

11 July 2018

Conference on Banking Regulation, Competition
and Risk, Brunel University, London

Regulatory and Resolution Lessons from the Cyprus crisis



Panicos O. Demetriades
University of Leicester

March 2013: Cyprus and Euro at breaking point

- ❖ 16 March 2013: Eurogroup agrees unprecedented deposit levy
- ❖ 19 March 2013: Cypriot parliament votes NO to the levy
- ❖ 21 March 2013: ECB announces ELA decision for Cypriot banks
 - ❖ Cyprus facing sovereign default, financial meltdown and exit from Euro, unless programme agreed by 25 March 2013
- ❖ 25 March 2013: Revised programme agreed by Eurogroup, involving resolution of Laiki and BOCY and bail-in of uninsured deposits
- ❖ Presentation draws on “A Diary of the Euro Crisis in Cyprus: Lessons for Bank Recovery and Resolution”
 - ❖ Book documents the events of March 2013 in detail but starts from 3 May 2012 and documents all the events until 10 April 2014
 - ❖ Today’s presentation draws mostly on chapters 17 and 18

Ingredients of the crisis

- ❖ Significant economic and political ties with Russian Federation (account for large capital inflows) => Large size of banking system: 953% of GDP (June 2010)
 - ❖ Six domestic banks accounting for 601% of GDP (June 2010)
 - ❖ Size of two largest banks: 4 times GDP (TBTF and TBTS)
 - ❖ 35 Foreign banks (5 subsidiaries of EU banks and 3 subsidiaries on non-EU banks)
 - ❖ Rapid credit growth (24% p.a. during 2005-2010) with large exposure to real estate
 - ❖ Large and poorly supervised credit cooperative sector (94 local coops)
 - ❖ Cypriot bank branches in Greece = 140% of Cyprus GDP
 - ❖ Large investments of big-two in Greek Government Bonds (33% of GDP)
- ❖ Public debt to GDP: 71% of GDP (Dec. 2011, 11th highest in EU)
- ❖ Private debt to GDP: 286% of GDP (Dec. 2011, 3rd highest in EU)

Banking sector assets (million euro)

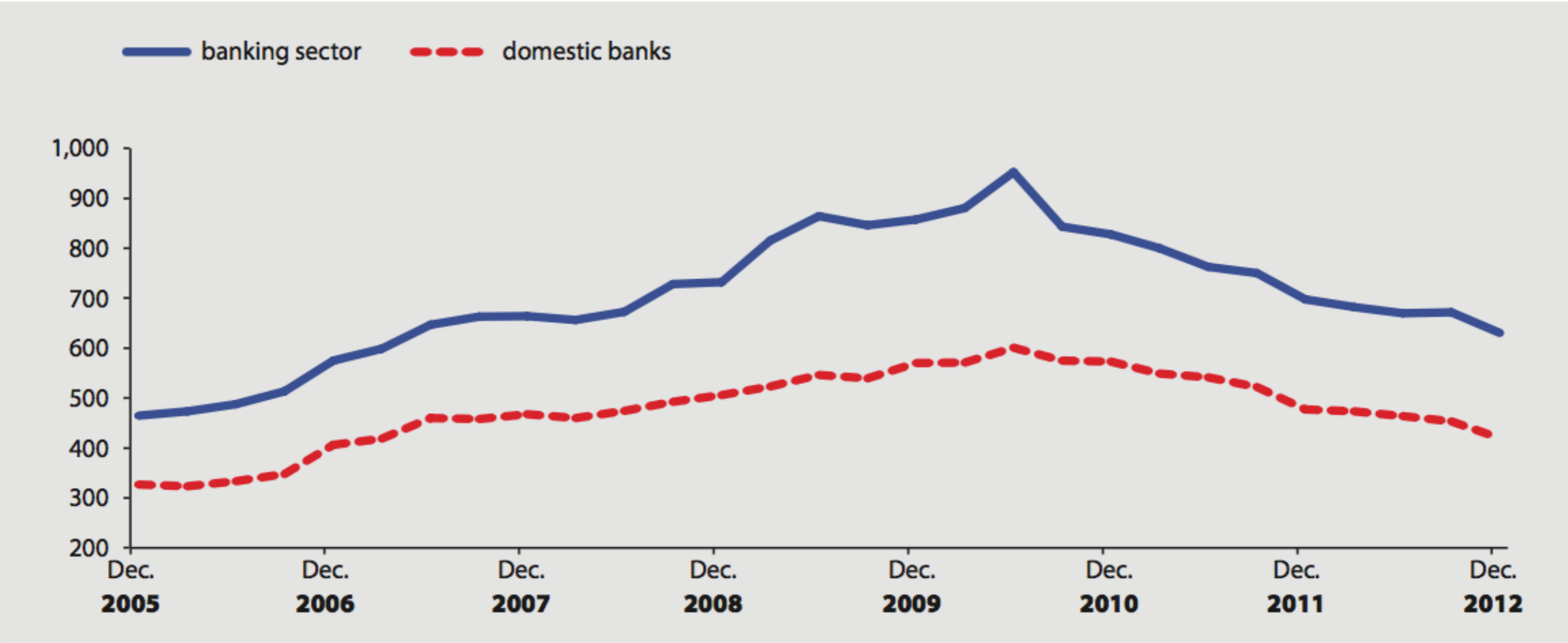
	Cyprus		Overseas		Total	
	2005	2011	2005	2011	2005	2011
<i>Domestic banks</i>	34.960	64.306	15.720	34.444	50.680	98.750
<i>of which</i>						
- 'Big 3'	23.739	45.072	15.720	34.444	39.459	79.516
- Coops	9.068	16.214			9.068	16.214
<i>Branches of foreign banks</i>	3.571	8.264	--	--	3.571	8.264
<i>Subsidiaries of foreign banks</i>	14.897	38.457	--	--	14.897	38.457
<i>Total</i>	53.428	111.026	15.720	34.444	69.148	141.170

