INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/338

CYPRUS

SELECTED ISSUES

November 2018

This Selected Issues paper on Cyprus was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on November 8, 2018.

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November 8, 2018

Approved By
European Department

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CONTENTS

CHALLENGES IN REDUCING NPL OVERHANG AND RESTORING CREDIT FINANCING[1]

Non-performing loans are declining in Cyprus, reflecting mainly write-offs and the sale of loans. However, repayments have not improved significantly despite a strong economic recovery. This paper identifies key challenges among households in reducing NPLs further in Cyprus, namely, (i) low repayment capacity, particularly among a certain group of debtors, and (ii) weak repayment discipline owing to strategic behavior. Despite some revival of lending activity, the role of bank credit as a funding source remains limited. External inflows, drawdown of savings, use of own funds, and unpaid debt service obligations are contributing to financing economic activities, but these sources may not be sustainable over the medium term. Addressing NPLs to lower borrowing costs and reviving credit supply will be important for supporting longer-term growth.

A. Background

1. A key economic challenge in Cyprus is the large stock of non-performing loans (NPLs). This paper discusses recent trends in the evolution of NPLs and seeks to identify the key challenges in reducing NPLs. Given the strain on bank balance sheets and the need for further deleveraging of the economy, this paper also attempts to understand what the main sources of financing underlying the current recovery are and whether they can sustain longer-term growth given the need for deleveraging in the economy.

B. Evolution of NPLs

2. NPLs remain very large at 39 percent of total loans (second-highest in euro area) or 85 percent of GDP (the highest in euro area), as of Q2:2018, although declining. Small borrowers (households and micro, small and medium-sized enterprises (SMEs)) owe more than 90 percent of the NPLs. NPLs owed by nonfinancial corporates (NFCs) are mostly in tourism and trade (€2.3 billion, 36 percent of NFC NPLs), construction (€1.8 billion, 28 percent), and real estate (€0.9 billion, 14 percent) sectors. About a half of NPLs relate to terminated accounts (in which outstanding balance has been called in), while about a third of the NPLs have been restructured.[2]

3. The NPL problem is largely a legacy issue from the financial crisis. NPLs increased from 13 percent of total loans (or 64 percent of GDP) in 2010 to 48 percent of total loans (or 161 percent of GDP) in 2014 (peak year).[3] The large increase in NPLs reflected weak lending standards before the Cypriot financial crisis of 2012–13, when lending relied more on collateral values than on borrowers' capacity to repay. As some debtors defaulted, unpaid interests were accrued, further escalating

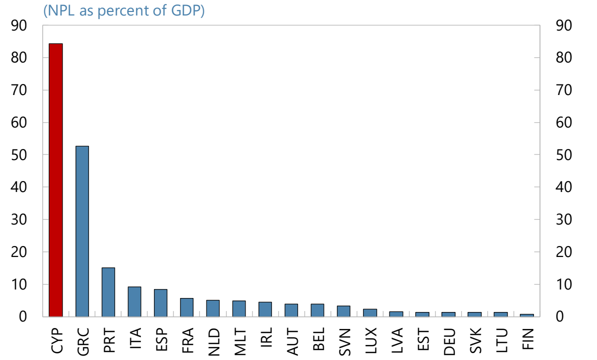
[1] Throughout this note, all data are consolidated accounts of all banks unless otherwise specified. In 2014, the CBC changed its definition of NPLs to be consistent with the European Banking Authority's definition. From 2018, a shift to IFRS9 accounting standards required recognition of accrued interest on NPLs as part of NPLs.

[2] According to the EBA definition of nonperforming exposures, restructured loans remain classified as nonperforming for at least 12 months.

[3] Years 2010 and 2014 are not fully comparable because the CBC changed its definition of NPLs to be consistent with the European Banking Authority's definition in 2014.

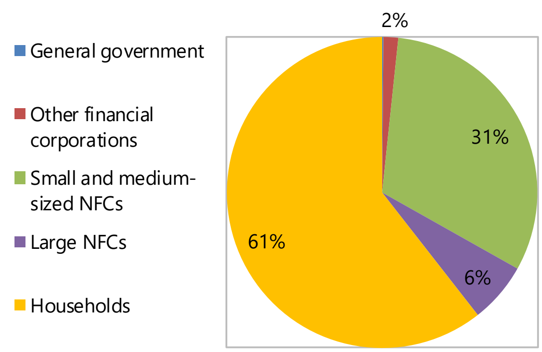
outstanding NPLs. Since their peak in 2014, NPLs have declined to 39 percent of total loans (or 85 percent of GDP) by 2018:H1. More than two-thirds of the NPL reduction was made by NFCs. NFC NPLs were reduced especially in construction, real estate, and tourism and trade sectors. The reduction of NPLs by households has been more limited. Much of these loans reflect housing loans or loans collateralized by primary residences.

NPL-to-GDP Ratio in Euro Area Countries, 2018H1
(NPL as percent of GDP)



Sources: Central Bank of Cyprus, EBA, WEO, and IMF staff calculations.

Composition of NPLs by Sector
(Percent of total loans, 2018H1)



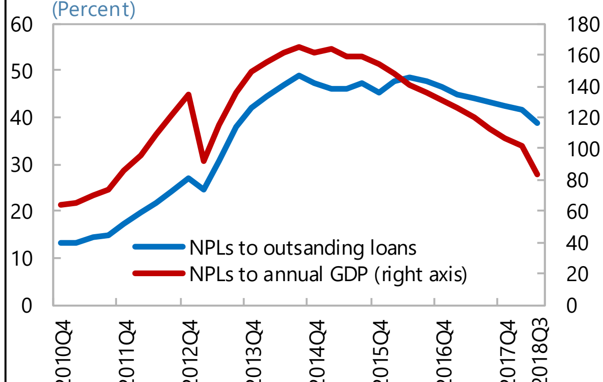
Sources: Central Bank of Cyprus; and IMF staff calculations.

