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The Cyprus banking crisis: the bail-in strategy as a game changer for the too-big-to-fail mentality of the fractional reserve banking system[*]

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In March 2013 all the attention of the financial world was focused on Cyprus. The news of the impending haircut on the deposits of the island's failing banks spread rapidly throughout the media, causing panic and distress. The decision for the infamous bail-in, a term coined by the Economist as opposed to the bailout strategy, came as a shock. For years, the Cyprus economy seemed durable enough to sustain the effects of the 2008 global financial crisis. The gigantic but prosperous banking sector was its prized gem, attracting deposits from overseas and yielding considerable profit. In 2008, when Cyprus adopted the Euro, the local banks were gaining more than 30 billion euros, an amount about 160% the size of the state GDP[1]. Indeed, the Cyprus banking sector seemed larger than life and no one would have imagined its demise.

This article examines the events that lead to the decline of the Cyprus banking sector and traces the most significant reasons behind the crisis. More specifically, the effect of the bail-in on the deposits and the subsequent waning of confidence are analyzed. It is reflected that the bail-in strategy has caused an irreparable damage to the very foundations of the fractional reserve banking system, the platform on which all modern

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[1] Wray, L. Randall (2013) 'What went wrong in Cyprus: an MMT perspective'. *EconoMonitor*. Available online at http://www.economonitor.com/lrwray/2013/03/29/what-went-wrong-in-cyprus-an-mmt-perspective/

banking industry operates. The bail-in strategy has not only destroyed the Cypriot banking sector but is about to become the norm in future bank rescue operations.

Back in 2012, after sensing the impending systemic risk the major banks were posing on the island's economy, Cyprus called its European peers for financial assistance. Due to the waling macroeconomic conditions of the Greek economy and its subsequent sovereign debt haircut, the Cypriot banks suffered losses and needed recapitalization. The state was unable to provide liquidity to its banks as it needed financial assistance after five years of reckless spending by the government. The total amount requested was 17.5 billion euros, a mere pittance compared to the sums of the previous bailout packages of Greece, Ireland, Portugal and Spain[2]. The impending elections in both Cyprus and Germany made things more difficult, as voices of criticism of the bailout strategy monopolized the German public opinion, calling for no more financial aid to the fiscally undisciplined EU member states. Letting Cyprus default was not an option the European bureaucrats could afford, since this could potentially damage the common currency experiment[3]. So, the idea of the depositors aiding the banks' relief was placed on the table. Through this scheme, the European taxpayers would not be obliged to bear the burden of 5.8 billion euros. Instead, the money would be taken away from the existing deposits of the customers. On March 16, all funds were locked in and no unauthorized transaction was permitted.

The final strike came on the 26 of March, when all insured deposits, i.e. up to 100000 euros, were transferred from Laiki Marfin to the Bank of Cyprus. These deposits escaped the haircut due to existing EU legislation. In addition to these, other deposits deemed exceptional, were spared from the haircut, either through public outcry or political intervention. These included various governmental and non-governmental funds, such as school, insurance and JCC credit card operations deposits. All other funds were 'frozen' for the impending bail-in, amounting loses up to 50% in the case of Bank of Cyprus and up to 100% for Laiki Marfin.

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[2] The Cyprus economy is only 0.2% of the total Eurozone GDP.

[3] Since the Eurogroup was reluctant to provide total liquidity assistance to the island, Cyprus was bailed out by a tripartite group of financial supervisors – the European Commission, the European Central Bank and the International Monetary Fund- which the locals call emphatically 'troika'.

Forbes columnist Louis Bennetts makes some interesting observations on the Cyprus bail-in strategy:

> *"The 'bail-in' model used to address the insolvency of Cyprus's two largest banks has its roots in the Federal Deposit Insurance Corporation's megabank recapitalization proposal. Importantly, this is the first time that the model has been used where the banks in question are 'too big to fail' in their local economy. And, as it turns out, banks aren't too big to fail, and 'bail-in' works rather well to limit the systemic effects of a bank failure, all the while shielding taxpayers. It is also a warning to creditors: be more vigilant about the institutions you do business with."*[4]

The fact that a bail-in strategy was used to save these 'megabanks' proves there is no such thing as 'too big to fail'. The European authorities were clear about this when they argued against providing further assistance to Cypriot banks. The assumption that a great deal of Russian oligarchs has traditionally used Cypriot banks for money laundering and tax avoidance was used as an excuse, without tangible evidence. Consequently, the tax payer (whether local or European) should not be penalized with having to pay for the transgressions of the bankers. Furthermore, the existence of such tax heavens around Europe must seize. Another argument used by the German finance minister Wolfgang Schaeuble was the oversized banking sector, which amounted to 7.5 times the island's mediocre GDP of about 18 billion euros. According to Schaeuble, the business model of the Cypriot banks was faulty and so a reduction was necessary to balance things out and bring the banking sector to a more sustainable level. Luckily, the tax payer was spared from having to pay for the sins of the bankers. Nevertheless, the burden of having to rescue the banking sector fell on the backs of the depositors, who had their money confiscated against their will.

