Cyprus as EU-Location for Asset-Protection

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Abstract

The purpose of this paper is to provide a framework to develop a competitive advantage of the financial market of Cyprus interrelating political, historical, legal and economic aspects. As the current era of globalisation implies intense international competition for attracting financial resources, the discussion has been positioned in the context of competitive advantage. The research intends to provide authorities and all stakeholders involved with a comprehensive pool of internal and external competitive elements reflected in a holistic framework synthesising country, industry and company perspectives. Whereas current literature refers more to individual and scattered elements of competitive advantage a coherent view is very seldom applied. No such study on comprehensive factors of competitive advantage of the Financial Centre of Cyprus has been provided so far. The paper qualitatively validates a model applied for another successful financial market, Liechtenstein, to analyse its applicability to the Cyprus case. Against the background of the global financial crisis and the still existing Cyprus problem, the paper pays special attention to the security aspect penetrating all factors of the model. The paper intends to provide a holistic view on the factors of competitive advantage of the Financial Centre of Cyprus.

Keywords: Private Banking, Competitive Advantage, Financial Centres, Cyprus

Introduction

Cyprus is not only acknowledged as a popular tourism destination in the most south eastern part of Europe but it is also renowned as an attractive real estate market, a holding location, and an international financial centre which represents a strategically important bridgehead to three continents. Incorporating the results of qualitative research, a detailed description of factors of competitive advantage follows, highlighting security aspects that refer to: the role of the government, especially in regard to its tax policy and coordinating role; factor and demand conditions; the banking and financial services system; the impact of related and supporting branches; and suggestions for further concerted strategies. Finally, in conclusion, the key findings are summarised and some possible future scenarios are briefly envisaged.

Factors of Competitive Advantage Related to the Security Aspects

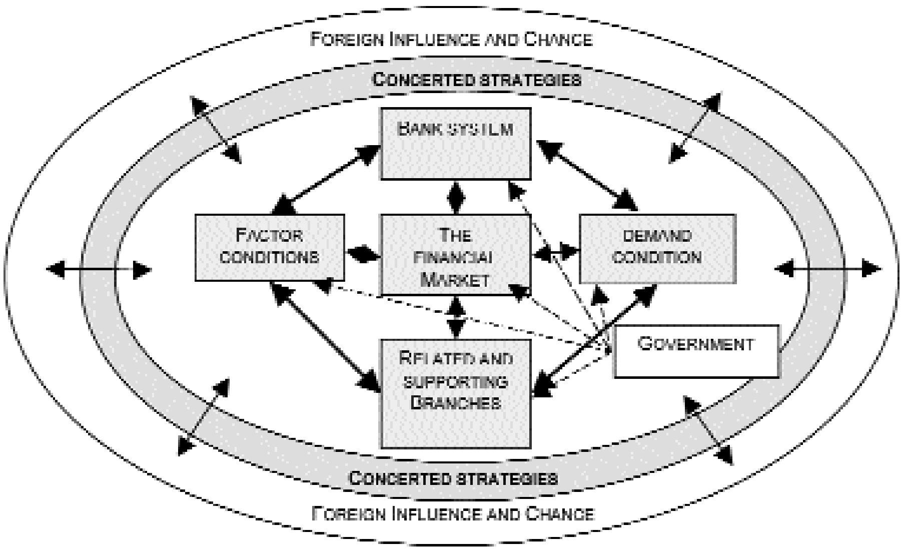
In times of a global economic and financial crisis the protection of property, private equity and the well established legal, accounting and audit, banking and communications' sectors of Cyprus, coupled with the social and politically safe environments, have contributed to the spread of the Cyprus offshore business sector. However, in the wave of the current global economic crisis, the basic economic data referring to the government controlled area of Cyprus (mainly based on the Economist Intelligence Unit, 2009) still compare well with European average figures although they are becoming gloomier. Hence, efforts should be undertaken to soften the blow of the global crisis on the Cyprus economy. For 2009-2010 the budget balance is expected to be in deficit, mainly due to higher levels of social spending, a decreasing fiscal discipline and a substantial reduction of government's income from taxation. For the first time since 1978 the Cyprus economy went into a recession (negative GDP). Inflation is predicted to increase by 0.8% in 2009 rising to 1.8% in 2010. The current account deficit is expected to sharply decline from 18.3% in 2008 to 8.5% of GDP in 2009 due to decreasing consumer and import demand and declining rates of commodity prices offsetting the weak export performance. Summarising, the Cyprus economy, especially its pillars, tourism, construction and financial services might be negatively affected in future years by an expected sharp downturn of the economy of three of its major trading partners: UK, Greece and Russia. This situation is also strongly influenced by the development of the exchange rates of the US dollar and sterling pound against the euro. The necessity to take security aspects into consideration is also reflected in that a state guarantee on deposits of up to €100,000 had to be announced by the government and Central Bank of Cyprus to assure depositors of the health of the Greek Cypriot banking system.

In the eyes of foreign investors particularly, the still existing 'Cyprus problem' could detrimentally influence the trust on the security of financial assets invested in Cyprus. Notwithstanding strong international pressures, progress, in terms of settlement, is perceived to be very slow. The chance for a solution during the period 2009-2010 has been estimated to be 40% (Economist Intelligence Unit, 2009).

To précis, the perceived security of financial assets invested in Cyprus can be regarded as the *conditio sine qua non* to develop a competitive advantage for the Cyprus financial market.

The model of Romero and Kaufmann (2006) is used as a conceptual basis to describe the factors of competitive advantage of the Cyprus financial market and, implicitly, the influential factors for asset security (figure 1).

Figure 1: Determinants of Competition



Source: Developed from Sele (1995) and Porter (1980)

The model has been developed from Sele (1995) who adjusted Porter's (1980) model of generic determinants of competition to specifically fit the idiosyncratic factors to a financial market by adding the financial market as a nucleus and replacing the firm strategy, structure and rivalry by the banking system.

