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‘*The Cyprus Debacle: Implications for the European Banking Union*’

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The Cyprus Debacle: Implications for the European Banking Union

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The Cyprus levy plan has been described by some officials as a bleak day for banking Union - the grand and unfinished project to shore up the Eurozone through a single supervision, resolution and deposit insurance system. The most immediate effect is on the credibility of the deposit insurance regime, that is the promise to protect savings under 100,000 Euro that the EU rushed through to build confidence after the 2008 crisis.(Financial Times March 18 2013)

1. Introduction

The events of March 2013 made Cyprus a household name around the world. The haircut of deposits in the country's two largest banks was unprecedented in conception and scale and had a huge impact on the island's economy. Such events can be traced back to market distortions and inefficiencies over a number of years and to various actions by many players, which created the collapse of the economy. The collapse is spectacular for an economy, which withstood the impact of the Turkish invasion back in 1974, which displaced a large part of the population, and recovered to become a thriving economy again in subsequent years. Since its recovery from the Turkish invasion and until the start of the crisis, the average rate of GDP growth had been 4% and the unemployment rate 3.5%.[1]

The purpose of this chapter is first to discuss the events of March 2013, second to put these events in a broader historical perspective, concentrating on the economic developments in Cyprus, especially those related to the banking sector and finally to discuss the crisis and its resolution in relation to the European Banking Union. The whole issue is multifaceted, but the emphasis of this chapter will be on the banking sector.

2. The events of in March 2013

In March 2013, after 30 years of uninterrupted economic prosperity on the island, economic growth came to an end. The problems however started much earlier. In May 2011 Cyprus was cut off from international markets. This marks the start of the Cyprus crisis. More than a year later, in June 2012 the Government applied to the International Monetary Fund-European Commission- European Central Bank (IMF-EC-ECB, the "troika") for assistance. Cyprus was unique in that it refused to finalise a memorandum of understanding (MoU) after it asked for assistance. In contrast Spain, which also asked for assistance on the same day completed its agreement 3 weeks later, on 20th of July 2012. Cyprus on the other hand agreed a programme 271 days afterwards, when a new government was elected.[2] This delay by the communist government to avoid short-term political cost before the election in February 2013 made the crisis deeper and the impact on the economy more severe.

It was only on the 16th of March 2013, Nicos Anastasiades, the President of Cyprus, of the newly elected right wing government and the Eurogroup agreed a rescue plan which would include the bail-in of uninsured and insured depositors in all Cypriot financial institutions. The bailout Cyprus needed to cover government debt expiration, projected government deficits

[1] For a historical overview of the Cyprus economy see Orphanides and Syrichas, 2012.

[2] The communist Government secured a bilateral loan from the Russian government that allowed it to circumvent its inability to access markets and postpone meaningful negotiations until after the election of February 2013. This side-tracked attention from sorting out the deteriorating fiscal balances. The government even ignored the repeated ECB warnings about its fiscal imbalances.

and financial system support was calculated to be €17 billion, out of which the €7 billion were for the recapitalization of the financial sector. The Troika were willing to fund €10 billion, which was relatively big for the size of the economy (56%of GDP in 2012).[3]

Troika's willingness to fund only €10 billion rested on two reasons. First, Germany and other Eurogroup countries believed that a high proportion of the banking sector's deposits belonged to wealthy non-EU depositors, attracted to Cyprus by the high interest rates paid by the banks. Since these depositors were receiving 3-4% higher interest for a few years (inflation was also higher than in these other countries, implying that some of the differential was justified), it considered justified for the depositors to contribute to the recapitalisation of the banks. Secondly, the IMF would not participate in a programme that would result in the debt of Cyprus becoming unsustainable. The Cyprus banking system was much larger than the country's GDP, and was funded by depositors (€66.7 billion) and made up 71% of the liabilities. 40% of the deposits belonged to Cypriot residents, 34% to non-residents domiciled in Cyprus, 19% to residents from Greece, 2% to residents from Russia and 5% to the rest of the world.[4]

Thus, Cyprus had to find the €7 billion needed for the banking sector from its own resources. The Cyprus government suggested plans, such as to have pension funds contributing to the funding gap, that would avoid the bail-in of depositors, but on the 15th March it was made clear to the Cypriot delegation that only proposals where depositors would be affected would be considered.

