The Myth of Cypriot Bank Resolution ‘Success’: A Plea for a More Holistic and Less Costly Supervision & Resolution Approach

Abstract
This paper advocates for actively minimising the price of bank resolution at each part of the new regulatory banking structure. It does so by examining how the banking resolution costs were increased due to decisions taken at different stages of the regime during the experience of Cyprus with bank supervision, early intervention, resolution and liquidation. The paper then moves on to argue that increasing instead of decreasing the lingering bank resolution costs in Cyprus tainted the picture of bank resolution success for which the Cypriot experience has become somewhat of a posterchild. It argues that if the success of bank resolution is evaluated after a series of bad supervisory decisions, it is more than likely to conclude that resolution was successful because it resolved a very detrimental situation. Simply put, the success of the Cypriot bank resolution might as well equate to a gigantic failure of bank supervision. As such, while acknowledging the benefits and successes of the new regime, this paper tries to showcase that the application of the supervisory and resolution regime in Cyprus hides a lot of elements that are very far from successful, but which can nevertheless form constructive lessons for the practical application of the regime in the future.

Keywords (separated by ‘-’) Resolution - Supervision - Supervisory failures - Resolution costs - Bank Recovery and Resolution - Bail-in - Cyprus

Footnote Information
This paper was prepared for the ‘A Dynamic Economic Monetary Union’ (ADEMU) Workshop (11 October 2016) held in Florence. Special thanks to Professors Grundmann, Monti and Singh and Christy Ann Petit for organising the conference. The author is grateful to Christy Ann Petit for her very extensive comments and Federico Della Negra for drawing attention to the recent case by the ECJ in Ledra which is of core interest to the case of Cyprus.
The Myth of Cypriot Bank Resolution ‘Success’: A Plea for a More Holistic and Less Costly Supervision & Resolution Approach

Mikaella Yiatrou

Abstract This paper advocates for actively minimising the price of bank resolution at each part of the new regulatory banking structure. It does so by examining how the banking resolution costs were increased due to decisions taken at different stages of the regime during the experience of Cyprus with bank supervision, early intervention, resolution and liquidation. The paper then moves on to argue that increasing instead of decreasing the lingering bank resolution costs in Cyprus tainted the picture of bank resolution success for which the Cypriot experience has become somewhat of a posterchild. It argues that if the success of bank resolution is evaluated after a series of bad supervisory decisions, it is more than likely to conclude that resolution was successful because it resolved a very detrimental situation. Simply put, the success of the Cypriot bank resolution might as well equate to a gigantic failure of bank supervision. As such, while acknowledging the benefits and successes of the new regime, this paper tries to showcase that the application of the supervisory and resolution regime in Cyprus hides a lot of elements that are very far from successful, but which can nevertheless form constructive lessons for the practical application of the regime in the future.

Keywords Resolution Supervision Supervisory failures Resolution costs Bank Recovery and Resolution Bail-in Cyprus

A1 This paper was prepared for the ‘A Dynamic Economic Monetary Union’ (ADEMU) Workshop (11 October 2016) held in Florence. Special thanks to Professors Grundmann, Monti and Singh and Christy Ann Petit for organising the conference. The author is grateful to Christy Ann Petit for her very extensive comments and Federico Della Negra for drawing attention to the recent case by the ECJ in Ledra which is of core interest to the case of Cyprus.

A6 & Mikaella Yiatrou
mikaella.yiatrou@eui.eu

A8 1 European University Institute Florence, Florence, Italy
Introduction

The experience of Cyprus with bank ‘resolution’ in 2013, 2014, and 2015 carries many lessons and insights with regards to the practical application of the bank resolution regime as it currently stands in the Banking Union. This paper focuses on what is possibly the most important such lesson that emerged. Namely: the need for reaping the advantages of the ‘holistic’ approach in bank regulation under the Banking Union by exercising supervision, early intervention, resolution and post-resolution in a way that seeks to collectively reduce the price of bank resolutions from the outset and throughout each pillar, before a credit institution actually needs to be recapitalised or resolved.

