Introduction

"Nothing so concentrates the mind as an urgent and complex problem." ¹

Good corporate governance is a crucial ingredient in a country’s infrastructure and cannot be ignored. Proper governance processes are likely to create an environment that is conducive to success and increase the creation of wealth by improving the performance of honestly managed and financially sound companies.² It does not follow that there exists a perfect corporate governance system that can guard companies and their stakeholders from the consequences of error. Companies are not immune from failure. Corporate collapses happen for many reasons, but there is little doubt that poor corporate governance plays some part in contributing to such collapses. That is precisely why the system of checks and balances that supports corporate governance needs to work well. The presence of an effective corporate governance system within institutions and across economies, promotes a level of confidence that is fundamental for the appropriate functioning of a market economy.² By developing good governance practices, corporations have more chances of performing well, while the contrary, bad governance corporate practices, joined with some other elements, have exactly the opposite result. The recent global financial crisis of 2008–09 is indicative of this. While corporate catastrophes are not a new phenomenon, Cyprus appears to have learnt few lessons from previous experiences to safeguard the long-term prosperity of its institutions. Corporate governance failures were instrumental in bringing about the country’s financial ruin and as the Cypriot economy has become dependent on state support for its continued survival, reinstating the trust in its corporate governance structures becomes a matter of urgency.

There were many problems with the corporate governance practices of financial institutions in Cyprus; in fact, it is easier to point to examples of “bad” governance than “good” governance, with the collapse of Marfin Laiki Bank being the most talked about illustration of this. The bank had weak governance, poor strategic direction and unsound policies. The executives failed to use the bank’s resources productively, showed little competence in running the bank and seemed unable to improve its financial results for a long time. There was poor leadership and inept management, and whether this was due to an attitude of apparent indifference or a deliberate disregard of the bank’s underlying problems remains unclear. Despite this, the value of the executives’ personal share options, pay and bonuses continued to steadily increase. Remarkably, their actions went unnoticed by numerous “interested” parties, such as the banks’ shareholders, investors, auditors and regulators, who failed to realise what was going on. Communication with shareholders and other stakeholders was generally poor and in addition, the board failed to provide a balanced and clear assessment of how Marfin Laiki Bank could achieve its business purposes and future financial targets. It also failed to assess correctly the extent of the risks it intended to take in realising the banks’ strategic objectives. These are significant issues. Good corporate governance dictates that boards should establish formal and transparent arrangements in relation to corporate reporting, risk management and internal control principles.³ Additionally, the matter of remuneration is crucial; the procedure for developing a policy on executive remuneration and for fixing the remuneration packages of individual directors should be formal and no director should be involved in deciding his or her own remuneration. Although the levels of executive remuneration should be sufficient to attract, retain and motivate directors of the quality needed to lead companies effectively, companies should avoid paying more than is needed for this purpose. A large part of executive pay should be designed in such a way so as to link rewards to corporate and individual performance.⁴ Nevertheless, this does not appear to have been common
practice in the majority of Cyprus’ financial institutions.

The first part of this article considers good and bad corporate governance in light of the 2008–09 financial crisis. That is a critical period; it is when a number of corporate governance aspects were put to the test, eventually showing their inadequacy in a truly dramatic fashion. The benefits of proper corporate governance procedures as well as the key indicators that signal poor governance practices are examined in some detail. After, the article focuses on the case of Cyprus, currently one of the most powerful examples of poor corporate governance practices within Europe. There are many aspects of corporate governance linked with the emergence of the Cyprus financial crisis, with the absence of proper procedures being a key issue, particularly since weak bank governance appears to have been systemic to the country’s economy. By and large, Cyprus has found itself on the brink of economic collapse following decades of bad governance in both the public and private sectors. Using recent key reports written on the Cyprus banking crisis, the article examines the main factors that contributed to the country’s financial disaster from the perspective of corporate governance: the government and political interference in business decisions; the lack of independence within boards and the impact of this on executive remuneration; the country’s corporate culture that appears conducive to nepotism; and finally the “revolving door” phenomenon prevalent within Cypriot society. The next part of the article discusses the implications to the key questions and possible ways forward. That it is imperative to improve corporate governance mechanisms in Cyprus cannot be denied, and while some measures were adopted to improve upon its practices, more dynamic and vigorous steps need to be taken. Crucially, the country’s culture of nepotism, deference and government “intrusion” into business decisions must be addressed. Although these issues can only be properly deliberated once the market and corporate culture mature to a greater degree, they can at least be given some consideration. Now is a good time to do that, since, following the crisis, this subject has finally provoked strong emotional reactions by many, particularly shareholders, investors and politicians, as well as the Cypriot public at large. An improved structure will place companies and shareholders on a more effective and realistic footing; until this happens, the country’s corporate governance system will continue to be the source of dissatisfaction for many.

**Corporate governance failings and the recent financial crisis**

Good corporate governance matters. It persuades, prompts and encourages institutions to preserve the honesty and integrity of key promises made to investors. In literature, the subject of corporate governance is treated in either a narrow or broad manner; the narrow approach focuses on corporate accountability to shareholders while the broad interpretation of the term views companies as accountable to the whole of society, future generations and the natural world. Whether preference is shown to the narrow or broader approach, the role of corporate governance is to safeguard and advance the interests of a number of stakeholders through the setting of strong strategic goals and the appointment and monitoring of capable management to achieve crucial company objectives. Importantly, corporate governance is there to ensure there is proper accountability for corporate failures. Proper corporate procedures also turn countries, particularly in the developing markets, into magnets for global capital; that is why they are now form part of the international financial architecture.

