ACCA

Access to finance for SMEs in Cyprus: an update from ACCA

About ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 170,000 members and 436,000 students in 180 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of 91 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development.

ABOUT ACCA'S GLOBAL FORUMS

To further its work, ACCA has developed an innovative programme of global forums which bring together respected thinkers from the wider profession and academia around the world.

Global Forum for SMEs
The Forum provides a unique platform for promoting the role of SMEs in the global economy. Representing over 15 countries and a wide range of professional backgrounds – from finance institutions, academics and professional advisers to entrepreneurs themselves – the Forum represents the sector's needs at a global level and facilitates the sharing of best practice.

www.accaglobal.com/globalforums

This paper is an update to ACCA's early 2014 review of SMEs' access to finance in Cyprus.[1] It presents new analytical and theoretical work performed by ACCA in the meantime, and proposes possible avenues for further research.

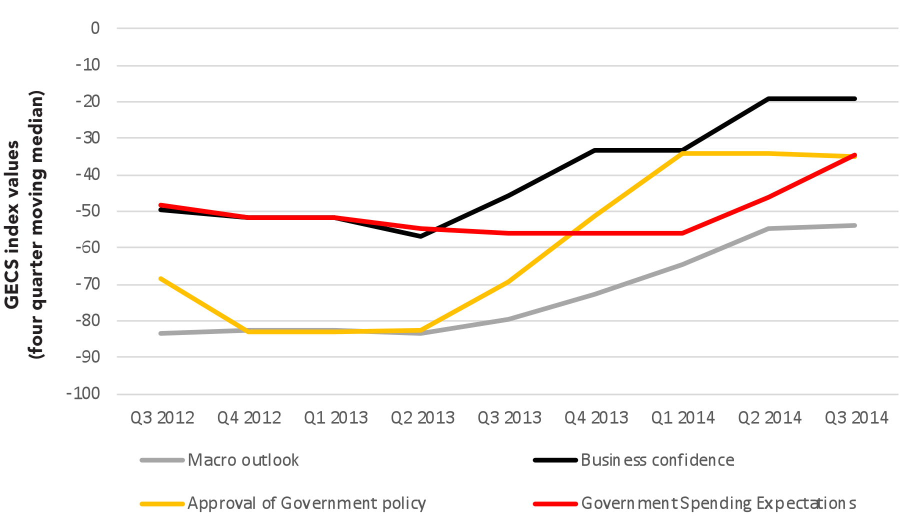
1. RTD Talos, *Financing SMES in Cyprus: No Stone Left Unturned?*, ACCA, 2014. <http://www.accaglobal.com/content/dam/acca/global/PDF-technical/small-business/pol-afb-fsic.pdf>.

1. Economic developments in brief

As of early November 2014, the European Commission was forecasting a 2.8% drop in Cyprus's GDP for the year 2014, and modest growth (0.4%) in 2015. This is a faster recovery than many had predicted, with substantially less dislocation than was seen, for instance, in neighbouring Greece.

ACCA monitors global economic conditions on a quarterly basis through the ACCA–IMA Global Economic Conditions Survey (GECS),[2] the largest survey of its kind in the world. Since the findings of ACCA's review of SMEs' access to finance were published in May 2014, conditions have improved somewhat in Cyprus, against a backdrop of very pessimistic expectations (see Figure 1). In particular, members are revising upwards their expectations of medium-term (five-year) trends in government spending, and business confidence has been rising relatively steadily since mid-2013. Of course, improvements across the board have slowed down or even reversed in the second half of 2014, but the overall trend is still pointing upwards.