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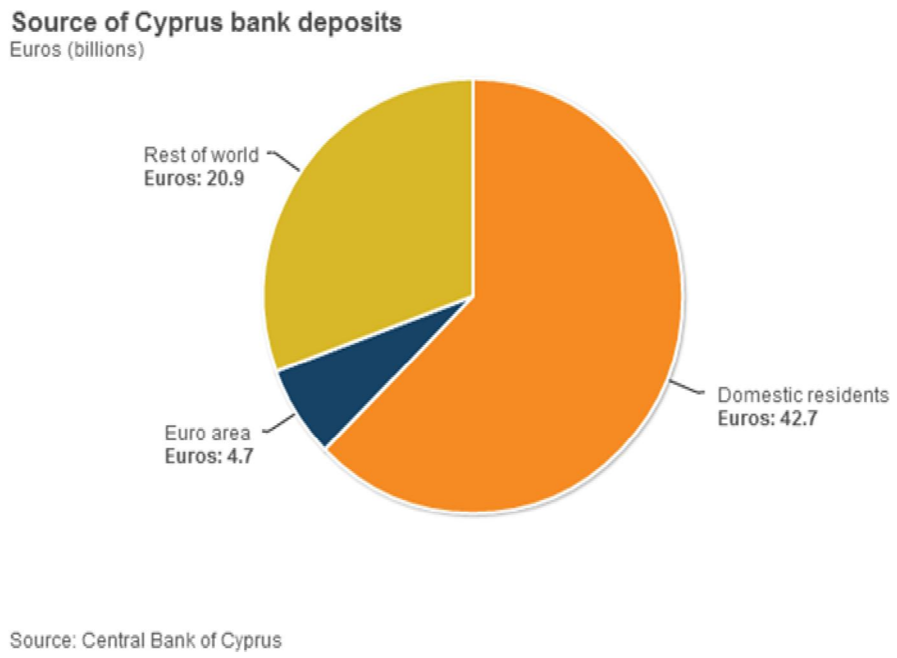
[4] Bernetts, Louis (2013) 'The Cyprus bail-in exposes 'Too big to fail' as too timid'. *Forbes*. Available online at http://www.forbes.com/sites/realspin/2013/04/18/the-cyprus-bail-in-exposes-too-big-to-fail-as-all-too-timid/



Certainly, such pitiful arguments used by the European delegates demonstrate the vulnerable position Cyprus was in at the time of the 'haircut' proposal. The 'tax heaven' and 'money laundering' excuses have never been a problem for the European Union before, and neither has the engorged banking sector. Back in 2003, when Cyprus was approved to join the EU, no such warning was imposed. Likewise, in 2007 when Cyprus joined the Eurozone, no special conditions were levied[5]. According to Reuters, there was 'no official red flag that Cyprus's oversized banking sector posed a big risk to its economy' until the year before the bail-in[6]. Based on an official report published in 2012 by the European Commission, the Cypriot banking sector ranked fourth on the list of potentially endangered banking sectors in the Eurozone. The other countries ahead of Cyprus were Luxembourg (24 times the national GDP), Ireland (8 times) and Malta (7.8

[5] In 2007, about half of the deposits in Cypriot banks came from foreigners.

[6] Strupczewski, Jan (2013) 'Does size matter? Cypriot bank sector problem went overlooked'. Reuters. Available online at http://www.reuters.com/article/2013/03/21/us-eurozone-cyprus-banking-size-idUSBRE92K0YK20130321

times).[7] Nevertheless, the financial pundits deliberately seized the opportunity to attack the banking sector by ordering its contraction to 50% by 2018 a rule that has been crystallized in the memorandum of understanding[8].

