Cyprus Economic Society

Discussion Paper

Anatomy of the Cyprus Economic and Banking Crisis 2008-2013: An Assessment of What Really Happened and Why

By Mikis Hadjimichael PhD, CFA - Economic and financial advisor, former senior advisor to the Chairman of the Board of the Bank of Cyprus, and former senior official of the Institute of International Finance (IIF) and the International Monetary Fund (IMF)

CES Discussion Paper No. 11 / September 2023

Abstract

More than ten years since the dramatic events of March 2013, there seems to be more consensus on the broad causes of the crisis. Yet, there is still no succinct and comprehensive account of what really happened and why. This paper addresses all the related questions, including the built-up of vulnerabilities and the weaknesses in the assessment of the related financial stability risks and in evaluating the proper timing and nature of the needed policy options. The proximate causes of the crisis were: (a) the bursting of the housing and property price bubble; (b) the impact of the Greek debt restructuring on the capital of the two largest banks in Cyprus; (c) the European Banking Authority bank stress tests and the resulting bank capital shortfalls; (d) the worsening in public finances and the related loss of market access

for new financing; and (e) the loss of access to the ECB refinancing window. The true origins of the Cyprus economic and financial crisis were: (a) the escalating vulnerabilities and distortions in the banking system that had been fueled by excess liquidity, excessive reliance on volatile non-resident deposits, extremely poor risk management and corporate governance by bank managements, and anachronistic and dangerous practices for lending decisions (through reliance on the value of collateral rather than the borrower's ability to repay) and for recognizing non-performing loans. The extremely high level of bank balance sheets and the low quality bank loans was a time bomb waiting to explode; (b) ineffective bank supervision caused by the outdated bank supervision legal framework, past forbearance practices and political interference and collusion with bank managements; (c) the emergence of large budget deficits and the loss of market access that substantially limited the available policy options; (d) the apparent lack of an appropriate framework for analyzing financial stability risks and of adequately appreciating the evolving risks in the Euro Area and the related concerns and objectives of official creditors; and (e) the long delay by the government in seeking financial assistance from the troika and the government's unwillingness to reach an agreement once a program request was finally made. Arguably, a larger financing package than the one agreed in March 2013 without a bailing-in might have been possible if a troika-supported program had been agreed during July-October 2012.

Introduction

The first draft of this paper was prepared in early 2019. At that time, six years after the lowest point of Cyprus' economic and banking crisis of 2008-13, there were still conflicting views among politicians, analysts, and the public at large on the underlying nature and causes of the crisis, on the alternative policy options and consequences and on what really happened in March 2013 and why. In part, this was understandable, as some of the main protagonists had tried to deflect attention from their actions or inactions, with a tendency to blame someone else, such as the greedy bankers, or key members of the Eurogroup or the troika. However, in large part this was due to the absence of a complete picture or understanding of what really happened, and of the very dynamic way of how the crisis had evolved.

Four years later, and more than ten years since the dramatic events of March 2013, there seems to be more consensus on the broad causes of the crisis. Yet, there is still no succinct and comprehensive account of what really happened and why.

Key questions that could be clarified or addressed include the following:

- What was the true nature of the crisis? Was it a banking crisis or a public finances crisis, or both? What were the channels for the negative feedback loops between the banking system and public finances?
- How critical was this channel? Was the banking crisis inevitable, even in the absence of the Greek debt restructuring? Could the bank capital shortfalls have been covered by the government if public finances had not deteriorated and the government had not lost access to capital market financing? Was the bank exposure to Greek Government Bonds (GGBs) the main cause of the crisis?
- How did the gaps in the capital position of Laiki Bank (commonly referred to as simply Laiki, but formally known as Marfin Popular Bank or Cyprus Popular Bank) and the Bank of Cyprus emerge in 2012? Were Laiki and the Bank of Cyprus insolvent by end-2012?
- Was bank supervision by the Central Bank of Cyprus (CBC) effective? Would it have been possible to achieve a bail-out instead of a bailing-in of the two key banks and obtain a larger financing package from the troika? If yes, why was this opportunity missed?
- What were the various policy options for dealing with the crisis and why did the IMF, the Eurogroup and the ECB change their approach and the available financing envelope for Cyprus?
- How did the first Brussels agreement in March 2013 come about and why did it collapse? How did the final Brussels agreement come about?
- Why was it necessary to sell the branches in Greece of the Cypriot banks and how was the sale price determined? What was the outcome of the resolution of Laiki and the Bank of Cyprus? Have the right policy lessons been drawn from this experience?

This is a rather tall order of interrelated questions.

The present paper is intended to provide a succinct assessment of what really happened and to attempt to address the above questions and issues. It is based on number of sources: (a) a thorough review of available official reports (from the IMF, the European Commission and the government); (b) articles, books and public statements by key participants; (c) the statements before, and the final report of, the three-member panel set up by the government to investigate what happened (the Pikis Report); (d) in-depth discussions on a background basis with several key officials from the Ministry of Finance, the CBC, the IMF and Cypriot banks that participated in the program negotiations and the events of March 2013; and (e) in part, my personal involvement as an official of the Institute of International Finance (IIF) that participated in the negotiations for the restructuring of GGBs during 2011-12 and served briefly in October 2012 as a consultant to the Ministry of Finance and the CBC on the negotiations with the troika at the invitation of the Cypriot authorities.

What Was the Nature and Origin of the Crisis?

President Christofias and his AKEL party government forcefully blamed the crisis on the problems created by the banks and accepted no responsibility for the large imbalances in public finances. This view was shared and publicly defended by CBC Governor Panikos Demetriades (who was at CBC during May 2012-April 2014). President Christofias and Governor Demetriades resorted to "bank-bashing" as a way of explaining the fiscal imbalances and the spillover effects on the budget from the restructuring of the GGBs held by Laiki and the Bank of Cyprus.

In contrast, the previous CBC Governor, Athanasios Orphanides, blamed the crisis on the widening fiscal imbalances and the lack of a timely response to the evolving crisis by the Christofias government. He also blamed the government for bank-bashing and for deliberately inflating the recapitalization needs of the two largest banks as a way of diverting attention from the fiscal imbalances before the 2013 presidential elections. In addition, he blamed President Christofias for not objecting to the European Council decision for the 50% GGB haircut in October 2011 that was so damaging for the Cypriot banks and for not asking for compensation for Cyprus from the Eurozone.

In its conclusions, the official panel appointed by President Anastasiades to investigate what had led to the crisis (Pikis Report) considered that the widening fiscal imbalances were the principal reason for the collapse of the Cypriot economy. The Pikis Report attributed the *"main and principal political responsibility for bringing the Cypriot economy to the edge of bankruptcy"* to President Christofias. It noted that the cabinet of ministers and the political parties supporting the government (AKEL and in part DHKO and EDEK) also bore political responsibility. The Report considered that President Anastasiades and his government were *"responsible for only one reason,"* their weak *"preparations for the Eurogroup negotiations in March 2013 and for the mistake of not inviting bank representatives to the negotiations."*

Among political circles and the Cypriot public at large, including especially those closely affected by the bank resolution or restructuring, the crisis was blamed either solely on the impact from the Greek sovereign debt restructuring, or on an alleged conspiracy by official creditors to punish peripheral Eurozone countries by imposing a harsh and painful bail-in.

It is true that the Greek debt restructuring had a major adverse impact on the Bank of Cyprus and Laiki—Cyprus' two largest commercial banks. Their holdings of GGBs amounted to €2.2b and €3.2b, respectively (equivalent to 70% and 170% of their capital base, which were unwisely and unduly large exposures). This combined exposure to GGBs, particularly relative to capital, was the highest outside Greece. In addition, these two banks had an even larger exposure to the Greek private sector through the lending of their branches in Greece, whose quality was severely undermined by the steep contraction of economic activity in Greece. The

Greek financial crisis and debt restructuring were the main proximate causes of the financial crisis in Cyprus, but they were not the only reason, nor were they the underlying root of the financial difficulties and imbalances faced by Cyprus and the Cypriot banking system. Cyprus' problem was far deeper and far more fundamental.

The origins of the Cyprus financial and banking crisis reflected a number of interrelated contributing factors, linked to the timing of Cyprus entry to the EU in May 2004 and its eventual entry into the Euro Area (European Monetary Union--EMU) in January 2008. The root cause of the crisis lay in the consumption and investment-led boom and overheating in the economy during 2004-2010, the unsustainable way it came about and the deep distortions it created in the housing market and the quality of bank portfolios. This domestic demand boom was made possible by a number of factors, including primarily the reduction in the interest rates on bank deposits and lending following the lifting of bank interest rate controls (moving away from the upper limits on the interest rates on bank loan and deposits) and the liberalization of capital movements, as part of the preparations for joining the European Union. While declining, bank interest rates remained higher than the EU average even after Cyprus joined the Eurozone and the exchange rate of the Cypriot pound was stabilized ahead of its linking to the Euro.