Figure 1: Key economic indicators for Cyprus

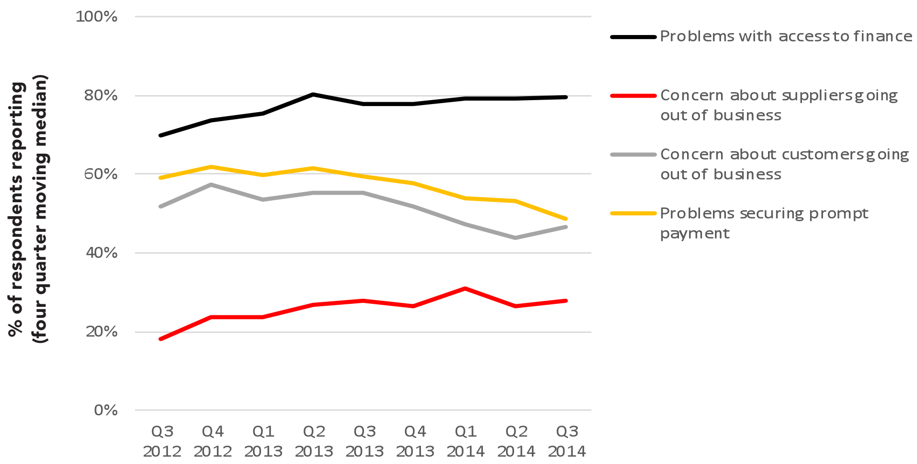


Source: ACCA–IMA Global Economic Conditions Survey

Access to finance remains a first-order problem in the country, with almost 80% of GECS respondents in Cyprus reporting finance-related issues. This figure shows no signs of recovery as yet, and is over twice as high as the survey's regional averages in Europe and the Middle East. Much of the country's financing problem appears to be driven by cash flow conditions, including the legacy of capital controls. The proportion of ACCA members expressing concern about the financial health of their suppliers continues to rise steadily, and is now clearly above one-quarter. On the other hand, access to long-term finance for investment appeared to have improved by early November 2014, while late 2013 also saw the return of investment opportunities. With the right support, business financing in Cyprus could rebound significantly. For the moment, however, capital expenditure has yet to recover to late 2012 levels, despite a modest improvement over the nine months to Q3 2014.

2. <http://www.accaglobal.com/gb/en/technical-activities/browse-resources/gecsr-update.html>.

Figure 2: Selected business cash flow indicators for Cyprus



Source: ACCA–IMA Global Economic Conditions Survey

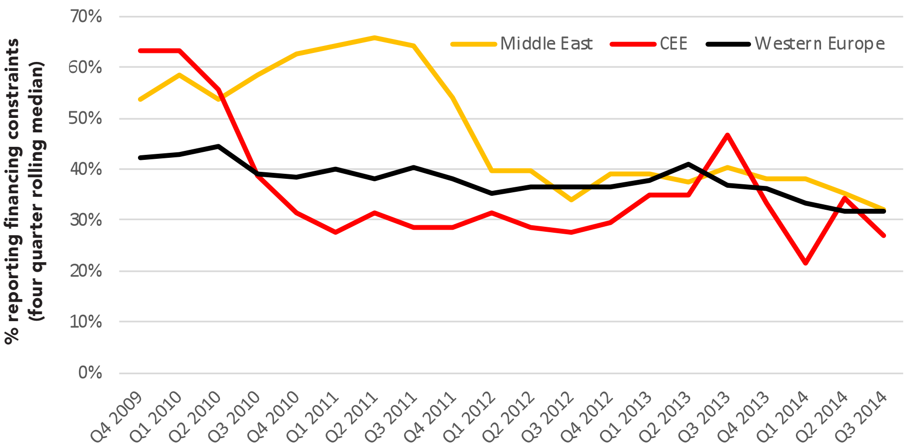
On the face of it, late payments to businesses in Cyprus have fallen significantly in the post-bail-in period, with fewer than half of all respondents affected. It is almost certain that this trend reflects the reduction in trade credit, as opposed to an improvement in credit conditions. If this interpretation is true, then it suggests that a substantial number of businesses in Cyprus have reverted to working mostly on a cash basis, post-bail-in.

2. ACCA's State of Business Finance Review

In November 2014, ACCA completed its 'State of Business Finance' review.[3] This was an ambitious project, tracking the evolution of access to finance for corporates and SMEs worldwide throughout the recovery, as seen through the eyes of ACCA members. It was also an opportunity to interview members in depth about their involvement with financing businesses and to promote their work. One of the interviewees was Dr Petros Alexandrou of the European University of Cyprus, who discussed at length the plight of SMEs and aspiring entrepreneurs in the country.

Overall, the study revealed that the global liquidity landscape is currently exceptionally benign, and collateral values are high; while this benefits SMEs now, both sets of conditions cannot last for ever, and access to finance is bound to tighten again (see Figure 3). ACCA also warned that the banking sector is over-reliant on collateral and guarantees, and is leaving itself wide open to disruption from innovative newcomers, who stand to exploit the fragmentation between the financing markets for small and large business as well as between developed and emerging markets. ACCA highlighted the substantially negative attitudes of smaller businesses worldwide towards the fund-raising process and warned that finance providers can only salvage the SME banking relationship by restoring trust, ownership and service.