Junior bond holders would lose €1.2 billion but there was disagreement how to raise the remaining 5.8 billion from the depositors. An agreement was reached where an across the board shares for deposits swap on all depositors of all banks was agreed upon, in order not to have a bail-in above 10 % of any depositor. That implied that all Cypriot financial institutions were going to be affected. Depositors with over €100,000 would have 9.9% of their deposits converted into shares of the troubled institutions that would have received their deposits in order to recapitalise. At the same time, insured depositors would have 6.75% of their deposits similarly affected.

The Eurogroup immediately regretted its decision to bail-in even insured depositors and the Eurozone was only saved embarrassment because the bailout was rejected by the Cypriot Parliament. However, the damage had been done that insured depositors were not safe. Small depositors should not expect to believe that their savings are safe from overnight taxes to avert bank collapse.

While a deal was negotiated the banks in Cyprus remained closed to avoid bank runs. The economy of Cyprus was transformed into a cash only exchange economy as no one was allowed to withdraw more than €300 a day from ATMs.[5] The banks opened again on the 25th of March, after a 12 -day banking holiday, when a deal was agreed with an increase of the

[3] For an account of the events in March 2013 see Apostolides, 2013.
[4] See PIMCO, (2013).
[5] That implied that a Cypriot Euro was not the same as a German, or a Dutch Euro as they could not be freely exchanged via the banking system, a contradiction to the idea of a Banking union.

bailout amount from 17 to 20.6 to take account of the impact on the economy caused by the capital controls. Further capital controls had been imposed to prevent capital flight.[6] The new deal required Cyprus to bail-in the uninsured depositors of the two largest banks on the island, Marfin-Laiki Bank and the Bank of Cyprus (BOC). It was decided not to close down either of them but to restructure them instead. Marfin-Laiki's insured depositors would be transferred to the BOC, along with all the performing assets. The uninsured depositors of Marfin-Laiki were bailed-in and would become the shareholders of "bad Marfin-Laiki", which had an undisclosed amount of non-performing assets. In the process Marfin-Laiki shareholders and junior bondholders were wiped out.

The BOC would partially bail-in uninsured depositors at an unknown percentage, take the insured depositors and good assets of Marfin-Laiki. The BOC Board refused to sign and the Bank was taken over by the Central Bank of Cyprus (CBC) who sacked the Board. CBC initially cancelled all shareholders, but reversed its decision after the local courts put a halt to the proceedings, questioning the legality of cancelling existing property rights. The CBC responded by creating 4 categories of shares, placing the new bailed-in shareholders in the first category, with junior bondholders and existing shareholders in lower categories. Several individual cases have been filed to the Supreme Court, as well as to the district courts claiming that the bail-in is unconstitutional. Cyprus, has followed the British legal system as an ex British colony, and had adopted the common law system, which respects property rights and protects minor shareholders.

The new deal also entailed the sale of Cypriot bank branches in Greece. The bank branches of all Cypriot banks, irrespective of whether they were in trouble, were to be sold to Piraeus bank in Greece, by the order of CBC. The deal was very bad. CBC sold 16 billion of assets for a mere 0.525 billion, which was effectively funded by the Hellenic Financial Stability Fund [HFSF]. Cyprus had to recapitalise the Greek branch losses prior to the sale, which was estimated just for Laiki to be 2.8 billion. Thus Cyprus was obliged to cover the liquidity gap created by the withdrawal of Greek deposits from Cypriot banks, despite being guaranteed on Greek assets, which were in any case sold. Marfin-Laiki executors refused to sign, so CBC signed on their behalf.

Troika insisted on the sale of the Cypriot branches in Greece to cut off any channel of contagion to the rest of the Eurozone. Depositors in Greece avoided the bail-in, but at the same time Cypriot depositors were to be bail-in much more as a result.