Non-Performing Loans
(Billions of euro)

	2014Q4	2015	2016	2017	2018H1	2018H1
			Change			
Total	28.4	-1.1	-3.0	-3.4	-4.0	16.9
HHs	12.8	-0.1	-0.7	-1.1	-0.8	10.2
NFCs	14.4	-0.5	-2.2	-2.2	-3.1	6.4
Large enterprises	5.3	-0.7	-3.1	-0.5	0.0	1.1
SMEs	9.0	0.1	0.9	-1.7	-3.1	5.3
NFCs						
Tourism and trade	4.0	-0.1	-0.3	-0.6	-0.6	2.3
Construction	5.1	-0.2	-1.1	-0.7	-1.4	1.8
Real estate	2.4	0.0	-0.3	-0.5	-0.6	0.9
Others	2.9	-0.2	-0.4	-0.4	-0.5	1.4
Other financial corporates and government	1.2	-0.5	-0.2	-0.1	-0.2	0.3

Source: Central Bank of Cyprus and IMF staff calculations.

Non-Performing Loans
(Percent)



Sources: Central Bank of Cyprus; and IMF staff calculations.

4. Early legislative reforms failed to address the large NPLs, in part reflecting weaknesses in the legal framework and lack of enforcement. Legislative reform on sale of loans, foreclosure, and insolvency were undertaken during 2014–15. However, the use of the foreclosure framework was limited. This is because (i) whether the new procedure applies for legacy cases was uncertain; (ii) foreclosure auctions remain unpopular and often faced protests; and (iii) potential court delays due to challenges and appeals discouraged the use of the new procedure. Personal repayment plans (PRPs), introduced in the 2015 reform on insolvency framework, have also been rarely used. Furthermore, until recently, the sale of NPL portfolios has been limited.

5. More ambitious reforms have been legislated in 2018.[4] The amendments have addressed some of the shortcomings of previous reforms. For example, the new sale of loans law allows creditors to break down the mortgage in multiple pieces and to give loans buyers increased access to data to assess debtors' indebtedness, which has already led to a tentative agreement of a sale of loans of a significant amount. The securitization law was also approved, which is expected to facilitate the sale of loans. The 2018 amendment aims to make foreclosure a more credible threat to debtors and to make the insolvency framework more usable. The 2018 amendments seek to address some of the challenges, e.g., they (i) made it clear that the law applies for the legacy cases; (ii) allow the introduction of electronic auctions; and (iii) further facilitated the auction process.

6. Partly due to the limited use of foreclosure and insolvency tools so far, preferred modalities for NPL resolution have been write-offs and the sale of loans. For a year up to June 2018, outflows from NPLs were almost three times the inflows to NPLs. The outflows from NPLs consisted of write-offs (about one-third), sale of loans (one-third), migration to performing category (20 percent), NPL cash repayment (10 percent), and debt-to-asset or equity swaps (6 percent).[5] With further sale of loans in the pipeline, NPLs are expected to decline on bank balance sheets. Furthermore, the bulk of the NPLs previously owned by the Cyprus Cooperative Bank (CCB) has been moved out of the banking sector in 2018:Q3 to a newly created state-owned asset management company.

7. Outflows from NPLs by cash repayments or migration into performing category have not substantially accelerated despite a strong economic recovery. Even with GDP growth above 4 percent annually since 2016 and a strong recovery in employment, the size of cash repayments or migration into performing category has not substantially increased, implying that the payment discipline remains weak. However, inflows into NPLs are on a declining trend, likely reflecting more stricter lending standards.

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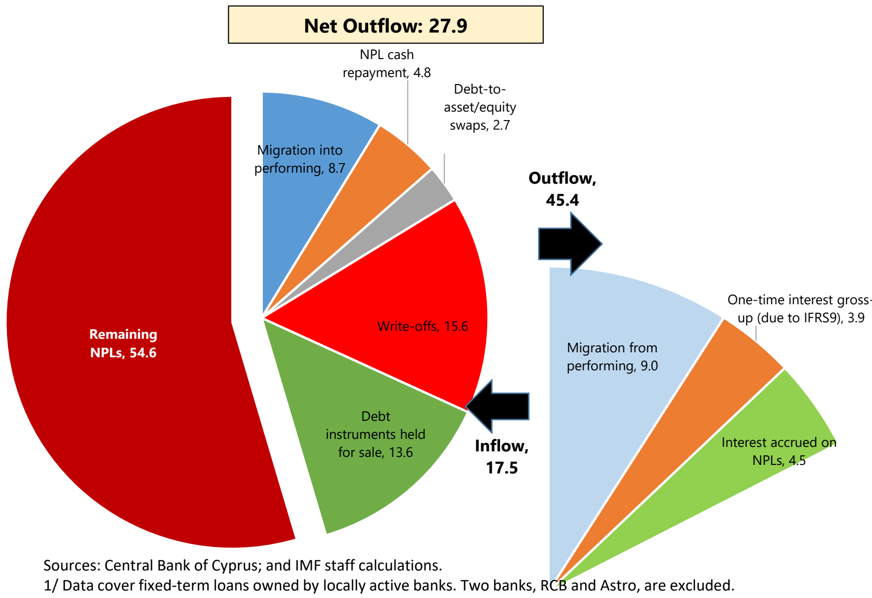
[4] For reforms undertaken prior to 2018, see "Reforming the Legal Framework to Support Private Debt Restructuring" (IMF (2017), pages 30–45.)

[5] Some write-offs were in response to one-time interest gross-up due to the adoption of IFRS9 in 2018:Q1. The majority of the sale of loans reflect a transaction made by a bank in 2018:Q2. The sale of loans is a recently introduced tool and has not contributed prior to end-2017.