There are a number of key indicators that signal poor corporate governance practices. Weak management is one powerful sign, particularly the lack of effective governance that typically happens when boards fail to ensure that institutions have proper procedures to monitor and control risk. Even where the accounting systems produce accurate reporting, boards may lack the financial literacy to understand the nature of what is being reported to them. Such lack of knowledge can impact on their ability to provide crucial checks on company executives. One individual, who might disregard expert advice or who may inappropriately delegate his or her responsibilities without properly supervising management, typically controls boards. Board accountability becomes distorted and there is insufficient examination of company decisions; reviews of decisions are casual or even completely absent. Further, companies tend to follow unsound policies; for instance, executives can be over-optimistic about sales targets. They might hold high levels of stock, thereby restricting the company’s working capital and reducing its cash flow in the process. This can prove detrimental in the event of a liquidity crisis. Companies that have poor corporate governance standards also tend to borrow more than they are able to service and this puts them at risk of being unable to make repayments when they are due. This casts doubt on their ability to create future sustainability; in fact, one major impact of poor corporate governance is the failure of businesses to develop in a sustainable way. Also significant is where companies have deficient or inadequate accounting.
systems in place: companies with poor financial reporting systems fail to evaluate performance accurately and have difficulties with regard to future forecasting and cash flow planning. They also tend to concentrate excessively on one single project, ignoring other, lower risk projects. Investing too much time, effort and resources in an individual project can be damaging to their future survival.

Corporate governance was tried and tested during the 2008–09 financial crisis, when a number of corporate governance aspects were found unsatisfactory. Certainly, the global financial catastrophe has made companies, regulators and society more aware of the possible failings in regulation, board function and shareholder behaviour. The roots of this crisis were many and varied, including: loose credit conditions; risky over-trading in parts of the financial sector; over-optimistic risk management; lax accounting standards; greedy, short-term compensation regimes; and excessive remuneration. These elements, hazardous even in isolation, created an environment filled with over-optimism and overconfidence. Avgouleas explains the causes of the crisis in two ways. First, commercial and investment banks exploited the prevailing conditions of excessive liquidity and financial innovation to obtain substantial and largely impossible-to-value exposures in the global credit markets. Secondly, by using elaborate alternative investment schemes and complex credit derivatives they moved a gigantic amount of assets and liabilities of balance sheet, creating a kind of shadow banking. Writing about the financial crisis in the US, two further under-recognised causes were identified by Coffee: the excessive reliance on credit rating agencies which became gradually subject to client pressure as competition in the market increased, as well as the shift toward more self-regulatory rules that permitted investment banks to increase leverage and reduce diversification under the pressure of competition. Also crucially, numerous other factors, many linked to poor corporate governance, were detrimental to institutions: questionable monetary policies, implicit government guarantees, greed, excessive remuneration and inadequate corporate governance. Holding too many directorships, warned against by corporate governance policy, was another contributing factor. Evidence points to the fact that directors of subprime lenders sat on significantly more company boards than directors of other lenders and this resulted in poor monitoring of subprime lending and exacerbated financial risk.

Importantly, the key problem of the 2008–09 financial crisis was not the absence of foresight about the dangers of the massive credit expansion and housing price bubble but the absence of proper corporate governance procedures within institutions. The crisis, which resulted in the worst recession for many countries around the world, caused a collapse of confidence and led to extraordinary reductions in national output and industrial production. It also gave rise to a considerable breakdown of trust in and within the financial system: in politicians, in bankers and directors and even in the whole process of globalisation. It showed that bad governance can affect not just companies but also societies at large. It exposed the problems that derive directly from poor corporate governance practices and revealed that without a strong corporate governance structure, there is weak management and preference for risky business models. These can contribute to the poor performance of banks and in some cases, to banks’ failures, bailouts or nationalisation. Banks must have strong corporate governance procedures that encourage management and owners to appreciate the risks they are pursuing and to price risk efficiently for the purpose of covering both the private costs that such risk-taking presents to shareholders and the social costs for the broader economy in the event of bank failure. But while corporate governance and personal accountability in the investment banking industry remains weak, reckless business decisions will continue to happen, with disastrous consequences for the global credit markets and the worldwide economy. Certainly the case of Cyprus is a very strong illustration of this.

National financial crisis—the case of Cyprus

Cyprus became a member of the EU in 2004 and a member of the euro zone in 2008. In 2007 the assets of the Cypriot banks were 700 per cent of the country’s GDP. By 2008 the local economy (including household, business and public) was heavily indebted and had lost its competitiveness. It was also seriously dependent on the banking sector. Its foreign-related business was too large and its banks accounted for over 90 per cent of the financial intermediation. This is in contrast to the rest of the euro zone, which was only 50 per cent of the financial intermediation. Once the world economic crisis had set in, it was difficult for the economy of Cyprus to survive. A significant layer of the graveyard came as a result of the devaluation of the Greek government bonds (GGBs) of which the local banks had acquired €5.7 billion worth in 2009–10, at a time when the Greek economy was turning "sour". In 2010 a "haircut" of 80 per cent of the private sector holdings of GGBs by the Eurogroup had cost the Cypriot banks €4.5 billion. More troubles were to follow when in 2011 a huge
explosion at the Mari naval base (for which the Minister of Defence was subsequently convicted of negligence and imprisoned) destroyed the power generating station. In May 2011 the Cypriot market was excluded from the world market and by October 2011 the local banks had declared a loss of €4.5 billion due to the drastic devaluation by the Eurogroup of the Greek bonds, in which Cypriot banks had invested heavily. This loss amounted to 25 per cent of the country’s GDP. Against the backdrop of the failure of the Cyprus Government, the Central Bank and the banking sector to avert a national economic catastrophe, in March 2013 the new government “agreed” to a bail-in by the Eurogroup (European Central Bank, IMF and the World Bank) in order to save the country from complete bankruptcy. During this time, the provident funds, as well as all deposits in Marfin Laiki Bank over €100,000 were lost owing to the bail-in and, in addition, various restrictions on financial transactions were imposed by the Eurogroup. The period 2008–2011 was described as “bad judgment period” and many perceived the bail-in agreement in March 2013 as the final gravestone to the country’s economic tragedy. *J.B.L. 367*