Figure 3: Financing conditions for SMEs in Europe and the Middle East in the recovery



Source: ACCA–IMA Global Economic Conditions Survey

The review noted the promise of new types of finance provider such as peer-to-peer, crowdfunding and invoice auctioning platforms, but also noted that distraction is dangerous for fundraising SMEs, who need advice to help them not only navigate but also narrow down their options. ACCA warned that innovative financing solutions are even now creating demand for a new breed of finance professionals, who can liaise with operations and the supply chain as well as with finance providers.

3. *The State of Business Finance*, ACCA 2014. <http://www.accaglobal.com/gb/en/technical-activities/technical-resources-search/2014/october/business-finance.html>.

Table 1: ACCA Cyprus members' involvement in accessing business finance, Q1 2013–Q3 2014

Types of finance	% of members involved in financing	% of all members	Absolute number (rounded)
Bank loan/overdraft	81.0%	25%	700
Commercial mortgage	38.1%	12%	300
Venture capital or business angel investment	14.3%	4%	100
Long-term debt or equity from capital markets	0.0%	0%	0
Liquidity from capital markets	4.8%	1%	50
Mezzanine finance	4.8%	1%	50
Factoring/invoice discounting/trade finance	9.5%	3%	100
Government loans, grants or guarantees	19.0%	6%	200
Supply chain finance	0.0%	0%	0
Specialist export/import finance	4.8%	1%	50
Crowdfunding/Peer-to-peer loans	0.0%	0%	0
Debt or equity from directors, friends and family	19.0%	6%	200
Other	9.5%	3%	100

Finally, the review revealed that about 31% of ACCA members in Cyprus are regularly and actively involved in raising finance for businesses – which is more or less in line with the findings elsewhere. In Cyprus, the review found a greater reliance on commercial mortgages and directors' loans than in other major ACCA markets, in both cases as a direct effect of the state of the banking system (see Table 1). Also striking was the under-representation of asset-based finance and export/import finance in the mix of financing sought; the gap in asset-based finance supply in Cyprus was also highlighted in detail in Talos RTD's report, *Financing SMEs in Cyprus: No Stone Left Unturned?*, published by ACCA in May 2014.

The 2014 *State of Business Finance* review is the first of many, with a review of trade credit and late payment currently under way and due to report in January 2015. ACCA believes that understanding this unseen market for business finance will uncover important trends and complement its knowledge of the access to finance agenda.

3. The stress tests and their aftermath

The latest round of EU-wide stress tests (results announced October 2014), combined with the Asset Quality Review (AQR) by the European Central Bank (ECB), have received widespread publicity for their implications on capital adequacy, and their various methodological shortcomings. Overall, ACCA welcomed the results of the exercise as a great first step in ensuring comparability of asset quality and exposures, and predicted that investors and the public would find the outcomes reassuring.[4] In Cyprus, the results were received with relief.

Only one of Cyprus' banks formally 'failed' the stress tests, in the sense that, even after recent recapitalisation efforts, it was considered not sufficiently capitalised to weather an adverse economic scenario. Hellenic Bank was found to have a €176m capital shortfall in the adverse scenario tested, meaning that it would have to present a plan within two weeks that would see it recapitalised within a nine-month period. It was successfully recapitalised in early November, but its new investors now own about three-quarters of the bank, with the original shareholders diluted substantially.

Perhaps as importantly, the stress tests and AQR provide detailed information on the breakdown of assets within 130 major European banks as of the end of 2013. In Cyprus, the tests covered in detail the Bank of Cyprus, Hellenic Bank, and the CCB (Co-operative Central Bank of Cyprus).[5]

The stress tests and AQR break banks' SME exposures down into categories across two dimensions: one dimension is the type and size of the exposure (SME retail, SME corporate and SME property) and the other is the quality of the asset (defaulted v. non-defaulted). The 2014 stress tests were the first to apply a uniform definition of defaults across the whole of the EU, with loans labelled 'non-performing' if payments were overdue by 90 days or more.

The stress test results reveal that SME loans make up just under 30% of the balance sheets of Cyprus' banks (see Figure 4). This equates to total outstanding loans of €14.9 billion, equivalent to 82.1% of GDP. By this measure, Cypriot banks are SME-heavy compared with their European counterparts. Across the European banks covered by the latest stress-test, SME exposures made up only 11% of the total balance sheet.