Methodology

Contradictory to Porter (1980), the authors, in line with Sele, regard the government as an independent determinant of competition. This is due to the immediate and, often crucial and long-lasting effects that governmental interference, i.e. in terms of legislation, policy of competition, finance and tax policy, labour market, immigration policy or education, has on matters relating to the financial market.

Based on qualitative research, Romero and Kaufmann (2006) expanded the model investigating the relevance of fiscal systems as a determinant of competitive advantage. The main research aim was to gain insight into the phenomena which influence the competitiveness of Cyprus as a financial service centre. The research objective was to validate the model 'Determinants of Competition' which was developed from Romero and Kaufmann (2006) for the Liechtenstein case by qualitative research on the basis of Sele (1995) and Porter (1980), hence, contributing to assess the reliability of the model. The researchers were especially interested in verifying the role of the government as an independent determinant of competition.

The research method of a case study was chosen due to the unique characteristics of the Cyprus setting. Moreover, the case study method and the research technique of in-depth semi-structured expert interviews allowed the identification and understanding of interplay (rather than comparing the statements of the interviewees) between the various actors involved (strategic and operational decision makers) and the collation of rich and detailed data (purposive sampling). The model mentioned earlier was also used as a basis for categorising the data.

Typically, qualitative research is concerned with small samples, and the decision on the adequate sample size to achieve the research objective is a function of judgement and experience of the researchers (Sandelowski, 1995). The view of Onwuegbuzie and Leech (2007, p. 240) – referring to Connolly – was followed for this research stating that "qualitative researchers typically do not make inferences about the underlying population but to obtain insights into particular educational, social and familial processes and practices that exist within a specific location and context" (Connolly, 1998).

The following assessment of Cyprus is based on Christophorou (2007) who conducted nine face to face in-depth expert interviews with respondents involved in offshore banking, namely, senior bank managers, government tax experts, and representatives of the private sector on the factors of competitive advantage for the Cyprus Financial Centre.

The high level of expert knowledge and professional standing of the interviewees enhanced the validity of the research findings. The results of this exploratory research are integrated but further validation and triangulation is suggested by quantitative research studies. For the sake of completeness, the development of the property and private equity sectors has also been included in this paper. Generally, the majority of the respondents (five interviewees) see a bright future for the Cyprus Financial Centre based on distinct factors of competitive advantage. The interviews imply, however, that certain areas require future concerted efforts and improvement.

Government

The role of the government in relation to the financial centre is suggested to be one of a catalyst or referee. In this respect, Silvani (2005, in Romero and Kaufmann, 2006) appeals to the government to be more pro-active if it is to be serious about conserving its autonomy of acting and its *raison d'être* against the backdrop of increasing pressure by international organisations and competitors. Providing a catalytic infrastructure refers to the transparency, simplicity and competitiveness of the tax system, providing forums for discussion and international networking, and introducing special purpose companies, reflecting a long-term commitment to the financial sector, negotiating double taxation or other agreements especially for the trade with brands, licences and patents and supporting education, training and research in the field of banking and its support services.

Tax Conditions

Tax conditions which are favourable for international investment in Cyprus refer, for example, to the lowest corporate tax rate in the EU (10%), the beneficial treatment of international trusts based on the specific International Trust Law, no taxation on capital gains earned on any recognised stock exchange and an exemption of taxation for any profits and capital from re-organisation or repatriation. Moreover, any dividends and profits earned from a permanent establishment outside of Cyprus (subject to conditions) are also not taxed. Incomes and gains from a Cyprus International Trust received from sources outside of Cyprus are exempt from taxation. This might be seen as a relevant service of Family Offices, which are independent advisers and consultants for investments of wealthy families. Beyond the low corporate tax rate of 10% there are many more benefits enjoyed by holding companies, i.e. no corporate tax on dividends and other profit distributions from Cypriot or foreign companies; exemptions of tax on dividends and profits in case of 1% ownership of the company paying them; received income taxed abroad is not taxed in Cyprus (based on unilateral or bilateral treaty conditions); no taxation on dividends of non Cyprus residents, shareholders, individuals or corporations received from Cypriot companies; no minimum withholding period; withholding tax exemption of dividends received from subsidiaries abroad (under certain conditions); exemptions of non resident shareholders from any withholding taxes on outward dividends (Philippides, 2006, quoted by Marray, 2006), and VAT exemption (subject to conditions). In addition, based on the double taxation agreements (DTA's) (Verbist, 2006) Cyprus companies might be used as intermediaries, licensing vehicles for the extraction of royalties between Cyprus and those countries with DTA's, so long as the royalties are not considered a Cyprus source income (Christophorou, 2007). Whereas the tax regime combined with the DTA web might be regarded as Cyprus' main competitive advantage, an improvement and clarification of the tax system might contribute to the confidence of investors and the attraction of investment funds (Tsialis, 2006). A debatable component of the tax system is also the existence of stamp duties on documents referring to assets in Cyprus (PriceWaterhouseCoopers, 2006).

According to Tsialis (2006) the Cypriot tax system entails factors and restrictions that discriminate domestic companies, who obtain dividends from companies which are established abroad. On the other hand, dividends received by a company registered in Cyprus from another company registered in Cyprus are not subjected to these restrictions. Furthermore, the tax regime has played a major role in the development of the system which has been stable and well defined and has provided competitive international rates that attracted large numbers of offshore companies to register in Cyprus and operate from the island. Between 1980 and 1995 the offshore businesses sector contributed substantially to the GDP of Cyprus, but with the start of the accession process towards full EU membership, Cyprus began to lose its tax advantages for offshore companies and many of these establishments left the island between 1995 and 2004. In the period since, the number of new establishments registering in Cyprus has declined considerably.

