

Constantinos Herodotou: The financial ecosystem from a regulator's perspective

Speech by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, at the TechIsland Summit, Limassol, 20 September 2023.

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Ladies and gentlemen.

It is a pleasure to have the opportunity to speak to you here today at the TechIsland Summit. In this speech I will focus on the modernization and digitalisation of the financial sector and the relevant policies and regulations.

Introduction

Digitalization has spread to every corner of our lives. To accommodate our needs, the world we are living has become more interconnected and the financial landscape is witnessing a relentless transformation.

The integration of technology into banking processes has unlocked opportunities, streamlined operations, enhanced customer experiences and redefined how financial institutions interact with their customers.

To navigate this evolving landscape successfully, safely and efficiently, profound collaboration and solid synergies are needed between technology and the banking sector, delivering to the public a more transparent and efficient financial ecosystem. The ease of use, the speed and cost of executing transactions, are all factors that businesses and individuals take into account when deciding with whom to cooperate.

The financial soundness and resilience of the Cyprus banking sector

The Cyprus banking sector has enhanced its strength and resilience through 2023, despite the turmoil of the recent economic and geopolitical events. In particular, it has maintained a high liquidity level, with its Liquidity Coverage Ratio standing at 318% in March 2023, compared with the European Union average of 162,8% (March 2023). The Common Equity Tier 1 ratio (CET1) stands at 18,9% at the end of the second quarter of 2023, a rate which is a strong indication of the Cyprus banking sector's ability to absorb future shocks. Furthermore, the Non Performing Loans in the banking sector have been reduced drastically, with the ratio declining from 44% in 2017 to 8,7% in June 2023.

Although, with the help of regulatory measures, the Cyprus banking sector has successfully weathered recent shocks, the uncertain economic environment leaves no room for complacency. Banks should continue improving their balance sheets and adapting to the changing environment in which they operate. Digital advancement sits at the core of this adaptation process.

The new digital era, and the adoption of the convenience it provides to both businesses and personal customers, has created an unofficial mandate for banks to invest in

technology and transform their business models towards technologically advanced services. Therefore there is a requirement for further significant improvement. Technological advancement moves at a fast pace, constantly creating room for more actions to ensure and maintain the sustainability and resilience of the Cyprus banking sector.

The Central Bank of Cyprus (CBC) has taken initiatives towards creating a binding bridge and fostering enhancement of technological advancement within the banking and payments sector. Let me briefly refer to two of these initiatives, that are important for the facilitation of modernization of our financial services.

Digital on-boarding

The CBC, in our effort to push the sector into digitalisation for a better and more efficient customer experience and help the economy, has developed and issued a tender for the implementation of a remote electronic digital on-boarding technological platform and process, aiming to speed-up the process for collecting, identifying and reviewing data of current and prospective bank clients. We lobbied the Cypriot banks to participate in this effort. I'm happy to report that a significant interest was shown by local and international tenderers, resulting in a remarkable participation to the tender.

This digital solution will bring benefits to individuals and corporates, reducing the time needed for their bank transactions and upgrading the quality of service they receive through:

1. remote/non-physical on-boarding of new customers via a digitalised process,
2. remote updating of existing customer data and information

and in phase II of the project-

3. information sharing between participating credit institutions and
4. connectivity with utility service providers and governmental services.

At the same time, it will improve the efficiency and openness of banking services, while adhering to relevant European regulations for on-boarding clients thus creating a comparative advantage for the Cyprus banking system. To this end, the customer account opening and account review time is expected to be significantly improved both for the banks as well as the customers. This should result in an efficient financial ecosystem to be formed, encouraging collaboration among financial institutions, through trustworthy information sharing.

At its first stage it will be implemented in the banking sector, but our intention is to subsequently scale it to other CBC regulated service providers, such as Electronic Money Institutions and Payment Institutions.

Innovation Hub

In order to further encourage, promote and support domestic financial innovation, the CBC has also established an Innovation Hub. It's aim is to become an official platform

for communication between the CBC, as a supervisory and regulatory authority, and businesses or startups active in Fintech.

Stakeholders' access to the Innovation Hub is based on pre-established objective criteria, which include climate sustainability, benefit to the consumers and novelty of the proposed product or service. The innovation hub is able to respond swiftly, providing non-binding guidance on requests, including the provision of information and guidance on actions required for the licensing of innovative Fintech products or services.

In this way, the CBC initiates a continuous and productive dialogue with innovative firms for the implementation of new ideas and the adoption of new technologies, making it easier for them to become aware of their regulatory obligations within the financial system. By maintaining an open channel of communication and feedback with the fast-growing Fintech industry, the CBC seeks to safeguard the financial system through an understanding of new risks, as well as reaping the full benefits from these activities.

The Innovation Hub is a crucial step in the broader context of the supervisory objectives and priorities of the CBC, which also include digital operational resilience and cybersecurity.