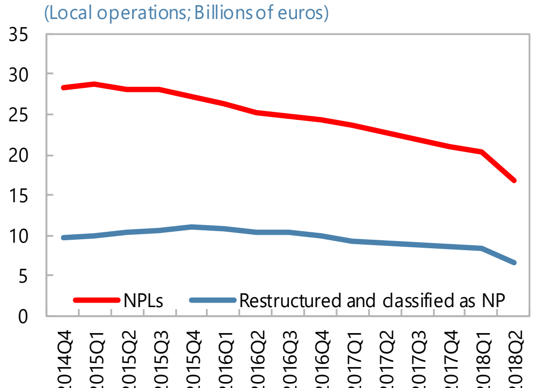
Flows of Non-Performing Loans 1/
(Q3:2017-Q2:2018. Stock at the beginning of the period normalized to 100.)



Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Data cover fixed-term loans owned by locally active banks. Two banks, RCB and Astro, are excluded.

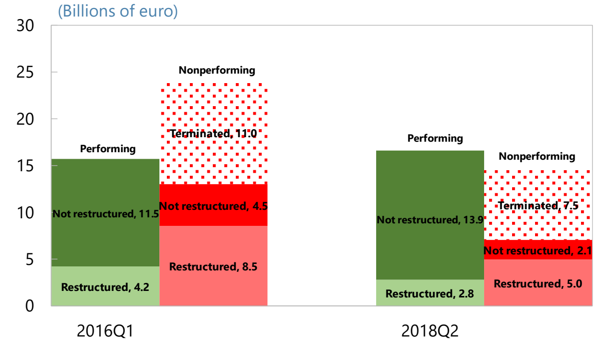
8. Sustainable restructuring of NPLs has been challenging. Almost two-thirds of the restructuring flow is on the loans already restructured at least once. With more than half of NPLs related to terminated accounts, the large share of re-restructuring may imply that, under the current environment, further restructuring efforts will not lead to a substantial NPL reduction. Furthermore, the redefault rate on loans restructured one year before has increased in 2018:Q2. These trends underscore the limited effectiveness of the insolvency and foreclosure framework and weak enforcement of restructuring guidelines to achieve viable restructuring solutions.

Restructured Loans Classified as Non-Performing
(Local operations; Billions of euros)



Sources: Central Bank of Cyprus; and IMF staff calculations.

Loans by Classification 1/
(Billions of euro)

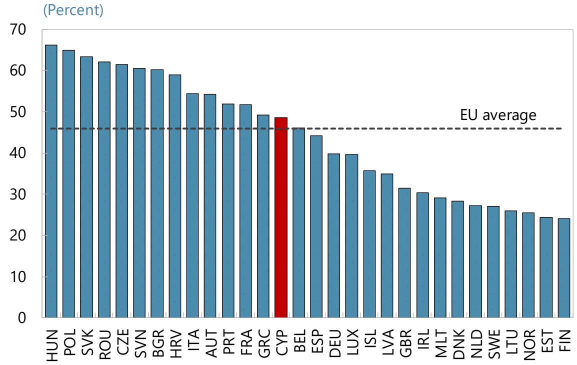


Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Fixed term loans. Local operations only. Excluding RCB bank. An account is considered terminated if the outstanding balance has been called in.

9. **The need to accumulate provisions, along with declining net interest margins, have also put downward pressure on bank profitability, undermining NPL resolution.** Loan loss provisions at Cypriot banks are close to 50 percent of NPLs, slightly above the EU average, as of 2018:H1. The provision ratio has increased steadily since 2014. ECB data indicates that provisioning and collateral coverage is close to 100 percent of NPLs. Nevertheless, given that the time required for the foreclosure process is long, banks needed to continue to accumulate provisions as continued difficulties in collateral recovery increased the risk that transaction price of NPLs may be lower than their book value, leading banks to further recognize losses. More recently, however, the accumulation of provisions has facilitated the sale of NPLs by banks.

Provisions as Percent of NPLs, 2018H1

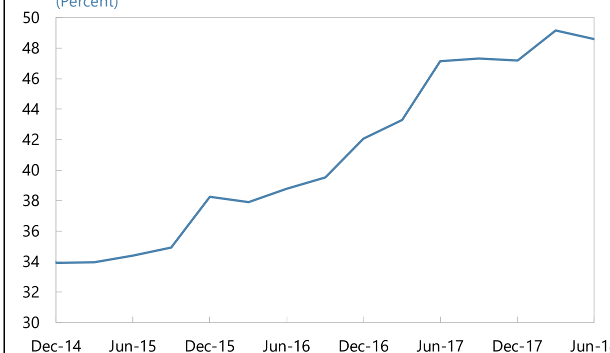
(Percent)



Sources: Central Bank of Cyprus and EBA.

Provision Coverage Ratio

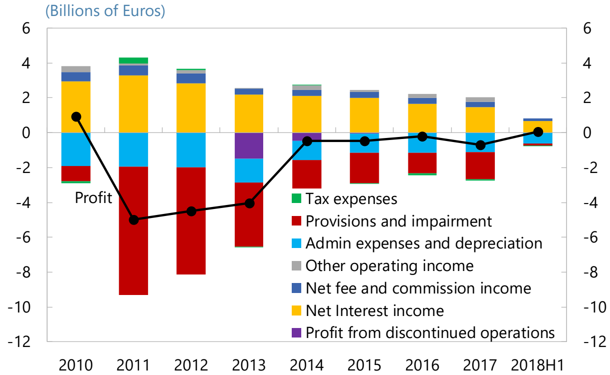
(Percent)



Sources: Central Bank of Cyprus and IMF staff calculations.

Banking Sector Profits

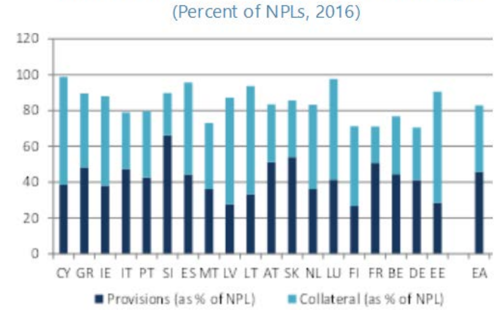
(Billions of Euros)



Sources: Central Bank of Cyprus and IMF staff calculations.