Quality of Service

The Cyprus government has identified the benefits for the national economy and plans to increase the levels of diversification in its economy. It has also identified the need to strengthen the institutional framework to promote Cyprus as an entrepreneurial island. As part of this policy the Cyprus Investment Promotion Agency (CIPA) was established in 2007 by a Council of Ministers decision.

As regards the quality of the public service, contradictory statements have been encountered. Kasapis (1999) and Christou (1999) perceive that public services are efficient and operate without problems of bureaucracy. This is supported by Kochan (2006) who refers to the creation of a 'one-stop-shop', established in 2007 by the Foreign Investor Service, which allows for a company to be established or bought within one week. In practice, based on the information provided by the Registrar of Companies (12 January 2009), a company can be registered in Cyprus within three days provided an extra fee of €85 is paid otherwise the process might last approximately one month.

The government plan for expansion includes a budget for research, development and innovation which was increased in 2008 and 2009 but reduced in the 2010 budget. Nevertheless, two interviewees perceive an overemphasis on the part of the government regarding the Cyprus problem which is detrimental to other urgent challenges, for example, the creation of an international financial centre. Two of the interviewees voiced an appeal to make the tax system clearer and pointed to the possibility of chances for non-uniform decisions when individual government officers have the authority to choose which amount will be taxed, as is dispensed in some provisions of the tax laws. In effect, the absence of objectivity and the permission of subjectivity when applying the relevant provisions of the tax laws may result in future problems of implementation. Three respondents called for more intensified relationships between the government and the private sector in relation to the orientation or culture towards the private sector. On the whole, the impression from the interviews endorsed the view that the private sector would prefer greater involvement in the decision-making process concerning the financial centre plus a better consideration of their specific needs.

Factor Conditions

Inherited Factors

According to Porter (1980) the factor conditions have to be differentiated between inherited and newly created factors of production. 'Inherited' factors refer, for example, to capital, human resources or land. Newly created factors refer to know-how, infrastructure, networks or corporate culture. The newly created factors are mostly regarded as being more influential for developing the competitive advantage, but the inherited geographical situation has a strong bearing on the success of an offshore financial centre. Many offshore financial centres are either islands or peripherally situated (Sele, 1995). From a strategic viewpoint, Cyprus is ideally located as a stepping stone between the Middle East, Europe, Africa and Asia representing the most south-eastern outpost of the EU. Hence, the location predestines Cyprus as an international investment and business turntable (Kasapis, 1999; Tsialis, 2006; Phylactis, 1995; Roussakis and Bisha, 2006; Lilikas, 2006; PriceWaterhouseCoopers, 2006; Kochan, 2006). Cyprus' investors can also benefit from the time zone which allows for transaction dealings in Japan during the day as well as in North-America in the afternoon (Kasapis, 1999; Phylactis, 1995; Roussakis and Bisha, 2006). The majority of the Cypriot interviewees regard the geographic position of Cyprus as an advantage, whilst three respondents perceive its importance to be decreasing due to advanced telecommunications technology.

Communications

To compensate for a potential disadvantage of lack of accessibility, it is vital that international financial centres offer both excellent telecommunications services and easy physical access (Bornscheuer, 1999; Sele, 1995). The island's telecommunication system is regarded as one of the most developed in the world and the most advanced system in the Middle East and Eastern Mediterranean (Ministry of Industry, Press and Information Office, 2007; Kasapis, 1999; Christou, 1999; Phylactis, 1995; Roussakis and Bisha, 2006). The respondents, in the main, confirmed the high level of quality of the current telecommunication services in Cyprus. One respondent pointed to a lack of competition in the field, and another called for an improvement of the telecommunications system. Although a globally well-developed network of air connections exists (Ministry of Industry, Press and Information Office, 2007; Kasapis, 1999; Christou, 1999; Phylactis, 1995; Roussakis and Bisha, 2006) accessibility could be significantly increased by negotiating routes with low-cost carriers in the future.

Manpower

One of the most important factors is the availability of highly qualified manpower, particularly experts in the sphere of private banking, institutional wealth management, trustee business, lawyers, computer scientists, auditors and accountants. The requirement for foreign experts (Phylactis, 1995; Kasapis, 1999) in the above mentioned areas is increasing. According to the Ministry of Economics and the Ministry of Commerce (Autumn 2009) there might still be a need for highly trained, mostly managerial foreign staff although Cyprus' universities increasingly supply degree holders. New research in this field is suggested by the ministries. The majority of interviewees (seven) confirmed the generally good professional services with five, however, pointing to possible areas that require improvement: attitudes, project management, higher levels of service, cultural knowledge and teamwork. The level of bank secrecy is determined by EU membership (two interviewees) and one respondent highlighted very strict and rigid policies with regard to the secrecy applied in international banking units, which reflects that OECD criteria are followed and applied.

The population of Cyprus is regarded to be well-educated, being bi-lingual in Greek and English (Tsialis, 2006; Roussakis and Bisha, 2006). According to Tsialis (2006), an experience and speed gap exists between the highly reputed private and the public sector. For the most part, a better infrastructure for Research and Development is suggested to increase the quality of private and public decision making, i.e. in terms of foreign investments and the origin of foreign money inflow (mentioned by three interviewees).

Demand Conditions

Historic Events Influence Real Estate Assets

An important demand condition is the status of the real estate market, which in Cyprus has been influenced by historical events. Its attractive location has made it a colony of powers aiming to exercise control in the region. The most recent powers to colonise Cyprus, the Ottomans and the British, left their distinct mark on the development of the property market in Cyprus.

A combination of the land registry system of the Ottomans together with the lands survey and registry of the British left Cyprus with a unique system of accurate land registration whereby almost no inch of territory on the island was left unregistered. This explicit registration system, coupled with the protection of property rights derived from British law which applied to Cyprus during the colonial period, created a safe low-risk framework in which the property market of Cyprus could develop.