The Cypriot experience signals the passage from an era of bail-outs to an era of bail-ins. Cyprus was the first case where a ‘bail-in’ was imposed within the European Union, in the spirit of shifting the burden of dealing with troubled banks onto the banks’ creditors instead of the tax-payers. However, despite this shift in burden, it is evident that failures in supervision and resolution still had a massive impact not only on the bank’s creditors who were called to recapitalise the banks through the bail-in tool, but also on the economic output of the country, and, as such, on the public. Even if not directly taxed to bail out the banks, the public is still burdened indirectly, either through the direct consequences to the country’s diminishing economic output such as perishing wages, increased prices, or...
diminished supply of credit,\textsuperscript{7} or through being bailed-in to recapitalise/resolve the bank, since the bank’s creditors to a large extent are the same persons as the taxpayers.

Both these indirect ways of burdening the public can resonate long after a bank resolution is completed. Firstly, this is because an impaired economic cycle (i.e. a negatively affected national primary balance and an increased cost of borrowing/cost of interest payments) can amplify the downturn of the economic activity and the degree of activation of automatic fiscal stabilisers, such as increased unemployment benefits, reduction in tax revenues and increases in interest rate expenses. This effectively stalls the speed of recovery, since the country will be in a financial position that is disadvantageous to boosting economic activity.\textsuperscript{8} Secondly, if bailed in, the creditors/taxpayers are likely to pursue judicial redress by seeking to establish that the bail-in interfered with their property rights. However, such proceedings are most likely going to be unsuccessful given the disheartening ruling of the European Court of Justice in the Ledra case where it was held that any resolution tool imposed is likely to be justified as a ‘tolerable’ and ‘proportionate’ interference in the face of the ‘imminent risk of financial losses to which depositors […] would have been exposed if the [bank] had failed’. The Court’s eagerness to base, rather tacitly, the existence of a public interest to ‘uphold the stability of the banking system’ on an unfounded conjecture that the ‘no creditor worse off’ principle applies, without materially considering the potential losses of the creditors if the bank in question was indeed instead liquidated, reduces the pursuing of such proceedings to a waste of more time and money—stretching the duration and depth of the indirect ways in which taxpayers/creditors are affected.\textsuperscript{9} This is despite the fact that the ruling was delivered two long years after the imposition of the bail-in in Cyprus.

The Cypriot case’s inability to shield the taxpayers from being affected indirectly demonstrates how the idea of a clean, prompt, resolution without involving the taxpayer, solely by shifting the burden to the creditors and over-relying on the resolution stage to fix the problems, is unrealistic no matter how desirable it may be. Instead, a holistic approach to bank regulation—with supervision and resolution working in concert from the outset and continuously thereafter to minimise both the indirect consequences and the costs of a potential resolution/recapitalisation—is thought to be essential for truly managing successfully any future banking crises.

For this reason, it is argued that while the debate on the cost of bank resolution has mostly focused on the resolution stage of dealing with banks and on the tools to

\begin{footnotesize}
\begin{enumerate}
\item Baglioni (2016), p. 9 points out that there are two channels through which banking crises can impact the public: (1) a direct channel, including governmental measures to support distressed banks (e.g. bailouts) in order to avoid liquidation and/or limit the costs to bank stakeholders, particularly depositors and bondholders, and (2) an indirect channel, including all the other ways a banking crisis can negatively affect the primary balance and the interest expenses of the public sector, i.e. negatively affect the economic cycle, by causing a fall to the supply of credit and in assets’ values. See also Clerides (2014), p. 32.
\item Baglioni (2016), p. 9.
\item See Joined Cases C-8/15 P to C-10/15 P Ledra Advertising Ltd and Others v. European Commission and European Central Bank (ECB) (20 September 2016).
\end{enumerate}
\end{footnotesize}
be used to finance/recapitalise resolution and bank restructuring,\(^{10}\) supervision, early intervention, resolution, and post-resolution, all make up the eventual price of bank resolution during and after its completion since decisions taken at each stage can affect the level of the economic downturn and the percentage of bail-in needed for recapitalizing/resolving the bank. As such, all the stages of the new regime should work in concert to minimise the costs and losses.\(^{11}\)