The positive interest rate differentials, the exchange rate stability, the freedom of capital movements, and the membership of the EU provided important incentives for attracting large capital inflows. These incentives were reinforced by other inherent advantages that Cyprus offered, such as the low corporate tax rate of 10%, political stability, the wide use of the English language, the highly regarded professional services by accounting and law firms and a legal system based on common law.

The capital inflows took the form of foreign direct investment for property purchases and bank deposits, mainly from the UK, Russia, and Ukraine, making Cyprus a favored offshore financial center and tax shelter within the EU. At the same time, concerns intensified—both inside, and especially outside, Cyprus—about the effectiveness of Cyprus' framework for anti-money laundering (AML) and its implementation in practice, over and above the bad legacy of Cyprus' involvement in the money laundering by Milosevic and other former Yugoslav leaders in the late 1990s.

The banks on-lent a growing part of their new mushrooming deposits to new low-quality loans to the Cypriot economy, particularly for housing and real estate development. This process was exacerbated by the reduction by CBC of the 70% liquidity requirement on euro-denominated deposits by non-residents (notwithstanding their widely considered volatile nature) to 20%, the same requirement that applied to euro bank deposits by residents. The banks also actively sought out potential high return investments in Greece and East European countries through the opening of new branches or subsidiaries. This led to an exceptionally large expansion in the size of the Cypriot banking system, including bank holdings in other countries, to 8 times Cyprus' GDP by 2010.

The two largest commercial banks led the search for high yield with risky investments, even after the onset of the global financial crisis in 2007. The Bank of Cyprus opened subsidiaries in Serbia, Romania, Ukraine, and, one month after the collapse of Lehman Brothers, in Russia in October 2008. The Bank purchased 80% of Uniastrum Bank, a fairly large Russian bank with weak risk and operational management and with 164 branches throughout Russia, larger than the number of Bank of Cyprus branches in Cyprus itself. The expansion of the deposit base both inside Cyprus and in Cypriot bank branches abroad was accompanied by a little-noticed expansion in the largely unfunded government contingent liabilities for insured bank deposits of up to €100,000 per person, which amounted by end-2011 to some €26b or the equivalent of 128% of Cyprus' GDP, an astoundingly large government vulnerability.

The vulnerabilities in the banking system—including the Cyprus Cooperative Bank, the third largest commercial bank, which did not accept foreign deposits—were aggravated by four critical contributing factors:

- poor risk management.
- weak bank corporate governance.
- the prevailing anachronistic bank lending practice based on the value of collateral rather than the borrower's ability to repay.
- the misguided prevailing definition of non-performing loans.

Bank loans were classified as non-performing only after being 280 days in arrears and if the value of the outstanding principal and overdue debt service obligations exceeded the value of collateral (usually in the form of housing or property, which were routinely overvalued). In contrast, the modern definition of non-performance prevailing elsewhere in Europe comprised any loans in arrears for more than 90 days.

Bank supervision exercised until 2012 by the Central Bank of Cyprus was unfortunately rather weak and ineffective in identifying and lowering the mounting risks to bank assets and financial stability, as well as for public policy and macroeconomic performance (the current account deficit was widening sharply). Bank supervision was regrettably compromised by the existing outdated legal framework for bank supervision, by past forbearance practices (whereby bank violations of or partial adherence to supervision rules or recommendations were tolerated for long periods), by political interference and unwillingness to rock the boat and by collusion among the management of major banks (especially Laiki's management) and political parties.

One other consideration that affected adversely the banking system and increased its vulnerability to a sudden stop or reversal of short-term capital inflows was that the domestic banking operations were not insulated from the strong expansion of the international business operations of Cypriot banks. More specifically, a large and expanding share of foreign deposits was on-lent to the domestic economy, rather than being invested in foreign liquid and other assets, as was the case at the time in other European financial centers such as Luxemburg, the Netherlands and in large part Ireland.

The macroeconomic consequences of these developments were, until 2008, highly positive and politically and socially welcomed. The boom in economic activity boosted the growth in real GDP, employment, private incomes, and government revenue (especially from fees on property transactions) (see Table 1). The government budget shifted into surplus and public debt declined to 46% of GDP by 2008. The overheating pressures, however, led also to a bubble in housing and property prices, steep increases in the indebtedness of the Cypriot household and corporate sectors, a substantial weakening in Cyprus' external investment position and an associated sharp widening in the current account deficit to over 15% of GDP by 2008.

These domestic and external imbalances were severely aggravated by several interrelated developments during 2008-12. More specifically, five events unmasked the increasing liquidity and insolvency risks in the banking system and sparked the onset of the Cyprus economic and banking crisis:

- the bursting of the housing and property price bubble in 2009.
- the worsening fiscal imbalances and the associated loss of access to foreign financing in May 2011.
- the launching of two stress tests by the European Banking Authority (EBA) for all systemic European banks in 2010 and 2011.
- the restructuring of Greek sovereign bonds during 2011-2012.
- the loss of access by Cypriot banks to the ECB refinancing window in June 2012.

As in other Eurozone countries, there were in Cyprus negative feedback loops between the deteriorating financial position of the banking system and the state of public finances. The main channel for this in the Eurozone were the large bank holdings of sovereign debt, as the declining market value of government bonds worsened bank balance sheets and raised their capital requirements, thus necessitating more government assistance financed through new government debt. In the case of Cyprus, in addition to this channel, there were two other parallel channels. First, the large bank exposures to government bonds of another Eurozone country, Greece; and second, the high unfunded contingent government liabilities through the guaranteeing of bank deposits of a banking system that were extremely large relative to the size of the Cypriot economy and included bank deposits in Cypriot bank branches outside Cyprus. The latter channel was the most binding, as it severely limited the government's room for maneuver and resolution options in dealing with the problems in the banking system. This was especially the case as the government debt was already very large again by 2012 (80% of GDP) and the government had practically run out of liquidity by March 2013 and any ability to borrow domestically or from abroad.

As will be shown below, the sharp worsening in public finances and the associated loss of access to new borrowing and of bank access to the ECB refinancing window were critical factors for the crisis that unfolded. They made it impossible for the government to finance its budget deficit and precluded any government support or contribution to covering the mounting capital shortfalls of the two largest commercial banks.

How did the Crisis Unfold?

The first spark of the crisis came with the onset of the global financial crisis that led to a weakening of capital inflows from the UK and East European investors, starting in 2008. This contributed to a leveling off of housing and property prices and a subsequent bursting of the housing and property price bubble. Prices started to decline by early 2009, with a cumulative fall over the subsequent years between the peak and trough of the cycle of 30-50%, depending on which index is used. Despite this, bank lending continued to expand rapidly through 2012, with new bank adventures in other countries in search of high yield, including new purchases of GGBs. Bank exposure to Greek residents and to GGBs amounted to the equivalent of 130% and 30% of Cyprus' GDP, respectively, by end-2011.

This also weakened economic activity and government revenue. However, the worsening of public finances was driven primarily by a deliberate attempt by the new government of President Christofias to increase social spending to support the AKEL party constituency. The fiscal expansion during 2008-10 amounted to some 4 percentage points of GDP in the form of higher employment and salaries in the public sector and higher social and pension benefits. This shifted the budget to large deficits of 5-6% of GDP with a related increase in public debt and the cost of government borrowing (Table 1). The primary budget balance deteriorated cumulatively by 7 percentage points of GDP, switching from a surplus of 3.5% of GDP in 2008 to a deficit of 3.5% by 2011.

Successive letters to the President by Governor Orphanides about the mounting risks posed by the widening imbalances in public finances were ignored by President Christofias. Orphanides argued correctly that sound public finances were an essential ingredient for financial sector stability. Regrettably, however, relations between the central bank under Orphanides and the government were non-existent. Orphanides' term of office ended in May

2012, and he was replaced by President Christofias' preferred candidate, Panicos Demetriades.