It is believed that the property ownership of the Greek Orthodox Church of Cyprus was created and developed during the Ottoman period which began after the siege of Nicosia in 1571 and lasted until 1878. Following the same practice that the Ottomans pursued in the ex Byzantine world, the Orthodox Church was exempted from heavy property taxes that individuals had to pay. Those who could not afford to pay the heavy taxes imposed on them faced either the death penalty or the danger of becoming slaves and working for the Ottomans in lieu of their unpaid taxes. The alternative was to donate their land to the Church and its establishments (mainly monasteries), in order to avoid punishment. In exchange, the Church would allow them to continue living in their property and use it, mainly to produce basic agricultural products to support their own living. Through this model, the Orthodox Church eventually amassed huge areas of land and other property ownership, a right of possession that it still enjoys and economically exploits today.

With such accumulated wealth, the Greek Orthodox Church of Cyprus has, over the past forty-five years, contributed considerably to the economic development of Cyprus. In 1973, one year before the Turkish invasion of the island, it established the Hellenic Bank; a bank that eventually became a public company and which is the third largest bank operating in Cyprus today, and which has recently commenced a modest expansion into the Greek market. In addition, the Greek Orthodox Church of Cyprus is the major single shareholder of the Bank of Cyprus with a shareholding stake of approximately 4.5% (at the end of 2009). As well as bank share holdings, the Greek Orthodox Church of Cyprus has developed areas of the land that it owns by erecting hotel buildings and production units and these units are still rented out as property to entrepreneurs as well as to large companies. Furthermore, this activity helped the Cyprus economy to recover from the effects of the Turkish invasion, providing the necessary direct investment needed for the domestic economy.

Cyprus was a British Colony until 16 August 1960. The protection of human rights that the British applied together with the legal and regulatory framework concerning property and financial assets has remained close to the one adopted in Britain. After independence, a shake up in property use distribution (ownership remained unchanged) resulted following the developments of 1974 when Turkey invaded the northern part of Cyprus, and occupied 38% of the territory of the Republic of Cyprus ever since. More than one hundred and sixty two thousand Greek Cypriots[1] moved to areas still under the control of the government of the Republic of Cyprus, while around 45,000 Turkish Cypriots (PIO, 2007) moved to the north. Since then, access to property of Greek Cypriots in the occupied north has been denied by Turkey but their ownership rights have been upheld in international courts, notably in the European Court of Human Rights, in its judgement of 18 December 1996, on the individual application of the Greek Cypriot displaced owner from Kyrenia, Ms Titina Loizidou vs. Turkey; the Fourth Interstate Application of Cyprus against Turkey of 10 May 2001; and the European Court of Justice judgement of 28 April 2009 in the case of Apostolides vs. Orams.

The settlement of the Cyprus political question is still pending. The current negotiations are focusing on the creation of a federation consisting of two constituent states. It remains an open question how the property question will be dealt with and whether there would be any restrictions on the property purchase rights of non-residents of the Turkish Cypriot constituent state.

Property rights in the area under the control of the Government of the Republic of Cyprus, remains well protected and secured. Cyprus property has been in high demand among European expatriates and especially British, who find the system familiar to their own social and cultural demands. Lately, the government's severe delay in issuing title deeds has become an issue for foreign buyers, although it does not seem to prevent the buying and selling of property. The attraction of property to foreigners allowed the opportunity for the development of a niche property market, addressing the needs of this specific target group of property buyers. Before the EU accession of Cyprus, the purchase of property on the island by non-nationals was difficult and regulated by a specific provision of the law that required buyers to obtain the permission of the Council of Ministers of the Republic of Cyprus. Even though such permission was usually granted to the vast

1 See [http://www.cyprus.gov.cy/moi/pio/pio.nsf/All/C0872092FC133645C2256D6D001E9265?OpenDocument].

majority of the applicants in the end, the process was bureaucratic and time consuming and resulted in an extra cost burden on the buyer. From the date of EU accession, the requirements of the Law, at least for EU citizens ceased to exist and consequently the demand increased. Together with falling interest rates, rising employment and strong population growth, this is another important reason why property prices increased substantially between 2005 and 2008 (Buy Sell Index of property stood at 116.2 in January 2007 closing at 143.5 in December 2008 before falling to 140.1 in March 2009). Based on information received from the Buy Sell company, the Buy Sell Home Index has been suspended as from the first quarter of 2009 in anticipation of the production of an official index by the Department of Statistics of the Republic of Cyprus. The latest internal statistics of the Ministry of Finance indicates that 2009 experienced a decrease of 44.3% in the number of sales in house contracts (8,170) compared to 2008, where the house contracts sold amounted to 14,700.

An additional factor that has generated an increase in the demand for property is, of course, derived from the extra political security that EU accession has provided to Cyprus. It can be argued that the EU accession removed a large amount of political risk implied by the Turkish occupation of the northern part, since from 1 May 2004 (date of accession of the Republic of Cyprus to the EU) the territory of the Republic of Cyprus became an EU territory (according to Protocol 10 of the Act of Accession the EU's *acquis communautaire* is "suspended" in the north).

To a large extent it can be claimed that property supply is not free of government intervention. The so called "Building zones" that determine the usage of land including the regulation of what is permissible to erect on a piece of land and its area coverage, is a direct intervention in the market. Such a market intervention and regulation can restrict the supply of land and differentiate prices on the basis of determination of which zones might be considered as being residential (and consequently of a higher value) and which might not. It is therefore possible to contend that there is a government regulated, market supply segmentation, leading to a price discrimination of privately owned property. In turn, it may be asserted that this influences property rights in determining the actual value of individual property ownership.