European rankings by assets/GDP

Number	Bank	Bank assets/GDP
1	<i>Bank of Cyprus Group</i>	211.1%
2	<i>Cyprus Popular Bank Group</i>	189.7%
3	<i>ING Bank</i>	176.7%
4	<i>Nordes Bank Finland Group</i>	152.5%
5	<i>Rabobank</i>	128.4%
6	<i>Dexia</i>	111.6%
7	<i>Bank of Valetta</i>	110.2%
8	<i>Banque et Caisse d'Epargne de l'Etat</i>	101.4%
9	<i>HSBC Malta</i>	100.3%
	<i>National Bank of Greece</i>	67.9%
	<i>Eurobank</i>	57.0%
	<i>Alpha Bank</i>	36.2%
	<i>Piraeus Bank</i>	26.3%

FIRST INGREDIENT OF THE CRISIS: RAPID FINANCIAL DEEPENING

Figure 6: Total consolidated assets of the banking sector as a percentage of GDP

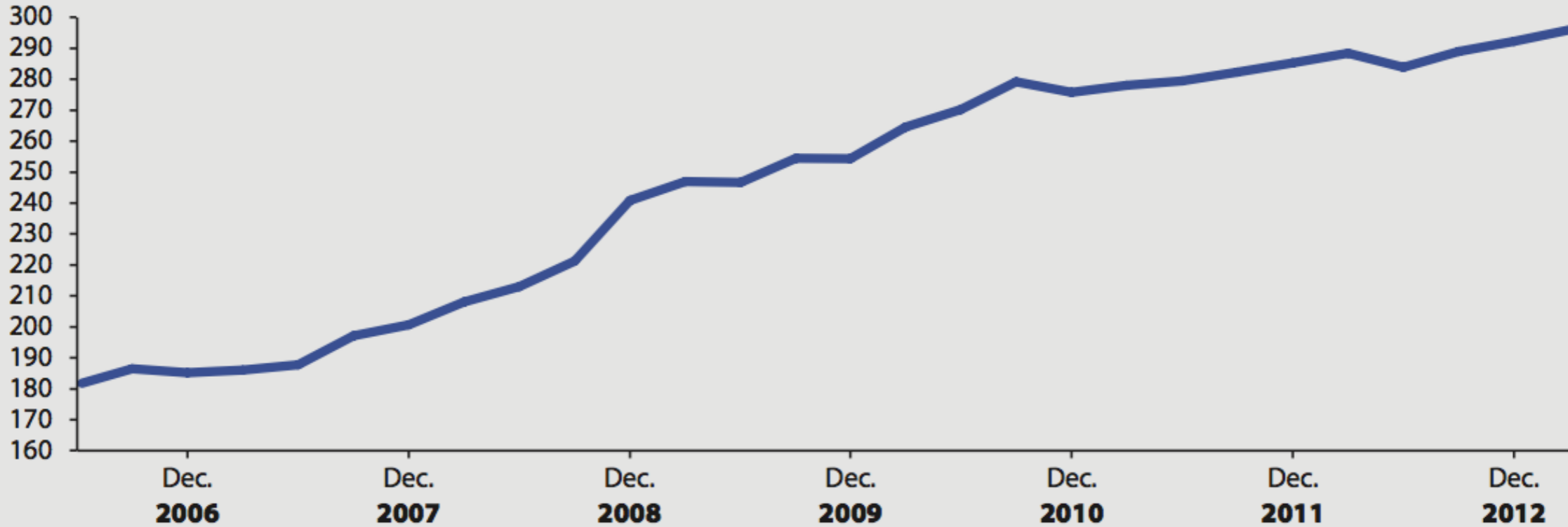


Source: CBC.

