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# Lessons from Cyprus

**In March 2013,** the government of Cyprus experienced a banking crisis that almost forced the country to abandon the euro. The purpose of this brief is to explain how that situation came to pass and what lessons it has to offer. The brief has six parts. The first part outlines what happened. The remaining parts answer questions that arise from the basic story.

## The basic story

The narrative of the crisis is straightforward. The two largest Cypriot banks, the Bank of Cyprus and Popular Bank (or Laiki), were insolvent. They were able to service their accounts only by borrowing liquidity from the Central Bank of Cyprus. And the Governing Council of the European Central Bank decided that the Central Bank of Cyprus would have to cut off that flow of liquidity until the government of Cyprus found some way either to close down the banks or to bail them out.

The problem was that the government of Cyprus did not have the money to do the bailout on its own, and so it asked the European Union for help. In turn, the Council of the European Union offered to provide roughly €10 billion of the €17 billion experts believed would be required in exchange for commitments from the government of Cyprus to undertake reforms of financial services and government finances. The government of Cyprus had to come up with the rest.[1]

The government of Cyprus faced a dilemma raising even this reduced amount of capital. Four options were available. It could sell bonds to borrow the money; it could raise the money in taxes; it could find some other international donor; or it could force the banks to write down their debts to shift the cost onto those people who had lent money to the banks in the first place.

None of these options was attractive. The finances of the government of Cyprus were already in bad shape, and few investors were eager to buy more of the government's debt. The population in the government-controlled part of the island is only about 850,000 people, and so raising taxes in the amount of €7 billion would impose a heavy burden on a per-capita basis. Among potential international donors, only Russia showed much interest in helping out the Cypriot government, and that proved illusory.



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The option left was to force the banks to write down their debts (or liabilities). Here, the problem was who should pay. Investors who bought bank bonds were an obvious target because they were sophisticated enough to have understood the risks involved in lending money to financial institutions. Unfortunately, this group did not offer much in absolute terms. That left depositors, both large and small.[2]

The large depositors could provide enough resources but only at the risk of scaring large deposits away from Cyprus. This would not only hurt the country's banking system but also all of the related industries such as accounting, law and tax advising. These industries represented not only the lion's share of value added in the Cypriot economy but also a huge swath of the island's employment – by some estimates as high as 70 percent.[3] If the large depositors should flee the country, then the economy of Cyprus could collapse.

The small depositors, meaning those with accounts below €100,000, could share some of the burden. However, that would mean revoking a government guarantee that these deposits would be insured against bank-failure risk.

Initially the government chose to find the resources across all classes of creditors, including bond-holders, large and small depositors, and it placed controls on bank withdrawals and international capital flows in order to hold the money in place until the write-downs could be assessed. The European Union accepted this formula. The parliament of Cyprus did not.[4]

Faced with this rejection, the government of Cyprus had to choose between insulating small depositors from any losses or finding some other solution altogether – meaning one beyond government borrowing, raising taxes, or some additional international bailout. That other solution would most likely involve abandoning the single currency. The government chose to insulate the small depositors and hence to shift the bulk of the cost onto large depositors, both foreign and domestic.

Most economists in Europe and elsewhere saw this as the obvious choice. The costs of leaving the euro would be high both for Cyprus and the euro area as a whole. Moreover, Cyprus has little industry beyond tourism to benefit from the relative cost-competitiveness that having a national currency might bring. Hence the advantages of devaluation against the euro would be small.

Within Cyprus, however, it was a close call. Although politicians were aware of the relative costs and benefits of leaving the euro, they were also frustrated with being told what to do by European institutions like the ECB and by other member states. Leaving the euro might not bring many economic benefits, but it would restore national sovereignty.[5]



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## How did Cyprus end up with banks that were too big to bail out?