Customer Demands

In a comparative study on service quality in the banking industries of both northern and southern Cyprus a gap was identified between bank customer expectations and perceptions on service quality (Arasli *et al.*, 2005). The research concluded that these industries were insufficiently customer focused; a situation, which threatens the competitiveness of local banks in light of increased international competition. In line with Smid and Zwart (2002) the authors reason this deplorable state by a '*de facto* cartel-like' position not requiring high levels of personalised services. The biggest expectation-perception gap within these industries refers to a lack of empathy in their customer services. Additionally, empathy, tangibles, reliability, assurance and, accordingly, all dimensions of Parasuraman *et al's* (1988) SERVQUAL model, were found to be significant explanatory variables, albeit with differentiated values in the respective industries. As a consequence, the authors suggest intensified training programmes in terms of implementing a service culture with improved interpersonal communication and customer care.

These findings are also in line with quantitative research conducted by Golob and Podnar (2007) who investigated components of competitive advantage of firms in terms of market offerings. The authors elected to differentiate between competitive product strategies with regard to old and new member states of the European Union. With more than 20% of the total weighting, the elements regarded as most influential for competitive product strategies were quality and distribution. Other considered elements relating to differentiating strategies were innovation, variety, distribution and price. Whereas the old member states preferred quality and distribution components (31.2% compared to 23.9% of new members), new member states focused more on price and quality factors (30% compared to 14.7% of old countries). Taking into account that – due to government pressure – the three main Cypriot banks were urged to forego a planned increase in lending rates and that the current lending rates are still well above the EU average (Economist Intelligence Unit, 2009), it would appear that Cypriot banks emphasise the price factor.

The Development of Private Equity

The structure of the economy of Cyprus did not allow the creation and development of large corporate establishments and the growth of any kind of financial market. The only company that developed over a period of 100 years (from 1899) was Bank of Cyprus, which was established as a small savings trust, The Nicosia Savings Trust, and developed into the largest public company of Cyprus (measured by market capitalisation). Since independence, many Cypriots have viewed Bank of Cyprus as an important banking institution that helped to develop the economy. Moreover, Bank of Cyprus has created an excellent name and gained trust among the general public, which is an important factor in attracting the savings of Cypriots as well as drawing many of them to invest in its share capital. It is estimated that approximately 35% of Cypriot households maintain some kind of participation in the share capital of Bank of Cyprus (Public Company) Limited (Christou, 2006).

After independence, a number of other public companies began to establish themselves, mainly in the banking, insurance and construction sectors, which until today remain the dominant sectors in the Cyprus Stock Exchange. Serious activity in creating a stock market in Cyprus was observed in the late 1980s and early 1990s. However, the world market problems following the crash of 1987 and the Gulf war of 1991 eased the strong momentum that had been stimulated earlier. Stock exchange meetings were organised under the umbrella of the Cyprus Chamber of Commerce and Industry and these meetings were organised three times weekly (Monday, Wednesday and Friday) which created awareness in the Cypriot population. In the second half of the 1990s the interest was high, leading the government to propose a law to the

Parliament governing the establishment and the operation of a Cyprus Stock Exchange. On 27 March 1997, the Cyprus Stock Exchange started trading officially on the basis of the legislation created. For all that it was very general and held many deficiencies which played an important part in the creation of the Cyprus stock market bubble of 1999 and 2000. Following teething problems the Parliament has since adopted very strict legislation which has created a well protected system. The Cyprus Stock Exchange currently lists 140 titles and operates with the Financial Times Index Company, the Cyprus Stock Exchange Index (GSE Index) and the FTSE/GSE-20 Index in which twenty selected company shares participate. As from 2006, a dual listing agreement has been reached with Athens Stock Exchange in an attempt to create a common platform. Nevertheless, progress made in this direction has remained below expectations. Marfin Popular Bank and Bank of Cyprus are the only two companies that have applied and have been accepted to enjoy dual listing in both Athens and Nicosia; The FTSE/XA-XAK Banking Index has been jointly created.

The vast majority of companies in Cyprus are not listed on the Cyprus Stock Exchange. The small size of the economy of Cyprus, offered an opportunity to small private businesses to expand and these enterprises are mostly registered with the Registrar of Companies as Limited Liability Companies. At the end of 2007 the number of registered companies in Cyprus totalled approximately 190,000 according to the estimates of the Office of The Registrar of Companies of the Republic of Cyprus. This number is extremely high for the small economy of Cyprus, hence in this context, the sector of private equity has been developed. It is important to stress that ownership of private equity has always been well protected.

Suggestions for an Efficient Cyprus Stock Exchange

Referring to the case study of the Cyprus Stock Exchange (CSE), Charitou and Panayides (2009) highlight the idiosyncratic market problems of emerging European Exchanges which currently consider the implementation of market making systems: low liquidity, capital supply shortage, general attitude of indifference and mistrust of both domestic and international individual and institutional investors. These factors have to be taken into account when designing an adequate market making system. The authors, Charitou and Panayides, suggest that "the emerging market's exchange authorities inform all market participants involved of the risks and benefits of the implementation of a market making system" (*ibid.*, p. 58) based on the following decision criteria:

- "current exchange design and the costs of restructuring
- current investors' sentiment towards the exchange, both domestically and internationally
- the market design in countries hosting the target foreign capital
- size of the emerging market" (*ibid.*, p. 57).

From the above criterion, the authors emphasise the benefits of the non-centralised market system in an order driven market (compared to the quote driven market making system and the centralised market making system in an order-driven market). Furthermore, referring to Chan *et al.,* (2005, cited in Charitou and Panayides, 2009) the necessity is stressed to design a respective market making system in such a way that it resembles the market design of the foreign investors to be attracted. Implicit higher familiarity with market design may positively affect the investment intentions of foreign investors.