The widening fiscal imbalances also prompted EU warnings and the placement of Cyprus under the EU's excessive deficit procedures in 2010, but to no avail. Rating agencies downgraded Cyprus' sovereign debt to below investment grade, and by late May 2011 Cyprus lost access to international capital markets (in the sense that it became prohibitively costly to issue new debt, with no interest in any new lending by investors). The economy turned into recession during the second half of 2011, particularly after a major ammunition explosion at Mari in July 2011 (due to severe government negligence) that destroyed Cyprus' main electricity generation station and cut total electricity supply by half. To cover its funding needs, the government resorted to a 5-year €2.5b bilateral loan at 5% from Russia at end-2011 and the issuance of Treasury bills to banks and public pension funds.

The crisis deepened further during the second half of 2011 by the results of the second EBA stress test and the restructuring of GGBs. The first EU-wide EBA stress test was held in July 2010, and Laiki and Bank of Cyprus passed easily after some capital mobilization through the issuance of capital-eligible bonds. However, this test was assessed *ex post* as not strict enough as it excluded bank holdings of government debt. Its validity was further undermined after a Belgian bank (Dexia) that had easily passed the EBA stress test collapsed due to difficulties with its government bond holdings. In response, EBA launched in October 2011 a new, supplementary recapitalization exercise requiring the attainment by end-June 2012 of a Core Equity Tier 1 (CET1) capital ratio of 9%, plus a buffer equal to the gap between the market value and the book value of all bank holdings of government debt at end-September 2011. The timing of the stress test was rather unfortunate as it coincided with the peaking of the sovereign debt crisis in Europe and the announced plans for the restructuring of GGBs in July and October 2011. Any losses from the GGB restructuring were allowed to be offset against the capital buffer. This EBA initiative and the GGB restructuring unmasked the weaknesses in the Cypriot banking system and sparked the banking crisis.

The restructuring of GGBs took two different forms in July and October 2011. It was initially made necessary by a request from Germany and other key Eurozone states for a contribution by the private sector as a precondition for agreeing on a new 3-year troika-supported economic adjustment program for Greece. The Institute of International Finance (IIF), based in Washington, as the principal global association of major banks and other investors, was invited in May 2011 by the Eurogroup to provide (a) financing assurances for Greece for the rest of 2011, which was a precondition for the completion by the IMF in early July 2011 of the fourth review of Greece's program; and (b) a financing contribution offer for the period 2011-2014. The latter was intended to serve as a burden-sharing of Greece's funding needs among public and private creditors, requiring limited involvement by the Greek authorities. To this end, the IIF, representing Greece's private creditors, agreed with the Eurogroup on a financing offer entailing a flow rescheduling of some €36b of the GGBs maturing during the consolidation period of 2011-2014 (and a larger amount for the period 2011-2020) with a Net Present Value (NPV) loss of 21%. This offer was accepted by the Eurozone Heads of State and Governments (the European Council) at their meeting in Brussels on July 21, 2011. It became known as PSI1 (Private Sector Involvement 1). Contacted by IIF officials on the next day, both Laiki and the Bank of Cyprus agreed to voluntarily participate in this financing offer.

At the same meeting on July 21, 2011, the European Council agreed on major enhancements of the European Financial Stability Facility (EFSF) that had been set up in June 2010 (after the Greek crisis) to provide financial assistance to Eurozone member states facing sovereign debt and other financial difficulties. These reforms entailed *inter alia* very long maturities at very low lending rates marginally above short-term money market rates for new lending, designed to assist Greece and other Eurozone member states agreeing on new programs. It also envisaged ECB purchases of government bonds of countries with agreed programs and the option of direct EFSF recapitalization of ailing banks under some conditions.

To become effective, however, the EFSF reforms needed to be approved by each Eurozone member state according to their national procedures, which entailed in most cases parliamentary approvals or even referendums (Ireland) or new elections (Slovenia). These procedures were not completed until mid-October 2011. By this time, however, the economic situation in Greece had deteriorated dramatically beyond what had been anticipated in July. By necessity, the program funding needs escalated and the PSI1 financing offer became grossly inadequate. This was addressed with a new, more comprehensive agreement initiated in October 2011 and concluded in early 2012 to restructure virtually all of Greece's stock of GGBs, some €207b, of which €3.2b were held by Laiki and €2.2b by the Bank of Cyprus and about €45b by Greek banks and pension funds. European banks, pension funds and insurance companies were large holders of GGBs as well.

Negotiations on the second Private Sector Involvement (PSI2) between senior IIF officials and European bank representatives and the Eurogroup working Group (EWG) were held in Brussels in October 2011, and were concluded at the European Council meeting of October 26/27. On this occasion, the initial phase of the negotiations was in fact concluded at a special meeting between the creditor representatives with Chancellor Merkel of Germany and French President Sarkozy outside the European Council meeting room. The restructuring deal envisaged an upfront nominal haircut of 50% and completion of all the restructuring details through voluntary negotiations among creditors and interested parties (the Eurogroup, Greece, other Eurozone member states, the IMF, and the ECB) in subsequent months. The PSI2 deal was put to the vote in the morning hours of October 27, 2011, by the full European Council and was approved unanimously. Present at this meeting were Prime Minister

Papandreou of Greece, who had not been consulted beforehand, and President Christofias, both of whom did not raise any concerns or objections.

Under the troika program for Greece, Greece was provided with a recapitalization fund of €50b to allow the state to participate in the recapitalization of Greek banks (giving the state majority ownership) after the PSI2, with restrictions on its voting rights as a shareholder. Cypriot banks were not eligible to benefit from this fund as they had only branches, and not subsidiaries in Greece. Earlier in 2011, Laiki had decided to convert its subsidiary in Greece into a branch, a decision that required only approval by a Cypriot Court with no required legal involvement by the Central Bank of Cyprus according to the then existing legal and regulatory framework. President Christofias was *ex post* criticized by Governor Orphanides, political parties and others for not using his veto power at the European Council meeting of October 26/27 or at least for not raising objections and asking for special compensation for Cyprus as the Cypriot banks' exposure to GGBs was the largest among all creditors as a share of GDP. However, according to the EFSF rules, Cyprus could only benefit from Eurozone assistance if it applied for a program itself, something that the government was not willing to do. Arguably an expression of concern by Cyprus might, with the benefit of hindsight, have extracted promises for due consideration down the line.

The PSI2 negotiations were not concluded until February 21, 2012, in a Eurogroup meeting in Brussels, by which time the worsening economic and political situation in Greece required even further concessions by the creditors (including a higher haircut, of 53.5%, of GGB holdings). The PSI2 deal was approved through a tender by the majority of private creditors in March/April 2012, including by a positive vote by both Laiki and the Bank of Cyprus. The final terms of PSI2 entailed losses of up to 75-80% in NPV terms, amounting to around €4.5b or 25% of Cyprus' GDP. Both banks had to make provisions for these losses in late 2011 and early 2012. For the Bank of Cyprus, the GGB losses amounted to around €2.0b, including €300m for the cost of swaps of indexed GGB holdings.

The impact of the GGB restructuring and of the deteriorating situation in Greece increased the need for provisions for the deteriorating quality of the bank loan exposures to Greece, particularly by Laiki. This gave rise to recapitalization needs under the EBA 2011 exercise of €1.8b for Laiki and €1.3b for the Bank of Cyprus, that needed to be met by end-June 2012. In a letter to CBC in December 2011, the Bank of Cyprus outlined a range of corrective or mitigating measures that it intended to take, that lowered its capital gap to around €500m by June 2012. To address this remaining gap, the Bank of Cyprus requested in July 2012 government assistance under the EU state-aid rules and an extension of the deadline. In the end, this request was superseded by events that led to the March 2013 agreement.

Laiki's capital requirement of €1.8 billion could not be covered by its own means. Pressures by the then Chairman of Laiki, Michael Sarris, to the Christofias government to request a bank recapitalization program under EFSF rules were not heeded, nor were requests by Sarris to the Bank of Greece to include Laiki under the troika-financed Greek bank recapitalization program. This made it necessary for Laiki to resort to an equity issue with government underwriting in May 2012. However, as no material interest was expressed by private investors, the government essentially nationalized Laiki through an injection of capital paid by government bonds (equivalent to 85% of Laiki's total equity). This action was taken by the government as a measure of last resort as Laiki was considered a systemic bank and its liquidation was not viewed as an option. Liquidation would also have required the government to compensate the €8.5b of Laiki's guaranteed deposits at a time when public finances were already under pressure. Conversion of senior Laiki bonds into capital was also precluded as it was feared it might constitute an event of default for Laiki.

