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Terms of Cyprus Bail-Out Signal Policy Shift for Bank Resolution in the Eurozone

The financial assistance package for Cyprus that was agreed in broad terms on 25 March and confirmed by Eurozone Finance Ministers meeting in Dublin on 12 April has expanded the range of bank creditors who may be expected to bear losses as part of any future Eurozone-funded bank bail-outs.

The global financial crisis of 2007-2009 and the Eurozone financial crisis which followed it has led to several initiatives to recapitalise either individual banks or whole banking systems. In some cases these initiatives have been shaped by national governments, albeit within a context heavily coloured by a need for wider budgetary support from the Eurozone countries, and in other cases they have been shaped more directly by the Eurogroup, the body which co-ordinates policy for the 17 countries that are members of the Eurozone.

Many of these initiatives have entailed losses for bondholders.

The Irish government's recapitalisation of Anglo-Irish Bank in 2010 imposed losses on holders of subordinated debt. Holders of Greek government debt agreed to a haircut of more than 50% in the value of their bonds in order to facilitate a broader rescue package provided by Eurozone countries and the IMF in 2012.

In February this year, the Dutch government used powers bestowed by the Dutch Intervention Act, passed in June 2012, to expropriate subordinated bonds issued by SNS Reaal as part of a wider package of measures to nationalise the group. Technically, the bonds were converted to equity, but the bondholders were given nothing because the Dutch Government stated that the bonds would have had no value if the bank had been allowed to go bankrupt. When bondholders sued, the courts upheld the Government's position.

None of the bank bail-outs of recent years – whether structured by national governments or by the Eurogroup – had sought to impose losses on depositors: until Cyprus.

Too Big When They Failed

Much of the analysis of the Cypriot rescue package has focussed on the unprecedented scale of losses incurred by the largest two Cypriot banks – Bank of Cyprus and Popular Bank – and on the unnatural size of the Cypriot banking system as a whole.

The extent of the two banks' losses is still being calculated, but it is clearly huge in relation to their total assets – almost certainly comparable to the 39% of risk-weighted assets lost by Anglo-Irish Bank between 2007 and 2010, and far more than the 16% of risk-weighted assets lost by Dexia or the 14% lost by UBS. (Figures are taken from Report of the U.K.'s Independent Commission on Banking, page 112.)

What's next for Cyprus's Russian Connection?

Cyprus's "Russian Connection" loomed large in discussions about the terms of the Eurogroup's rescue package.

Conspiracy theorists, and many others, have argued that the Eurogroup's decision to force losses on bank depositors was driven by a desire to close down the island's offshore banking market, and punish its citizens for allowing its financial system to be so freely used by businessmen from a country which is notorious for the extent of its corruption and financial crime.

Concern over Cyprus's Russian Connection has been particularly intense since the island joined the Eurozone in 2008: once legitimised within the Cypriot financial system, it was relatively easy for money to circulate throughout the Eurozone.

Estimates of Russian-owned deposits in the Cypriot banking system vary widely, even among people who ought to know. Well-informed Cypriot sources told me in February that the total ranged between €4.9bn and €10.2bn. The lower figure is the amount of deposits that are explicitly owned by Russians (individual or corporate). The higher figure assumes that all "brass plate" entities in Cyprus are Russian-owned, but that is not a reasonable assumption. A realistic estimate would be €7bn - €8bn, these sources said.

The Financial Times has estimated Russian deposits at more than €20bn. The total size of the banking system at the end of 2011 was €120bn.

The Cyprus-based subsidiary of Russia's VTB bank had assets of €6bn at the end of 2011, making it the fifth largest banking group in Cyprus.

Whatever the exact numbers, the extent of Russian business involvement in Cyprus is far greater than can reasonably be explained by platitudes such as "the Orthodox Christian connection," "direct air flights" or "long standing political ties going back to the time of Archbishop Makarios (died 1977) and the continuing strength of Akel", the unreconstructed Cypriot communist party.

As a resident of Cyprus from 1990 until 1999, I witnessed the initial Russian influx first hand. True, at that time, Russians were also being seen in large numbers in other countries (I saw them also in Dubai) but the scale and speed with which Russians became part of the business landscape was extra-ordinary (as had been the influx of Serbs, shortly before).

It has yet to be seen whether the bailing-in of deposits has in itself led to a wholesale withdrawal of Russian money from Cypriot banks. To the extent that such money comprises amounts over €100,000 in the two big banks then, like all other such money, its freedom

Even more striking is the size of the Cypriot banking system in relation to the country's economy. Banks' assets totalled €120bn at the end of 2011 – seven times the size of the island's Gross Domestic Product (GDP).