As Figures 4 and 5 demonstrate, the three major banks' exposure to the SME sector varies in quantity and quality, with the Bank of Cyprus leading with SME exposure at nearly 40%, and the CCB lagging at just under 10%. In fact, through both focus and sheer size, the Bank of Cyprus dominates SME credit in Cyprus, having 79% of the total SME loans outstanding in the country's banking system. Hellenic follows with 12% and the CCB is last of the Big Three, with 9% of total SME exposures.

The clear majority (81%) of SME exposures of the Cypriot banks were classified as 'corporate', while 10% were classified as 'retail' exposures, and another 9% were classified as backed by real estate. The CCB stands out for its relatively high exposure to 'retail' as opposed to 'corporate' SME loans, at a full 45% of its total SME loan portfolio.

Crucially, the Asset Quality Review found that half (50%) of the banks' total exposure to SMEs is in fact made up of non-performing loans – loans to SMEs are almost twice as likely as other balance sheet items to be non-performing. This is not a problem unique to Cyprus but, given the country's much greater reliance on SMEs for output and employment, it is a major issue.

4. An ACCA statement on the stress tests results is available at: <http://pr.euractiv.com/pr/statement-manos-schizas-senior-economic-adviser-acca-re-ecb-and-stress-tests-european-banks>.

5. All stress test data is sourced from the EBA's *Bank-by-Bank Credit Risk* (by country of the banks) <http://www.eba.europa.eu/documents/10180/851809/4_Credit%20Risk_Individual%20Banks_Country_v2.xlsb>, and *Country Aggregated Credit Risk Figures* datasets <http://www.eba.europa.eu/documents/10180/851809/3_Credit%20Risk_Country%20Aggregate.xlsb>.

Figure 4: Performing and non-performing loans to SMEs as a % of major Cyprus bank balance sheets

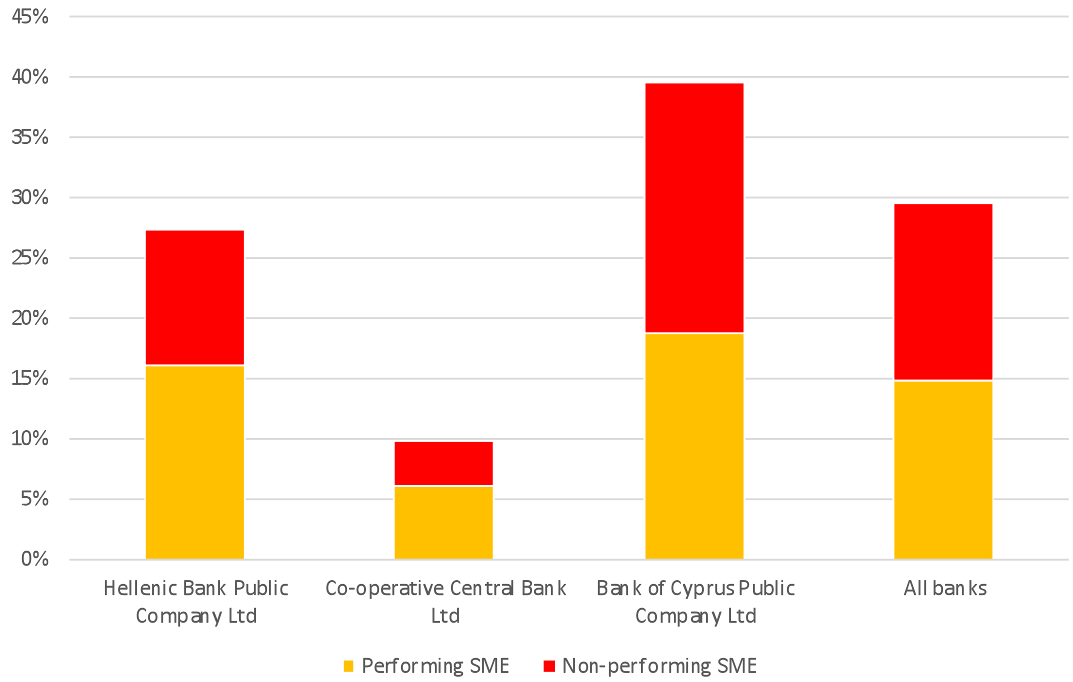
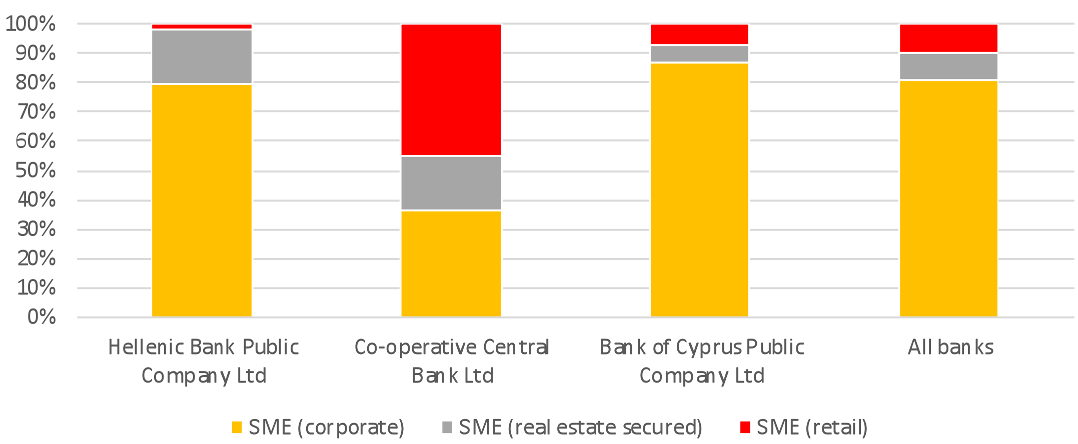