An Independent Commission on the Future of the Cyprus Banking Sector (ICFBS) had been set up in November 2012 by the Central Bank of Cyprus to make recommendations for the long-term recovery of the Cypriot banking industry. The interim report was published in July 2013 and the final report in October 2013. Following the bail-in decision by the Eurogroup in March 2013, the newly elected government of Cyprus appointed three retired judges to investigate the banking crisis and the reasons for the country’s economic collapse. The Committee of Enquiry, chaired by the distinguished jurist Justice Pikis, was given six months to publish its report. The committee members were free to conduct any interviews they deemed necessary, including of current and previous presidents or government ministers. The final report was published on September 28, 2013. Soon after, Professor Zenios, ex-rector of the University of Cyprus and one of the experts appointed to assist the three judges, published a separate report (referred to as the *Zenios Report*), examining issues of a more financial nature not discussed in the *Pikis Report*.

The general consensus of all key reports is that the economy would have had stronger chances of survival had there been more professionalism among executives, better corporate governance structures and more ethical behaviour within the banking sector. Also, had there existed stronger political will to encourage proper corporate governance procedures and to prevent the debt from rising to €17 billion, 100 per cent of GDP. Crucially, the period 2011–2013 was labelled as the period of “negligence, amateurism, timid tactics and political motives”, with much of the blame placed on weak bank governance as well as the culture and attitude of personal and political relationships that significantly affect matters of business in Cyprus. Interestingly, the Eurobarometer survey by the EU Commission supported these conclusions; according to the survey, 88 per cent of the Cypriot respondents believe the only way to succeed in business is through political connections.

Following the bail-in agreement by the Eurogroup, Cyprus became something of a “guinea pig”, and while it is difficult to isolate the main causes of the country’s economic downfall, it is clear from a close reading of the *Pikis Report*, *Zenios Report* and the IFCBS interim and final reports that, had there been effective *J.B.L. 368* corporate governance, a number of disastrous events might have been avoided. The economic crimes committed within institutions, the corruption that possibly characterised them, the numerous disastrous financial decisions, as well as the mismanagement of the bank that led to Cyprus’s financial ruin, Marfin Laiki Bank, might not have happened, at least at such a catastrophic level, had there been better corporate governance policies and procedures. While a criminal investigation into the actions of those allegedly instrumental in the economic ruin of Cyprus is under way, the matter of corporate governance becomes crucial.

**Cyprus’ corporate governance—addressing the key issues**

Cyprus has found itself on the brink of economic collapse following decades of bad governance in both the public and private sectors. Drawing on a ranking of the EU corporate governance codes based on the OECD principles, it is apparent that the symptoms of the economic catastrophe were evident years earlier: in one particular study, the corporate governance guidelines of a number of countries were granted five stars and were described as vigorous and strong. Cyprus’s best practice standards were ranked 12th out of 25 countries and were awarded three stars. Remarkably, countries awarded the low score of two in the same ranking, namely Portugal, Spain, Italy and Greece, went on to face serious financial problems in the economic crisis that followed. As noted by Krambia-Kapardis and Psaros, Cypriot companies “have a long way to go before they achieve international benchmarks
of good corporate governance”. They are also far from recognising the cultural factor that prevent them from bettering their governance procedures. Sad, nine years later this statement continues to reflect the position of Cyprus rather accurately.

Whereas numerous causes can be identified, the following four summarise the key factors contributing to the country’s economic crisis from the perspective of corporate governance: the government and political interference in businesses’ decisions; the lack of independence within boards and the impact of this on executive remuneration; the country’s corporate culture that appears to be conducive to nepotism; and finally the “revolving door” phenomenon, prevalent in the Cypriot society. This part will consider these factors and will assess their impact on the country’s corporate governance structure and procedures. Although not mutually exclusive, they are considered separately in distinct categories in order to underline their key concerns and think through their implications in more detail.

**Government and political interference**

There appears to be a high degree of government and political interference in business decision-making. Even though corporate collapses happen for many reasons, there is little doubt that this “intrusion” played its part in weakening Cyprus’ corporate governance system. The Pikis Report provides a number of interesting examples that point to this: for instance, in 2008 the Government had decided that a three-member committee of the Ministry of Finance ought to be responsible for overseeing the public debt rather than the Central Bank, a decision possibly triggered by the poor relationship between the then Governor of the Central Bank and the country’s President. This caused a conflict of interest: the members of the committee, being public servants working in the Ministry of Finance should not have been given the responsibility to check and monitor the work of the Ministry itself. In another example, even though it was clear that Marfin Laiki Bank was on the verge of collapse, the political party in power at the time, perhaps motivated by political reasons, the most obvious being the safeguarding of votes in the forthcoming presidential elections, decided against letting the bank go bankrupt; bankruptcy would have resulted in the loss of several jobs and benefits. The party in power perceived this as a negative pre-election step, instead deciding to bolster the bank by borrowing heavily from the European Lending Agency (ELA). As noted, due to the presidential elections, the biggest bank in the country was placed on a ‘breathing machine’ until the election period was over. With hindsight, this was not the cleverest of moves. Interestingly, the Minister of Finance at the time was asked not to make any public comments that contradicted the government’s financial stance. After leaving his post, he expressed his regret for allowing himself to receive political pressure to formulate economic policies.