In parallel, Laiki was experiencing major deposit losses and liquidity shortfalls, necessitating a gradually increasing resort to Emergency Liquidity Assistance (ELA) from the CBC. Under ECB rules, ELA was meant to be provided to solvent banks with adequate collateral, renewable every 15 days and subject to no objections by the ECB Governing Council. Even if Laiki could have been considered solvent in June 2012, this came under serious doubt in subsequent months as the run on its deposits continued, especially in early 2013. Governor Demetriades stated before the Pikis Investigating Committee that *"Laiki was kept on an artificial respirator for 9 months until the new government took over in March 2013."*

The worsening fiscal finances were aggravated further on June 25, 2012, when Fitch became the last rating agency to downgrade Cyprus to below investment grade. This automatically meant, according to ECB rules, the loss of eligibility of Cyprus government bonds for rediscounting by the ECB, in the absence of an EFSF-supported program for Cyprus, and thus an inability of Cypriot banks to access ECB normal refinancing facilities. On the same day, the government of Cyprus was forced to request program assistance from the troika.

Notwithstanding the urgency of the situation, and unlike the experience of other Eurozone program countries that concluded agreements within a month or so after making a formal request, President Christofias was unwilling to reach an agreement with the troika. This reluctance was driven by concern about the potential political responsibility from the likely adverse impact on the AKEL constituency and the Cypriot public in general from the inevitable bitter economic and other corrective measures under a reform program. He chose, instead, to pass on this responsibility to the new government, after the presidential elections of February 2013, which he was not planning to contest himself.

A program request and agreement with the Troika should ideally have been made before Cyprus lost market access in May 2011. Eurozone and IMF officials were becoming increasingly impatient and bewildered by the attitude of the Cypriot government. The delay in requesting assistance and concluding an agreement not only aggravated the economic and financial situation in Cyprus and increased the funding needs of both the government and the banking system. It also posed risks to the stability of the Euro as the concerns about a potential Grexit increased in the period to November 2012, while the situation in Italy was also deteriorating. The Chairman of the Eurogroup Working Group (EWG), Thomas Wieser, visited Cyprus in July 2012 and strongly advised the government *"not to miss the train,"* by concluding an agreement and requesting Eurogroup approval for a program in July 2012, at the same time as Spain's request for EFSF support for the recapitalization of its banks was scheduled for discussion by the Eurogroup. A request at that time would have helped ensure that Cyprus got comparable favorable terms as Spain. Similar encouragements to the Cypriot government were made by other senior European Commission and IMF officials, but to no avail.

Finally, the government consented to accept a troika mission in October 2012 that formulated a draft memorandum of understandings (MoU) and the needed policy reforms, but the government was still reluctant to sign an agreement. The October and November 2012 versions of the MoU (which were leaked and widely reported in the press) included in paragraph 1.19 a vague reference to *"including by own means"* as way of covering the recapitalization needs of the banking system. The meaning of this term was left undefined, but it was tacitly understood by the CBC and government officials to mean at least a partial or full conversion of bank capital securities into equity. The troika financing envelop in October was still around €17.5b, covering both the budget funding needs and the recapitalization needs of the banking system, but it was quickly becoming questionable. By March 2013, it was limited to only €10b, covering the budget funding needs and the recapitalization needs of the cooperative banks, with a cushion for other smaller banks should it be needed, but not the needed funding for the recapitalization of Laiki and the Bank of Cyprus.

The main policy adjustments pushed by the troika in October 2012, but resisted by the Christofias government and CBC Governor Demetriades (on point c), included the following measures:

- the inclusion in the budget of all the royalty receipts from natural gas exploration deals rather than in a separate fund, controlled by the government, outside the budget, as the government was pushing for.
- downward adjustments in the cost-of-living provisions under collective agreements during the program period.

- a shift of the supervision of the cooperative institutions from the Ministry of Commerce, Industry and Tourism to the Central Bank of Cyprus like all other banks.
- a tightening of the framework and enforcement of AML regulations.
- commitments for the privatization over time of two key public enterprises.

These measures could not realistically be considered as too onerous, especially with the benefit of hindsight, if they could unblock agreement on a bail-out program of €17.5b with no deposit haircuts.

There were several reasons explaining the gradual hardening of the troika position and its willingness to consider a large financing package, especially after November 2012. These reasons included:

- the lack of cooperation by the Cypriot government, ironically at a time when Cyprus held the rotating presidency of the EU during the second half of 2012.
- the easing of bank pressures in Spain after the July 2012 agreement for EFSF assistance for the recapitalization of Spanish banks.
- the easing of pressures in Italy's bond market and the associated decline in spreads.
- the completion of the negotiations and approval by the Eurogroup in November 2012 of a new program for Greece and, thus, the evaporation of the associated risk of a Grexit.
- the easing of the pressures on the Euro and the concerns about the viability of the Eurozone.

The latter reflected in large part ECB President Draghi's declaration in July 2012 that the ECB would do *"whatever it takes"* to support the Euro and the introduction by the ECB in October 2012 of the Outright Monetary Transactions facility, under which the ECB committed to purchasing unlimited amounts of government securities of Eurozone countries under support programs agreed with the EFSF/ESM (European Stability Mechanism).

Against this setting, the IMF also was, by late 2012, no longer prepared to accept that the situation in Cyprus posed systemic risks for the Eurozone. Thus, it was no longer willing to provide *"exceptional assistance"* as it was the case for Greece, Ireland and Portugal where IMF financing was well in excess of 600% of these countries' quotas. Instead, the eventual IMF commitment for assistance to Cyprus was limited to €1b or 563% of Cyprus' quota and only 10% of the €10b total financing finally provided by the troika, compared to the one third share in the case of the other three countries.

Topping up all of these reasons for the reluctance by the troika to consider a large financing package for Cyprus was the launching in November 2012 of the campaign for the parliamentary elections (in December 2012) in Germany. In this campaign, the two main political parties declared their unwillingness to provide German support for another Eurozone bail-out program, especially for Cyprus which was rumored to be an offshore financial and tax shelter facilitating money laundering by Russian and other East European oligarchs. Cyprus was the last Eurozone country to request program assistance. But by late 2012, as the Euro stabilized and the zone's viability was no longer an issue, "bail-out fatigue" had set in and essentially Cyprus missed the boat.

To its credit, however, the government of President Christofias proposed in December 2012 a budget for 2013 and a fiscal adjustment program that included all the tax increases, cuts in spending and other fiscal adjustment measures (amounting to the equivalent of 4.5 percentage points of GDP) called for in the draft MoU of November 2012. These fiscal reforms were a prior action for an eventual agreement for a troika program and were adopted unanimously by Parliament, with full support from all opposition political parties. Ironically, the early adoption of the needed tax and other fiscal measures by the outgoing government allowed Finance Minister Harris Georgiades of the incoming government to truthfully indicate that President Anastasiades' government did not raise taxes under the troika program. While supporting the budget, the opposition parties, including in particular DISY, the principal opposition political party, did not push the government to reach an early agreement with the Troika. Instead, they tacitly welcomed the increasing political cost of the unsolved economic crisis for the government of President Christofias and his AKEL party ahead of the February 2013 presidential elections.

Regrettably, what the government of President Christofias and all the opposition political parties did not fully appreciate was that timing was rapidly working against Cyprus' best interests. The passage of time and policy inaction worsened the available policy options and strategies for securing external financial assistance for dealing with the crisis. With the delays in taking appropriate corrective policy action and requesting external assistance, the damage to the Cypriot economy was becoming deeper and more serious.

Yet, at the same time the potential adverse spillover impact of the Cyprus' crisis on the rest of the Eurozone was becoming less worrisome for the Eurozone authorities, the European Commission, the ECB, and the IMF. It is this dichotomy that played a critical role in the final outcome.

Was Bank Supervision by CBC Effective?

Questions have arisen about the effectiveness of bank supervision by CBC during the period leading up to the crisis. More concretely, questions arose as to whether Governor Orphanides was equally concerned about the excesses in the banking system and the overheating in the economy as he was about the mounting fiscal imbalances. With the benefit of hindsight, it would appear that the corrective measures taken or pushed by the central bank were too little too late and were not sufficient to contain the risks and abort the crisis.

To be fair, Governor Orphanides and CBC officials were concerned about the rapid credit expansion for housing, the upward pressures in housing prices and the overheating of the economy. To help cool down these pressures, CBC introduced a number of macro-prudential measures, including a reduction in the loan-to-value ratio for new housing loans from 80% to 70%, and slowed down the needed convergence of Cypriot interest rates to those prevailing in the rest of the Eurozone and the stabilization of the exchange rate as required for the envisaged entry into the Eurozone by January 1, 2008. Unfortunately, these measures were resisted and not adhered to by the banks (including the long-existing 70% stock liquidity ratio for foreign non-Euro deposits), while the maintenance of tighter monetary conditions in Cyprus through positive interest rate differentials encouraged even more capital inflows.