Figure 5: Breakdown of SME exposures in the Big Three banks

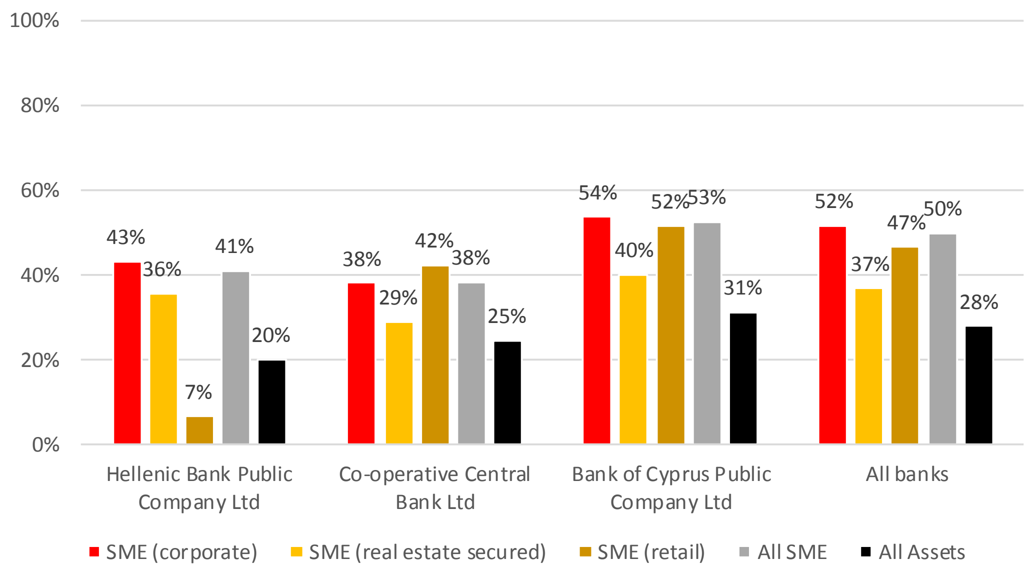


As Figure 6 demonstrates, default rates vary substantially by both bank and type of exposure. As a rule, Bank of Cyprus has the largest percentage of non-performing SME loans across all categories, while the CCB has the lowest percentage across all corporate and secured SME loans. 'Corporate' SME exposures carry the greatest risk of default, while real-estate secured exposures have the lowest risk. As a rule there does not appear to be a correlation between the default rates of banks' SME portfolios and those of their wider balance sheets.