SECOND (RELATED) INGREDIENT: RAPID GROWTH OF PRIVATE CREDIT



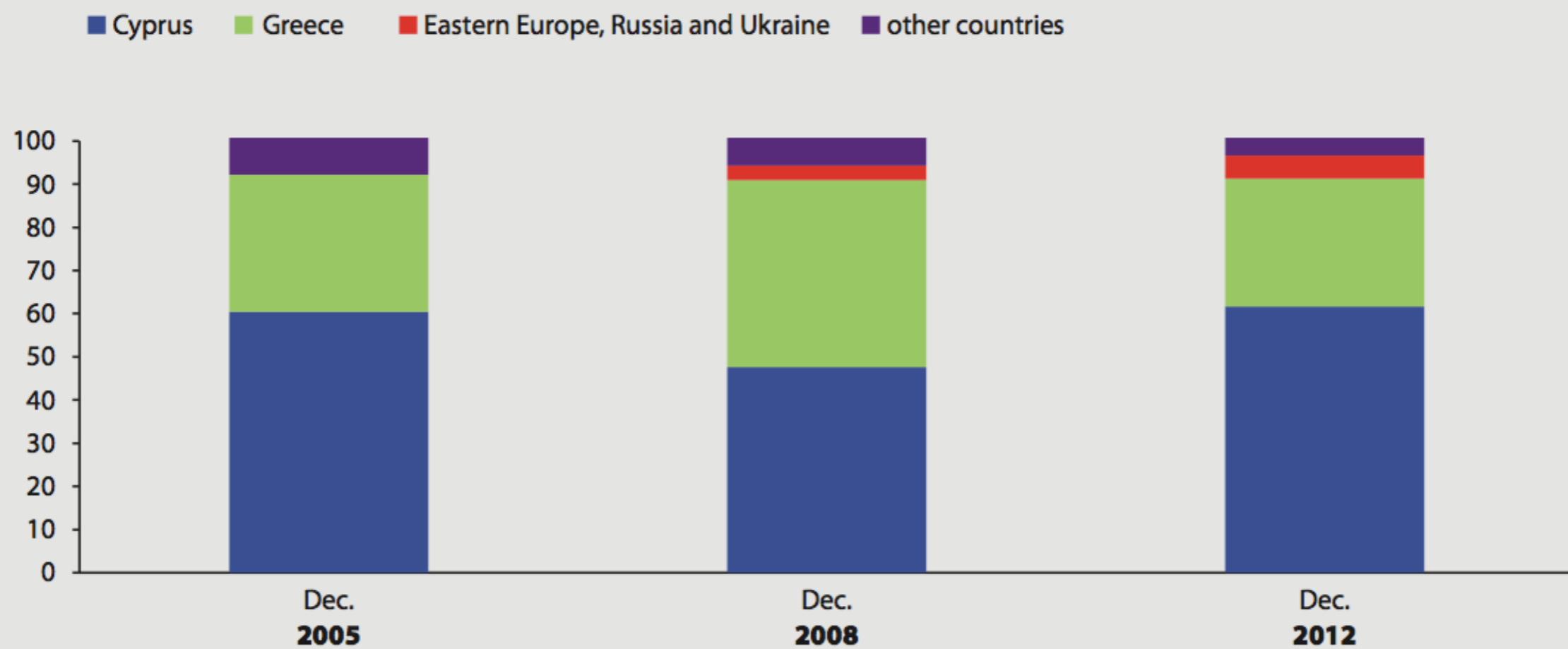
Figure 7: Bank credit to the private sector as a % of GDP



Source: CBC.

THIRD INGREDIENT: EXPOSURE TO GREECE

Figure 5: Asset allocation of the three Cypriot banking groups by country (%)