A few more issues can be raised that illustrate the problem discussed here. To start with, two notable incidents are worth mentioning, such as the fact that days before the elections a significant potential investment that eventually failed to materialise was not disclosed to the public, and secondly, a negative Fitch evaluation report on Cyprus, published the week before the presidential elections, was made public only two days after the elections were over. Further, politics and board diversity is another crucial issue addressed by the Pikis and ICFSB reports. There are very few women and only a handful of people with knowledge and experience of international finance matters appointed on boards, possibly due to the fact that political affiliations matter more in Cyprus than appointments based on merit. Although there is no shortage of women to serve on boards, there is a significant gender gap and a “concrete rather than a glass ceiling” with regard to such appointments. This is not due to lack of knowledge, qualifications or experience on the part of women; rather, it is possibly due to the fact that political connections and affiliations are not as strong among the female population as among men. Additionally, it is possibly due to the prevailing view that women will be “pulled away” from their work obligations and responsibilities as a result of their family commitments.

A close scrutiny of bank boards shows a lack of independence within boards, a relatively small number of new people joining boards (who can potentially bring with them “fresh” ideas) and “limited international brain power”. These corporate governance characteristics are believed to considerably limit the likelihood of proper corporate governance standards being implemented within banks and other large institutions. In addition, the general consensus that stems from the key post-crisis reports is that the political interference in the management of banks, as well as the governments’ decision to withhold crucial information about the state of the national economy (possibly motivated by the desire to protect votes) contributed to the worsening of the crisis. Until the government and
politicians truly understand that "interference in the management and supervision of banks seldom makes things better"; there is little space for improvement here.

**Lack of independence and the matter of executive remuneration**

Research shows that most company boards in Cyprus primarily comprise of executive directors. There are not many independent, non-executive members. This is a matter of concern; since executive board members have greater information and influence, non-executives are expected to challenge boards effectively while helping companies fulfil their strategic direction. Certainly their presence on company boards is important in today’s investment environment; boards need to have a sufficient number of independent, non-executive directors to monitor the executives’ decisions. In fact, the weight of current opinion is that it is desirable to have a majority of independent directors on boards (particularly within large institutions) because they can provide protection against the folly of management. Sadly, this does not appear to be the norm in most local banks in Cyprus.

Furthermore, it is not uncommon to find people who are employed by the same institution, either as employees or members of boards, for considerable periods of time. There are examples where people have had a working relationship with the same institution for over 20 years, starting as employees, then as executive directors and even reaching the post of Chair of the Board in some cases. Viewpoints vary on long-tenured directors. Long-lasting working relationships are common, with certain governance observers advocating that long tenure is an indication of directors’ loyalty to their firms. Although they can manifest commitment and devotion to banks, such lengthy affiliations, particularly in small countries such as Cyprus, can affect people’s independence. Indeed, opponents would argue that directors serving on boards for long periods of time may lack independence and impartiality.

Long-lasting working relationships can also have an undesirable impact on executive remuneration. As explained in the Pikis Report, in the years leading up to the crisis, each time new executive directors were appointed, their bonus payments would typically exceed their actual salary, a practice that would subsequently be applied to other executives within the same bank. In one particular instance that provoked great public outcry, an executive who left his post to take up a political appointment as Minister was given an additional “golden handshake”. Since his new position as Minister would be prominent and influential, this golden handshake was exceedingly high in value, reaching the excessive figure of €2 million. This compromised his independence as Minister of Finance. It also brought to light the high degree of dependency that evidently exists between bank boards and former executives of banks who are subsequently appointed to political positions. The problem becomes more severe when such political positions have the potential to influence the operations of banks.

Just as the high levels of executive pay were a contributing factor to the global financial crisis, they were also a causative factor to the collapse of Cyprus’ economy. Although concerns about pay structures appeared even prior to the global economic problems, this issue became more acute following the crisis. Misaligned remuneration arrangements encourage management to agree to risky pathways while letting failure go unpunished. Executives of Cypriot institutions typically received excessive pay, at least in the years leading up to the crisis, and therefore concerns were raised relating to the negotiating process through which their salaries were decided. There were also significant asymmetries in remuneration, particularly between remuneration and bonus payments, with bonuses sometimes exceeding salaries by 30 per cent. In one particular example, if the bank exceeded its targets by “110% of what was expected” the target would reach 100 per cent of the salary and if it was reached “by 100%” the bonus would be 95 per cent. Such an arrangement encouraged bank managers to grant large numbers of unsecured loans, because for each approved loan bank managers would be rewarded with a generous bonus. On another occasion in 2009, the Bank of Cyprus decided that if a director had a loan greater than €500,000 at any time in the past three years of his appointment, he would not be defined as “independent”. A particular member of the board, who was also chair of the remuneration committee, obtained loans from the bank worth €27 million. He was nevertheless allowed to remain in his post and no questions were raised regarding the matter of his independence, despite the fact that, according to the rules, he was clearly no longer an “independent” board member. There are further examples: for instance, a board member who had been with the same bank since 1991 held loans worth millions of euros with that same bank, yet no inquiries were made nor any concerns raised regarding this. In another example, the bank’s chairman was allowed to obtain loans totalling €319 million. These large loans were
endorsed as a result of weak corporate governance within banks, a matter acknowledged by the Minister of Finance in his testimony before the Pikis Committee of Enquiry. The Minister also stressed that, in his view, poor corporate governance procedures created a type of dependency between executives and non-executive directors.22