The Cypriot banking sector was given special attention in 2012 because of its urgent need of recapitalization. The final blow for the local banks came from the heavy losses suffered after the Greek sovereign debt restructuring. The report of the European Commission provides special attention to this development:

> *"As a result of large losses on Greek government bond holdings, Cypriot banks' solvency ratios fell below the required supervisory levels and this needs to be addressed in order to reach the EBA targeted minimum of Core Tier 1 of 9% by June 2012, with one main bank needing government intervention to meet its recapitalization needs."*[9]

Before the decision for intervention, the banks possessed a great amount of Greek bonds, estimated in 2011 at 4.7 billion. After Greece's managed default, the losses suffered by the Cypriot bond holders were around 3.5 billion (20% of the national GDP). Indeed, this has been catastrophic for the banking sector. But it does not explain why the Cypriot banks, mainly Bank of Cyprus and Laiki Marfin, kept investing in high risk, junk-rated Greek bonds[10]. Indeed, during the late 2009 to early 2010 crucial period, when European and international investors were avoiding investing in Greek governmental bonds, the Cypriot banks were spending billions of euros on them. The unraveling of the crisis has left thousands of Cypriots, among them depositors of the aforementioned banks, wondering why this was allowed to happen. The banks' executives argued that this investment seemed a good idea. High-yielding but high-risk governmental bonds would provide compensation for the rising number of non-

[7] European Commission (July 2012) 'European economy. Macroeconomic imbalances: Cyprus'. *Occasional Papers* 101. Available online at http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp101_en.pdf

[8] According to the provision, the size of the banking sector needs to be around 3.5 times the national GDP, which is the EU average.

[9] Ibid, p. 35.

[10] In October 2013, a group of Bank of Cyprus executives was fined for failing to disclose appropriate information to the company's shareholders regarding the authorization of investing in the toxic Greek bonds. For more details see http://www.fin24.com/Companies/Financial-Services/Bank-of-Cyprus-fined-for-Greek-bond-buys-20131004

performing loans and thus patch a hold in the balance sheets of the banks. This is the reason the executives avoided the disclosure of information regarding their clandestine investments to the board directors as well as delaying external investigation on the issue:

> *"In December 2009, managers told media and their own board that most of the bank's Greek bond holdings had been sold - but the bank did not then disclose that it had almost immediately bought more."*[11]

In 2012 the Central Bank of Cyprus, chaired by Mr. Demetriades, hired Alvarez and Marshall, a U.S. based restructuring firm, to investigate the circumstances that led to the decision to require financial assistance by the state. At that time, Cyprus was the fifth Eurozone country to seek European aid after the second largest bank of the island, Laiki Marfin, needed 1.8 billion euros to survive. This was followed by the island's principal credit institution, Bank of Cyprus, which required about 500 million euros. The two banks, classified by the state as systematically important, were on the verge of default and called the state to intervene.

It is interesting to note that the Alvarez and Marshall report[12] noted 'a culture whereby senior management decisions were not challenged', a factor which lead to clear corporate governance failure and explains the lack of disclosure of vital information to the companies' shareholders. Among the directors of the banks there was overwhelming optimism that the Greek government would find its way out of the crisis and the investment would yield. Data obtained by the European 'stress tests' in 2010 proved that larger European banks had nowhere near as many Greek bonds. With the fear of the impending insolvency growing, the bonds began losing value. The Cypriot banks panicked and, together with some accounting tricks[13], decided not to mention potential losses to their shareholders. The ex CEO of the Bank of Cyprus, Andreas

[11] Kambas, Michele and Grey, Stephen (2013) 'Insight: Why did Cypriot banks keep buying Greek bonds?' *Reuters*. Available online at http://www.reuters.com/article/2013/04/30/us-cyprus-banks-investigation-insight-idUSBRE93T05820130430

[12] The full text of the confidential report is available here http://ftalphaville.ft.com/files/2013/04/AM_Marfin.pdf

[13] The BOC in April 2010 moved about 1.6 billion euros of Greek bonds from its trading account to its 'held to maturity' book. This meant the bank did not have to mark down the value of the bonds.

Eliades, asserted that nobody could possibly expect that a European country, in the euro, could possibly default[14]. In October 2012, it is estimated that a great amount of banking data has been purposely deleted to conceal evidence of mismanagement and malfeasance[15]. In Lord Acton's own words, power tends to corrupt, and absolute power corrupts absolutely.