Euro Area: Provisioning and Collateral Coverage

(Percent of NPLs, 2016)



Sources: European Central Bank.

C. Key Challenges to Reducing Household Sector NPLs

10. This section examines the key challenges in reducing NPLs among households in Cyprus. The Household Finance and Consumption Survey (HFCS) data provides useful information on the repayment capacity of households and on potential strategic behavior of debtors.[6]

Low Repayment Capacity

11. Household debt servicing burden suggests that weak repayment capacity is a key factor in the non-repayment of loans. Median net wealth in Cypriot household decreased by 36 percent between "Wave 1" (2009–10) and "Wave 2" (2014) of the HFCS. This rate of decrease in net wealth is large, compared to the euro-area average of 4 percent. Real and financial assets decreased by 30 percent and 29 percent, respectively, while liabilities increased by 26 percent. Gross income also decreased by 30 percent. As a result, indicators of debt burden—debt-to-income ratio, debt-service-to-income ratio, debt-to-asset ratio, and loan-to-value ratio of primary residence—all deteriorated substantially. In particular, the debt-to-income ratio increased from 1.57 to 2.51, which is significantly above the euro-area average of 0.72. The deteriorated debt burden has not fully recovered.[7] The still-lagging outflows from NPLs despite the recovery reflects such financial difficulties.

Household Finance Survey, Medians
(Thousand euros)

	Wave 1 (2009-10)	Wave 2 (2014)	Change in percent
Real assets	314	218	-30
o.w. Household main residence	240	200	-17
Financial assets	22	16	-29
o.w. Deposits /1	6	12	112
o.w. Voluntary pensions and life insurance	16	10	-38
Liabilities	60	76	26
o.w. Mortgage debt	87	100	15
Net wealth	267	170	-36
Gross income	32	23	-30

Sources: ECB HFCS.
1/ An increase in deposits partly reflects the cashing of voluntary pensions and life insurance during the crisis. However, average deposits are reduced by 14 percent.

Net Wealth of Households, Medians
(Thousand euros)

	Wave 1 (2009-10)	Wave 2 (2014)	Change in percent
Cyprus	267	170	-36
Euro area	108	104	-4
Germany	51	61	18
Belgium	206	218	6
Greece	102	65	-36
Spain	183	160	-13
Italy	173	146	-16
Luxembourg	398	438	10
Malta	201	210	4
Portugal	79	71	-10

Sources: ECB HFCS.

12. In particular, low-income households seem to face debt service obligations much exceeding their repayment capacity. The HFCS ("Wave 2") documents that 59 percent of Cypriot households owe debt (compared to 42 percent in euro area). The debt-service-to-income ratio for those who owe any debt is the highest at 36 percent, relative to 14 percent in euro area. Debt burdens are especially heavy for the households with bottom-20-percent income or wealth level. The survey indicates that the debt-service-to-income ratio of the households with the

[6] The HFCS provides household-level data related to household balance sheets in participating countries in euro area. In Cyprus, 1,237 and 1,289 households participated in "Wave 1" (2009-10) and "Wave 2" (2014), respectively, while 930 households participated in both. As in other survey data, the representativeness could be an issue.

[7] Although declining, nonfinancial private sector's debt service ratio remains relatively high at 20 percent of GDP, as of 2018:H1.

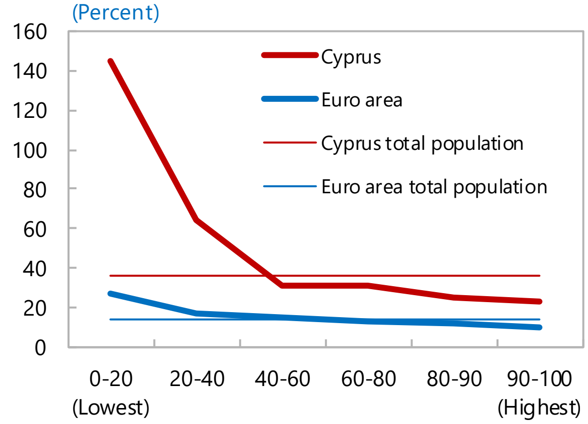
lowest-20-percent income level is over 140 percent, compared with 25 percent in the euro area. This reflects not only the large drop in income following the crisis but also the lax lending standards that paid little attention to income and repayment capacity before the crisis. This is shown by the high debt-to-income indicators during the pre-crisis period of Wave 1, particularly in the lower income bracket, despite the concentration of financial wealth on a smaller group compared to its peers. Cyprus also has higher Gini coefficients (based on wealth or income) as well as a higher at-risk-poverty ratio than many of its peers.

Financial Burden Indicators, Medians

	Cyprus		Euro area	
	Wave 1 (2009-10)	Wave 2 (2014)	Wave 1 (2009-10)	Wave 2 (2014)
Debt-to-income ratio	1.57	2.51	0.63	0.72
Debt-service-to-income ratio	0.23	0.36	0.14	0.14
Mortgage-debt-service-to-income ratio	0.25	0.34	0.16	0.16
Debt-to-asset ratio	0.17	0.23	0.22	0.26
Loan-to-value ratio of main residence	0.32	0.42	0.38	0.44

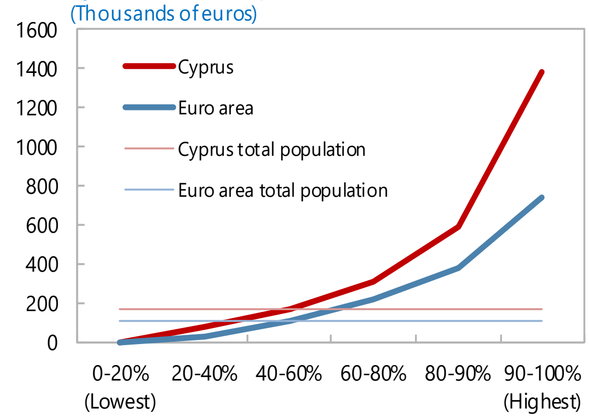
Sources: ECB HFCS.