Micro-prudential measures and strict bank supervision were something new in Cyprus but were reinforced by the adoption by the European Commission of the Basel III rules through the introduction of the Capital Requirements Regulations (CRR) in 2008. Thus, starting in 2009, the CBC sent annually formal SREP (Supervisor Review and Evaluation Process) letters to each one of the banks establishing Pillar 2 requirements raising the total Core Tier 1 capital ratio (including both a Pillar 1 requirement of 8% and bank-specific Pillar 2 requirements) to 11-12% by late 2011. These requirements could be met by equity and outstanding convertible bank bonds. Governor Orphanides also sent a letter to each one of the main banks in March 2010 pointing to the high exposures to GGBs in relation to their capital (170% for Laiki and around 70% for the Bank of Cyprus) and the associated risks, but there was no follow up. Orphanides argued before the Pikis Committee that the regulatory framework did not provide the legal right to CBC to forbid the purchase of GGBs or set limits on such holdings. All bank holdings of government bonds issued in the local currency of the countries in which the banks were registered (including GGBs) carried (and still carry) a zero-risk weight in the calculation of their risk-weighted assets and capital requirements. Moreover, the Bank of Greece, after pressures from Vgenopoulos, the Chairman of Laiki, complained to Orphanides about his letter on GGBs.

Going after the banks at the time was not easy or popular, as they were strongly supported by political parties. Orphanides was in fact accused by the Ethics Committee of Parliament for "being biased against Laiki and favoring the Bank of Cyprus," after Vgenopoulos threatened to move the headquarters of Laiki from Cyprus to Greece. Ironically, Laiki's decision to convert its subsidiary in Greece into a branch in early 2011, was reportedly welcomed by CBC as it gave CBC the sole responsibility for the supervision of Laiki, including the power to test whether Vgenopoulos met the "fit and proper" criteria for serving as Chairman of Laiki—he had been approved initially for that position by the Bank of Greece as Laiki had merged with Marfin Egnatias Bank in Greece. Fearing disqualification, and more importantly due to the worsening condition of Laiki, Vgenopoulos decided to resign from the Laiki Board in November 2011.

The CBC views on the risks from GGBs were toned down also by Governor Orphanides' reluctance, as a member of the ECB Governing Council, to express concern about the bonds of another Eurozone country. He was also unconvinced of the wisdom of a GGB restructuring, favoring instead, together with ECB President Jean-Claude Trichet, higher financing to Greece by Eurozone member states. This might have led to an underestimation by CBC of the adverse impact on Laiki and the Bank of Cyprus from the GGB restructuring.

More gravely, however, CBC seems to have not fully appreciated the underlying vulnerabilities in the banking system during 2010-12 and the rapidly worsening quality of the bank loan portfolios. As a consequence, CBC made no significant effort to encourage corrective measures, including adequate provisions, redefinition of non-performing loans and urgent improvements in risk management. It appears that there was no effective framework at the time for the central bank and the government adequately to evaluate financial stability risks arising from the actual and potential further worsening of the quality of bank balance sheets. These risks emanated from poor bank risk management and governance practices and the expansion in bank operations in other countries and thus the potential bank capital depletion. The EBA stress tests of 2010 and 2011 should have been seen as part of broader financial stability risks. At the same time, there was a widespread analytical misperception by the government and the CBC that private sector imbalances and hence the contribution of these imbalances to the recorded huge current account deficits of the balance of payments did not matter. Only public sector deficits were thought to matter for policy consideration and policy action.

These two analytical weaknesses were critical for the apparent inability of the government and the CBC to fully grasp the perils the Cypriot economy and banking system were facing. Thus, the warnings and pressures by the troika for urgent corrective action were considered overblown. The policy implications of the findings of the PIMCO report that suggested large negative capital ratios and bank insolvency under the adverse scenario for Laiki and the Bank of Cyprus (see below for details) that were available to the Cypriot authorities before the March 2013 Brussels meetings appear not to have been given the attention they deserved.

How did the March 2013 Deal Come About?

By late 2012, the troika decided to no longer pursue a deal with President Christofias in view of the forthcoming presidential elections of February 2013. At the same time, the attitude of key Eurozone countries, the IMF and the ECB was hardening further, as evidenced by the leaking in the *Financial Times* in November 2012 and again in February 2013 that the European Commission was exploring novel options for dealing for the recapitalization of the

Cypriot banks, including the bailing in of shareholders, bondholders, and other uninsured creditors (depositors). These options were part of the tools or instruments envisaged by the draft Bank Resolution and Restructuring Directive (BRRD) that was being debated by the EC and the Eurogroup, before its final adoption in June 2013. In fact, a draft piece of legislation (Bank Resolution Law) providing for the adoption of the BRRD in Cyprus had been prepared by the Ministry of Finance in late 2012 under the Christofias government.

Alerted to these new pressures and initiatives by the IIF and some top government officials, both the outgoing and the incoming governments underestimated or dismissed the risks. They argued, instead, that no bail-in options had been formally proposed to Cyprus by the troika or the Eurogroup, and at any rate such options would violate the protection of property rights under Cyprus' Constitution and the European Human Rights laws. They were so mistaken. There were also increasing lobbying efforts to the incoming government by introducers on behalf of their Russian and other expatriate clients with bank deposits in Cyprus to totally avoid any bailing in of uninsured deposits. The DISY party and its leader, Nicos Anastasiades, were also, with the benefit of hindsight, rather overconfident. They thought that their close links with conservative political parties in the European Parliament and in particular with Chancellor Merkel herself, who attended a pre-election event in Limassol, would allow Anastasiades, once elected President, to reach a better deal with the troika than what had been leaked in the press or offered to President Christofias.

In the meantime, by the time of the presidential elections the government was literally running out of funds as it had exhausted all its options of tapping any available liquidity in the hands of public enterprises and public pension funds. Going into the first round of negotiations with the Eurogroup on March 15, 2013 in Brussels the Cypriot delegation had essentially no strategy or any leverage to resist any pressures as it was desperate for a solution to avoid suspension of government payments and bankruptcy.

Predictably, the Eurogroup, led by Germany, the IMF and the ECB pushed, with no objections or comments from other countries, for the funding of the recapitalization needs of Cypriot banks, estimated at around €8b, through "own means." More specifically, they proposed a special one-off financial stability levy (they did not want to call it a tax) of 13% on all uninsured domestic deposits of all Cypriot banks. EC officials tried to find some softer options, such as the non-distribution of interest income on bank deposits for two years (yielding €3 billion), but it was turned down as insufficient.

The Cypriot delegation (particularly President Anastasiades) reportedly argued that a 13% levy on uninsured deposits would have had an excessive adverse impact on foreign deposits in Cypriot banks and that it would threaten the viability of the offshore financial center business model of key Cypriot banks. The delegation reportedly suggested that a levy higher than 10% would not be acceptable. The IMF quickly recalibrated the levy calculations and proposed what was finally and very reluctantly accepted by the Cypriot delegation as a compromise. This entailed a levy of 9.9% on the uninsured deposits and 6.75% on the insured deposits of all banks. The German Finance Minister Wolfgang Schäuble, who was present at the meeting, stated publicly later that this compromise was proposed by the Cypriot delegation. The IMF and Greece, however, raised concerns about the impact of any solution for Cyprus on the banking system of Greece. It was considered imperative that Greece avoided a run on its bank deposits and achieved insulation from developments in Cyprus, as its program and financial position were still very fragile.

The outcome of the first round raised concerns and criticisms, both within and outside Cyprus. Within Cyprus, it was received with great surprise and disappointment, it was very unpopular, and it affected all banks, even those with no recapitalization needs. To demonstrate their displeasure, in a quick vote by Parliament, all opposition parties voted against it, with the ruling DISY party abstaining, reportedly, in a last attempt to resist Eurogroup pressures, raise concerns in capital markets and pave the way for convincing the Eurogroup to offer a better solution. At the same time, there was an outcry in financial markets in Europe as the proposed levy on insured deposits was considered as undermining the existing legal framework for government guarantees for bank deposits up to €100K, risking a weakening in bank confidence throughout the Eurozone.

Against this background, after some attempts to introduce layered obligations for insured deposits, the whole offer was withdrawn by the Eurogroup, and a new round of negotiations was called for during March 23-25. During the intervening days, CBC restricted capital outflows through Cypriot banks, the Cypriot banking system was closed down for two weeks (until March 28) and contacts were initiated with the Bank of Greece for the possible sale of the Cypriot bank branches in Greece (by Laiki, the Bank of Cyprus and the Hellenic Bank). There was also a last-minute failed attempt by Finance Minister Michael Sarris to visit Moscow, at the request of the government, to try to secure a new bilateral loan from Russia.