3. Historical developments in Cyprus prior to the crisis

The above bailout conditions together with an array of additional conditions to consolidate fiscal balances to enable Cyprus to service its loans left Cyprus to face an unprecedented economic recession, and a banking system in disarray. The European Commission estimated a cumulative fall of nominal GDP to be of 15% over three years, while the IMF suggested a fall of more than 12% in 2013 alone. In this section we will provide a background to the

[6] The imposition of capital controls contravened the premises of free capital movement in the monetary union.

deterioration of the fiscal balances and the developments of the banking sector, which led to the twin fiscal and banking crises.

3.1 Public finances

Cyprus had historically sustained a fiscal deficit, which reached 6.5% of GDP in 2003, while its public debt rose to 70% of GDP following a major tax reform in 2003. However, Cyprus in order to meet the criteria for entry into Euro adopted a policy of fiscal discipline, which resulted in reversing the deficit into a surplus of 3.5% and reducing debt to GDP to 48.9% by 2008. This improvement was however due to a tax amnesty and capital gains tax from real estate transactions, which were high due to the real estate bubble.[7]

In 2008, the new government, which was positioned politically to the extreme left embarked on a spending spree, with rapid increases in social spending and government employees, which together with a fall in tax revenue resulted in cumulative deficits over the period 2009-2013 of about 30% of 2013 GDP.[8] The generous increases in pensions and other retirement benefits without taking steps to ensure their funding generated serious sustainability concerns. The deterioration of fiscal imbalances eventually led to the government to lose access to the international markets in May 2011.

3.2 The financial system

The problems of the banking sector had their roots in the protected environment of the past, before Cyprus joined the European Union. Cyprus had a tightly controlled and profitable banking system, which supplied the economy with sufficient credit. It was stable, and had not experienced any major crises in the commercial banking sector (apart from the co-operative sector crisis in the early 1980s). The allocation of credit was not however, optimal. Interest rate regulation encouraged lending on the basis of collateral value and personal guarantees.[9] Thus, credit went to sectors, where collateral was available. So Cyprus overinvested in real estate, which was amenable to collateral and underinvested in machinery and equipment, which are important factors to economic growth. Personal loans took over-increasing share of the credit. Cyprus private sector credit as a percent of GDP rose to 298%, in 2011, only surpassed briefly by Iceland in 2006.[10] Local institutions not being able to compete on price adopted non-price competition through the provision of quality of service and extended branch network. They became inefficient, with little expertise in project appraisal and risk

[7] For a detailed review of the public finances See Zenios, 2013.
[8] It should be noted that in July 2011 there was an explosion, which destroyed the island's largest power station and half of its electricity supply with a catastrophic impact on the economy and the rate of unemployment, adding to the deteriorating economic situation.
[9] See Phylaktis 1995 for a comprehensive history of the banking system in Cyprus from its inception in the 19th century to the mid-1990s; and Clerides, 2014 for developments in more recent times.
[10] World Bank Data.

management, which were very important skills when the financial environment became open with Cyprus accession to EU and the Euro.

The integration of Cyprus into the Eurozone facilitated significant growth in professional services activity in Cyprus during the 2000's, which helped Cyprus emerge as a leading regional provider of international banking services, along with related accounting, legal and other professional services. This was accompanied by rapid growth of foreign financial flows, which in turn led to substantial expansion of the balance sheets of the Cyprus Banks. Total assets of the Cyprus banking sector stood at €143bn in March 2012, while the GDP was €17.8 bn.[11] As a result the banking system became far greater than the monetary authorities ability to monitor and support it.

The substantial capital inflows financed Cyprus current account deficit, which had deteriorated to an average of 10.5% of GDP for the five year period prior to the crisis from an average of 5.7% of GDP in the previous 10 years - making Cyprus vulnerable to a reversal of inflows at times of global uncertainty. This capital was not directed towards productive investments and continued to go into consumption and real estate investment. The result was the development of a property bubble especially in the period 2006-2008, which burst eventually with the global economic crisis.