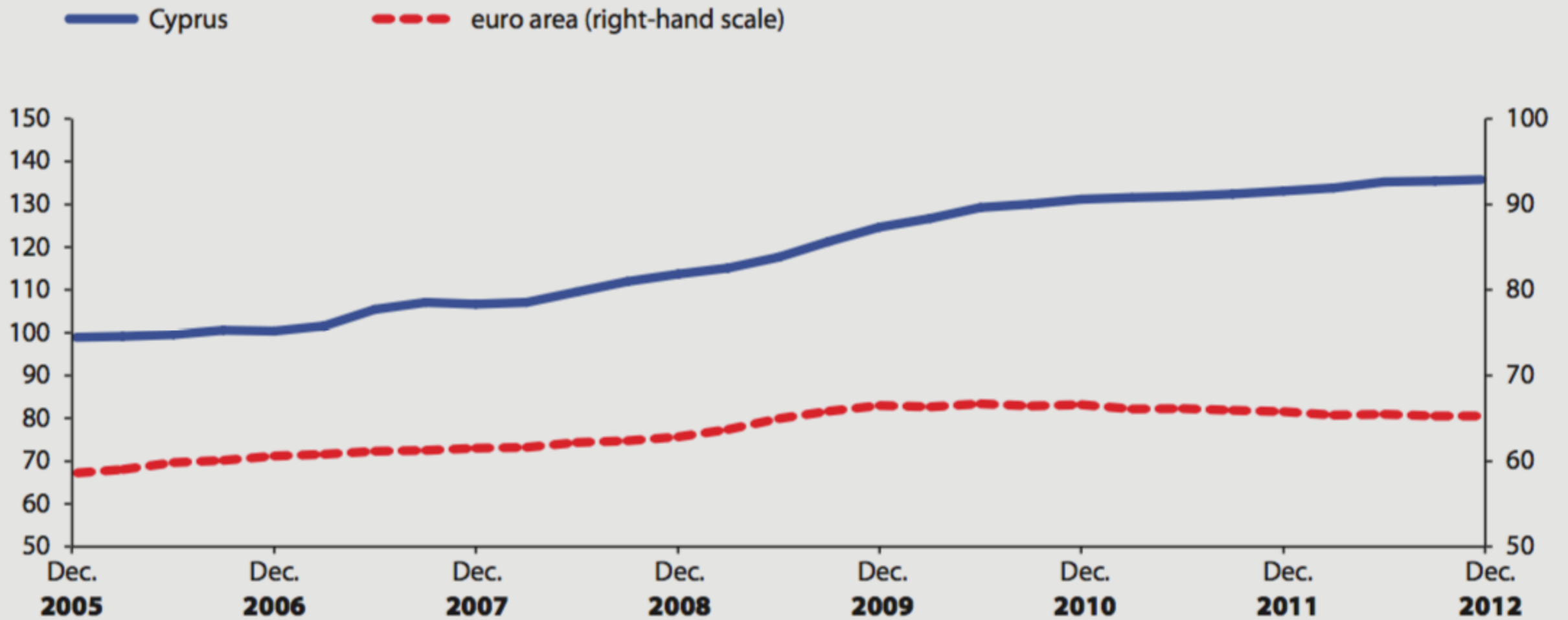


Source: CBC.

FOURTH INGREDIENT: OVER-INDEBTEDNESS OF HOUSEHOLDS



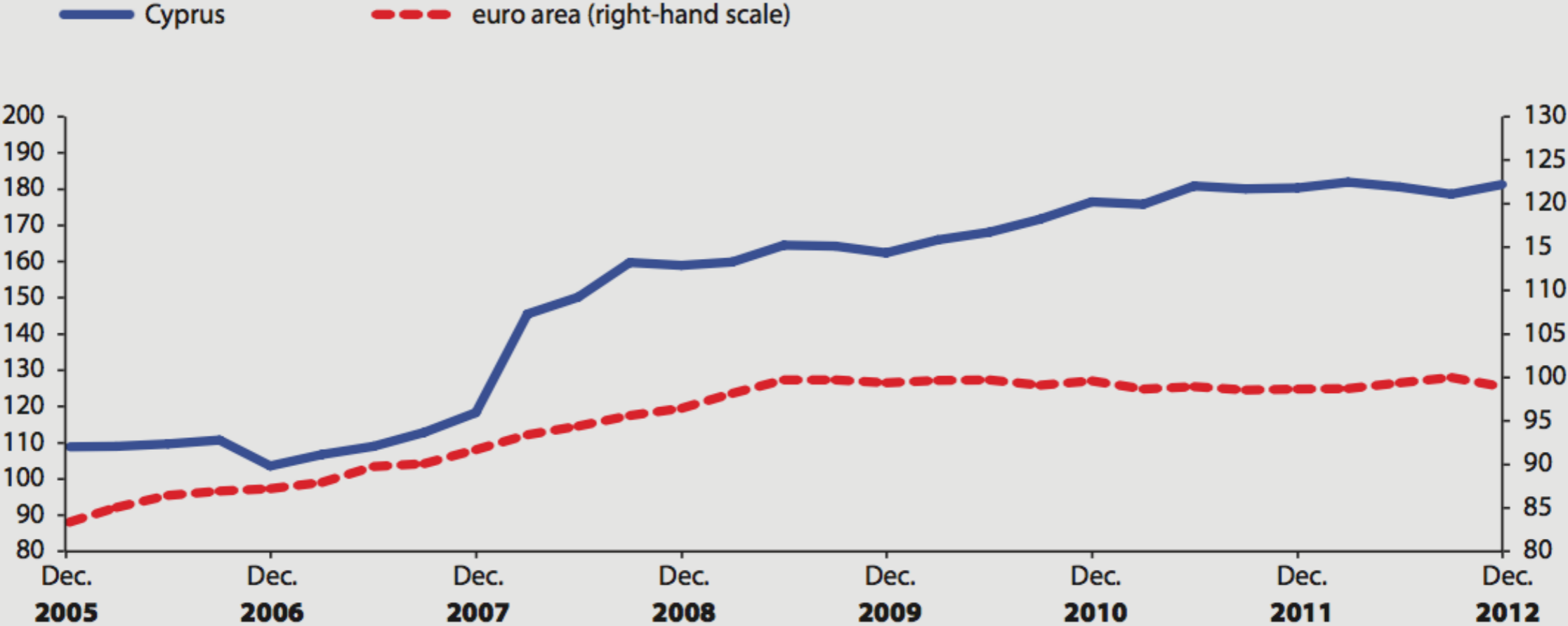
Figure 8: Total household debt as a % of GDP



Source: CBC.