Cyprus was not always a financial center. Before the island joined the European Union, it had fewer banking assets relative to gross domestic product, and financial services played less of a role in the economy as a whole. During the run-up to accession, however, the Cypriot economy began to specialize in banking services, and Cypriot banks began to target foreign deposits.[6] Some of these deposits came from the United Kingdom, which has a long association with the island. Many more came from Greece, which shares language and culture with the government-controlled areas. And a growing share came from Russia, with which the government of Cyprus has negotiated a favorable bilateral tax agreement.[7]

This Russian share has attracted considerable attention from critics of Cyprus who see the island as a safe haven for money laundering. There may be some truth to the allegation, particularly given the large share of deposits from abroad. However, in absolute terms, Cyprus was neither unique nor even a major player. Other small countries like Malta and Iceland were in a similar situation in terms of foreign deposits; the banking system in Luxembourg is many times larger and so is in a league of its own. Moreover, the level of activity in Cyprus was insignificant compared to the main financial centers in New York and London; it was hardly noticeable relative to Paris, Frankfurt, Zurich, Amsterdam or Brussels either.

The problem was not the absolute size of Cypriot banks; it was the size of those banks relative to the resources available to rescue them should they run into trouble. Here the comparison between Cyprus and Iceland is appropriate. So is the comparison between Cyprus and Ireland. As the Cypriot economy began to specialize in financial services, its banks grew rapidly in terms of assets under management.[8] They also grew in terms of leverage, which is the ratio of banking assets to equity. Moreover, this growth was intentional. The growth in assets and the increase in leverage were what drove the profitability of the financial sector.

By 2007, the Cypriot banking sector was the dominant force in the economy. It was also highly competitive in the wider European market space. In that sense, the strategy of economic specialization was a success.



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## How did those banks run into trouble?

Any economy that specializes in financial services has vulnerabilities associated with the performance of banking asset portfolios, the availability of liquidity, and the maintenance of capital buffers. By these measures, Cyprus was relatively conservative. Cypriot banks were not exposed to sub-prime lending in the United States; they did not face asset price bubbles in domestic commercial or residential real estate markets; and they did not speculate on complex derivatives contracts or collateralized debt obligations. In other words, the problems of Cyprus are different from those experienced in Iceland, Ireland, or Spain. They are also different from the problems experienced in the United Kingdom, Belgium and the Netherlands.

The Cypriot banks were relatively solid on the liability side of their balance sheets as well. They did not rely heavily on inter-bank lending and so did not experience the same sort of shocks that brought down the Northern Rock in 2007 or that jeopardized much of the European banking system after the collapse of Lehman Brothers in 2008. If anything, the Cypriot banks benefited from the increase in the preference for liquidity because investors were willing to park their money in deposits. Indeed, so long as the Cypriot banks could attract fresh deposits, they could not only service their existing liabilities but also acquire new assets.

The problem arose in the capital structure, which is the portfolio of highly liquid assets that banks use both to absorb losses and to post collateral for routine transactions. The Cypriot banks relied heavily on the purchase of sovereign debt instruments to build up these capital buffers. That reliance was consistent with international accounting rules that assign relatively low risk ratings (and implicitly high liquidity value) to sovereign debt.

The accounting treatment of sovereign debt instruments created a perverse incentive. Cypriot banks could use their deposits to buy Greek sovereign debt which offered a relatively high effective rate of return (or yield) on the initial investment. In turn, the Cypriot banks could then use this Greek debt as collateral in order to borrow liquidity from the European System of Central Banks which would allow them to buy more Greek bonds and so double-down on their bets. They could also use the relatively high yields that Greek bonds were offering in order to pay more for deposits and so attract money from abroad.

As the Greek sovereign debt crisis took root in the winter of 2009-2010, the perverse incentive for Cypriot Banks to speculate on Greek debt strengthened because the greater distress in Greek sovereign debt markets resulted in higher effective yields.[9] Meanwhile, the flow of Greek deposits to the relative security of Cyprus provided more resources for the Cypriot banks to invest in Greek sovereign debt.



