Policy Should Focus on the Need to Overcome Private Indebtedness

Savvides, Savvakis C.

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I am often asked to give my opinion on what I consider to be the right policy for solving the problem of non-performing loans (NPLs). My response is that NPLs are the symptom not the cause of the predicament the Cyprus economy finds itself in. The real problem is **private sector indebtedness**.

The focus should not be on how to compensate depositors or bond holders or even shareholders of the affected banks. It should be on how the over-indebted businesses and households can lighten their debt burden and be in a position to engage in normal economic activity in a stable and sustainable manner. Cyprus is prone to suffer, like several other countries have (Ireland, Iceland, but most notably Japan), from what Richard Koo has coined a '**balance sheet recession**'. This happens when a country's economic agents (businesses and households) have taken up so much debt that they are not able or even willing to undertake new debt. In such cases, of which Japan is the most stark example in terms of magnitude and length, austerity measures usually prescribed by the IMF and traditional economic thinking, not only do not help but they have the opposite effect of further depressing the economy and causing a downward spiral where savings do not go back into the economy as new loans thereby aggravating and elongating the recession. Koo's general advice is that a more expansionary fiscal policy is required to offset the fall in domestic demand arising from efforts of private sector entities to reduce their indebtedness via increased savings in order to prevent the economy from shrinking.

I believe correct strategies do exist for reducing the high level of indebtedness in Cyprus. One is to find ways for the borrowers to benefit from the substantial provisions made by the banks (which will continue in 2018). The only reason banks prefer to sell their loans (even at huge discounts) is because they consider it to be the only way for them to **write back accounting profits and thus help them with their re-capitalisation needs.**

Following five years of inaction during which NPLs have remained stubbornly high the Government is now considering the creation of a "bad bank". But once again, politicians do not seem to understand the real issues and the consequences of what they propose. One perhaps should remind many of the politicians who are now pushing for this that they were the same people who killed a similar idea in 2013 when it was put forward by the then Governor of the Central Bank. Be that as it may the proposal raises more questions than answers. At what price would the fund/bad bank buy the loans? What would they do with them? Where would the funding come from? What would the consequences be for the real estate market? Even more importantly, how is this going to help private debt and the real economy? These are the real questions no one is asking!

A good policy would be one that provides the benefits the banks would derive from selling the loans (even at huge discounts) but which utilises the provisions to make possible viable restructurings and, more importantly, extend new loans to new entities. For this to happen one needs to settle an existing loan and to refinance viable businesses using the assets that are thus released by creating new SPVs (special purpose vehicles – or, more simply, new companies) funded by new loans and by new equity. This is why I have been arguing since 2013 that we need a Reconstruction and Development Bank or a Development Finance Agency. Not a bad bank, whose main objective at best, is to manage break-down assets (rather than to create new competitive enterprises).

For households and small businesses there are other such policies which can be pursued. The starting point is to identify what is impeding a settlement within the margins afforded by the provisions and causing the economy to be held to ransom, with unpaid debts on the one hand and "counterpart" depleted equity on the other keeping idle potentially productive assets. For example, there should be a limit on the exposure of people to guarantees. There must be a way for borrowers (as there is in some other countries - notably the United States) **to hand over the mortgaged asset and walk away debt free**. The aim of policy should be to enable economic agents to start again. Unfortunately in Cyprus, bank lawyers and poorly informed borrowers have created this mess. The loan contracts asked for the kitchen sink while ignorant borrowers and even innocent bystanders (friends and relatives) were willing to sign anything that was put in front of them. There is also the moral responsibility of banks which should perhaps be made legally binding, in a similar fashion as the Law of Fraudulent Conveyance of New York. Under this law, it is considered illegal if a lender has given a loan **without first assessing the ability of the borrower to repay**. In such cases, the borrower can walk away debt free (even without losing the asset that was put up as collateral). This may be a rather extreme measure for Cyprus and one which in any case is unlikely to have retrospective effect, but a law or, better still, **a central bank regulation** in this respect, would surely apply pressure on banks to co-operate and even compromise in reaching settlements with borrowers. That should indeed be the ultimate aim. To help the economic agents of the country **overcome their indebtedness** and **re-enable them to undertake new viable capital investments** (and take up new loans) in conditions of **strong domestic** (and foreign) **demand**. Without such policies we will be trapped in a stalemate for too long and this helps no one. Not even the banks themselves.

Savvakis C. Savvides *is an economist, specialising in economic development and project financing. He is a former senior manager at the Cyprus Development Bank and has been a regular visiting lecturer at Harvard University and currently at Queen's University, Canada. Author page:* http://ssrn.com/author=262460