Cyprus exemplifies that not taking advantage of this concerted approach, and relying instead excessively on the resolution stage to fix the problems after a trail of supervisory and other failures, leads to an exponential increase of the losses which in turn triggers the need for deeper haircuts to recapitalise and resolve the troubled banks.\(^{12}\) Just as an indication to that extent, after long delays in taking action to deal with the failing banks (supervisory & institutional failures\(^{13}\)), and limited and ineffective use of early intervention and preventative measures in dealing with troubled banks (supervisory failures), the percentage of bail-in imposed reached the order of 47.5\% of the uninsured depositors (the main creditor base) in the Bank of Cyprus (the restructured bank), while uninsured deposits were wiped out in the Laiki Bank (the resolved bank). These failures made resolution the best/cheapest option by default—with no thorough assessment to that regard other than who was to bear the costs directly.

It is apparent that actions taken at different stages of the supervision/resolution regime had a direct impact on the aggregate eventual losses of resolving the Cypriot banks. And these losses were largely absorbed by depositors—the class of creditors that coincides the greatest with tax-payers. Therefore, it is submitted that while resolution is capable of mitigating a detrimental situation, as the Cypriot experience has shown, it cannot make up for the losses already accumulated due to poor prior decision-making. In this regard, Cyprus arguably exemplifies how not to apply the new regime. Instead of idolising the merits of burden-shifting for the sake of burden-shifting and focusing solely on resolution, or solely on supervision for that matter,\(^{14}\) future cases should focus on taking advantage of the full scope of the regime which targets the minimization of the immediate and long-term costs that stem from failing banks in general—regardless of who pays the bill—at every stage of the Banking Union’s pillars.

This paper argues that only such a holistic approach, if executed properly and not the way it was executed in Cyprus, can be truly successful in safeguarding the interests of the taxpayers and the interests of the economies that experience the

\(^{10}\) See Hadjiemmanuil (2015); Hellwig (2014); Yiatrou (2016).

\(^{11}\) See Basel Committee on Banking Supervision (2015), stressing the need for: (i) early intervention and use of recovery and resolution tools; (ii) improving supervisory processes (e.g. incorporating macro-prudential assessments, stress testing and business model analysis); (iii) dealing with liquidity shortfalls, risk concentrations, and misaligned compensation schemes; and, (iv) further guidelines on information-sharing and cooperation of relevant authorities.

\(^{12}\) If formal resolution is to be considered at all at that point.

\(^{13}\) Institutional failure due to the lack of a pre-existing regime to deal with the crisis to enable prompt action.

\(^{14}\) See Clerides (2014), noting that supervision ‘is not an exact science’ and as such it cannot dodge all future bank failures. Therefore, focusing solely on supervision would also be insufficient.
resolution and restructuring of their banks, and, as such, in achieving the objectives of the Banking Union. To showcase how the regime can live up to the potential of its intended holistic approach, the paper starts by examining how supervision, early intervention, and resolution, respectively, can minimise the immediate and long-term costs stemming from bank resolutions (Sect. 2). In doing so, examples of actions and inactions that increased instead of decreased the costs in the Cypriot banks’ resolution are provided to argue that the Cypriot case failed to truly harvest the benefits of such a holistic approach (Sect. 2). Section 3 then discusses on this basis why Cyprus was unsuccessful in applying the holistic standard advocated. Section 4 concludes.