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This accumulation of Greek sovereign debt securities in the portfolios of the Cypriot banks continued through the first Greek bailout in 2010 and as the ECB began pumping liquidity in the European banking system through the first of two long-term refinancing operations (LTROs) in 2011. By 2012, however, it became clear that Greek public finances were unsustainable and that the troika of the International Monetary Fund (IMF), the European Commission, and the ECB would insist on private sector involvement in any second Greek bailout.

For the Cypriot banks, this private sector involvement posed two dilemmas. First, the second Greek bailout imposed losses on asset portfolios, which forced the Cypriot banks to draw down on their capital buffers. Second, the technical default of the Greek government rendered Greek sovereign debt instruments ineligible as collateral for routine banking operations – like accessing liquidity from the European System of Central Banks. As a result, the Cypriot banks not only lost much of their capital, but they also lost access to liquidity necessary to service their liabilities.

Between March and April 2012, the Cypriot banks suddenly found themselves dependent upon emergency liquidity assistance from the Central Bank of Cyprus. Moreover, as new deposits into the Cypriot banking system started to dry up and increasing amounts of capital started flowing out of the country, this dependence on emergency liquidity assistance only increased. Meanwhile, the Cypriot banks shut down new lending and looked for ways to shore up existing assets. The Cypriot economy fell into a downward spiral of declining output and rising unemployment. Ultimately, it became clear that the country's two largest banks were insolvent. Without access to emergency liquidity assistance, the two largest banks would collapse.[10]

## Why did the Governing Council of the ECB threaten to cut off the flow of liquidity?

Emergency liquidity assistance is a stop-gap measure. Whenever banks are unable to access liquidity from the European System of Central Banks through the normal procedures, they turn to their national central banks for support. The idea is that the national central banks can accept weaker collateral when extending loans as a temporary measure until the banks in distress are able to find new sources of capital or until national governments step in to bail the banks out.

This unusual state of affairs cannot go on forever. The reason is two-fold. First, any bank that is dependent upon emergency liquidity assistance will have a hard time attracting deposits, selling bonds, or borrowing from interbank markets – because people will worry that the bank will become insolvent and so will be unable to pay back the deposit, investment, or loan. Worse, this lack of confidence creates a self-fulfilling dynamic as



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existing depositors try to get their money back and so threaten to trigger a run on the bank. This is what happened to the Northern Rock in the United Kingdom (outside the euro area): The Northern Rock requested a form of emergency liquidity assistance from the Bank of England, and this in turn sparked a crisis of confidence among Northern Rock customers who quickly lined up to withdraw their deposits. The pressure on the two largest Cypriot banks was similar even if the draw-down on deposits was slower.

The second reason that emergency liquidity assistance is temporary is more unique to financial operations within the euro area. When people in Cyprus began to draw down their deposits, they kept the money in euros but sent that money abroad. In some cases, the Central Bank of Cyprus implicitly financed the flow of capital out of the country by borrowing the money from the European System of Central Banks as a whole. This meant that Cyprus developed a negative balance in the country's Target2 accounts, which is the system for cross-border financial settlement.[11] Under emergency liquidity assistance, however, the Central Bank of Cyprus does not borrow the money from the rest of the Eurosystem. By implication, the liquidity that is created to shore up the banks in Cyprus adds to the creation of liquidity for the Eurosystem as a whole.

This creation of liquidity within Cyprus runs against the basic principles of a monetary union, which is supposed to have a single monetary policy to underwrite the single currency. It can be tolerated as a temporary exception; it cannot be allowed to become the new normal. Hence, the Governing Council of the European Central Bank is responsible for authorizing any use of emergency liquidity assistance – not just in Cyprus but also anywhere else. The Governing Council is also responsible for determining how much emergency liquidity can be created and how long banks can remain dependent upon access to special treatment.

The Governing Council has threatened to restrict access to emergency liquidity assistance to other countries. It had several arguments with the Central Bank of Ireland and also with the Central Bank of Greece; it expressed concern about emergency liquidity assistance provided by the Banca d'Espana as well. The case with Cyprus was nevertheless different because the flight of deposits from the country's two largest banks was so prolonged that they were technically insolvent. Hence the time had come for decisive action. The threat to withdraw permission for the Central Bank of Cyprus to continue with emergency liquidity assistance was intended to force the government of Cyprus to agree to a bailout. It triggered a crisis instead.

