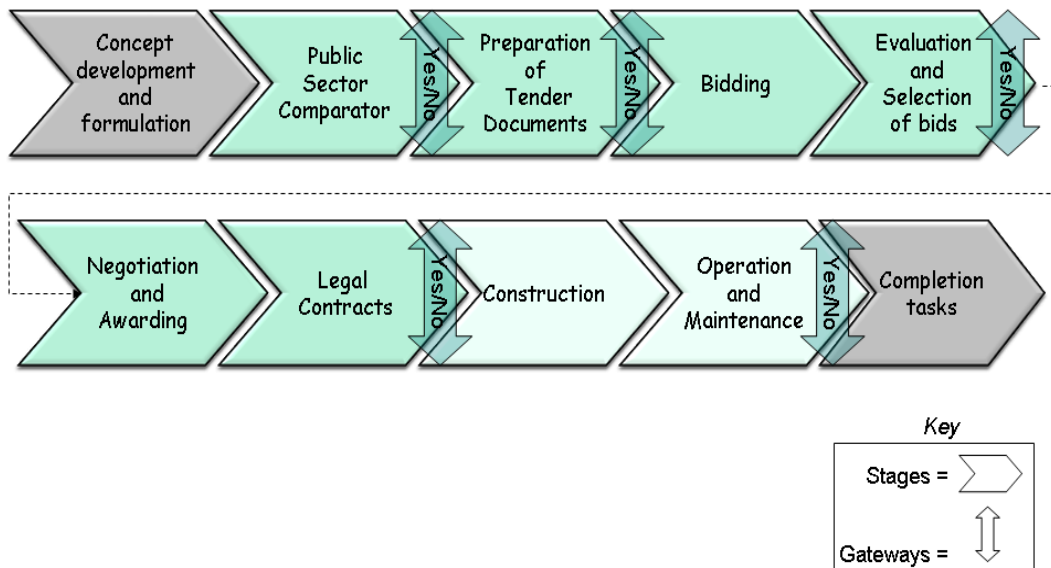


Figure 3: The public sector project development and procurement process

### 6.3 Evaluation and Management System for Public-Private Partnerships

It is very important to have in place a well trained team with expertise in the methods and tools of project finance and one that is able to consider together with potential investors project proposals and to advise the Government on how and what concessions may be made to facilitate and enable a Public-Private Partnership project which has been appraised to be economically viable for the country.

An evaluation and management system capable of facilitating economic development should ensure:

- That the project is economically and financially viable.
- That the risks are manageable and allocated correctly and fairly among the project stakeholders.
- That any burden or cost on the tax payer arising from the project is within budget.
- That the services are provided efficiently and meet customer expectations – in other words, that tax payers get value for money.

- That the Government monitors and remains in control of the situation throughout the project.

To attain these objectives it is required that:

- Projects are awarded in a competitive environment
- Economic appraisal techniques, including a proper application of risk are applied rigorously.
- Risk is allocated between the public and private sectors so that the expected “value for money” of the services provided to the public is maximised; and
- Comparisons made between publicly and privately financed options are fair, realistic and comprehensive.

## 7 The National Development Finance Agency

To fulfil the needs and requirements of an evaluation and management system capable of facilitating economic development it is recommended that the Government creates an expert **National Development Finance Agency** (NDFA) which will be advising the Government as well as to provide financing to projects involving the public sector. This should be set in the mould of the Irish model described below:

- In 2003 the Irish Government established the **National Development Finance Agency** (NDFA)<sup>12</sup> to assist in providing cost effective finance for priority infrastructure projects as an alternative to up-front Exchequer funding or unsuitable private sector funding. NDFA was **established on a statutory basis** and staffed by experts with experience of corporate finance, risk assessment and the delivery of major projects.
- The role of the National Development Finance Agency is to advise State authorities on the optimum means of financing public investment projects in order to achieve value for money. State authorities, who are the decision-making bodies in regards to projects undertaken or to be undertaken, are obliged to seek the advice of the National Development Finance Agency in relation to all capital projects or grouped projects valued in excess of certain amount (€20 million in Ireland - in the Case of Cyprus this amount could as low as €10 million). For projects valued under that amount, the advice of the Agency may be sought but is not obligatory.
- In addition to its advisory role, the NDFA is empowered to advance moneys and to enter into other financial arrangements in respects of projects approved by any State authority.
- In July 2005, the role of the NDFA in Ireland was expanded to facilitate the establishment of a new **Centre of Expertise** which would be responsible for the procurement of all new PPP projects in the Central Government area.