The results of the second round are well known. To force the Cypriot delegation to accept the inevitable option of a bailing in, the ECB representative at the meeting, Jörg Asmussen, threatened that, without an agreement, the ECB will discontinue the ELA for both Laiki and the Bank of Cyprus. This would have caused essentially the closing down and liquidation of both banks, irrespective of their systemic status in Cyprus, with catastrophic consequences for Cyprus. To minimize the adverse impact, it was finally agreed by the Cypriot delegation to go along with a liquidation/resolution of one bank (Laiki) and the resolution of another bank (Bank of Cyprus). At the same time, as a prior action, it was agreed during the meeting to sell all Cypriot bank branches in Greece to Piraeus Bank at a then agreed price based on the adverse PIMCO stress test scenario, plus a cushion for potential restructuring costs. The selling price was agreed with the involvement of the EC General Directory for Competition, but the buyer among Greek banks was decided by the Hellenic Financial Stability Fund, which was controlled by the Greek government.

The rationale for both measures was to avoid an unsustainable increase in the public debt of Cyprus—through a government-funded bank recapitalization and/or an activation of the government guarantee of bank deposits of both Laiki and the Bank of Cyprus and of the Cypriot bank branches in Greece—and the insulation of Greece from developments in Cyprus' banking system. The poor state of public finances left no other realistic option. The draft bank resolution law prepared for a possible BRRD adoption was reviewed and revised quickly by ECB and Cyprus' lawyers and was adopted overnight on March 25, 2013, by the Parliament. Under the law, great powers were recognized for the Resolution Authority, which was comprised from only one person, at least for a while, namely the Governor of the Central Bank of Cyprus, Panicos Demetriades, who implemented the decisions agreed in Brussels.

The assessment of the recapitalization needs of the Cypriot banks was based on a special due diligence independent study prepared by PIMCO during November 2012-February 2013, undertaken at the request of the troika and monitored by a steering committee, comprised by representatives from the troika and the Central Bank of Cyprus. The macro-economic assumptions for the baseline and adverse scenarios for the 3-year period 2012-15 were provided by the steering committee. These macro assumptions and the assumptions for the Loss-Given-Default probabilities (LGD) used under the adverse scenario (entailing a GDP cumulative decline of 10 percentage points during 2012-14 and a large decline in housing prices) have been criticized by Governor Orphanides and others as unduly negative, inflating the bank recapitalization needs. However, with the benefit of hindsight, and even though the PIMCO report was finalized in February 2013, when the bail-in was imminent, the actual outturn for real GDP growth was very close to those assumed under the adverse scenario. The assumed LGD probabilities proved *ex poste* too optimistic as the actual decline in housing prices was much larger. Some other analysts have justifiably argued that the PIMCO results might have in fact underestimated the actual recapitalization needs, given for example the additional €1b capital injection needed by the Bank of Cyprus in November 2014 and the cumulative large bad loan provisions made by the Bank of Cyprus in subsequent years out of operating profits.

The conclusions of the PIMCO Report and the way they were used in the second round of discussions in March in Brussels are summarized in Attachment 1, which reproduces Box 2 of the IMF Staff Report on Cyprus' Program Request of May 2013. PIMCO found both Laiki and the Bank of Cyprus as *"economically insolvent,"* with negative Core Tier 1 capital ratios of 5.8% and 4.7%, respectively, under the baseline scenario, and substantially larger negative capital ratios under the PIMCO adverse scenario (15.7% and 16.3% of Risk Weighted Assets, respectively). The combined capital shortfall under the adverse scenario relative to a required Core Tier 1 ratio of 6% amounted to €8b or 44% of GDP. Based on these findings:

- The bank branches in Greece were sold out at a total cost (loss) of €5.5b for the Bank of Cyprus and Laiki, lowering their balance sheets by one third (as targeted under the troika program from their excessive starting levels) and reducing the government deposit guarantee contingent liabilities by €9b. Laiki was deemed as non-viable as a stand-alone institution, given *inter alia* its limited collateral buffers for its €10b ELA liabilities and its deteriorating asset quality.
- Laiki was split in two, with the Resolution Authority (CBC) managing the legacy part with no banking license. The remaining part, comprising the bulk of its assets, the insured deposits, interbank liabilities, ELA and the Laiki staff were transferred to the Bank of Cyprus.

The main features of the restructuring of the Bank of Cyprus and Laiki are highlighted below, based on actual published data and other information included in the financial statements of the Bank of Cyprus for end-2012 and end-June 2013. Key points to underscore include the fact that the net fair value of the Laiki assets transferred to the Bank of Cyprus (as estimated by KPMG, appointed by the Resolution Authority) amounted to €0.5b (comprising €15.1b in assets—including €414m in Deferred Tax Assets--and €14.6b in liabilities). This surplus was deemed by the Resolution Authority as sufficient to cover the capital requirements for a CT1 ratio of 9%, and, importantly, was compensated with an 18.1% share in the estimated total share capital of the Bank of Cyprus, equivalent in value terms to €844m. Bailed-in depositors accounted for 81% of the share capital, with the remaining 1% belonging to the old shareholders and bondholders (their initial assets were almost fully, but not totally, eliminated by the resolution of the Bank of Cyprus). The Bank of Cyprus was under resolution from March 29 to July 30, 2013. At the end of this period, the total haircut for uninsured depositors was set at 47.5%. The total value of share capital bailed-in amounted to €2.4b. IMF estimates of the bail-in amounts for uninsured depositors and bondholders for Laiki and the Bank of Cyprus are shown in the table below.

Bail-in amounts (€billion)

	BOC	Laiki	Total
Uninsured deposits	3,9	4,0	7,8
Senior debt	…	0,1	0,2
Subordinated debt	0,6	0,8	1,3
Sum total	4,5	4,9	9,4
Ordinary shares	2,4	…	…

Source: BOC; IMF, Cyprus Selected issues, October 2014

About two thirds of the losses by depositors were roughly estimated at a later stage to have been borne by non-resident depositors.

Hellenic Bank was found by PIMCO to be solvent with positive equity, but with a €300m capital shortfall under the adverse scenario. This gap was covered by October 2013 through a €100m share capital issue and the conversion of €250m of junior debt into equity. The cooperative institutions were integrated from 93 to 18 entities under the Cyprus Cooperative Bank against political resistance and were recapitalized in March 2014 by a €1.5b capital injection by the government, financed by the troika.

Other key aspects of the March 2013 agreed program included (a) the imposition of capital controls (which were lifted by April 2015); (b) the introduction of an internationally comparable definition of non-performing loans, covering mainly all loans with arrears in excess of 90 days passed the due date; (c) the shifting of the supervision of the cooperative institutions to CBC; and (d) a tightening of the AML arrangements and enforcement. The coverage of NPLs was subsequently widened further to cover all non-performing exposures (NPEs) under strict criteria for NPE exit and curing.

The outcome of the second round of the March 2013 negotiations was greeted in Cyprus with disbelief, shock, and bitterness about the heavy-handed way Cyprus was treated by its Eurozone partners, including Greece, and by the ECB and the IMF. The outcome was totally unexpected, and strongly objected to by several groups, including in particular those more directly affected by the restructuring of Laiki and the Bank of Cyprus, namely the old shareholders, the bondholders, and those whose uninsured deposits were haircut or lost totally (in Laiki's case). Yet, the international reaction and that of the European financial institutions was minimal. Foreign press actually remarked that the Cypriot population took the shock with maturity, with no public demonstrations or objections to the severe limits on bank deposit withdrawals and other capital controls.

How Were Alternative Program Strategies Assessed?

The IMF Staff Report on *Cyprus' Request for an Arrangement under the Extended Fund Facility* issued in May 2013 indicates that *"alternative strategies were considered as either unavailable or undesirable (or both)."* More specifically, the IMF Report points out the following (page 10):

- *"Recapitalization of the insolvent banks with public money was not tenable, as it would have led to an unsustainable debt, peaking at close to 150 percent of GDP, with significant risks of increasing further. This would have overburdened the Cypriot taxpayer and* *maintained the large size of the banking sector, posing continued contingent risks onto the state."*

- *"Non-debt creating strategies, such as direct recapitalization of the banks by the ESM, ELA restructuring, or outright sale of the troubled banks, were not available."*
- *"The alternative of exit from the euro-zone would only partially address Cyprus' problems and would have deeply affected all market participants through devaluation and default, leading to large losses for taxpayers and insured depositors."*
- *"Finally, a proposal to impose a large one-off levy on both insured and uninsured deposits in all banks operating in Cyprus did not differentiate between solvent and insolvent institutions and conflicted with the aims of deposit insurance."*

Anatomy of the Agreed Solution

The above laconic language used by the IMF to describe each one of these options is rather dense and full of sub-themes and policy messages that describe the views of the Eurogroup, the ECB and the IMF.