2 Cost of Banking Resolution: A Holistic Approach

The objectives of the Banking Union are to establish a single regulatory, supervisory, and bank resolution structure that minimises the likelihood and severity of future banking crises—thus lessening their potential impact on EU economies and taxpayers, while at the same time increasing banking competitiveness by reducing fragmentation and maintaining the stability of the financial system—and, in turn, restores confidence in the financial sector to contribute to economic recovery. In other words, they are essentially already prescribing the advocated holistic approach for minimising the costs of a potential bank resolution.

In order to achieve these objectives, the regime allows ample room for discretion, whether at the national or at the European level, by adopting a minimum harmonisation approach with ‘soft triggers’ instead of outright ‘hard triggers’ for many critical decisions. In particular, soft triggers are adopted for the triggering of resolution, and a mixture of soft and hard triggers are adopted for early intervention measures. It follows that, discretion in the decision-making at all the stages of the new regime is instrumental in shaping the aggregate costs of resolution, and as such in achieving the holistic approach prescribed to limit the costs from the outset, leading to more efficient future resolutions with less casualties. For instance, the decisions of the supervisory authorities for early intervention measures can avoid an eventual resolution altogether; the discretion in the evaluation of whether liquidation or resolution are more beneficial for the public interest will determine what the ultimate losses on the creditors will be; the evaluation of whether creditors are better or worse off in resolution than under ordinary liquidation will determine whether the resolution fund will need to compensate creditors post resolution, increasing as such the cost of resolution, etc.

Boccuzzi (2016), p. 66 defines a ‘soft triggers’ approach as an approach based on an evaluation of the supervisory authority with regards to current or prospective (actual or potential) non-compliance with prudential requirements—the same approach pre-existed under Art. 136 of the Credit Ratings Directive (CRD).
Ibid., in a ‘hard triggers’ approach only predefined quantitative thresholds signalling the bank’s technical situation, such as capital, leverage, and liquidity, qualify as triggers for intervention.
Ibid., p. 168.
This section explores the importance of discretion in supervision, early intervention, triggering of resolution, choosing between liquidation and resolution, and choosing the resolution tools to be applied in calibrating the price of bank resolution not only prior and during resolution, but also in the aftermath of its execution. As such, it provides a guide of how to use discretion to facilitate the holistic approach advocated for. In doing so, it argues that, in the case of Cyprus, discretion was regrettably used to exacerbate the costs and hide the failures, bringing to the surface the adverse consequences of not following a holistic approach in bank regulation.

2.1 Cost of Prevention: The Role of Supervision

Supervision is important for minimising costs and losses because it is responsible for: ensuring resolvability and bail-in ability at all times in order to apply prompt and smooth resolution minimising systemic ripple effects; avoiding failures in the first place; and, in the event that failures do occur, rebuilding the competitiveness of the banking sector and reducing the long-term losses from resolution.

2.1.1 Supervision: Rebuilding Competitiveness of the Banking Sector

In post-restructuring and resolution countries, supervision is most important for regaining the investors’ trust in order to rebuild the banking sector’s competitiveness. Regaining this trust however is an incredibly difficult task given that the same supervisory authority has already proven itself to be incapable of effectively supervising the banks it was responsible for.

To re-establish competitiveness in a ‘crisis’ country, supervision must actively and vigorously apply the relevant international and European standards to the fullest effect in order to benefit from the levelled playing field, integrity, and stability that regulatory convergence (i.e. one-size-fits-all) can offer. Therefore, demanding requirements and capital buffers that can achieve competitiveness are not treated with hostility. On the contrary, setting such vigorous standards is welcomed given how crucial it is for countries that restructure their banks to get it.
right, since ‘failure would throw all confidence-building measures into reverse, with incalculable consequences’.

The Central Bank of Cyprus (the national supervisory authority) seems to acknowledge this fact since Cyprus is one of the two southern European countries (along with Malta) which has not set the countercyclical capital buffer for Other Significant Financial Institutions (O-SIFIs) at 0%, and since it rushed to immediately place the Federal Bank of Middle East (FBME) under special administration and subsequently resolution following suspicions of money laundering by the Financial Crime Enforcement Network of the US Department of Treasury (FinCEN). This demonstrates that it is no longer the constant thrill of higher earnings that takes priority in countries hit by the crisis. On the contrary, in order to regain trust and allow growth, crisis countries have to focus on constantly proving their resilience through a continuous process of benchmarking against international best practices for economic stability and service quality.