By Income Group: Debt-Service-To-Income Ratio
(Percent)



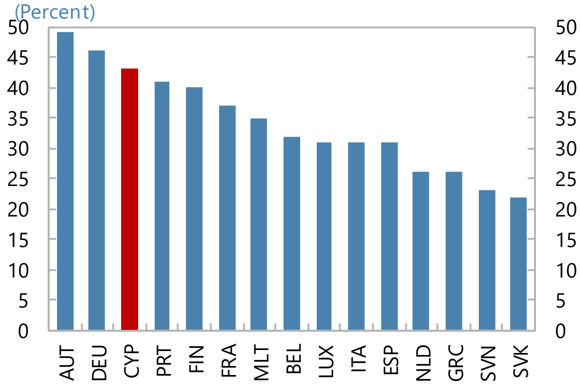
Source: ECB HFCS, Wave 2 (2014).

By Net Wealth Group: Net Wealth
(Thousands of euros)



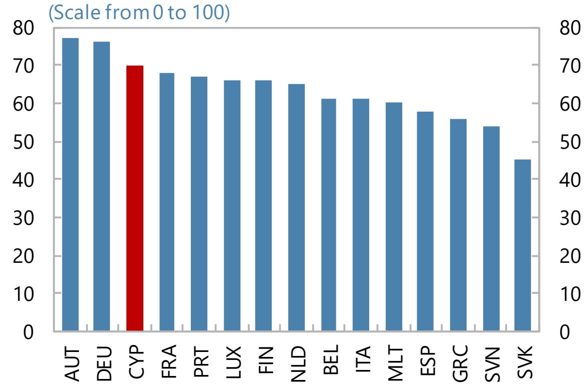
Source: ECB HFCS, Wave 2 (2014).

Share of Wealth Held by Top 5 Percent Wealth Holders, 2013
(Percent)



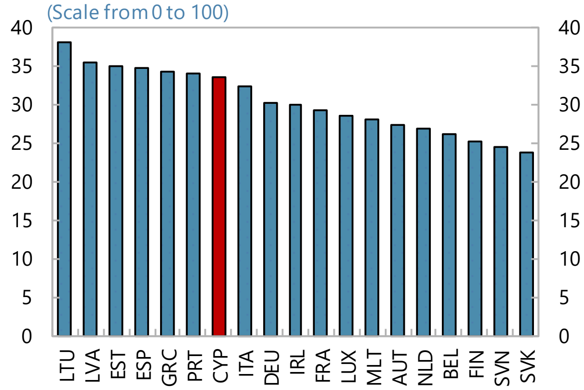
Source: European Commision.

Gini Coefficient Based on Wealth, 2013
(Scale from 0 to 100)



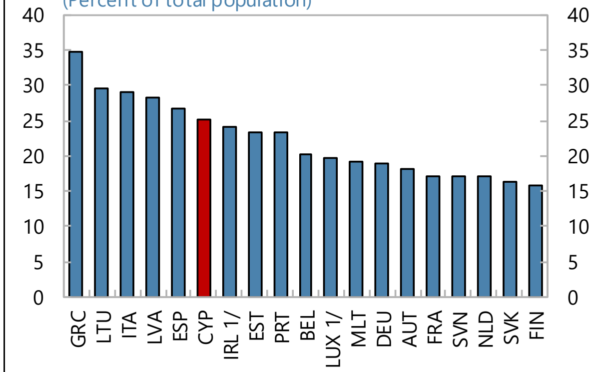
Source: European Commision.

Gini Coefficient Based on Disposable Income, 2015
(Scale from 0 to 100)



Source: Eurostat.

At-Risk-Poverty Rate, 2017
(Percent of total population)

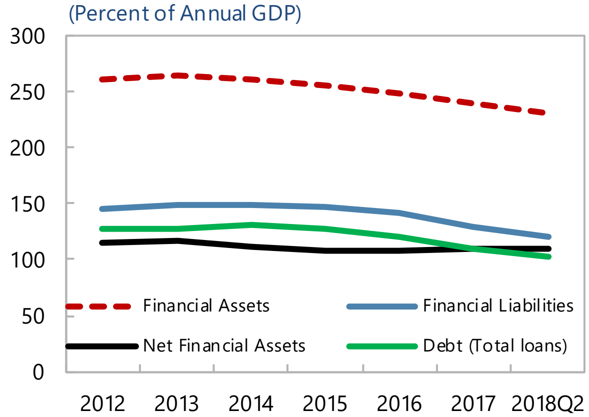


Source: Eurostat.

Weak Repayment Discipline Reflecting Some Strategic Behavior

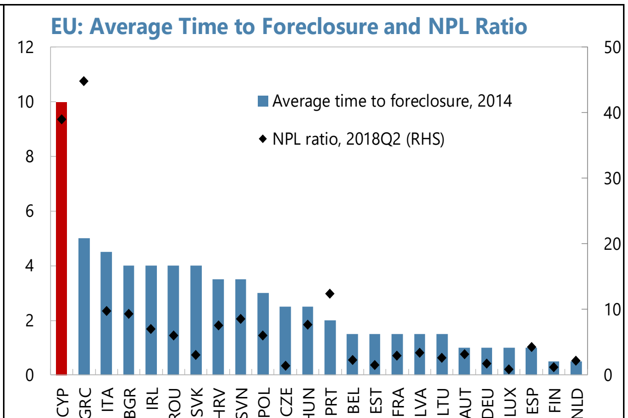
13. Asset holdings also suggest some strategic default on the part of household borrowers. Many households seem to have enough assets to repay their debt. In aggregate, Cypriot households own financial assets exceeding liabilities by 100 percent of GDP, as of 2018:H1. The HFCS suggests that a median household in Cyprus has net wealth of about €170,000, exceeding the euro area average, €104,000, as of 2013. At the same time, the outstanding loans by a median Cypriot household, which are 23 percent as a ratio to total assets, are lower than the euro-area level of 26 percent. For the bottom 20 percent households, net wealth levels are similar between Cyprus and the euro area. The fraction of households whose net wealth is negative was 6.9 percent in Cyprus, only moderately higher than the euro-area level of 5.2 percent. A sizable share of NPLs, particularly among the wealthier debtors, could therefore likely be serviced through disposal of assets. The strategic behavior likely reflects weak claims enforcement and non-credible threat of foreclosure so far.[8]

Financial Accounts of Households
(Percent of Annual GDP)



Sources: CBC; and IMF staff calculations.