The more open environment encouraged the banks to become more outwardly oriented institutions, expanding their operations in Greece and other countries. When the Greek economy run into problems a year later, it gave a huge blow to the Cypriot banks' exposure in Greece. Holders of Greek government bonds sustained large losses through the private sector involvement, (PSI). The Cypriot government did not attempt to ensure that the losses of the Cypriot banks would be accommodated, which amounted to 3.5 billion. Naively it was believed that the Eurogroup would not take kindly the bailout on banks which speculated on such bonds. The restructuring of the Greek debt in October 2011, created a disproportionately large burden for the Cypriot banks relative to other member states in the Euro area. The impact of PSI as a percent of GDP was 23% for Cyprus, compared to 12% for Greece and 0.14% for Germany.[12] The decision created an additional capital requirement of about 25% of Cypriot GDP for the Cypriot Banks. The two banks had extra capital requirement to cover 15% of GDP. For the remainder the banks, especially the second largest bank, Marfin-Laiki needed the temporary support of the sovereign. However, the sovereign could not provide that by issuing long-term public debt as it had lost market access. This was the beginning of the problems, which led to the crisis in March 2013.

The blow was magnified by the failure of the Cyprus government to act promptly to the oncoming crisis, [13] and the failure of the CBC to control the deteriorating financial position of the banks.

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[11] PIMCO, 2013.

[12] Zenios 2013, which was based on calculations by the EBA.

[13] For an account of the government's inertia to act promptly to the deteriorating banking situation, which aggravated the situation see Orphanides (2014).

The Cyprus banking sector had total liabilities of about 800% of GDP and was dominated by two banks, which were "too big to fail" and too big "too save". At the same time, the Cyprus authorities did not realise the risks of running a big banking industry, paying insufficient attention to the fact that the banks were acting imprudently and how potential shocks may be handled. They gave low priority to monitoring banking risks and supervising the banks.[14]

4. What insights does the Cyprus crisis hold for the European Banking Union?

The European Banking Union has three pillars, the Single Supervisory Mechanism (SSM), Bank resolution and deposit insurance. Progress has somewhat been made with regard to SSM with the ECB beginning its role as a supervisory authority by starting an asset quality assessment review of European Banks. However, progress has not been made with regard to the other two pillars in spite proposals by the EU Commission.

The Cyprus crisis brought to light two issues, which have implications for the formation of the European Banking Union, which need to be addressed. Firstly, the EU banking sector, has become interconnected as banks have found it easy to expand their operations across countries, so that problems in the banking sector of one country can spill over to other countries, making national banking supervision ineffective; and secondly, the link between the sovereign and banking risks, which increases the risk for a country to sustain a crisis.

4.1 Interconnected Banking sector

The Cypriot banks having outgrown the Cyprus market, expanded to Greece and other countries. The two biggest banks had large exposures to both the Greek public and private sectors on their loan portfolios. According to S&P Total exposure to Greece of BOC and Marfin Laiki was 30.4 billion Euro, or 168% of GDP. It should be noted that both of these banks are domestic implying that national authorities will bear the support in the event of a crisis.

The problems in the banking sector and generally in the economy of Greece highlighted how easy it is for problems to spill over to another country. In addition it highlighted the difficulties that a national supervising authority will have in supervising its banks in such an environment, due to either inexperience, or frictions between the Central Bank and the government (Ministry of Finance). It seems that the national supervisory authority of Cyprus, the CBC made several mistakes, actual or perceived, which either contributed to the crisis, or failed to stop it. The major mistake was to allow the banks to pay above market interest rates than the rest of the Eurozone members, which attracted huge deposits and boosted the growth of the banking sector. The banks then invested the funds in high yielding Greek bonds, which carried zero-risk weight against capital for regulatory purposes but in reality were very risky. There was failure on the part of the Cyprus authorities (Ministry of finance and CBC) to understand the risks of running a banking sector, which was 8 times the size of the economy.

[14] Independent Commission on the future of the Cyprus Banking Sector, 2013.