FIFTH INGREDIENT: OVER-INDEBTEDNESS OF NFCs

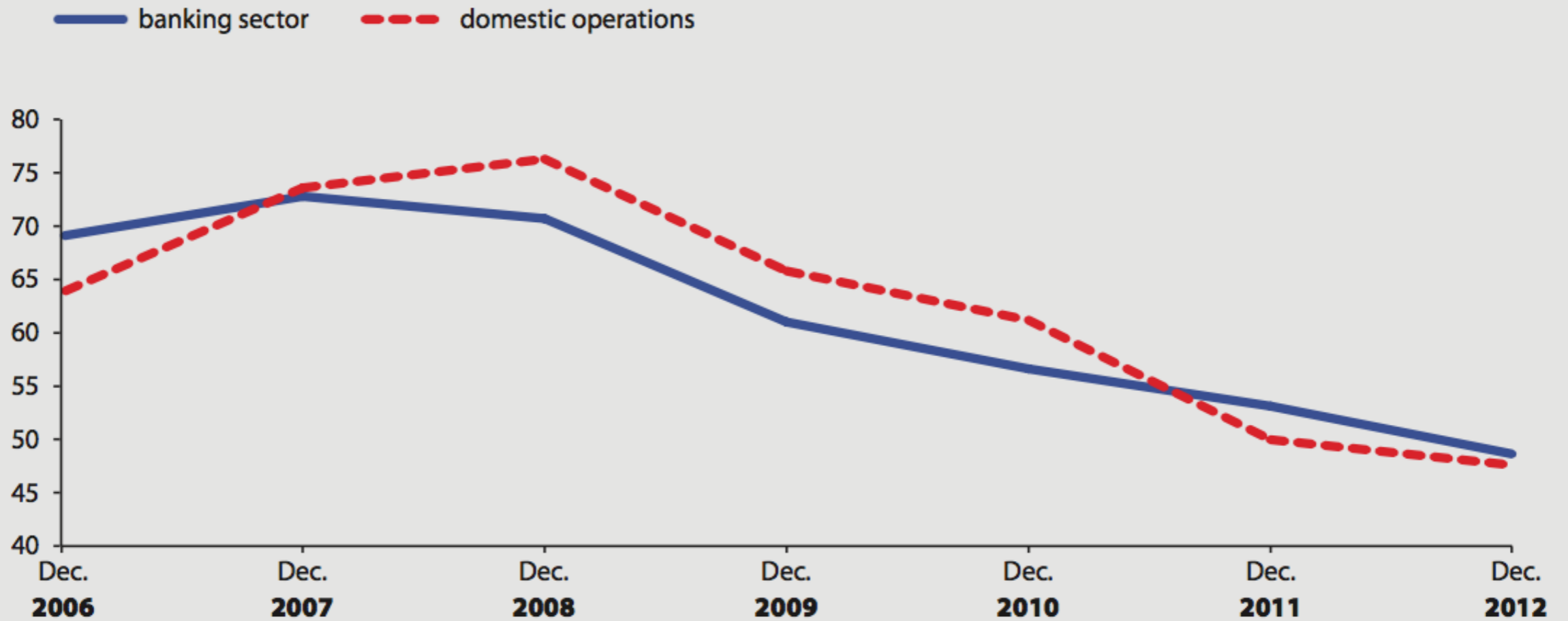
Figure 9: Total non-financial corporate debt as a % of GDP



Source: CBC.

