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Some Observations on Offshore Banking in Cyprus

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The Banking Sector

There are 41 banks operating in Cyprus. Six are local banks, 16 are subsidiaries or branches of E.U member states, while the majority are non E.U member state banks (Central Bank of Cyprus 2013). Like a number of other small island territories, Cyprus facilitates an offshore financial sector. A predominant feature of which is the exemption, of offshore firms, from the domestic regulatory environment and taxes. Offshore banking licenses can be obtained for banks that operate only with non-residents and in foreign currencies. These offshore "banking units" can be associated with already existing resident banks or can be entirely offshore in structure (The republic of Cyprus and overview). To date there are over 20 licensed offshore banks operating through Cyprus.

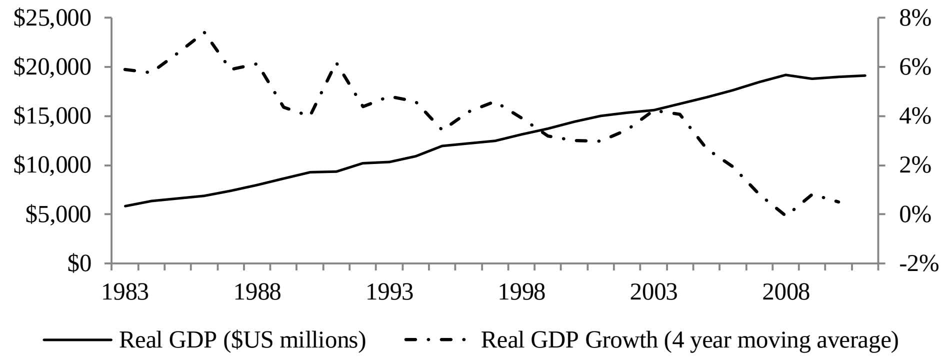
A significant segment of the Cypriot offshore sector is its facilitation of International Investment Schemes as governed by the International Collective Investment Scheme Law (1999). The "objective of which is the collective investment of funds"… "with the option of withholders to redeem or repurchase directly out of the assets of the scheme". Such schemes are also tax exempt (section 76) and have a duty to maintain secrecy (section 79).

As of December 2012 there were 114 investment schemes registered in Cyprus. Half of which were listed as using equities as there investment policy. The remaining segment of investment schemes are categorized as using either, the bond market, hedging, real estate, or mixed investment policy (Central bank of Cyprus 2013a).

Economic and Financial Statistics

Economic output in Cyprus was estimated at US$19 billion in 2011 with an annual per capita income of approximately US$30 thousand. Figure 1 below shows that prior to 2003 Cyprus demonstrated an average annual real GDP growth rate of 5%. Subsequently annual GDP growth fell to an average low of less than 1%.

Figure 1



International investment positions has shown tremendous expansion since 2003 in which the financial account expanded from a net credit position of US$550 million to a net debtor position of US$16.5 billion in in 2011.[1] Changes in the portfolio investment environment account for the vast expansion of total investment positions, in which total portfolio investment stood at a net credit position of US$26.2 billion in 2011 compared to US$2.9 billion in 2003. The bond market illuminates the observed trends in Cyprus' international investment position. It accounts for 93 percent of all portfolio positions. Interestingly, it is *the growth in bond asset holdings* that accounts for almost the entire change in Cyprus' international positions between 2003 and 2011. More specifically bond assets grew from US$4 billion in 2003 to US$30.7 billion in 2011, demonstrating an average annual growth of 22 percent (Central Bank of Cyprus 2013b).

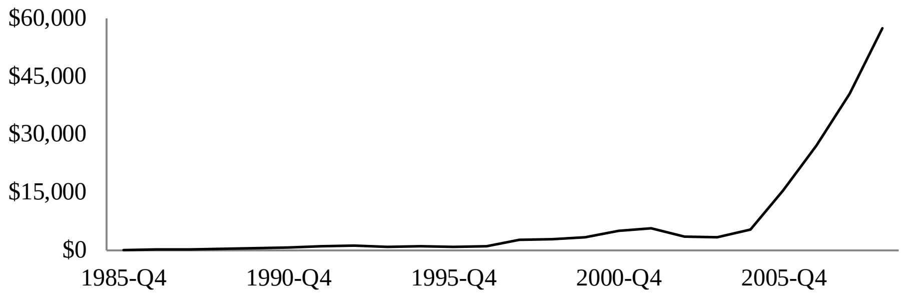
Monetary financial institutions account for the majority of international bond asset holdings. Similarly, reported bank asset and liability positions demonstrate significant foreign and non-resident positions. In 2004 foreign assets were 38 percent of total bank assets, while non-resident deposits accounted for 38% of all deposits held with financial institutions (Central Bank Cyprus 2011).

At the time of this commentary is was unclear whether banking statistics of monetary financial institutions include that of the offshore sector and more specifically the financial activity of international investment schemes. To explore in more detail offshore financial activity we employ a measure developed by Zorome (2007) and used by Butkiewicz and Gordon (2012) to estimate a potential minimum size and scope of offshore financial activity. Based on this

[1] All reported economic and international investment positions are converted to real $U.S values based on the CPI in Cyprus, then converted to U.S dollar values based on the relevant Euro/U.S exchange rate.

technique it is observed that Cyprus has demonstrated a measurable offshore sector since 1985, in which offshore assets in Cyprus, of non-residents, is estimated to be at least US$82 million.[2] Figure 2 below shows the time trend in the estimated size of the offshore activity.

Figure 2 Estimated Offshore Financial Sector (US$ millions)



Caribbean offshore centers have also been evaluated with regard to size and scope (Butkiewicz and Gordon 2012). Up to 2005 the measured size of the offshore sector in Cyprus, relative to the size of its own economy, is smaller than those of the Caribbean. During this time the relative size of the sector did not exceed 50% of GDP, while Caribbean offshore centers almost always demonstrated offshore banking significantly in excess of the value of domestic output.

Notably, in 2005 offshore banking activity in Cyprus began to demonstrate exponential growth. Its estimated size increased tenfold from US$5 billion in 2004 to over US$57 billion in 2008. In absolute terms the extent of offshore activity still dwarfs that of Caribbean OFCs the Cayman Islands and the Bahamas, but becomes comparable in magnitude to that of Barbados. Most notably, claims on Cyprian banks by BIS reporting countries increased from US$2 billion in 2004 to US$28.7 billion in 2011.

Summary

The opaqueness of offshore financial center activity almost always leads to concerns stemming from the unknown. Due to the relatively small size of its offshore financial sector, banking in Cyprus does not pose a systemic risk to international finance. There could be however investor specific concern due to the predominance of bond asset investment conducted through Cyprus.

[2] This minimum estimate is based on the only 21 countries reporting locational banking positions to the Bank of International Settlements. Subsequently offshore positions may significantly exceed this amount. The number of reporting countries grew to 40 by early 2000.

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