These examples highlight one crucial problem: longstanding relationships can easily affect one’s judgment and independence, particularly when considering the matter of the issued loans. This complicates things even more. When directors are indebted financially to such great magnitude to the same bank they direct and control, then their impartiality will become affected.46 This is problematic; Cypriot institutions’ pay policies must not compromise the interests of companies, their employees and investors, compared with those of outstandingly well-remunerated executives.22 While executives should expect to receive competitive and credible remuneration suitable to their expertise, the incentive and remuneration systems in operation must not promote a culture of short-term thinking that ends up sacrificing long-term incentives for short-term goals.46 The OECD has also highlighted this problem: in a series of successive reports written after the financial crisis, it found that in a number of major financial institutions around the world, serious failures of risk management systems were worsened by incentive systems that promoted and rewarded high levels of risk taking.41 Cyprus is a powerful illustration of this global problem: the scale of basic pay and the appropriateness and levels of the bonuses there underlie the country’s financial crisis. Given the current state of the country’s economy, the prospect of taking an apathetic stance is justifiably worrying. *J.B.L. 373

Corporate culture of nepotism and deference

According to the third annual corruption perception survey by Transparency International Cyprus, a non-governmental and politically independent organisation, 80 per cent of the respondents regard the relationship between the business sector and politicians to be “very close”.45 Also, the vast majority (91 per cent) consider that corruption is a significant problem; they believe it exists both locally and nationally and that in future it will increase owing to the current economic crisis.63 The ICFCBS44 report reached a similar conclusion; it found that personal and political relationships play too great a role in the management of businesses, pointing to the existence of corruption and nepotism within the system.44 The problem appears to be a matter of culture. The prevailing culture in Cyprus averts the political establishment from fully appreciating the benefits of preserving the independence of the banking system and its regulators. In addition, it is thought that the corporate environment is prone to nepotism at various work levels; nepotism, the favouritism occurring in business or politics to people on the grounds of their family connections, is generally perceived as a corrupt practice, both on the part of the employer and employee.45 The Cypriot corporate environment is understood to exist within a closed network culture, where regularly appointments are not based on merit but on the “ethos” of nepotism, favouritism and undisclosed conflicts of interest.62 Importantly, the sociocultural, economic and political structure is the underlying reason for such favouritism. Nepotism and cronyism, the latter term referring to the partiality shown to friends or associates, can be the cause of short- and long-term negativity among employees, and this, in turn, can significantly weaken company growth. Also relevant is the country’s culture of deference: bank employees generally shy away from voicing their views, particularly if, in doing so, they might appear to be questioning those in authority.67 People are expected to “follow” those in power and although this makes business sense, at some level it is also concerning. A culture of subservience rather than challenge prevailing in the face of “domineering chief executives”63 can negatively affect the corporate environment, inhibiting the creation of a healthy governance setting.

Linked to this, the lack of qualifications by board members is another cause for concern. The leading reports found that board members frequently lack the qualifications needed to run large banking institutions. The absence of proper qualifications gives space to powerful senior executives to bypass internal controls and to pursue risky strategies that might be strongly influenced by personal ambition. This enables them to dominate boards.49 Executives tend to discourage other bank members from expressing views on strategy and direction and, coupled with the fact that there are problems linked with the independence of boards, their expertise and qualifications, the communication barriers suffer and the flow of information becomes unbalanced. To illustrate this point, the ICFSB report refers to the decision by the Bank of Cyprus to buy another foreign bank at the cost of €450 million, the highest acquisition ever made by a local bank. This was “presented to the board as a fait accompli”67 and there was little discussion internally as to the possible consequences of this decision.67
The "revolving door" phenomenon

Cypriot society is characterised by the "revolving door" phenomenon: this relates to the movement of high-level employees from public sector jobs to private sector jobs and vice versa. For instance, regulators might become consultants for the industries they once regulated, or some private industry heads might get appointed to government posts that relate to their former private posts. This creates a link, or a "revolving door" between the two sectors and, according to evidence, this is not an unusual occurrence within Cypriot institutions; it is common to find people who held various positions in the public sector (such as in the Central Bank of Cyprus) to be subsequently appointed executives or supervisors in banks.\textsuperscript{21} According to Transparency International Cyprus, such movements have become more common in recent years owing to the fact that ministers and crown servants often leave public office at a younger age than used to be the case. In addition, those in public service have become keener to learn from corporate experience.\textsuperscript{24}

When there are "revolving doors" without any regulation or "cooling-off period", there is a significant risk that people’s independence will become compromised, a matter also emphasised by a report of the EU Commission.\textsuperscript{22} While there is no shortage of qualified people to serve on company boards, Cyprus’ boards tend to become “just a club of friends”.\textsuperscript{23} That there can be a high degree of dependency \textsuperscript{\textit{J.B.L. 375}} between bank boards and executives who are subsequently appointed to political positions, is concerning. The practice of elected government employees leaving public service jobs to work in the private sector can cause serious conflicts of interest with their former role, and is therefore a matter that needs addressing. Strong and healthy corporate governance practice must ensure that the appointment process is well structured, transparent and based solely on merit. It must also close any window of opportunity for "revolving doors" to make an appearance. This, in turn, will help to ensure that high quality individuals undertake senior positions within institutions.

Implications of the key questions and ways forward

The poor practices within Cyprus’s large institutions, particularly banks, point to the existence of a governance failure within the country’s corporate system. The interwoven relationships and strong connections that exist between politicians and businesses, the failure to control the phenomenon of the “revolving doors”, as well as the expectation that banks will voluntarily comply with corporate governance codes in a culture where the prevailing attitude is that of the "old boys’ network", are signs of corporate governance gone wrong. These problems, potent even in isolation, appear to have contributed to the country’s catastrophe to a significant extent.\textsuperscript{24} Ironically, there is one positive, albeit unintended, consequence to all these: other countries can learn a lot from Cyprus’ financial ruin.\textsuperscript{22}