A notable aftereffect is the impact of the crisis on the confidence of the banking system. People tend to trust their local banks and the legislation which regulates them. But confidence can be very fragile at times; even a rumor can cause panic and lead to the phenomenon of bank runs. In 2013, confidence has been evaporated and has yet to return. Local depositors have watched their money confiscated and were unable to react. Stringent rules were imposed for money withdrawals in an attempt to withhold deposit flee[16]. Depositors in other heavily indebted European countries are constantly facing the danger of repetition. Moreover, European investor confidence declined further a month after the bail-in. Insurance prices for potential bank default rose across the euro area, weakening the possibility of economic recovery[17]. But the ramifications for Cyprus are irreparable; the island's status as a tax heaven will be coming to an end, as the 13 billion euros bail-out memorandum specifically commits the government to raise the corporate tax to more than 10%, implement anti-money laundering laws and increase taxes on specific capital transactions. In other words, the Cypriot banking system's confidence has been shattered beyond repair for its current and prospective clients.

After all the recapitalization assistance, the newly-merged Bank of Cyprus is still vulnerable. The main reason for this is the persistence of the non-performing loans burden, which has yet to be solved to this day[18]. Moody's ratings agency which praised the bank's capital raise, warned about whether this development will lead to a sustained improvement in the bank's financial performance, given the given the acute

[14] The bank's management had given the impression that it had off-loaded toxic Greek bonds when in fact it had invested heavily in them.

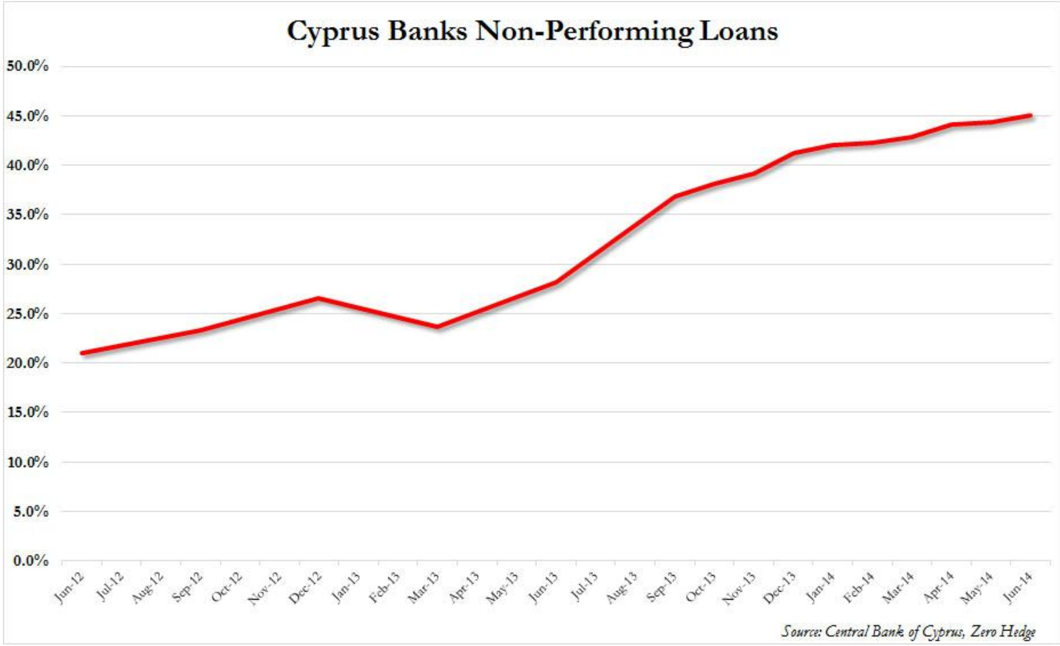
[15] Kambas, Michele and Grey, Stephen (2013) 'Insight: Why did Cypriot banks keep buying Greek bonds?' *Reuters*.

[16] Only 300 euros per day could be withdrawn for the first few months after the bail-in.

[17] Black, Jeff (2013) 'Sentix European Investor confidence falls after Cyprus bailout'. *Bloomberg*. Available online at http://www.bloomberg.com/news/2013-04-08/sentix-european-investor-confidence-falls-after-cyprus-bailout.html

[18] Currently, the bank's top 22 holders of NPL jointly owe 4 billion euros to the bank.

asset quality pressures the bank faces and its low provisioning against losses from problematic exposures[19].