DETERIORATING BALANCE SHEETS

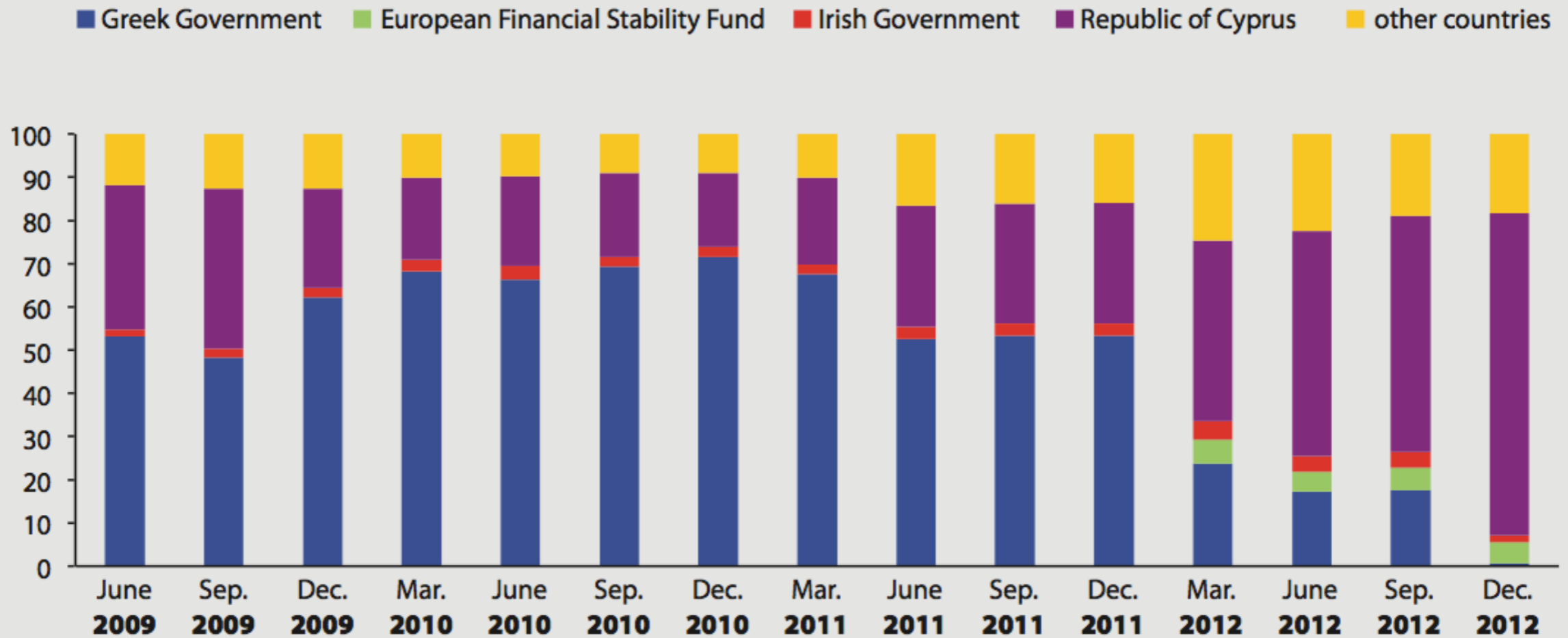
Figure 12: Provisions as a percentage of non-performing loans (coverage ratio)



Source: CBC.

GAMBLING FOR RESURRECTION ON GGBs?

Figure 14: Exposure of domestic banks in government securities by country (nominal value)
(%)



Source: CBC.

Timeline of crisis

- ❖ Dec 2011: EBA stress tests reveal capital shortfalls; banks given until June 12 to raise capital
- ❖ **3rd May 2012: Change of central bank governor**
- ❖ 6th May 2012: Laiki requests state aid followed by BOCY in June
- ❖ June 2012: Government injects €1.8b recap bond into Laiki and applies for financial assistance
- ❖ July 2012: Troika submits programme proposals
- ❖ November 2012: Troika agreement with outgoing government
- ❖ December 2012: Eurogroup decides to wait for presidential elections in Feb 2013
- ❖ 16 March 2013: First Eurogroup agreement involving deposit levy (“Taxing the poor...”)
- ❖ 19 March 2013: Cypriot parliament turns down deposit levy
- ❖ 21 March 2013: ECB announces ELA decision for Cypriot banking system - facing euro exit
- ❖ 25 March 2013: Second agreement between Eurogroup and new Cyprus Government

The crisis in a nutshell

- ❖ The crisis was primarily the result of two banks becoming TBTF, TBTS and TBTR
 - ❖ Risks ignored while bank balance sheets were growing rapidly, due to the influx of foreign (mainly Russian) deposits through politically connected law firms
 - ❖ Capital inflows helped to fuel easy credit and property prices (media described this as 'the miracle')
 - ❖ Weak corporate governance, poor lending standards and questionable investments overseas (e.g. acquisition of Uniastrum in Russia ultimately resulting in losses of €1.5 billion)
 - ❖ Definition of NPLs allowed banks to class loans over 90 days overdue as performing => little attempt to manage NPLs
 - ❖ Example of property developer connected to Church (major shareholder of BOCY) who became BOCY chairman
- ❖ Greek PSI and the deflating property bubble were the triggers but not the real causes of the crisis

Political economy causes

- ❖ Cyprus 'business model' had its roots to offshore status of Cyprus before EU accession
 - ❖ This created a large service sector consisting of law, accounting firms and banks with strong political connections - the "ruling elite"
 - ❖ Politically connected law firms received introducer fees for introducing foreign oligarchs to the banks and helping them set up shell companies in Cyprus (many were PEPs): explains capital inflows and expansion of bank balance sheets
 - ❖ Developers and other large businesses who benefited from poor lending standards had links to the main political parties (NPL ratio of corporates double those of households)
- ❖ Laiki came under the control of Greek oligarch in 2005, while BOCY had a dispersed shareholder basis with the Church being the major shareholder
- ❖ The media were captured through large advertising budgets and soft loans
- ❖ Parliament failed to make the CBC accountable (endogenous choice of lax regulation)