As Cyprus is an international banking centre, it comes as no surprise that 13% of the SME exposure of the country's banks involves foreign companies. Russia, Greece, the UK, Romania and Ukraine are the main counterparty countries when it comes to SME lending, though Russia is by far the largest recipient of SME loans from Cypriot banks. Most of this foreign SME exposure consists of the Bank of Cyprus' international lending (where it makes up 16% of all SME assets); Hellenic Bank, with a similar level of international activity overall, has only about 2% of its SME exposure overseas, while the CCB has no overseas SME exposure at all. As a result of regulatory guidance, the overwhelming majority of foreign SME exposures are classed as 'corporate'.

Default rates by foreign companies can also help to explain the country's domestic economic conditions: domestic SME loans are 94% and 47% more likely to be in default than foreign ones within the Bank of Cyprus and Hellenic portfolios respectively, even though the key counterparty countries have hardly been thriving economies during 2014.

Figure 6: Shares of SME loans classified as 'defaulted', by bank and type of exposure



4. The capital efficiency of SME lending in Cyprus

The stress tests have revealed, among other things, one usually unobserved element of SME lending – the risk weights applied to SME exposures, and how they vary across banks and countries. Because capital requirements are calculated as a share of risk-weighted assets, as opposed to nominal exposures, risk weights are extremely important, and can create incentives for banks that are trying to improve their capital position to shift their lending away from highly weighted assets. Another way of thinking about risk weights is as inverse leverage ratios – they dictate to banks how much each asset can be leveraged. When debt is relatively cheap, that provides an incentive for banks to create or buy assets with low risk weights. Thus in both good times and bad, risk weighting can skew the economics of SME lending in unhelpful ways.

As a rule, SME exposures attract high risk weights owing to their higher probability of default. For an illustration, consider the real figures on SME loans in Cyprus. These account for 30% of the balance sheets of the Big Three banks, but they account for 53% of their total defaulted assets and 45% of their risk-weighted assets. In other words, SMEs account for 45% of the capital requirements of Cyprus' banking sector. As Figure 7 shows, there are two important drivers of risk weights on SME exposures: performing vs non-performing status, and collateral. The impact of collateral, in particular, can be decisive, as for some banks some defaulted but secured exposures can attract lower effective risk weights than some performing but unsecured ones.

Figure 7: Effective risk weights on SME exposures and the total balance sheet, by bank

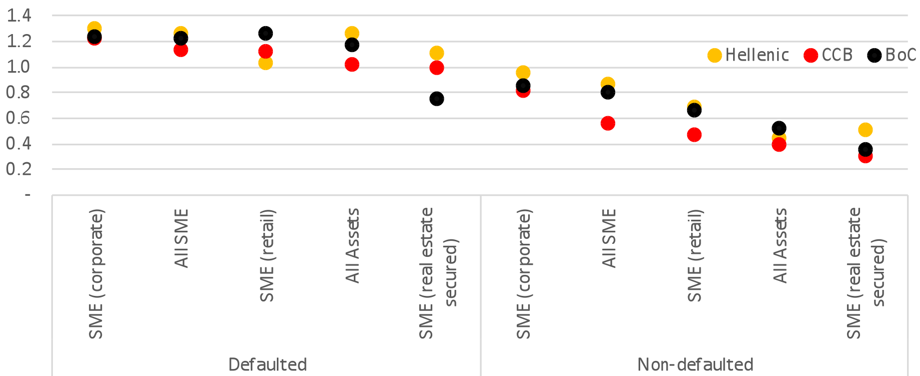
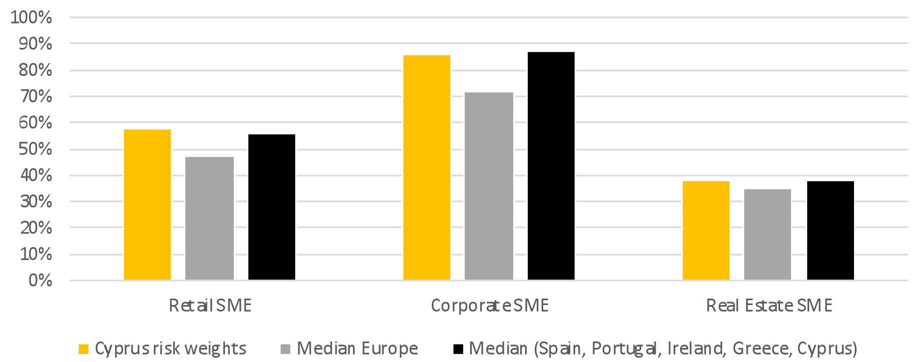


Figure 8: Effective risk weights on performing SME exposures for banks in Cyprus and Europe



Do these weights place Cyprus' banks (and its SMEs) at a disadvantage? It is not easy to tell. Among performing assets, Cyprus' effective risk weights for SME exposures are high compared with other European countries – its banks rank consistently around the top quartile for SME risk weights, whether for retail, corporate or real estate, but particularly so when it comes to retail SME exposures. Nonetheless, when compared with a more representative peer group (in particular, a median risk weight for banks in Ireland, Spain, Portugal, Greece and Cyprus), Cyprus' SME risk weights are not unreasonably high.