Interestingly, the steady rise of the number of NPL was the underlying reason for the risky investment in Greek bonds. Today, the NPLs of all the local banks amount to 28.88 billion euros, which is 47 % of the total amount of loans according to the Central Bank of Cyprus. [20] The biggest problem with the NPLs is in the arms of the Bank of Cyprus. A confidential list containing the names of the 24 largest debtors and the amounts they owed was leaked to a local news site[21]. According to the list, a very small number of debtors were responsible for the largest part of the bank's NPLs, amounting to 5 billion euros in 2013. Among the listed names are some of the richest families on the island, yet they appear to have difficulty repaying their loans. Other local banks, such as

[19] Psyllides, George (2014) 'BoC efforts are positive but NPLs are a drag'. *CyprusMail*. Available online at http://cyprus-mail.com/2014/10/04/boc-efforts-are-positive-but-npls-still-a-drag/

[20] For further information see http://cdn.cyprus-property-buyers.com/wp-content/uploads/2014/09/nonperforming-loans-july-2014.xls

[21] The full list is available here (in Greek): http://www.stockwatch.com.cy/nqcontent.cfm?a_name=news_view&ann_id=198570

Hellenic and Coops, are facing similar dangers from the rising cost of NPLs. This is a grave matter that requires urgent legal attention by the government, which was unable to solve the problem due to the reluctance of the House of Representatives to vote the appropriate foreclosure law. As a consequence, the next tranche by the Troika was delayed indefinitely. As the head of the Eurogroup, Jeroen Dijsselbloem, stated:

> *"Putting these legal provisions in place … is of course essential to make progress with the high level of non-performing loans (NPLs) in Cyprus, including large corporate loans, and to return Cyprus to financial health"*[22]

As the island's future hangs by the Troika's thread, the National council on the economy examined the possibility of the state purchasing some of the NPLs from the banks and implementing a mortgage-to-rent scheme. Nevertheless, it acknowledges the fact that the Cypriot economy needs a healthy banking sector to recover and that houses should be used by banks as collateral. Opposition politicians have caused unnecessary panic over the possibility of the loss of the 'primary residence' to foreclosures and called for its protection. Resorting to populist rhetoric is somewhat understood, since their role as lawmakers has been severely confined by the memorandum. But without the legal framework, the island's economy will deteriorate and time is not on their side. The IMF has warned that NPLs are a key challenge to the economy, an astounding 135% of the GDP.[23]

While Cyprus tries to recuperate from its severe financial troubles, European nations fear the introduction of the bail-in tactic is here to stay. The Cyprus 'successful' bail-in experience has become the blueprint for future bank rescue operations, prompting for the adoption of European directives to crystallize the practice. From now and on, shareholders and depositors will be responsible for assisting bank failures. This development shields the European taxpayer from bearing the heavy cost, a common practice since the 2008 financial crisis. The chairman of the Eurogroup, Jeroen Dijsselbloem, saluted the new framework as a positing step towards a banking union:

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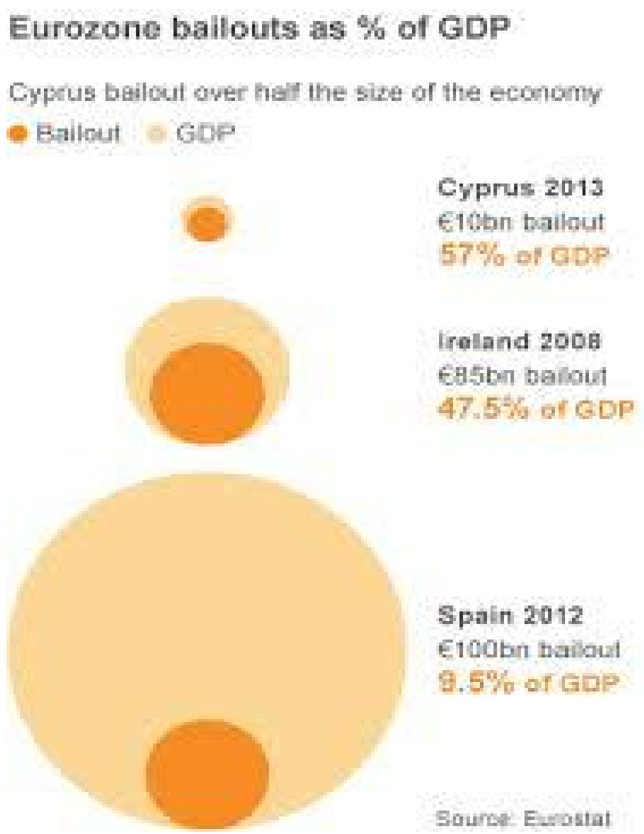
[22] Psyllides, George (2014b) 'No foreclosure law no money'. *Cyprus Property News.* Available online at http://www.news.cyprus-property-buyers.com/2014/10/14/foreclosure-law-money/id=0038857