The ill-conceived deposit levy

- ❖ IMF's DSA showed a shortfall of €5.8 billion: on 4 March 2013, Cyprus government was informed at Eurogroup
- ❖ Broad based deposit levy was CY government's response to protect the business model ("taxing the poor to protect the rich")
 - ❖ Trusted Russians were consulted and indicated willingness to contribute up to 10% of their deposits
 - ❖ That would have raised €3.0 billion, there was still a shortfall of €2.8 billion
 - ❖ The spin put on the levy by CY government was that it was very small and represented 'only' two years worth of interest (they still argue this would have been better than bail-in but deny it was their own idea)
- ❖ **CBC Governor objected to taxing deposits under €100,000 in Parliament**

Resolution/restructuring actions

- ❖ An unprecedented amount of bank restructuring was accomplished by the CBC in days
- ❖ Laiki and Bank of Cyprus brought simultaneously under resolution
 - ❖ Greek 'carve-out': bank branches in Greece sold to a Greek bank (using sale of business tool)
 - ❖ Laiki split into a 'good' bank folded into BOCY and a legacy bank (includes bondholders and uninsured depositors) - merged bank reopened within days
 - ❖ Final bail-in at BOCY (47.5%) decided after fair valuation of both balance sheets
 - ❖ Valuation process took about three months (assets valued around €30 billion)
 - ❖ Overseas branches merged into subsidiaries in coordination with local supervisors:
 - ❖ Laiki UK deposits transferred to Bank of Cyprus UK (agreement with BoE)
 - ❖ Bank of Cyprus Romania folded into Marfin Romania (Bank of Romania)
- ❖ Only 4% of depositors affected by the bail-in. Two thirds of value of bailed in deposits belonged to non-residents. Russian deposits bailed-in about €4.0 billion.
- ❖ Credit co-operative sector restructured, recapitalised and brought under CBC supervision

Bail-in protected public finances

- ❖ By April 2014, the restructuring of the banking system had been largely completed, all domestic capital controls had been lifted
- ❖ Cyprus received three positive troika reviews, commending on progress achieved in banking sector reforms
- ❖ Hellenic (third largest) bank was fully recapitalised without recourse to programme money, attracting foreign investors
- ❖ Restructuring and recapitalisation of co-operative sector completed with number of regional entities reduced from 94 to 18 and stronger corporate governance
- ❖ IMF described progress in restructuring and stabilising banking sector as a “remarkable achievement”
- ❖ Capital controls were fully lifted in early 2015
- ❖ In March 2016, Cyprus exited the adjustment programme with positive GDP growth and sustainable public finances: however, coop bank failure in last few weeks at a cost of 20% of GDP casts doubt on progress since exiting programme