As early as 2006, the IMF raised warning lights about the inadequate financial sector supervision and regulation. It recommended an expansion of supervisory resources, an enhancement of supervision skills, supervision of banks' internal risk systems and models, and a strengthening of cross-border supervision arising from bank expansion. The IMF recommended that CBC should consider requiring banks to set formal limits for country risk.[15]

However, the most controversial issue with regard to the crisis relates to the CBC's treatment of Marfin-Laiki and to the Governor Panicos Demetriades' policy of allowing Marfin-Laiki to stay operational by providing it with Emergency Liquidity Assistance (ELA) while the Bank was insolvent. The CBC, with ECB agreement, provided 9.8 billion of ELA by June 2012.The holes in the balance sheets of the Cypriot banks had however become obvious as far back as 2011 when the Greek sovereign debt was restructured. There is little doubt that Marfin-Laiki was insolvent by the end of 2012.[16] If that is the case, then the continued provision of ELA by the CBC was in violation of the ECB rule that an institution receiving ELA must be solvent. The governor supported his view by saying that he was expecting the government to agree a programme quickly.[17] As it has been mentioned earlier an agreement was only signed when there was a change of government and after 271 days of approaching the European Commission for assistance.

Thus, the need for a single supervisor, not captured by local interests is underlined. Had there been a supra-national supervision system the crisis might not have taken place. A SSM with the ECB at the centre and responsible for the health of all major banks, or indeed all banks including smaller ones within the EU would have been able to intervene early on and perhaps not allow the high interest rates, which encouraged the growth of the banking sector.

Furthermore, had there been a Single resolution mechanism, which would govern the resolution tools to banks within the banking union, the crisis might not have been averted but it might have been less deep. The problems of the Cypriot banks became obvious in 2011 when the Greek sovereign debt was restructured, but given the political inertia of the Cyprus government to do something about it and the lack of resources to undertake any restructuring, the problems were not assessed until it was too late. Had there been a Eurozone wide resolution authority with the necessary powers and resources the intervention could have taken place earlier, with less economic costs. As it happened the ECB found itself injecting money to keep insolvent banks alive since the Cyprus government was unwilling to resolve the failing banks due to the forthcoming election.

4.2 The link between the sovereign and banking risks

[15] IMF report Country Report, 2006.

[16] Although it is not easy to establish when Laiki became insolvent, it seems that in response to a request for an opinion on the government's plan for recapitalising Laiki, the ECB stated in July the 2nd 2012 that "the objectives pursued by the support measures may be better achieved through bank resolution tools". See Clerides 2014.

[17] According to Orphanides, 2014 the governor explained the rationale for his decision in an interview on 26th March 2013 as follows: "This was not something pleasant, but we had to sustain the bank. It was required to sustain the bank in order for the elections to take place, a new government to come to power, take its decisions, reach an agreement with our European partners, to avoid bankruptcy of the bank and the state.

The second insight that the Cyprus crisis has highlighted with regard to the establishment of a viable European Banking Union is the implications of the close ties between sovereign and banking risks. According to Angeloni and Wolff, 2012, there was a high positive correlation between sovereign and bank credit default (CDS) during 2011 for a number of Euro area countries, both periphery and stronger economies, such as France and Germany.

Evidence shows that banks of the European periphery have been investing more heavily than before in domestic government bonds. The banks in the Eurozone have been doing that because of the zero risk weights for governments bonds on their balance sheet within the EU. The proportion of sovereign debt that was held by the banks in EU in the form of the country's own bonds was on average close to 60% and has been particularly higher for banks of troubled sovereigns – Greece, Ireland, Spain, Portugal and Italy).[18]

During a crisis this link between sovereign and bank solvency deepens as the economy falls into recession, worsening the government's fiscal balance and increasing sovereign risk, which in turn puts pressure on the balance sheet of banks that hold government bonds but also depend on the same government for possible recapitalisation.

This is exactly what happened in the case of Cyprus. In 2008 when the new government was elected and embarked on a spending spree, fiscal balances deteriorated and the debt to GDP gradually increased from 48.9% to 71% by 2011. This led to a series of sovereign credit rating downgrades,[19] and as a result the Cyprus government lost access to the international markets in May 2011 and the ability to support the banks. This obliged the government to borrow short-term, with the result that 71% of total debt was maturing during the period 2013-2016. It should be noted that part of the short term borrowing was through the use of Euro Medium Term Note (EMTN) - 3.5 billion- which had a hard deadline and delays to repay it would have led to default. Thus, the newly elected government in February 2013 had no choice but to agree with Troika and the Eurogroup a programme.