[23] IMF Country Report No. 14/92 (April 2014) . Available online at http://www.imf.org/external/pubs/ft/scr/2014/cr1492.pdf

> *"This is a clear signal to the markets and citizens, and another major step forward towards a banking union. If a bank gets in trouble we will now, throughout Europe, have one set of rules on who pays the bill. The financial sector itself will now to a very, very large extent become responsible for dealing with its own problems"*[24]

Perhaps the most positive outcome of this decision is that the banks as private institutions will have to assume responsibility for their actions instead of relying on the state to bail them out. Reckless spending, clandestine activities and zero accountability of the directors will be a luxury of the past. The customers will become more educated and demanding knowing their money can be confiscated at any time. Banks have always enjoyed a crony relationship with the state authorities. In case of failure, they knew they could count on the politicians coming to their rescue. But this practice will soon come to a stop in the Eurozone with the implementation of the bail-in directive and the introduction of the banking union.

[24] Waterfield, Bruno (2013) 'EU makes bank creditors bear losses as Cyprus bail-in becomes blue-print for rescues' The telegraph. Available online at http://www.telegraph.co.uk/finance/financialcrisis/10145355/EU-makes-bank-creditors-bear-losses-as-Cyprus-bail-in-becomes-blue-print-for-rescues.html



The dramatic events that led to the bail-in in Cyprus have unraveled the brittleness of the fractional reserve banking system. The mechanism behind the complex way the bank operates is actually very fragile and has been tested every time a bank failed and needed governmental liquidity. In a fractional reserve system, only a small amount of deposits is withheld for the depositors' activities, with the rest of the money being converted into loans. The reserve requirement in the EU is only 1%. In the event of a bank run, the bank reserves will dry up and the bank will collapse. Knowing this eventuality, the central banks in the developed world have alleviated the danger of collapse by way of printing money and bailing out the insolvent banks. Such was the case of the bail out of Goldman Sachs and Citigroup by the Federal Reserve during the US financial crisis of 2008. The bailout strategy strengthens the trust in the system by manipulating the perception of the public that banks will be assisted whenever they are facing the danger of collapse. At the same time it raises concerns that one failed bank can bring down the whole system as in the too big to fail perception. This kind of deposit insurance provides the illusion that all of the deposits are always in the bank and can be obtained by the customer. With the introduction of the bail-in tactic, the confidence of the existing and prospective depositors mitigates and the system collapses.

Given the fragility of the fractional reserve banking system, it is a miracle it survived a series of crises to this day. In the late 80s, the industry suffered a big blow with the savings and loans crisis in the US. Later, the trend evolved into a domino effect with the currency crises in East Asia, Russia, Mexico and Argentina in the 90s. The ramifications of the financial meltdown of 2008 are still felt throughout the world. Until 2013, the crisis seemed to be under control. This ended with the Cyprus bail-in, which cast the final strike on the foundations of the system. Cyprus has been the testing ground for this experiment and the results have yielded positive reviews. It is certain we will see more banks bailed-in and all governmental guaranties rendered powerless. As Joseph Salerno has pointed out,

> *"A few more banking crises in the Eurozone - especially one in which insured depositors are made to participate in the so-called 'bail-in'- will likely cause the faith in government deposit insurance to completely evaporate and with it confidence in fractional-reserve banking system."*[25]

The Cyprus bail-in has demonstrated Europe's reluctance to save troubled banks. Constant bailout funding to undisciplined nations has caused fiscal fatigue and pubic discontent and threatens the overall economic recovery of the Eurozone. The bail-in has been described as a victory of common sense[26] as the new Europe has set the standards of a market where nobody is too big to fail.

[25] Salerno, Joseph (2013) 'The Cyprus deal and the unraveling of fractional reserve banking'. Mises Economic Blog. Available online at http://bastiat.mises.org/2013/03/the-cyprus-deal-and-the-unraveling-of-fractional-reserve-banking/

[26] Darvas, Zsolt (2013) 'The new Cyprus deal: Victory of common sense'. *Bruegel*. Available online at http://www.bruegel.org/nc/blog/detail/article/1057-the-new-cyprus-deal-victory-of-common-sense/#.UVNXgBlaOHl

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