EU: Average Time to Foreclosure and NPL Ratio



Sources: Central Bank of Cyprus; EBA; and Aiyar and others (2015).

[8] See IMF (2017a).

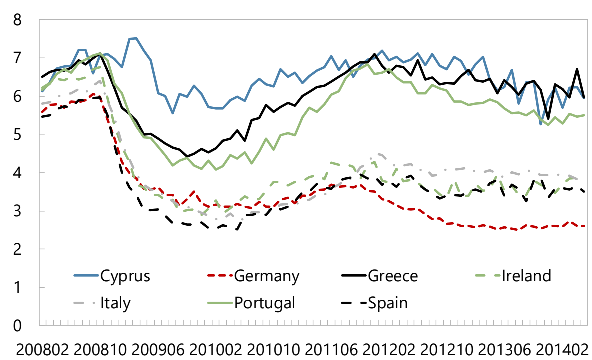
Policy Implications

14. Banks should utilize the foreclosure and insolvency framework more actively to improve payment discipline and NPL workouts. Even after the recent sale and transfer of banks' NPLs, Cyprus still has one of the highest NPL ratios in Europe. Recent legal amendments are expected to provide an improved framework to resolve NPLs by serving as a credible threat. However, implementation will be key. In particular, stronger collateral execution, durable NPL workouts, and improved payment discipline are still needed. In addition, the proposed *Estia* scheme to encourage distressed borrowers to begin servicing their loans should avoid supporting strategic default, by requiring a tight eligibility criteria and appropriate assessment of a borrower's capacity to repay the restructured debt on a sustained basis. Given the still high levels of NPLs and the need for provisioning, bank profitability will remain under pressure. Banks should therefore continue to strengthen their balance sheets, diversify income sources, and improve cost-income ratios.

D. Restoring Credit Financing

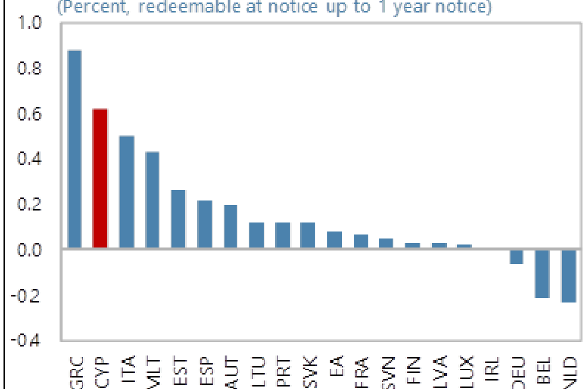
15. The high level of NPLs in the banking system and high leverage in the economy raise concerns about the prospect for credit financing and sustainability of growth. Large NPLs pressure bank profitability through high provisioning needs which limit banks' ability to extend credit. Furthermore, difficulties in collateral execution could lead to more risk averse banks limiting credit supply and increasing borrowing costs in the economy. Cost of financing in Cyprus indeed remains among the highest in the euro area reflecting these factors. Over the past year, Cyprus has had the largest decline in credit-to-GDP ratio in the euro area. Against the backdrop of the need for continued deleveraging, we examine below credit flow trends, current sources of financing underlying the growth pickup, and its implications for sustainability of growth.

Nonfinancial Corporations Cost of Borrowing
(Percent per annum)



Sources: EUDATA

Euro Area and National MFI Interest Rates, 2018M8
(Percent, redeemable at notice up to 1 year notice)



Source: ECB.

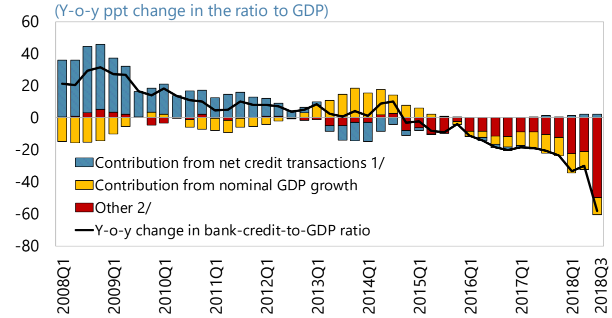
Change in Credit-to-GDP Ratio in Euro Area, 2017

	Change in credit-to-GDP ratio (yoy percentage change)	Real GDP growth (annual percent)
Cyprus	-24.3	4.2
Greece	-8.4	1.3
Portugal	-7.0	2.8
Netherlands	-6.3	3.0
Spain	-6.1	3.0
Estonia	-5.2	4.7
Italy	-4.3	1.6
Ireland	-3.0	7.2
Latvia	-1.8	5.0
Euro area	**-1.7**	**2.5**

Sources: Haver Analytics, and IMF staff calculations.

Bank Credit to Resident Non-Financial Private Sector

(Y-o-y ppt change in the ratio to GDP)



Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ "Net credit transactions" are pure new loans (excluding renegotiations) and interests accrued net of repayments (including debt-to-asset/equity swaps).
2/ Includes the contribution from write-offs.