The Role of the Banks

With such a small stock market, the development of the banking sector has been an important factor in supporting the expansion of private companies by generating the funds to finance their borrowed long-term capital as well as successfully prospering in parallel and in balance with the retail and corporate sectors. This is especially apparent after the 1974 Turkish invasion when individual savings peaked following a psychological change in the savings behaviour of Cypriots (Christou, 2003) who turned to a precautionary type of investment immediately after the invasion. Through the aggregation of funds the banks accumulated the savings of individuals which provided an important resource for financing private corporate loans, and by doing so it allowed the borrowed capital of private companies to mature. Guided mainly by the instructions of the Central Bank, this in turn benefited the growth of private equity since the banks followed a policy of balanced leverage (gearing) between their own capital (private equity and reserves) and borrowed capital. This proved to be a successful model of financing the long-term borrowed capital of private companies in Cyprus (Christou, 2002), and permitted both private equity to thrive and some private companies to expand their capital base in the absence of a venture capital market in Cyprus depending on the respective business sector and the specific collateral provided by each particular company. This enabled small companies to succeed in growing to a reasonable size which afforded them the opportunity to become listed companies in the then evolving Cyprus Stock Exchange. Before turning to recent developments in the Cyprus Stock Exchange, it is worth looking briefly at the advancement of the Cyprus offshore business sector.

Factoring

During the period between 1985 and 1995 a new financial asset sector was developed known as the trade debtors sector. This sector remained well under control even before this period due to the conservative character of the Cyprus economy and its trading policy at that time. Nevertheless, a wholesale and retail trading boom in the late 1980s (as opposed to foreign trade), coupled with the introduction of a number of new facilities to the Cyprus economy (credit and debit cards etc), gave rise to businesses entering an era of overtrading. As a result, in the early 1990s the economy was brought close to crisis point with severe liquidity problems. The banking sector, however, responded to the needs of the economy and thus initiated the factoring facility for the corporate market, with the creation of factoring companies operated by the three largest local banks. This provided the market with the necessary liquidity and an economic crisis was averted. Additionally, the introduction of factoring companies gave the Cypriot banks an opportunity to develop their know-how so that this facility could eventually be transferred through their operations in Greece. Bank of Cyprus generated the first factoring company in Greece in the mid-1990s, which gave the opportunity to Greek companies with liquidity problems to improve their liquidity position, while at the same time enjoying a competitive advantage which was one of the key components in its rapid expansion in the Greek economy. According to Factor Chain International[2] the total factoring turnover of the three factoring companies in Cyprus amounted to 3,255 Mio euro at the end of 2008. The rights of these kinds of creditors are well protected under Cyprus law and there have been no known cases where such rights have been violated over the past fifty years, since the establishment of the Republic of Cyprus and even prior to that, during the British colonial period. The law is extremely strict and until very recently, any failure to meet borrowing obligations resulted in bankruptcy and imprisonment, despite the slow process that such actions may take. Moreover, from 2002, the Law was amended and other liquidation procedures were introduced in its provisions including bankruptcy – the imprisonment provision was waived.

Insurance

The private insurance sector is an area that evolved mainly in the Cyprus economy in the 1970s and 1980s. Its progress was boosted by provisions in the Tax Law which offered important tax incentives for life insurance contributions at that time. These incentives were kept substantially high in the 1990s, despite the fact that their significance in the overall personal tax system had been reduced. Life insurance contributions became an important element of personal tax planning in Cyprus, particularly in the period that followed – the 1980s and 1990s. As a result, large insurance companies began to flourish in Cyprus, and in the 1990s this area became the first corporate sector to experience major mergers' and acquisitions' activities on the island (Christou, 2007). The local insurance companies became principal investors in a number of economic activities, ranging from the construction sector to tourism, private and public equity, government bonds, etc. In this respect insurance companies have contributed substantially to the developmental funding of the Cyprus economy.

An important factor that has not been examined so far is the contribution that insurance companies have made to the restructuring of the Cyprus economy. It is not easy to maintain large corporate investment and insurance funds such as Provident Funds, Pension Funds etc., in a small economy like Cyprus with small size businesses. With 96% of Cyprus businesses employing up to four people (Cyprus Statistical Office, Cystat), it is difficult to create such funds within this type of framework. As a result, insurance companies cover a vital sector in the Cyprus economy,

2 See Factor Chain International at [http://www.factors-chain.com/?p=ich&uli=AMGATE_7101-2_1_TICH_L470153550].

providing insurance and, at the same time, pension funds and other long-term savings facilities (such as provident fund facilities) to small size businesses and those individuals employed by them. The Cyprus economy has experienced a significant restructuring programme over the past twenty-five years, shifting from an economy which produced light manufacturing products (textiles, shoes, clothing etc.), to a service economy. A large number of small and medium size firms were forced to close down with the subsequent establishment of businesses operating in the services sector (tourism, food and beverages, financial services etc.). This process was the result of highly protectionist measures taken in the period after 1974 for the protection of newly established industries (mainly family businesses) by imposing high import duties and tariffs. The Customs Union agreement with the EEC to harmonise duties and tariffs over a ten-year period that began on 1 January 1998, lifted protectionism and exposed Cyprus' small manufacturing companies to international competition for which they were ill prepared. Within this context, individuals were able to maintain their personal long-term insurance schemes intact while transferring their employment or their business activity from one sector to another.

The insurance activity in Cyprus remains well protected and is overseen by the Registrar and Commissioner of Insurance Companies. The Insurance Law remains very strict and requires insurance companies to file with the Commissioner of Insurance Companies on a quarterly basis, their register of assets bi-annually and their audited accounts annually. Most of the insurance companies insure their activities with larger international insurance companies. For over forty-seven years – since the establishment of the Republic of Cyprus – there has not been a case of failure reported by any insurance company in Cyprus to meet its obligations, which is a good indicator of the low risk area in which the sector operates, implying that supervision in the insurance sector is adequate.