The Toxic Fallout

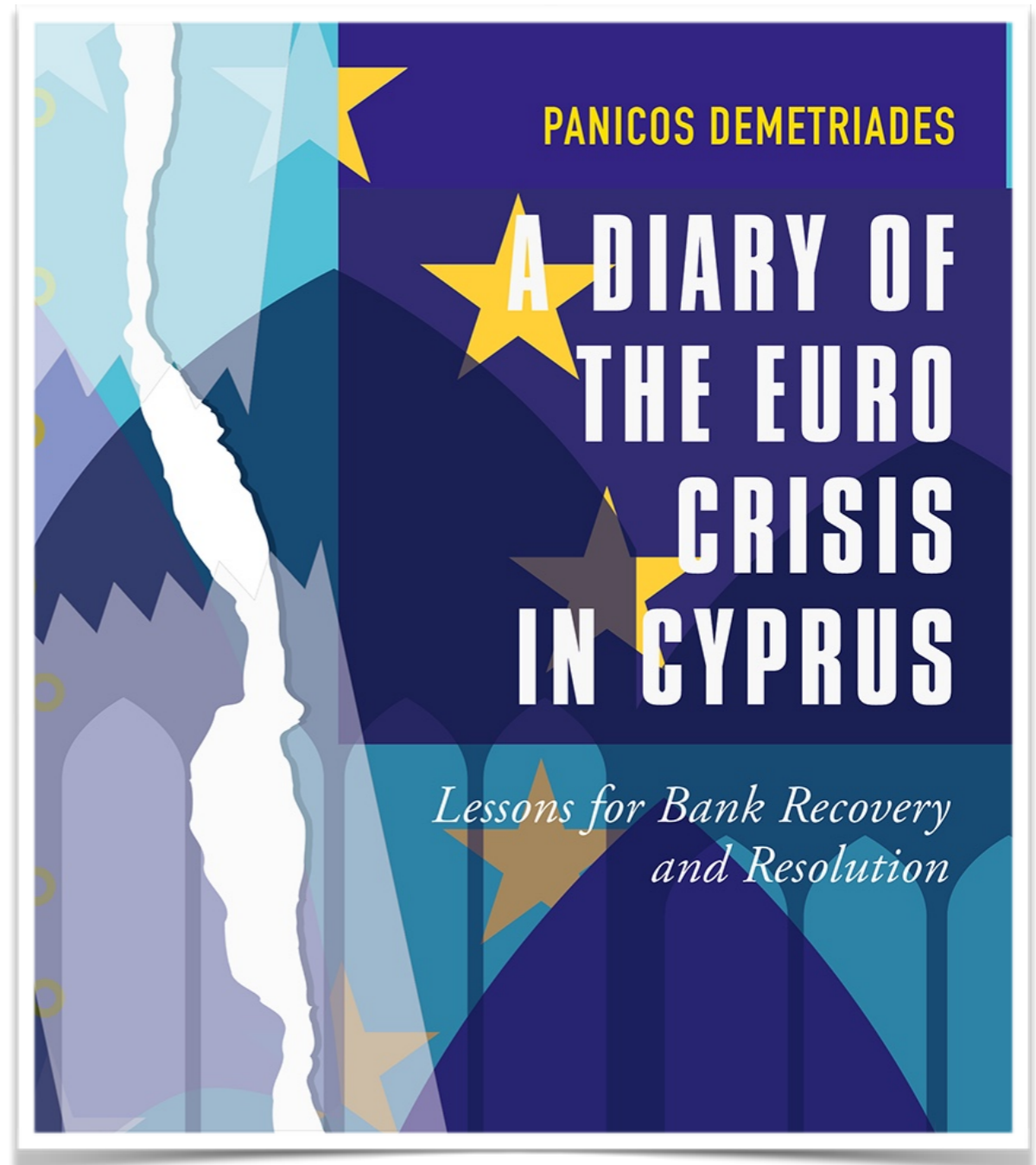
- ❖ Cyprus was the first (?) country in which depositor bail-in was used and resolution legislation was still new => massive shock to confidence (although deposit tax bigger)
- ❖ Bail-in protected taxpayer but affected the wealthiest and most influential (including the Greek Orthodox Church)
- ❖ In Cyprus many still view the Eurogroup decision as ‘the catastrophe of the economy’
 - ❖ Bondholders claimed they were misled, depositors claimed it was expropriation, shareholders claimed the capital needs were exaggerated
 - ❖ Populist political initiatives to compensate the “victims of Eurogroup”
- ❖ **Major unintended consequence of bail-in: Russian and Ukrainian oligarchs became major shareholders of Bank of Cyprus**
- ❖ The toxic political fallout led to legislative changes in the governance of the central bank that eroded its independence and finally led to Governor’s resignation

Lessons

1. Banks can become TBTR (risk of media & political capture) - SSM provides a reasonable answer to this but far from perfect e.g. AML remains a national responsibility
2. Banking supervisors and resolution authorities need to be independent from political pressures
 - limiting scope of central bank independence to monetary policy can be destabilising (e.g. recent coop bank failure in Cyprus)
3. Bail-in tool in BRRD may have unintended consequences:
 - bailing-in influential investors can create toxic political fallout
 - new shareholders may not be fit and proper to own a bank
4. Bail-in may not be feasible for smaller banks and mutuals (e.g. credit coops)

Concluding remarks

- ❖ The Cyprus crisis was the result of unchecked capital inflows, facilitated by a lax regulatory framework and politically connected law firms
- ❖ SSM a good step forward in terms of prevention but much more remains to be done (e.g. AML remains a national responsibility)
- ❖ Resolution actions protected public finances but had several unintended economic and political consequences, including erosion of central bank independence



FROM THE BACK COVER

“Cyprus is a small country with a big story: its 2013 banking crisis constituted a major episode in the larger Eurozone crisis. As central bank governor, Panicos Demetriades was at the epicentre of events. He tells the story of the crisis and political constraints on its resolution with verve and drama. Essential reading for crisis mavens.” **Barry Eichengreen**

“The banking crisis that erupted in Cyprus in 2013 shook the Eurozone and led to a drama with many ramifications. As the Governor of the Central Bank of Cyprus, Panicos Demetriades was both an actor and an observer of the unfolding drama. Nobody is better placed to tell us the gripping story of the Cypriot banking crisis.” **Paul De-Grauwe**

“The Cyprus banking crisis shook the country and was a major after-shock in the Eurozone crisis. The story of its crisis management as an interplay of politics and economics needs to be told. As the former Governor's account, this book is at the same time a most intense political thriller and an insightful economic analysis.” **Olli Rehn**

“This book should be on every reading list to train future generations of monetary economists and Central Bankers. It is also a ‘must read’ for anyone interested in the euro-crisis of 2012-13 particularly, and in European recent political history more broadly. But beyond all that, it is a vivid and dramatic story.” **Charles A.E. Goodhart**