Cyprus’s corporate governance practices in the banking sector certainly need to improve. Some valuable recommendations were made by the ICFCBS Report, such as, enhancing the independence of boards as well as improving the quality of directors by appointing on merit and international experience. The report also suggests increasing the number of independent, non-executive directors in boards to counterbalance the executive appointments, and further recommends bank directors receive training suitable to their particular positions. The report also proposes strengthening board committees, particularly in the areas of audit and risk; and, finally turning executive remuneration into incentive-based pay.\textsuperscript{24} The recent Central Bank of Cyprus Directive\textsuperscript{25} has incorporated all of the aforementioned recommendations, focusing primarily on the matter of board composition, training, key roles, responsibilities, duties and remuneration policies. Certainly, the matter of training is a constructive step forward, especially since “a lack of understanding \textsuperscript{\textit{J.B.L. 376}} of strategies and products, such as collateralised debt obligations, weak ethical standards and poor understanding of risk” was a contributing factor to the financial crisis.\textsuperscript{24} Indeed, in order to improve on the dispersed ownership model, it is logical to require board executives of large institutions to receive training. The necessity for a healthy set of skills and qualifications is further reinforced by the fact that neither qualifications nor training are required by the Cyprus Companies Law prior to becoming a director.\textsuperscript{24} Such a requirement will help executives improve their skills and knowledge of strategies, products and risk. In many ways, the larger and more complex the institution, the greater the demand for an appropriate set of skills and qualifications, linked to the functions performed.\textsuperscript{25} It would, furthermore, be hard to justify the scale of directors’ pay if they did not own comparatively strong abilities and as opined, for that reason it would ‘be surprising if directors were themselves to deny the possession of special skills’\textsuperscript{24} At the very least, a good corporate governance system should offer board executives more guidance on how to perform their job properly.

The Directive also pays special attention to risk culture and risk appetite, and supports the
establishment of risk committees, particularly within large institutions. As well as the problems that arise as a result of poor communication practices within banks, the Directive addresses the question of tenure. The issue of director tenure has recently garnered noteworthy attention both in Cyprus and abroad, and a growing number of countries have adopted tenure-related guidelines or restrictions for directors. Regarding this, it is suggested that in future, a cap should be imposed on the number of years a person is permitted to remain as board member and/or hold the position of chairperson within the same institution. Such a cap might prove to be a powerful mechanism ensuring there is a systematic refreshment of directors' skill sets. It could also boost diversity on boards, especially considering that term limits are not common in Cypriot firms. In relation to the issue of the poor communication, the Directive stresses the importance of requiring large institutions to appoint company secretaries, whose role is to ensure there is adequate information flow from executives to company boards. This is a significant measure. The company secretary can play a crucial role, not only in helping boards to accomplish their tasks, but also in ensuring a solid and free flow of information between the "governance circle" and the "managerial pyramid". Further, communication and dialogue are vital features of a good governance system; they should be based on a mutual understanding of objectives and in that regard the annual general meeting is the most appropriate place for company boards to "J.B.L. 377 "connect" with shareholders and other investors, and to encourage their involvement. The appointment of a company secretary can help fulfill this goal.

The Central Bank of Cyprus Directive is a positive start. It tackles some crucial corporate governance failures and weaknesses that appear to have contributed to the collapse of the Cypriot economy. The culture of seeming indifference or deliberate disregard on the part of senior executives for their companies can set in train a series of events that can end in a disaster of monumental proportions. The steps taken emphasise the need for the company stewards to pay close attention to any "warning" signs of trouble. Nevertheless, the Directive could have articulated this more clearly; it could have addressed a greater number of corporate governance deficiencies, especially since there were many other problems linked with the financial catastrophe in Cyprus. Particularly, the Directive fails to confront the problems resulting from the government and political interference within business decisions. The matter of the Cypriot corporate culture being conducive to nepotism and deference is not addressed either. Perhaps this is not surprising; these issues can be only be effectively considered when the market and corporate culture mature to such a degree that the benefits of corporate transparency, ethical behaviour and accountability are understood, valued and actively pursued.

More dynamic steps need to be taken. Corporate governance practices must provide the right types of mechanisms to align the interests of management with those of shareholders and greater efforts must be made to develop structures and procedures that ensure management is effective and that it adopts appropriate standards of corporate behaviour. Certainly, within this context it is crucial to at least address the matter of culture and the impact it has on the business community. Measures must be adopted preventing politicians from becoming involved in the appointment of board members or bank executives. When board appointments are based on merit and directors become legally accountable for poor decisions or inactions, banks will be better protected against the "old boys' network" wreaking havoc in Cyprus's economy. Additionally, capability and effectiveness, characteristics that matter greatly in a good system, need to be reinforced. Boards and other committees need to have an appropriate mix of experience, skills and independence to empower their members to discharge their duties and responsibilities well. This is significant; what a company board does and how it decides the company's values and principles matters immensely. Good corporate governance places a lot of importance on boardroom behaviour and expects management to consist of fit and proper people in the sense of ethics and competence, capable of discharging their responsibilities properly. This has to be emphasised more strongly, particularly since the widespread failure on the part of boards of directors to understand and control the risks taken by their companies is a major concern, not just in Cyprus but also in many other countries around the world; according to numerous post-crisis reports, such as the Green Paper on Corporate Governance commissioned by the European Commission, boards of "J.B.L. 378" directors were unable to ensure that the risk management framework was appropriate to their financial institutions. Boards were also found unable to recognise the systemic nature of certain risks, and consequently were not in a good position to deliver sufficient information upstream to their supervisory authorities. Linked to this is the matter of executive training: there was inadequate training for those employees in control of distributing risk products. According to a report by the International Corporate Governance Network, boards "failed to understand and manage risk and tolerated perverse incentives". Indeed, major weaknesses in bank corporate governance worldwide exposed a key flaw of the past few years; too many people simply failed to understand the risks linked to their companies' operations. These deficiencies raise
serious questions about the specific individual quality of the board of directors, its composition, training and qualifications. They also question the morality of those who participate in the direction and management of large companies, as well as their ethics and values. Certainly, this is a matter that cannot be taken too lightly, particularly in Cyprus. Although the Central Bank of Cyprus Directive highlights the importance of training, more practical steps are needed to improve individual directors’ skills, knowledge and overall quality.