Pension and Provident Funds

Despite the structural framework of the Cyprus economy being dominated by small and medium sized enterprises, larger organisations and, especially medium size companies, use the investment funds (mainly Provident Funds) operated by the large (trade) employees' unions. Although the employees' unions in Cyprus are attached to political parties and, therefore, draw substantial political power, they also run large group Provident Funds which provide services to their members, employees of companies and the companies themselves. The system has been effective in terms of covering a large number of employees who are able to enjoy life insurance coverage through a collective system. Furthermore, the above investment funds are all well protected under Cyprus Law and there have been no reported cases of failure to meet their obligations.

The Social Insurance Fund (SIF), operated by the Ministry of Labour and Social Affairs of the Government of the Republic of Cyprus since 1966, provides substantial insurance coverage to all employees or self-employed persons in the Republic of Cyprus. In order to provide arguments for the future sustainability of the Cyprus pension system (due to fiscal challenges created by an ageing population) the contribution rates to the social security system were increased in April 2008 and will continually be raised every five years until 2039 (Economist Intelligence Unit, 2009).

Government Bonds

Government bonds have proved to be useful financial instruments for the Central Bank of Cyprus to borrow on behalf of the Government, and, since 1 January 2008 when Cyprus entered the euro zone and officially adopted the change-over of currency from the pound to the euro, the government debt has, in general, been converted into euro denominated public debt. Cyprus Government bonds are also issued as government development bonds. They either carry a fixed or index based interest rate or they are issued at a discount through auctions by the Central Bank of Cyprus. Depending on their form, Government bonds may be traded on the Cyprus Stock Exchange (CSE). However, since almost no secondary market for government bonds exists, they have not yet developed into a significant financial asset for the private sector. Although the government has intended to create a platform for trading government bonds in the capital market for a number of years, no agreement has been reached so far, between Central Bank and the Securities and Exchange Commission on who will be authorised to oversee it.

Banking and Financial Services

Banking and financial services are also an important factor in demand. A strong financial service sector benefits from a high level of diversification of the economy. Offshore financial centres try to attract international investment from individuals and corporations by a wide range of special purpose entities, including favourable tax conditions for domiciliary and domestic companies alike or bank secrecy. However, 'ring-fencing', which refers to the allocation of privileges to domiciled companies in relation to tax rates, is regarded as a harmful tax practice by the OECD. In Cyprus the financial sector is also regarded to strengthen the national economy significantly, and contributed a share of 24.38% of the GDP in 2008 (Department of Statistical Service of the Republic of Cyprus, 2008). This, compared to other offshore financial centres, for example, Liechtenstein (more than 30%), is still a relatively low figure.

Although there are currently thirty International Banking Units on the island (Ministry of Commerce, Industry and Tourism - *Invest in Cyprus*, 2007; Roussakis and Bisha, 2006), Tsialis (2006) regards the banking infrastructure as weak in comparison with its competitors, due to an absence of the world's largest banks (*ibid.*). According to Roussakis and Bisha (2006), even two International Banking Units (IBUs) were required to close after 2004 due to the 10% corporate tax rate – the lowest rate in the EU – which was perceived too high by them.

Based on interview results, the demand conditions for Private Banking/Wealth Management or the trustee business should be judged differently from the retail banking market. The local retail market seems to be largely saturated, whereas the demand for Private Banking/Wealth Management services can be derived mainly from international investment, although the Cyprus financial centre still needs to provide certain preconditions for this to happen. The interviewees maintain that with regard to trustees, fund managers and wealth management companies, Cyprus has a strong demand to catch up on. It has been suggested (by three interviewees) that the understanding and knowledge of the trustee business ought to be developed and in the same vein, the interviewees stress that up until now wealth management services have been provided only to a limited extent by local banks. A turning point in this respect is perceived to be the attraction of large banks and mutual funds. So far, the market of Cyprus is dominated by local and, increasingly Greek, retail banks. Some interviewees view the motives for International Banking Units (IBUs) to be exclusively in the investment business and regard the market of Cyprus as too small for other IBU activities. Two respondents regard the existing political problem of Cyprus as an investment barrier for large banks and two other interviewees assume that the promotion of the Cyprus problem might be associated with a lack of political and economic stability. On the other hand, several authors regard an efficient investment fund infrastructure to be necessary in order to successfully compete with jurisdictions such as Luxembourg and Ireland (Tsialis, 2006; Roussakis and Bisha, 2006). With regard to potential Strategic Alliances, the positive professional organisation ratings of local banks, provided for example, by Moody or Standard and Poor, might attract large banks. Moreover, the interviewees suggested a change in the tax system and the provision of a legal framework for mutual funds which had not been included in prior tax reforms. For example, it is notable that despite the Mutual Funds Law, approved by the House of Representatives (Parliament) on 22 October 2009, no mutual funds have yet been established in Cyprus. Because of the size of mutual funds, one respondent views the local banks as inadequate to serve them, and to date, the establishment of investment funds in Cyprus is not regarded as favourable by one other respondent due to the relatively weak stock exchange.

Cluster of Related and Supporting Branches

Beyond the right factor and demand conditions and a competitive banking and financial services system, the competitiveness of a financial centre depends upon the efficient and synergistic interplay between both the banks and the competent branches which are related to, and support them. Owing to an increasing disintermediation of the financial value chain, banks must closely co-operate with a growing number of emerging financial trustee companies, brokers, insurance concerns, finance and industrial holdings, tax consultants, auditors or attorneys as offshore financial transactions are more complex than the juridical or cultural point of view. The previous paragraph mentions the seemingly still existing gaps in Cyprus on the grounds of their contextual interdependence.