## Would Cyprus have been better off outside the euro?

In an alternative reality, the government of Cyprus would not have to face a threat to withdraw access to emergency liquidity assistance because it would be outside the euro



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and so also outside the influence of the ECB's Governing Council. The question is how much that would alter the end result. The answer is found in the case of Iceland and the balance of payments constraint.

The Central Bank of Cyprus would have been able to provide unlimited amounts of liquidity to the country's two largest banks, but that would not have stopped people in Cyprus from seeking to pull their money out of the banking system and move it abroad. On the contrary, having a national currency would strengthen the incentive for both Cypriots and foreigners to move their money out of the country before it could lose value against currencies elsewhere. What started as a banking crisis would quickly evolve into a crisis in foreign exchange markets. Moreover, the ability of the Central Bank of Cyprus to finance this capital outflow would be limited by the amount of foreign exchange reserves it had available. As those ran down, it would have to turn to the IMF for balance of payments assistance. IMF conditionality would constrain domestic policy action as much if not more than the tutelage of the ECB and the European Commission.

The end result would be a mixture of forced bank resolution and capital controls. That is what Iceland experienced in the immediate aftermath of Lehman Brothers; five years later, the capital controls are still in place. The Icelandic government also found itself embroiled in a number of conflicts with the governments of the Netherlands and the United Kingdom over who should refund the deposits lost in those countries. In popular referenda, the people of Iceland chose to repudiate those debts.[12]

Cyprus also had to resort to capital controls; yet the impact on deposits has been more consensual, and the adjustment process is better structured. It may be many years before the Cypriot controls are fully lifted, but it is already making progress, and it remains part of the single currency. Indeed, the losses for large depositors have proven to be less than initially estimated as the crisis unfolded. In that sense, the handling of the crisis has been a success.

## How can European policymakers avoid similar problems?

The handling of Cyprus could nevertheless have been better. There are two competing sets of lessons to draw from the events. In one view, the key is to avoid having countries specialize in the financial services sector to such an extent that they can no longer bail out their own banks. This is the view taken by Dutch Finance Minister Jeroen Dijsselbloem in his role as president of the Euro Area. Dijsselbloem argued during the immediate aftermath of the events in Cyprus that investors should expect to bear the brunt of losses. Looking to the future, he suggested that countries should not expose themselves to the risks associated with specializing in the financial sector.[13]



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Dijselbloem's interpretation is problematic. He is right that Cyprus will go through a painful adjustment. What he implies is that countries like Malta and Luxembourg will also have to make significant adaptations to the new environment. That is unlikely – and the governments of both countries were quick to insist that they would not cut back on their financial services sectors. The same argument would apply to the United Kingdom as well. The UK government is unlikely to give up the privileged position of the City of London as a world financial center. The question is whether it has sufficient resources to bailout the country's largest financial institutions without suffering a similar crisis.

This is where the second interpretation becomes important. What Cyprus reveals is that banks should not depend on national governments for insurance and resolution if they are going to compete in a pan-European single market. Hence the solution to future problems like Cyprus is to ensure that some kind of banking union comes about. The Cypriot banks were only large relative to the government of Cyprus. They could have been handled much more easily by a single European resolution authority backed with a common resolution fund. Shared deposit insurance would also have helped by lowering the incentives for small depositors to withdraw their savings from distressed institutions.

Ironically, the relatively successful handling of the crisis in Cyprus is more likely to benefit the first interpretation than the second one. Future policy makers will find it easier to believe that banking crises can be managed at the national level, and they will withdraw support from the creation of common European institutions. Along the way they are likely to overlook the fact that in absolute terms the problem of Cyprus was very small. A larger country like Spain or Italy would be much more difficult to handle or to ignore.

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