Sources of Financing

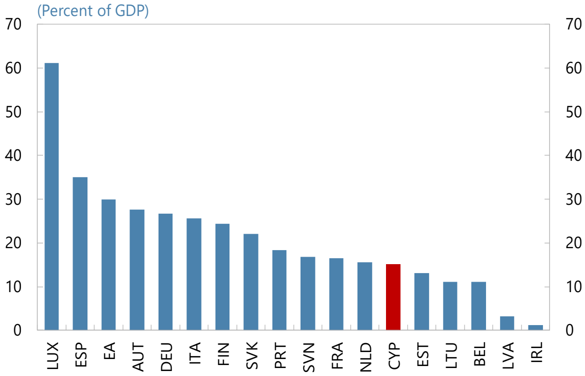
16. Since 2017, bank credit has provided only a moderate amount of new financing. The reduction in credit-to-GDP ratio has been almost entirely achieved by NPL write-offs and sale or transfer of loans out of the banking system, and through denominator effect (i.e., nominal GDP growth).[9] Transactional data in Monetary and Financial Statistics show annual increase in pure new loans and accrued interests (net of repayments) have been marginally positive, compared to a peak increase of nearly 40 percent of GDP during the pre-crisis credit boom period. Pure new loans to households and NFCs (excluding renegotiations) are about 15 percent of GDP as of 2017, lower than in the pre-crisis period or in other EU countries.[10] Two-thirds of pure new loans are provided to NFCs, especially in sectors which are substantially contributing to GDP growth. Pure new loans to NFCs from 2017:Q3 to 2018:Q2 were €2.0 billion, unchanged from a year earlier. On the other hand, pure new loans to households from 2017:Q3 to 2018:Q2 were €1.2 billion, which had increased by about 20 percent from a year earlier. As of 2017, credit *demand* appears moderately strong, in line with robust economic growth, while credit *supply* remains broadly unchanged, reflecting continued risk averseness by banks. These trends suggest that while deleveraging is expected to continue through cleanup of bank balance sheets, growth in credit flows (pure new loans) are likely to remain at a moderate level until NPL recovery and repayment discipline improves significantly.

[9] For example, a large reduction in credit-to-GDP ratio in 2018:Q3 reflects the transfer of some loans (mostly NPLs) owned by the residual entity of the Cyprus Cooperative Bank out of the banking system.

[10] "Pure new loans" statistics are available only as loans to euro-area residents. However, loans to non-Cypriot euro-area residents are believed to be small.

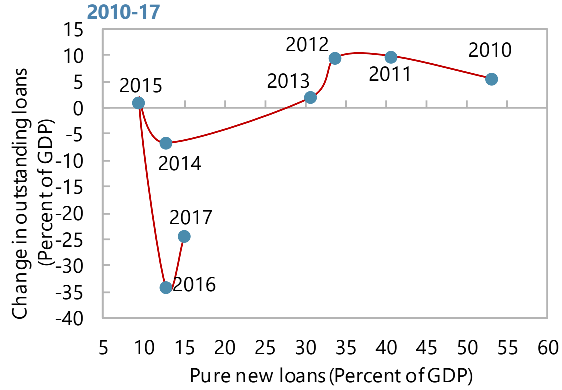
Pure New Loans to Nonfinancial Private Sector, 2017

(Percent of GDP)



Sources: ECB and Haver Analytics.

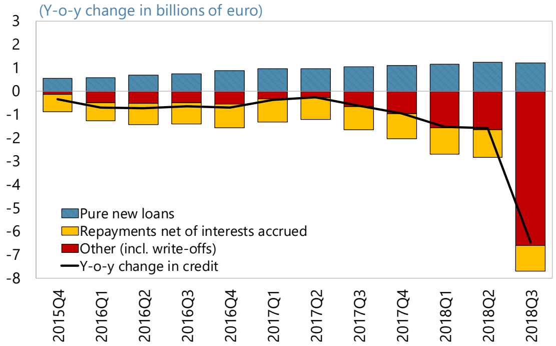
Pure New Loans and Change in Outstanding Loans, 2010-17



Source: CBC

Bank Credit to Households 1/

(Y-o-y change in billions of euro)

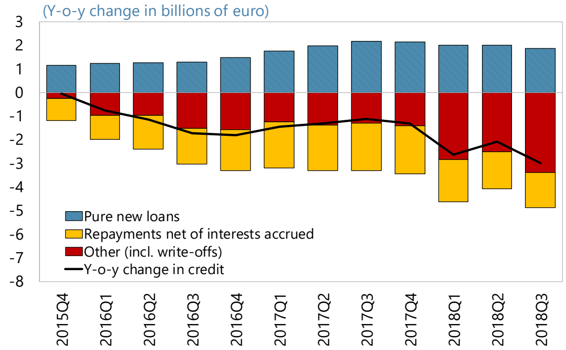


Sources: Central Bank of Cyprus; and IMF staff calculations.

1/ "Pure new loans" include loans to non-Cypriot euro-area residents.

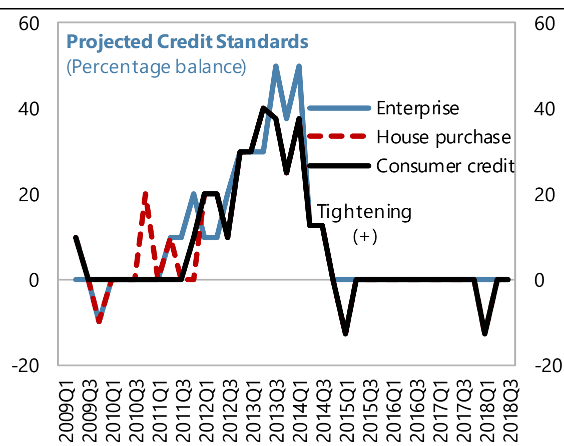
Bank Credit to NFCs 1/

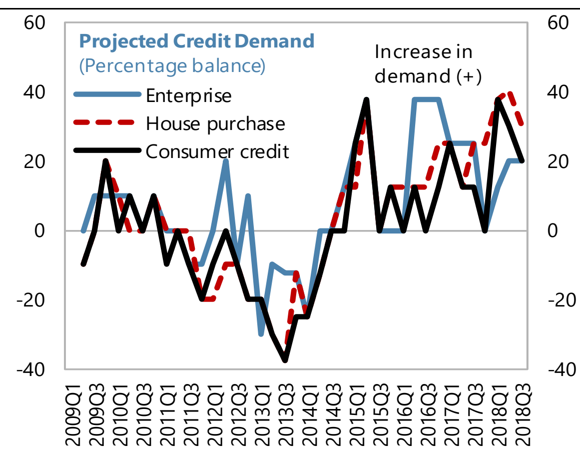
(Y-o-y change in billions of euro)



Sources: Central Bank of Cyprus; and IMF staff calculations.