A further, key driver of the disparity with 'core' Europe may be the methods by which risk weights are calculated by different banks. Banks have three options.

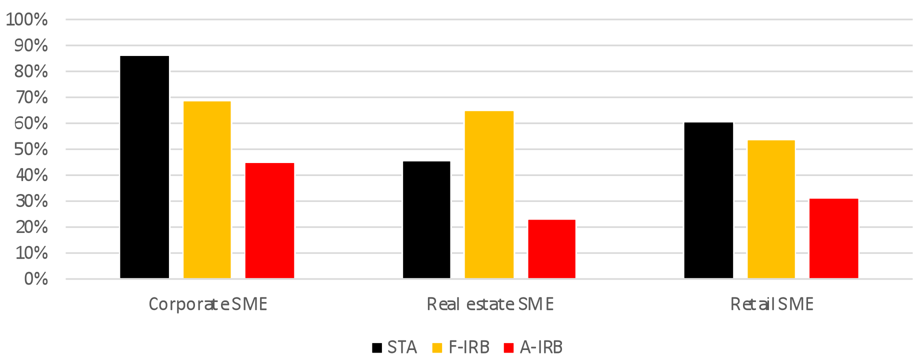
1. In the Standard approach (STA), risk weights are produced on the basis of guidelines provided by regulators. All the Big Three banks in Cyprus use this approach.

2. In the Advanced Internal Ratings-Based Approach (A-IRB), banks can, subject to regulatory approval, derive their own internal risk weights from historical evidence in their own portfolios. Internal ratings can vary substantially from the weights handed down by regulators, and from those of other banks, owing to different calculations of the risk of default, the amounts at risk in the event of default, and the final loss should default occur.

3. In the Foundation Internal Ratings-Based Approach (F-IRB), banks can, subject to regulatory approval, derive their own internal estimates of default risk, but must use standard estimates for other parameters of the risk-weight calculation, such as loss in the event of default.

Importantly, risk weights for performing SME exposures vary substantially according to which method is used. As Figure 9 demonstrates, the more discretion banks have to adapt risk weights to their own historical data, the lower are the effective risk weights for performing corporate and retail SME exposures.

Figure 9: Effective risk weights on performing SME exposures across all major European banks, by method of calculation



IMPROVING THE CAPITAL EFFICIENCY OF SME LENDING

In light of the above, the following initiatives could improve the capital-efficiency of SME lending, at least at the margins and over time.

A review of the capability of Cyprus' banks to move to internal ratings-based risk weights could require public investment in a comprehensive credit risk model, hinted at in ACCA's original review of SME lending in early 2014.

A long-term review of collections and forbearance practices and outcomes among the banks could be carried out with the ultimate goal of preparing robust evidence for internal ratings.

A review of the potential for re-classification of some SME exposures as retail exposures could focus particularly on small loans that are director-guaranteed.

A review of the potential for using alternative assets, especially registered Intellectual Property, as collateral for SME lending could be undertaken. State guarantees provided against the value of intangible assets in Singapore and Malaysia could provide a model for this.[6]

Clearly, merely reducing capital requirements for SME lending through methodological sleight of hand will offer nothing to Cyprus' economy in the long run, and would not be possible in any case in the context of pan-European supervision. Even well-documented and reasonable changes risk attracting criticism and reducing investor confidence in the country's banks. Hence it is important to understand these options as long-term improvements for which the groundwork has to be laid first through robust research and then through collaboration with regulators internationally.

6. An authoritative review of the potential for intangible-asset-based guarantees is provided in M. Brassell, and K. King, *Banking on IP?*, Intellectual Property Office, 2013. <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/312008/ipresearch-bankingip.pdf>. ACCA is honoured to be a contributor and has explored the idea further by piloting an intangible asset valuation tool for SMEs in Malaysia in 2014.

POL-TP-ATFFS