By a similar token, leadership is key. Boards must be motivated to steer the company to meet its business purpose in both the short and long term. To assist in this goal, there should be a clearer division of responsibilities between the running of the board and the running of the company’s business. The chairman should be responsible for the leadership of the board and, crucially, no one must be allowed unrestricted decision powers. Formal and transparent procedures should be adopted for the appointment of new directors to company boards and directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. It is also vital that the board regularly evaluates its own performance as well as the performance of its committees and individual directors. Directors must dedicate a great deal of time in the fulfilment of their roles, otherwise they will be unable to comply effectively with their responsibilities; in this regard, they must ensure they regularly update and revive their skills and knowledge. Also significant, the corporate governance framework should promote transparency and be consistent with the rule of law. Weak disclosure and non-transparent practices, such as the ones that characterise the Cypriot corporate governance system, can result in unethical behaviour and to a loss of market integrity at high cost. The sufferers of this are not just the company and its shareholders but also the economy as a whole. As the OECD puts it, insufficient or unclear information hampers the capacity of the markets to operate, increase the cost of capital and result in a poor allocation of resources.

Instilling a culture of transparency in the governance practices of Cypriot companies will also help promote shareholder participation, a key ingredient in any healthy corporate governance system. In a climate where shareholders’ engagement is widely promoted in numerous countries in Europe and elsewhere, Cyprus’ failure to consider this issue is problematic. Countries such as the UK, the Netherlands, France, and the EU and the US, have taken steps to encourage more responsible ownership among investors. Corporate governance, possibly owing to the failure of alternative solutions to solve the “agency problem”, views shareholders as capable of engaging with companies and holding management to account for its performance. Shareholders, particularly institutional investors such as asset managers, pension fund trustees and custodians can play a constructive role in improving the governance of institutions and can help create a firmer and more effective financial system. Their participation should not be restricted only to voting; their continuous engagement and involvement has the potential to promote the long-term success of their institutions. They can add value not just to companies but also the economy as a whole, making their involvement on a range of matters, such as corporate governance, remuneration, strategy and company performance, to be of utmost significance. Since shareholders, particularly institutional shareholders, are viewed as the ideal market participants to articulate and defend company interests, they have the potential to positively contribute to the governance of Cyprus’ institutions. In attempting to repair the corporate governance failures that contributed to the financial crisis in Cyprus, steps to encourage shareholder engagement must therefore be deliberated. Although there are incentive problems and structural limitations to the promotion of shareholder engagement, there are certainly measures that can be implemented. For instance, legislation could support the creation of a two-tier ownership system that recognises two types of ownership based on the shareholders’ philosophy on investing: the passive investor who prefers not to engage with management and the active investor, who does so, and who is therefore rewarded accordingly. Such a system, which already exists in other countries in Europe and elsewhere, can help tackle short-term behaviour, a contributing factor to the global financial crisis.

There are a plethora of issues that require careful reflection in Cyprus. The principles of good corporate governance must motivate boards to do the right thing while encouraging a type of structure that promotes a proper direction and performance within a healthy corporate environment. To adhere to the spirit of corporate governance of great significance are its independence, effectiveness and capability of the board as well as the honesty and sincerity of mind with which various matters are deliberated and confronted by directors. Also, the boards’ relationship with other key company participants such as shareholders and management, as well as the levels of executive remuneration are crucial issues. Any attempt to improve corporate governance practices must not be regarded as wasting valuable time but more as a necessary evil. Certainly, to achieve good governance requires continuing and high quality effort because boards must think carefully and endlessly about the
implications of their decisions. To run a company effectively is not an easy task; to follow the true spirit of corporate governance to good effect is an ongoing challenge. Cyprus’ corporate governance must recognise this and act more dynamically to better its practices. Adopting more stringent corporate governance policies will also bring the country into line with most of its European counterparts.

To the extent that the financial crisis provides a persuasive justification for fresh rethinking, the question that remains is how best to accomplish that. Some might argue that the vacuum that exists can be only filled by the adoption of rigorous laws rather than by self-regulation and that a robust approach on the problems facing Cyprus’s corporate environment is exactly what the country needs. In the absence of changes in the legal framework, things will not improve. Importantly, legislative change will have a wider reach than the Central Bank’s Directive. In this setting, laws that stimulate and improve Cyprus’s corporate arena while protecting companies and investors should be enacted. On the other hand, there are advantages to a self-regulatory model; it is not as rigid as the statutory regimes and has the benefit of adaptability. In contrast to the mandatory rules that can be too inflexible and harsh, self-regulation allows companies to follow the spirit of a Code rather than the letter. Encouraged by the market downturn, companies and shareholders may rise to the challenge to use their powers responsibly, especially as recession turns to recovery. Nonetheless, whether a statutory reform is required in Cyprus is a matter that will form part of a considerable debate in the years to come.

Conclusions

From having a reputation for prudence and stability through conservative practices, Cyprus’ banking industry is now a case study on irresponsibility, incompetence and bad corporate governance. The collapse of Marfin Laiki Bank, which caused a national financial crisis and put the country into severe debt, epitomises the deficiencies analysed here; the banks’ ruin was preceded by long-term blatant breaches of corporate governance principles and outright political interference. This is unacceptable. The principles of good corporate governance must support meritocracy, accountability and transparency within boards; poor corporate governance practices, symbolised by government and political interference, can only generate problems for a country’s economy. A healthy corporate governance system must leave no space for unrestrained self-interest, absence of professionalism and reckless decision-making, sadly common features of the corporate world in the past few years.