1/ Pure new loans" include loans to non-Cypriot euro-area residents.



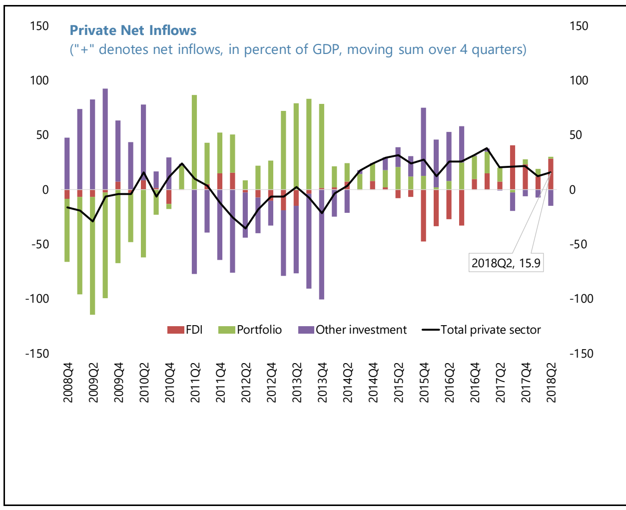


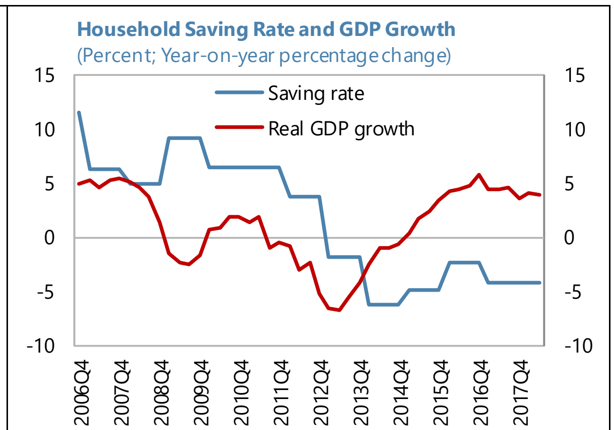
17. Financing for growth industries are primarily from external sources and through drawdown of savings. Country experiences indicate that industries that are more credit-dependent tend to grow disproportionately less than those that are more self-financed during the recovery from a banking crisis (Abiad, Dell'Ariccia and Li, 2011). In Cyprus, however, industries such as construction, professional services, and real estate sectors, which were heavily credit dependent and the primary sources of growth during the pre-crisis period, are once again contributing substantially to GDP growth, even though credit financing to these sectors currently remain limited. Their main sources of finance include:

- **External financial inflows:** Net FDI inflow reached almost a quarter of GDP in 2017, increasing substantially from about 10 percent of GDP in 2016.[11] Some large construction projects reportedly depend largely on foreign funding, including inflows through the Citizenship by Investment (CbI) scheme. Assets under management by investment funds increased by about 7.5 percent of GDP, from about €3 billion (2016:Q2) to €4.5 billion (2017:Q2), with a notable increase in nonfinancial assets.

- **Households' drawdown of savings and NFCs' own funds:** Saving rate of households has been around negative 4 percent of GDP for the past four years, as households draw down on their large stock of assets to finance consumption. Corporate income tax collections have increased significantly over the past two years as corporate profits recover, suggesting NFCs have increased "own funds" which are potential sources of investment financing. Given large debt service obligations in Cyprus, a high NPL ratio implies that a substantial amount of obligations is unpaid, which could be used potentially for consumption and investment.

- Debt from non-bank financial institutions or nonresidents does not seem to contribute substantially to finance Cypriot activities.[12] The use of equity financing seems to be also limited (EIB, 2017).





Sources: Haver Analytics; and IMF staff calculations.

[11] These statistics include the FDI flows with SPEs.

[12] NFCs which are special purpose entities (SPEs) tend to be financed mostly by foreign funding. These NFCs are not the focus of this paper.

18. In the absence of a recovery in new credit flows, there are risks that current sources of financing may not be sufficient to sustain longer-term growth. External financing remains subject to risks from geopolitical shocks, maturing of euro-area economic cycle, and abrupt tightening of financial conditions, which would adversely affect growth in investment in the real estate sector. High reliance on the CbI scheme also poses a risk for the construction sector. While household "dis-savings" may continue given significant positive asset positions, sustaining consumption growth through this channel will become increasingly difficult, especially if repayment of loans improves. While deleveraging is expected to continue as legacy NPLs are written down or worked out, it would be increasingly important for new credit flows to recover as a financing source for faster economic growth.

Policy Implications

19. The resolution of NPL overhang would help to restore the credit channel, which contributes to sustainable longer-term growth. Facing a large NPL overhang, banks are forced to maintain low credit supply and hence, bank credit has provided only a moderate source of financing. The Cypriot economy is currently financed largely by external sources, "dis-savings," and own-funds, but there are risks that they may not be fully sustainable in supporting longer-term growth. By substantially reducing NPLs, the credit channel would be restored, serving as an additional and sustainable source of financing for more productive, creditworthy borrowers and contributing to longer-term growth.

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