The National Development Finance Agency of Cyprus will fill the need for having a competent Government capability for assessing and financing public sector capital investment projects (and for advising the Government on such matters) and assisting in putting together and managing an efficient and economically productive PPP process in Cyprus.

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<sup>12</sup> <http://www.ndfa.ie/home.html>

### **7.1 Duties and Responsibilities of the NDFA**

The duties and responsibilities of the NDFA would include:

- Providing expert evaluation and management services for taking public sector projects from inception to completion.
- Optimizing Public Expenditure on Capital Investment Projects.
- Ensuring that the tax payers get value for money by applying commercial standards in terms of evaluating financial risks and costs for each project.
- Underpinning the PPP approach to the delivery of infrastructure
- Spreading the cash flow cost of major infrastructure projects over their lifetime.
- Advising the Minister of Finance and the appropriate PPP Unit on issues and decisions relating to capital investment projects and public private partnerships.

### **7.2 Project Finance Expertise and Staffing of NDFA**

It is imperative that Cyprus puts in place as soon as possible its own National Development Finance Agency. The right development and project finance experts should make up the management and a team of young but properly qualified professionals should be recruited and trained accordingly so as to make the Agency an expert and effective organisation ready to help in all aspects of the redevelopment of the Cyprus economy.

## **8 Learning Culture**

Superior civilizations evolve because they learn to take in the wisdom to be had from their past mistakes. Truly advanced cultures even seek out to learn from the experiences of other people taking place outside their own country. The main obstacle to progress is resistance to change and the fear of the new. This is the biggest problem Cypriots need to overcome. Unfortunately, Cypriot culture is deeply entrenched behind a self-imposed shield of seclusion and suspicion. Rather than embracing innovation and learning from their environment Cypriots face adversity as something alien and threatening that they have to distance themselves from at all costs. Hence we quickly dismiss rather than accept our mistakes with humility and view failure as an opportunity to learn and change for the better.

It is very rare to find people in Cyprus who can pose what should be obvious questions with no fear of ridicule. This open thinking is usually treated by our senior peers at work, representatives of special interest groups and politicians to be such a heresy. It is a risky venture for someone with an open mind to even consider the alternatives. This is partly the reason we are in such a mess as a country. We are only allowed to think what these self proclaimed experts put inside the box for us. So, as a result, we hear time and again the same issues and arguments being discussed in television and the public media or at work with only very rarely anyone really questioning the conventional.

In order for attitudes to begin to change it is imperative that the system allows for people with the right culture and leadership qualities to rise to the top of key organisations, be it in the private or public sector. The present shake-up in the ownership of banks for example presents an opportunity for the new owners to select their leaders on the basis of skills, competence and ability to lead as the sole criterion. Moreover, an enlightened

President and Ministers with leadership qualities can set the example for permeating a positive culture change down the Government bureaucracy.

Culture change is the most difficult to achieve and takes a long time to come about. But it is facilitated and accelerated through the successful implementation of economic development, a functional banking system and an efficient and unobtrusive Government. The change begins with the young people who in time replace the old value system with one that rewards results through creativity and innovation rather than just loyalty and hard work.

## 9 Conclusion

Politicians should tackle the causes rather than the symptoms of our failing economy. We need to go back to basics and rebuild the rules of the game by changing the self inflicted distortions in the foundations of our economy. The problem is not the free market. On the contrary, without the free market, it would be hard to imagine how things will not get even worse than they are today. What we need to correct however is the role of banks and Governments. Banks should be just banks<sup>13</sup>. They should not forgo or bypass proper credit risk assessment because they can pass on the risk to someone else or because they can collect their bonus before anyone finds out. The Government on the other hand should show restraint in their budget while it removes all economic distortions so as to ensure that the free economy is allowed to grow and prosper.

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