The ideal geographic positioning together with the EU accession, the corporate tax regime and, last but not least, the forty-plus double taxation agreements, thus attributes the destiny of

Cyprus as the archetypal island for the establishment of holding companies (PriceWaterhouseCoopers, 2006; Roussakis and Bisha, 2006; Philippides, 2006) that require complex and sophisticated international financial, legal, tax or management consultation. The fact that Cyprus law is based on English law might be regarded as conducive in relation to specific legal aspects, i.e. the stability of international investment and high levels of trust on behalf of international investors.

Concerted Strategies

The discussion, so far, reflects the strengths of the Cyprus International Financial Centre but also points out the necessity to create synergy between the private and public sector in Cyprus and the whole value chain. The research findings imply a lack of implementation of the flexible and indicative planning principles of the three major Cypriot planning authorities consisting of the Central Planning Commission (President of the Republic, all ministers and, albeit with an advising role only, the Governor of the Central Bank), the Planning Committee on Policy and Budget (Minister of Finance, Permanent Secretary of the Planning Bureau, Permanent Secretaries of the six key ministries, top executives of the Central Bank and the Accountant General) and Planning Bureau (administrative and economic arm of the Central Planning Commission and the Planning Committee on Policy and Budget with an advisory role) (Colson and Corm, 2006). One of the main features of the planning principles incorporates representatives from the private sectors and social partners who are participating in defining strategy and objectives. This is also reflected in the inclusion of consultative and coordinating committees which allow the private sector to engage in the planning mechanisms (i.e. development plans). In this respect, an earnest request was implored by three respondents to engender a certain culture of co-operation between the parties with the aim of enhancing closer relations. Although two of the respondents suggested that the government might involve the private sector at an earlier stage of the decision-making process, one respondent regarded the level of co-operation as satisfactory. Another respondent referred to the practiced Swiss model where the government takes the suggestions of the practitioners into account. In addressing concrete examples, one respondent suggested to regulate the environment for the fiduciary service implying legal services which are more focused on international business. Two other respondents petitioned for an intensified teamwork between the government, the private sector, the International Banking Units and the auditors when internationally promoting the island. Generally, the majority of the respondents appealed to the government to draw even more attention to the financial centre and the economic and political benefits it provides. Further synergistic activities have been recommended in the field of education and training as well as on the legal and tax framework.

Conclusions

Over the last three decades, the economy of Cyprus has developed to the extent that it needs a strong regulatory framework within which to operate efficiently, effectively and reliably. Against the historical background of the expansion of the Cyprus economy, the focus provided in this article is driven by the evolution of the Cyprus economy since the 1970s and, especially since 1974. The government of the Republic of Cyprus did not pay specific attention towards the creation of a sound regulatory framework, especially during the 1970s and 1980s. Paradoxically, it can be argued that the absence of such a framework might have given rise to the opportunistic development of a strong offshore sector, attracting offshore business and substantial direct foreign investment as a consequence. This is in line with the findings of the development of the competitive advantage model generated by Romero and Kaufmann (2006) in treating the government sector and, particularly, the fiscal sector as an exogenous factor. With the application of Cyprus to become a full member of the European Union, this trend had to be reversed in the 1990s. The EU regulatory framework required the creation of a tight institutional structure to be compatible with EU law, thus giving an important role to the government which either had to intervene as such in the economy, or create the necessary institutions to play a tight regulatory role. From that point onwards, it was evident from GDP figures that the activity growth had slowed down, suggesting that the findings of the model were applicable. This must, of course, be coupled with other competitive factors which have remained unchanged to a large extent. This process gives emphasis to the role of the European Union as a catalyst necessitating the government of the Republic of Cyprus, to fashion the necessary institutional and regulatory framework to control and manage the economic activity of the country, especially the part that relates to the emergence of a financial centre. This conclusion is confirmed by a perceived lack of timely government response to urgent market developments and the momentum (positive or negative) that the Cyprus economy gained. The government is recommended to embrace an even more driving and integrating role rather than an exclusive regulatory one.

Compared to a traditional offshore financial centre, Cyprus, complete with its stock exchange, has the potential to host a financial market and thus realise a more favourable market-making position rather than simply being able to transfer deposited funds to parent companies. On the other hand, Cyprus is situated on the periphery of various international finance markets which is reflected in its close affiliation with the stock exchange in Athens. Based on qualitative research, the expansion of more sophisticated financial products could come to the fore, for example, derivatives or mutual funds. To reiterate earlier, the lack of taxes on capital, on the formation of capital, and on capital transactions, make Cyprus an attractive financial centre. The close cultural and geographical proximity to the financial centre in Athens might be deemed a large advantage. Cyprus intends to position itself as a turntable to support the financial transaction platform operating in the whole of the Mediterranean, focusing on variety and quality. In the past, the political and economic stability has attracted investment from politically unstable Middle Eastern countries such as the Lebanon, being in close geographic proximity to Cyprus. On account of the Euro accession from 1 January 2008 the economic stability will increase even more because no exchange rate risk will exist any longer for Eurozone investors. Increased foreign investment contributes to an increase in the competitiveness of the financial centre of Cyprus (PriceWaterhouseCoopers, 2007).

With regard to marketing related considerations it is suggested that future competitive product/service strategies of Cypriot banks should embrace quality, distribution and service quality components to a larger extent in order to be internationally competitive and to achieve consistency with the high quality positioning.

Looking ahead, it is vital to stress that the efficient, effective and ethical operation of the economy as a financial centre is crucial for its further progression. The management of the institutional and regulatory frameworks that have been created are the responsibility of the government of the Republic of Cyprus and overseen by the European Union. It is, therefore, up to the government to act in an appropriate manner to protect the advancement of the financial centre that has been forged. Furthermore, in the longer term, the sustainability of financial activity in Cyprus depends on the ability of the European Union to monitor the situation in a member state where there is flourishing financial activity, especially in connection with Eastern Europe – an area of high interest for the European Union itself.

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