Furthermore, a large proportion of these assets were concentrated in three institutions – a greater level of concentration, in relation to GDP, than that seen in Ireland, for example. At the end of 2011, Bank of Cyprus reported assets of €37.5bn and Popular Bank reported assets of €33.8bn, in both cases about twice the size of the island's GDP. The Co-operative banking system – for which hard numbers are elusive – appears to have had assets roughly the same size as GDP.

Cyprus is a model for future bank re-capitalisations

But even though the scale of the losses was huge, the rescue package is not. True, in relation to Cypriot GDP, the €23.5bn package is much larger than those extended to Ireland and Portugal, and the one planned for Spain. It is only a little larger than the combined two packages received by Greece from the Eurozone and the IMF. But in terms of simple Euro amount, it is far the smaller than those for Portugal (€78bn), Ireland (€85bn) and the two Greek packages (€240bn).

If the Eurogroup had wanted to increase the size of the rescue package and leave all bank deposits untouched it could have done so. So why didn't it?

Speaking after the March 25 package had been announced, the President of the Eurogroup, Jeroen Dijsselbloem said that the group's approach to future bank bail-outs should be to push problems back to the banks themselves and only use government money as a last resort. In an interview with the Financial Times and Reuters, he said that banks should be asked, "What can you do to recapitalise yourself?" He continued, "If the bank can't do it, then we'll talk to the shareholders and the bondholders. We'll ask them to contribute in recapitalising the bank. And if necessary the uninsured bond holders."

Dijsselbloem appeared to be saying that imposing losses on uninsured depositors would in future be a standard policy approach when bailing out banks – in cases where writing off equity and debt would be insufficient to restore capital levels. His remarks were greeted, in some quarters, by gasps of horror and incomprehension, so much so that within hours of the interview appearing he issued a statement that, "Cyprus is a specific case with exceptional challenges ... Macro-economic adjustment programmes are tailor-made to the situation of the country concerned and no models or templates are used."

The day after Dijsselbloem's interview, Spanish Prime Minister Mariano Rajoy tried to put a line in the sand, saying, "[The Cyprus bailout] is an exceptional and unique case, which is being exceptionally applied to Cyprus."

Spain is negotiating a €100bn package specifically to recapitalise its own banks.

Yet Dijsselbloem's remarks were consistent with direction of financial sector regulation over the last few years, which has sought to limit taxpayer contributions to bank re-capitalisations by "bailing in" an ever-wider group of bank creditors. More specifically, the remarks are consistent with the European Commission's draft Directive on bank recovery and resolution, published in June 2012. The draft states that, "In order to ensure that the bail-in tool is effective...it is desirable that it can be applied to as wide a range of unsecured liabilities of a failing institution as possible..." It then states that insured deposits should not be subject to bail-in – implicitly reinforcing the point that uninsured deposits are subject to bail-in. (Paragraph 47 of the Draft's Explanatory Memorandum)

It is hard to overestimate the significance of such a policy shift.

Depositors have always been liable to losses in the rare cases when regulators have allowed banks to go into liquidation, but there has always been an assumption that when a government steps in to recapitalise a bank one of its principal motivations is protect depositors.

That assumption can no longer be made.

It is ironic that at a time when the Eurogroup is engaged in a long-term journey towards a banking union, the Cyprus rescue package implies that the Eurozone countries will be increasingly unwilling to socialise losses arising in individual member states. Of course, Cypriot banks incurred their losses while under the supervision of the Central Bank of Cyprus, but once supervision of Eurozone banks is transferred to the European Central Bank's Single Supervisory Mechanism, the case for containing losses within individual member states ought to become more difficult to make. ■

of movement is now severely constrained. (The two big banks account for 60% of the whole banking system.)

More significant will be the effect of tighter banking supervision at home and greater scrutiny from the European Central Bank in Frankfurt. The Eurogroup's draft Memorandum of Understanding published at the end of last year (and now overtaken by more recent events) made clear that home grown problems in the banking system (such as over-expansion in property markets) combined with poor central bank supervision were heavily to blame for bank insolvency. Exposure to Greece may have triggered the crisis, but decades of bad banking and bad supervision lay at its roots.

The arrival of European banking union, in the form of the ECB's Single Supervisory Mechanism (SSM) will dilute the power of banking supervisors in member states since, in theory at least, they will be operating to guidelines set in Frankfurt. The Eurogroup hopes that the SSM will begin operations in 2014.

Furthermore, transactions such as account opening and money transfers will in future be subject to much greater scrutiny, removing one of the competitive advantages which Cyprus held over most of the Eurozone countries, where such transactions,especially when conducted by non-residents, are subject to ever-increasing layers of bureaucracy and background-checks.

It would be unrealistic to expect a paradigm shift in banking practices in Cyprus within the short term, but the features which made the island's financial system so attractive to Russian businesses will start to fade, regardless of the specific trauma caused by the bailing-in of high-value deposits. ■

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