The Cyprus case has highlighted another implication of the link between sovereign and banking solvency. It has shown that when the solvency of the sovereign is in doubt, depositors lose faith in a deposit insurance scheme, and start withdrawing their deposits, thus defeating one the main objectives of a deposit insurance, which is to prevent bank runs. That was the idea behind the increase of deposit insurance limits across the Eurozone to €100,000 following the global financial crisis. The lack of confidence can only be overcome by a Eurozone wide deposit scheme, whose credibility will depend on having the ability to cope with large scale banking failures. National deposit insurance schemes are typically designed for idiosyncratic bank failures not for systemic crises, where public funding is required. The credibility of the public backing depends on whether the sovereign is solvent.

Unified deposit guarantee scheme will have many benefits. It will ensure that decisions that are taken at the supranational level affect depositors in all countries in the same way. Thus,

[18] Acharya, Drechsler and Schnabl, 2012.

[19] S&P downgraded Cyprus from "A" in March 2011 to "CCC" in 2013.

depositors would be treated in a uniform way across countries, independently of their location and the location of the bank with which they have entrusted their savings.

This issue of the link between sovereign and banking solvency needs to be addressed because in the long-term it increases the risks and the links between banks and sovereigns (Acharya et al 2012). This will put the currency Union on a more sustainable footing.

5. Conclusion

The Cypriot crisis has underlined the need for a supra-national supervision system, a Eurozone –wide resolution mechanism and for a Eurozone-wide deposit insurance scheme. We have outlined what would have been different if these pillars of the European banking union were in place.

One might say that the Cyprus crisis originated with the adopted business model for the banking system. The significant expansion of the Cypriot banking system and of the big domestically-owned banks in particular, has been part of the broader objective to promote the island as an international business centre, contributing to the growth of the financial services sector, to employment and GDP. The main problem was that the banking sector and the two biggest banks were too big for the economy, carried systemic risk and were domestically owned requiring the support of the national authorities in case of crisis. The CBC failed to understand the importance of supervising and monitoring more closely such a big banking sector and its cross-border activities.[20] The sovereign failed to understand the importance of strong macroeconomic fundamentals when adopting such model. In addition party political considerations came in the way. As Beck et al, 2013 have shown a large financial system might stimulate growth in the short-term, but comes at the expense of higher volatility. Furthermore, a recent study by Sahay et al, 2015 on the relationship between financial deepening and growth finds that when financial development proceeds too fast, deepening financial institutions can lead to economic and financial instability as it encourages greater risk-taking and high leverage, if poorly regulated and supervised.

Although there were many issues with the business model of the Cypriot banking sector, the banks' approach of pursuing deposit-funded balance sheets were the envy of many banks around the world after the Lehman Brothers collapse. The banks realising that in times of crisis bond markets dry up, leaving long-term lending commitments potentially unfunded, tried to boost deposits as their core funding mechanism. The drive has been underpinned by policymakers who have endorsed the push for deposits. In addition, to the EU's pro-deposit stance there has been a clear favouring of deposit funding by regulators around the world. The Basel Committee on Banking Supervision, which oversees global bank rules on liquid finance reserves, made it clear in January 2013 that it thought deposits were far less likely to flee in times of trouble than earlier drafts of the rules predicted, and as part of the Basel III package of reforms will require lenders to increase their highest-quality capital — such as equity and cash reserves — gradually from 2 percent of the risky assets they hold to 7 percent by 2019.

[20] Several studies at the time raised these issues. See Stefanou (2011a and b).

The business model for the banking sector was already in place in 2004 when Cyprus joined the EU and in 2008 when it joined the Euro. Had there been a European Banking Union along proposed lines in place during that time there might have been greater scrutiny when Cyprus joined the EU and recommendations would have been made on how to put the banking sector on a better footing. The proposed European Banking Union has come too late for Cyprus.

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