A dissection of the rationale of the positions of both sides may help bring a better understanding of why things happened the way they did.

To start with, the consideration by the Eurogroup of Cyprus' request for assistance from its Eurozone partners was unusual in that it was not based on an agreed document negotiated beforehand by Cyprus and the troika mission team as had been the case with all the other program countries in the zone. It was based, instead, on the November MoU, which was not fully agreed upon, and some of its key terms, such as the meaning of *"by own means,"* were totally undefined. It was also not agreed in advance what the total financing package would be and what it would cover. Given the urgency of the situation, the Cypriot delegation went to Brussels without knowing what to expect and what was on the table for negotiations.

From its point of view, the Cypriot delegation was desperate to get full financing to cover the funding needs of both the budget (€7-8b) and the banking system (€9-10b) under a normal bail-out three-year program, similar to that applied in other countries. However, at the same time, the delegation was not fully aware of the complexities and underlying difficulties faced by Cyprus' banking system, as indicated above. The results of the PIMCO report had not been digested or adequately appreciated. They were considered instead as more theoretical or procedural, as the report had been mandated by the troika. The delegation did not realize that the two largest banks were considered by the troika as insolvent, not only because of the impact of the GGB restructuring, but also, and indeed more so, by the underlying problem of non-performing loans (both in Cyprus and in other countries, especially Greece) that was revealed by the PIMCO stress tests. The rationale and the urgency of the pressures to sell the Cypriot bank branches in Greece were also not fully understood. In fact, until November 2012, it was Cyprus who was concerned about the spillover problems from Grexit risks in Greece and the need for the banking system in Cyprus to be insulated from developments in Greece. Governor Demetriades made a speech in Limassol in September 2012 about these issues.

The position of the Eurogroup was dominated in practice by the views of Germany, with strong support from the ECB and the IMF. By March 2013 all of them were convinced that the risks posed by the crisis in Cyprus for the stability of the Euro and the viability of the Eurozone had evaporated for the reasons outlined in an earlier section. The political party of Chancellor Merkel won the December 2012 parliamentary elections with a commitment for no more bail-outs. The exaggerated rumors of money laundering in Cyprus' banking system by Russians and other outside investors had poisoned the political climate in Germany and any sympathy for Cyprus. The IMF had also by now been severely criticized internally, at its Executive Board, for its generosity in the case of Greece and had thus no appetite to provide a large new financing package to another Eurozone country. The mounting criticism was that the IMF and other official creditors should not bail out private creditors or bank shareholders by covering the full funding needs of a program country.

Against this background, the rationale of the negotiating position of the Eurogroup, the ECB and the IMF was premised on the following arguments:

First, a financing package of €17.5b would have raised Cyprus' public debt to about 150% of GDP, which was deemed as unsustainable. It would have also penalized taxpayers and would have required steeper fiscal adjustment that would have further undermined growth. In the case of Greece, the objective of GGB restructuring was to lower Greece's public debt to 120% of GDP. In a sense, the maximum available financing for Cyprus of €10bn dictated, given the program objectives, the extent and scale of other adjustment measures.

Second, the sale of the Cypriot bank branches in Greece was necessary to insulate Greece from any risk of a run-on bank deposits if deposits in Cyprus were to be haircut. It would also in one stroke lower Cyprus' extremely large size of its banking system by one third, or the equivalent of 150% of GDP, to a level closer to the European average. This was a fundamental and explicit objective of the reform program from the point of view of the troika.

Third, the large public debt of Cyprus and the excessive contingent government liabilities due to the deposit guarantee scheme did not allow any room for maneuver in considering other options for the restructuring of Laiki and the Bank of Cyprus, such as the creation of publicly own asset management company that would take over NPLs. This dictated essentially the merging of the left-over part of Laiki with the Bank of Cyprus.

Finally, the fact that bail-in options had been discussed by the Eurogroup within the context of BRRD, made it less extreme to consider these options for Cyprus. The Eurogroup was very much aware that Cyprus was only a small Eurozone member, accounting for less than 2% of its total GDP. But it was equally aware of the reputational cost of not being able to help even a small member state that was in crisis. The likely modest spillover impact from Cyprus to the rest of Europe may have made the Eurogroup less sensitive to the impact of novel and unusual reform measures finally applied for Cyprus.

Overall, the respective positions and expectations of the two sides differed substantially. Cyprus had no negotiating power or leverage and had little no other option but to accept what was on the table.

It would appear that the underlying dynamic was not solely one of a perceived harshness by the Eurogroup in imposing its views on Cyprus, even though many mistakes were made in rushing through complicated solutions with limited involvement of experts, including Cypriot bank officials. Instead, it would also appear that there was a gap in the understanding by the Cypriot side, certainly among the political leadership, of the concerns by the lenders' side about the underlying weaknesses in the Cypriot banking system and the emerging size of NPLs, a gap that played a significant role as well.

Concluding Remarks

The March 2013 deal was perceived by most political parties and some commentators in Cyprus as implying that the impact from the GGB restructuring and the cost from the sale of the bank branches in Greece (amounting to €4.5b and €5.5b, respectively) accounted essentially for the total recapitalization need of Laiki and the Bank of Cyprus. These two factors alone, imposed essentially by outside forces, were interpreted to be the principal reasons for the difficulties faced by the banking system. Similarly, another point of view emanating from circles that were more directly affected by the restructuring of Laiki and the Bank of Cyprus, took a stronger and more emotional approach. It perceived the sale of the Cypriot bank branches in Greece as an exercise in blackmail by the Greek government against Cyprus and the Cypriot banks, in collusion with the troika. The emotional reaction and the bitterness felt by many Cypriots about the bailing-in are clearly understandable. However, underlying these two views was the perception that somehow Cyprus was entitled to be bailed out fully, with no contribution by the bank shareholders and bondholders.

The developments during 2011-12 and the restructuring of GGBs unmasked the low quality of the bank balance sheets and started to reveal the underlying non-performing exposures. The contraction in economic activity during 2012-14 certainly aggravated further the low loan quality challenges, contributing to a sharp increase in NPEs by end-2014 to €15b for the Bank of Cyprus and €28.4b (47.5% of outstanding loans) for the whole banking system. Laiki's problematic exposures to Greek residents were the main reason for the losses from the sale of its branches in Greece. However, the low-quality bank loans in East European countries had nothing to do with the Greek debt crisis. In addition, the NPE problems faced by the Cooperative Central Bank and other smaller Cypriot banks, while partly due to the economic recession in Cyprus, had nothing to do with developments in Greece.

The answers to the questions raised in the introduction of this paper should be clear from the above analysis. In a nutshell, the origins of the Cyprus economic crisis reflected fundamentally:

- The escalating vulnerabilities and distortions in the banking system, which had been fueled by excess liquidity, excessive reliance on volatile non-resident deposits, extremely poor risk management and corporate governance by bank managements, and anachronistic and dangerous practices for lending decisions (through reliance on the value of collateral rather than the borrower's ability to repay) and for recognizing non-performing loans.
    - The extremely high level of bank balance sheets and the low quality of bank loans was a time bomb waiting to explode.
    - The spark literally came from the Mari ammunition explosion and the associated decline in output, the global financial crisis, the bursting of the housing and property price bubble, and the Greek economic crisis and debt restructuring.
- Bank supervision was ineffective in practice to arrest the emerging vulnerabilities in the banking system. It was compromised by the outdated legal framework for bank supervision, past forbearance practices, and political interference and collusion with bank managements.
- The widening public deficits added to and complicated the banking crisis. Public finances initially benefitted from the excesses in the banking system, but with the onset of the global financial crisis, the budget surplus was wiped out and excessive increases in discretionary spending gave rise to large budget deficits and a rapidly rising public debt.
- The negative feedback loops between the banking system and public finances played a major role in escalating the crisis and in limiting the policy options for an appropriate solution.
    - The rising public debt and the largely unfunded contingent public liabilities in the form of government guarantees for insured bank deposits, including in Cypriot bank branches abroad, led to:
        - the loss by the government of its access to foreign, and eventually, domestic borrowing.
        - rating downgrades to junk status.