What can be done? Boards’ independence must not be compromised by members receiving large bank loans on very privileged terms, by members having long-term working relationships within the same banking institutions and also by the majority of boards comprising largely of executive directors. Corporate governance recommendations must ensure that bank members do not have the ability to accept large bank loans on very privileged terms and that executives are prevented from retaining lengthy affiliations within the same bank; rather, a cap should be imposed on the number of years a person is permitted to remain a board member and/or hold the position of chairperson. Also, boards must have a sufficient number of non-executive directors, whose role is to challenge boards effectively while helping companies fulfil their strategic direction. In certain institutions it might be desirable to have a majority of non-executive directors (provided they are truly independent), but flexibility ought to be retained to permit companies to be structured in a way that best suits their circumstances. The “revolving door” phenomenon, as well as the excessive “golden handshake” payments, two further complications of Cyprus’ corporate governance system, cannot continue to characterise it. The scale of basic pay and the appropriateness and levels of the bonuses also need serious deliberation, particularly since, on occasion, executives’ management style can resemble that of gamblers. A proper and efficient governance system will enable boards and auditors to realise what is going on long before an institution’s eventual demise. A disregard of fundamental corporate governance standards and policies, coupled with the absence of central principles such as openness, honesty, transparency, trustworthiness and accountability, can otherwise lead to the ultimate downfall of institutions. It can also increase corruption, resulting in the absence of accountability on public funds.

The prevailing corporate ethos of the Cyprus banking sector is weak for another crucial reason: political party affiliations and nepotism matter a lot in such a closed network culture. Merit is regularly pushed aside, overshadowed by nepotism and political connections. This significantly compromises boards’ independence. Against the backdrop of the impact of the international financial crisis on the Cyprus economy and the gross mismanagement of the national economy by the government, this
culture of nepotism and deference is believed to have accelerated the collapse of the banking sector, bringing Cyprus to the brink of financial catastrophe, only averted by the Eurogroup bail-in. When a particular industry is crucial to a country’s economy, as the banking sector has been to Cyprus, it becomes crucial to protect that industry. By developing good governance practices, shareholders benefit and institutional investors are happier to pay a premium for shares in well-governed firms. Corporate governance failures in Cyprus demonstrate the need to improve its procedures and mechanisms. Therefore, investing in good corporate governance is imperative if the country is to avoid a future financial catastrophe. Herein lies a salutary lesson for other countries in Europe and elsewhere.

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J.B.L. 2015, 4, 361-382


30. Justice Pikis is an ex-Supreme Court president and ex-International Criminal Court (Appeal Division) judge.

31. The report is henceforth referred to as the Pikis Report.


The matter of corruption is a matter currently being deliberated in court.


This is the view shared by many executives in Cyprus, as found by a study conducted by Krambia-Kapardis: M. Krambia-Kapardis, "Women on Boards: Dichotomising the Glass Ceiling" (2007) 3 Corporate Board Journal 34.

See Krambia-Kapardis, "Women on Boards" (2007) 3 Corporate Board Journal 34.


It is important to note the distinction between nepotism, cronyism and favouritism. "Favouritism" is the widest of the terms and refers to partiality on the grounds that someone is part of a favoured group (as opposed to relying on the job performance of that person). The term "nepotism" refers to partiality to family members, whereas "cronyism" relates to partiality to friends or associates.

For example, the OECD report notes that "CEO remuneration has not closely followed company performance’ with one study reporting that the median CEO pay in S&P 500 companies was about USD 8.4 million and had not come down at a time the economy was weakening". It also noted that executive pay is upwardly flexible, which means that it is characterised by an upside risk without much downside risk: OECD, "The Corporate Governance Lessons from the Financial Crisis" (2009), p.12.


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88% of the respondents believe that main reason for the existence of corruption in Cyprus is because politicians are not doing enough to combat it.

Independent Commission on the Future of the Cyprus Banking Sector.


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Independent Commission on the Future of the Cyprus Banking Sector, Interim Report (June 2013), p.27.

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77. As shown from the examination of the four key issues discussed in this article, which bring together the main causes of Cyprus’ financial crisis from the perspective of corporate governance.


81. As stated by Sir John Egan, the chairman of the ICSA Steering Committee, UK: R. Sullivan, “Good Chair is Key to An Effective Board”, Financial Times, August 1, 2010, p.2.

82. Cyprus Companies Law (Cap. 113) (September 2012), http://www.fbscyprus.com/assets/mainmenu/646/docs/The%20Cyprus%20Companies%20Law%20EN.pdf [Accessed March 31, 2015]. The law relating to registered companies is governed by the Cypriot Companies Law, Ch.113 (Cap. 113) of the Laws of Cyprus, as amended (the Companies Law), which is almost identical to the UK’s former Companies Act 1948. According to Cap. 113, a company cannot engage in banking, insurance or the provision of financial services to the public unless special permission is granted.


102. The UK represents the most detailed initiative to date to develop a Code which imposes new responsibilities on the investor and investee communities, promoting the belief that institutional investors are part of the solution, not part of the problem. The UK Stewardship Code is a significant attempt to redress the balance in the corporate governance matrix. Moreover, the Netherlands, France, the EU and the US are all hoping to encourage more responsible ownership among investors: Arsalidou, "Shareholders and Corporate Scrutiny" (2012) 9 European Company and Financial Law Review 342.


104. Such as the Sarbanes-Oxley Act in the US.


107. As shown by the events that took place in the two major banks in Cyprus, namely Marfin Laiki Bank and the Bank of Cyprus.