Enabling techs to provide services to licensed institutions (outsourcing)

Institutions providing financial services are expected to provide accessible, efficient and customer-centric services in an increasingly digital world. The challenges facing financial institutions in meeting these obligations, are multifaceted. Strict regulatory requirements, cybersecurity concerns and the demand for seamless online and mobile banking experiences, require a level of increased technological sophistication. This is an issue on which the Fintechs, possess certain advantages over traditional banks, such as state-of-the-art technology and no legacy operating infrastructures to maintain. These firms have taken advantage of the opportunities offered by technology and European Union (EU) regulation, enabling them to offer a multitude of products through the same channel, such as payments, currency exchange, stock-trading, insurance and commodities. As a consequence, they exert additional competitive pressure on established financial institutions. This is where enabling technology service providers may come into play.

Technology service providers, which offer solutions tailor-made to financial services, bring to the table specialized expertise, state-of-the-art solutions and economies of scale that a number of financial institutions may find challenging to develop in-house. The domestic and European economy are increasingly entering an environment where technology allows the implementation of innovative business models and services. Innovation has promoted for new ways of performing front and back-office processes, credit scoring, customer on-boarding, risk modelling and suspicious transactions monitoring. Innovation has also paved the way for new distribution models, such as mobile and online banking interfaces, and multi-service financial digital platforms.

Using readily available and scalable technology from specialized service providers, enables licensed financial or payment institutions to focus on their core business thus ensuring that they are able to adapt rapidly, meeting the ever-changing demands and

expectations of their customers. However, the other hand, outsourcing services to third parties is not something that should be taken lightly, having regard only to cost and efficiency. Licensed institutions are required to make sure that they are in full control of their business and operations, have an exit strategy in place to avoid excessive dependencies on a specific service provider and adequately manage any risks. Based on EU regulation, the outsourcing of critical and important services by licensed institutions to third parties, requires a prior notification to the supervisory authority.

Furthermore, while outsourcing allows institutions to focus on their core business, institutions continue to be responsible for the functions that have been outsourced.

Indeed, the partnership between technology firms and financial services firms, when carefully planned in order to avoid delegating the control and decision-making of a licensed institution, is important for the continued growth and stability of the financial sector, ensuring that it remains at the forefront of innovation and capable of serving the needs of our citizens in the digital age.

The supervisory role of the CBC

I also wish to say a few words about the supervisory role of the CBC. The CBC is responsible for the supervision of a broad spectrum of institutions, including banks, payment institutions and electronic money institutions. Furthermore the CBC supervises the compliance of licensed institutions with the anti-money laundering and countering the financing of terrorism legislation, as well as their compliance with the implemented Sanctions regimes.

The safeguarding of the financial sector's reputation is imperative for the CBC, and the CBC exercises its supervisory role through off-site supervision and on-site inspections.

Needless to say, failure to comply with the laws may have adverse effects on individual institutions, on the financial sector's reputation as a whole, as well as, on the economy of Cyprus. The CBC has thus a vested interest in encouraging and promoting compliant domestic financial innovation, as some of the startups may end up providing their services to supervised entities, or decide to apply for a licence and come under the supervision of the CBC.

Ladies and gentlemen,

I have shared my views on the emerging, fast changing and technologically challenging environment, as well as on the CBC's own initiatives, acting proactively and fostering enhancement within the financial sector.

Linked to this, I would like to briefly provide an overview of the 'international headquartering' trend in Cyprus.

International company headquartering has traditionally been a strategic decision influenced by factors such as tax benefits, access to key markets and infrastructure facilities.

In Cyprus, foreign direct investments, as a result of the inflow of a large number of foreign companies, contributed to the strengthening of economic activity in 2022. In particular, it has supported the inflow and expansion of operations of companies, mainly in the information and communication technologies sector.

The contribution of headquartering to GDP growth has doubled, from 0.7 percent in 2021 to 1.3 percent in 2022. However, we should bear in mind that with the rise of the digital era, the emphasis on physical location is waning. Talent acquisition, a crucial component for a company's success, is no longer confined by geographical boundaries. This shift is further intensified by the growing number of digital nomads, professionals who operate remotely and are not tethered to a specific location. These professionals prioritize flexibility, connectivity and work-life balance, and as a result organizations are rethinking their traditional operations model in order to attract this pool of global talent. The intertwining of company headquartering strategies, with the allure of remote work opportunities, showcases the evolving landscape of the modern business world.

Let me now conclude,

Innovation in the financial sector has become a crucial necessity. It enables contactless banking, it offers financial services' employees the possibility to work remotely, and provides a customer oriented efficient product. Undoubtedly, technological advancement comes with challenges and risks. These risks need to be effectively managed and regulated, so that financial sector participants and their customers reap the benefits of such technological advancement. Let me assure you of the Central Bank of Cyprus' support to all efforts that point towards the direction of technological advancement and of our readiness to contribute within the framework of our legal mandate.