        - the loss of access by Cypriot banks to the ECB refinancing window.
    - The imbalances in public finances could have been handled very easily if the banking system were not in trouble.
    - Similarly, had public finances been in good shape, the government could have been able to contribute to the covering of the emerging capital gaps of key Cypriot banks, with or even without a troika-supported financial program.
- The apparent lack by the government and the Central Bank of Cyprus of an appropriate framework for analyzing financial stability risks undermined the ability of the Cypriot authorities to adequately appreciate the emerging vulnerabilities. It also made it difficult to engage on a timely and more informed basis with the troika in identifying appropriate early policy solutions and adequate financial support.
- The delay by the Christofias government in seeking troika support and the government's reluctance to reach an agreement when a program request was finally made were catastrophic.
- Arguably, a larger financing package than agreed in March 2013 without a bailing-in might have been possible, if a troika-supported program had been agreed during July-October 2012.

In the aftermath of the crisis, both the government and the banks have drawn the right policy lessons and, more importantly, have been applying these lessons in their actions in subsequent years. The government has been very successful in maintaining budget discipline. Banks have made major strides in improving their risk management and governance structures, enhancing their capital positions, lowering sharply their non-performing exposures, and gradually restoring bank profitability. Bank supervision has been greatly enhanced under the ECB's Single Supervision Mechanism. However, progress in some key structural areas, such as the reform of the judicial system, remains modest or incomplete.

Annexes

Table 1: Cyprus - Selected Econo,ic and Financial Indicators, 2005-2018														
(In % or as otherwise indicated)														
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Nominal GDP, in billions of Euros	14.8	16.0	17.5	19.0	18.7	19.3	19.7	19.5	18.1	17.6	17.7	18.5	19.6	20.7
Real GDP growth	4.9	4.7	5.1	3.6	-2.0	1.3	0.4	-2.9	-5.8	-1.3	2.0	4.8	4.5	3.9
Unemployment rate	5.3	4.6	3.9	3.7	5.4	6.3	7.9	11.9	15.9	16.1	15.0	13.0	11.1	8.4
Nominal budget balance/GDP	-2.2	-1.0	3.2	0.9	-5.4	-4.7	-5.7	-5.6	-5.1	-0.4	-0.3	0.3	1.8	2.4
Primary budget balance/GDP	1.0	2.0	6.1	3.5	-3.1	-2.8	-3.5	-2.4	-1.7	2.7	2.8	3.1	4.3	4.9
Public debt														
In billions of Euros	9.6	9.6	9.5	8.7	10.1	11.0	13.1	15.6	18.7	19.0	19.2	19.5	18.8	21.3
In % of GDP	64.7	60.0	54.0	45.6	54.3	56.8	66.2	80.1	103.1	108.0	108.0	105.5	95.8	102.5
Banking sector														
Total assets														
In Euro billions						154.1	135.8	122.9	77.6	75.6	73.2	67.3	67.6	59.7
In % of GDP						798.5	688.3	630.7	427.8	429.4	412.4	364.2	344.3	287.8
Total credit to the private sector														
In Euro billions	23.1	25.9	31.5	40.3	42.1	45.5	48.1	48.5	45.9	44.0	43.6	41.0	38.8	29.4
In % of GDP	155.6	162.2	180.0	211.8	225.7	235.7	243.6	248.8	252.9	249.6	245.5	222.0	197.5	141.8
Annual % change		12.5	21.5	27.7	4.7	8.0	5.6	0.9	-5.4	-4.2	-0.9	-5.8	-5.5	-24.2
NPEs														
In billions of Euros										28.4	27.3	24.2	20.9	10.4
NPE ratio										47.5	45.4	46.2	42.5	30.5
Housing prices, % change			23.3	17.6	-4.7	-1.1	-3.3	-5.3	-6.5	-8.8	-4.3	-1.4	1.1	1.7
RICS composite housing prices														
Residential, % change							-7.8	-7.4	-11.4	-6.4	-2.0	1.7	5.2	6.0
Commercial, % change							-7.2	-11.2	-15.8	-8.6	-3.5	1.0	4.8	6.2
Source: Bank of Cyprus data base, based on actual official data.														

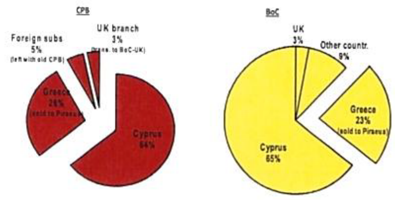
Box 1. Dealing with the Problem Banks

Issue. *According to the PIMCO due diligence analysis, the two largest Cypriot banks were economically insolvent.* Relative to other financial institutions in Cyprus, Bank of Cyprus (BoC) and Cyprus Popular Bank (CPB) were both projected to accumulate large losses through 2015 and reported a high level of insolvency under the baseline scenario. These losses were expected to be significantly larger under a stress scenario envisioned at the time to involve recession of close to 10 percent in 2012-14 and an implicit increase in non-performing loans (NPLs) to nearly 70 percent of gross loans by 2015 and provisioning of 50 percent. To achieve a Core Tier 1 (CT1) capital ratio of 6 percent under the stress scenario, these banks needed a total of 44 percent of GDP (close to €8 billion). However, these funds were not available in the private sector and a government capital injection was also not tenable, as such public support would have rendered public debt unsustainable.

Percent of GDP (unless otherwise noted)	BoC	CPB	HB	Foreign subs and branches	Coops	Total
Assets (net)	201	171	49	221	98	739
Loans (net)	146	126	27	132	73	504
Liabilities	190	165	46	210	89	701
Deposits	159	100	43	103	84	489
Central bank liabilities	21	56	0	NA	0	76
CT1 2015 (percent of RWAs)						
PIMCO baseline scenario	-4.7	-5.8	9.5	18.7	3.0	-1.1
PIMCO adverse scenario	-16.3	-15.7	-1.5	10.8	-4.1	-11.1
Capital shortfall (PIMCO adv.)	22.2	21.5	1.9	0.8	3.3	49.8

Note: CT1 and capital shortfalls for foreign subs and branches and coops only for those included in due diligence. Data on assets and liabilities are September 2012 data.

Strategy. *The Cypriot authorities took decisive, upfront steps to resolve, downsize, and recapitalize the two banks at no additional fiscal cost.*[1] On March 25, the Central Bank of Cyprus intervened CPB and BoC, and the following actions were taken:



- **Sale of the CPB and BoC Greek operations to Greece's Piraeus bank**. At the time of the sale, both Greek branches had a positive net asset position. Failure to reach agreement could have been disadvantageous both for Greece and Cyprus. The sale reduced the size of the balance sheets of the two banks by 1/3 and also contingent liabilities of the Cypriot government to cover almost €9 billion of insured Greek deposits.
- **Transfer of deposits of CPB's UK branch to the UK subsidiary of BoC.** In return, the BoC subsidiary received an equal amount of cash which the CPB branch held as reserves at the Bank of England.
- **Resolution of CPB by transferring assets, insured deposits, interbank liabilities, and ELA to BoC.** CPB was not viable as a standalone institution, having limited collateral buffers for its large ELA funding (about €10 billion), given deteriorating asset quality. Therefore, it was decided to transfer part of it to BoC. The value of the transferred assets exceeded the value of the liabilities, such that the transferred CPB balance sheet had a CT1-ratio of 9 percent under PIMCO's stress scenario. Uninsured deposits and remaining assets were left in CPB under liquidation. In exchange for the positive net asset position in the transfer, the unit under liquidation will receive BoC shares.
- **Recapitalization of BoC with participation of bank creditors, including uninsured depositors.** The recapitalization was done under the auspices of the new bank resolution law, which required participation of bank creditors in the order of seniority. Creditors' claims were converted into equity, as follows: uninsured deposits were converted into A-shares, senior debt into B-shares, subordinated debt into C-shares convertible capital instruments into D-shares, and rights of ordinary shares were suspended. Until holders of A-shares have recovered their full initial capital investment plus interest through dividends, other shares will not collect dividends nor have voting rights. This structure implied a preliminary 37.5 percent conversion ratio on uninsured deposits[2]. Of the remaining 62.5 percent, a further 22.5 percent were frozen until completion of an independent valuation of BoC's assets and liabilities. Withdrawals on the last 40 percent are subject to restrictions to be lifted gradually.

1\ Transferred assets and capitalization were made on the basis of PIMCO's stress scenario.

2\ The 37.5 percent ratio is based on a preliminary valuation of the assets based on PIMCO's stress scenario.