Having said that, when applying one-size-fits-all policies, special attention must be paid to the state of the economic cycle and the political economic considerations at play. For instance, the across the board capital exercise by the EBA that marked to market sovereign debt had disastrous effects for the financial stability of a country with pre-existing problems such as Cyprus. In Cyprus, the timing of the EBA’s capital exercise meant that higher Core Equity Tier 1 (CET 1) requirements were applied pro-cyclically. The banks were required to build up their CET 1 buffer in order to make up the difference between market and book value of government debt to reach the required 9% of CET 1 within 9 months. Simultaneously, it was decided to involve the private sector in restructuring the Greek debt (Greek Private Sector Involvement (PSI)), wiping out essentially about 80% of the value of Greek debt that the private sector held. This meant that the Cypriot banks, which were deeply affected by the PSI and did not receive any liquidity support to deal with these losses, were now required to also build up their equity base within 9 months. The fact that the country had been out of the markets for 5 months already, made raising additional capital, which the two troubled Cypriot banks had already done in

22 See Schoenmaker and Veron (2016), pp. 7-8 stating that ‘Most northern member states generally apply higher systemic buffers of up to 2% or 3%, while southern member states (except Cyprus and Malta) apply low systemic buffers of up to 1%. Remarkable cases are Italy and Latvia, which have set the systemic buffer for other systemically important institutions at 0%, with only a G-SIB surcharge of 1% for UniCredit following the Financial Stability Board’s guidance.’
23 ICFCBS (2013), p. 33, para. 5.5.12.
26 Orphanides (2013) stating that for Cyprus, the write-down of Greek debt was between 4.5 and 5 billion euro.
27 Michaelides (2014), p. 667, noting that while Admati and Hellwig (2013) argue that this decision made the European banking system safer by rapidly implementing higher capital ratios within nine months, Orphanides (2013), completely refuting Admati and Hellwig (2013), states that ‘That famous capital exercise created the capital crunch in the euro area which is the cause of the recession we’ve had in the euro area for the last 2 years.’
2009, 2010 and even as late as early 2011, much harder. This combination of
the haircut and the stress test left the two largest Cypriot banks in need of about
2 billion euro of additional capital. Since the banks had just lost more than 4.5
billion in the Greek PSI, it is evident that the banks did not require assistance
before these badly-timed regulatory interventions.

To sum up, while one-size-fits-all policies are beneficial counter-cyclically,
especially for increasing competition in post-crisis countries by earmarking
regulatory convergence, one-size-fits-all policies do not actually fit all when
fragility is present. Thus, discretion should be exercised to avoid unintended
consequences from the application of one-size-fits-all policies during crises.

2.1.2 Supervision: Ensuring Resolvability

Resolvability rests largely upon three factors. Firstly, on setting out and enforcing
sufficient capital requirements to ensure that the bank has enough capital to absorb
losses for financing its resolution and recapitalisation. Secondly, on drafting and
updating viable resolution plans to be followed swiftly if the need for resolution
arises. Thirdly, on the local government cooperating in supporting formal
resolutions and in keeping the costs of formal resolutions down by maintaining a
solid fiscal position and implementing structural adjustments if needed in order to
maintain confidence in its ultimate backstop abilities and enable the banks to build
up their capital cushion in case that becomes necessary—something that the Cypriot
government did not do.

Supervisory and resolution authorities are crucial in conducting the ground work
for resolvability by calculating and assessing the level and quality of loss absorbing
capital for each bank supervised, as well as drafting viable resolution plans, so as to
credibly cater for the speedy application of a formal resolution, if need be, at a
future time. The sufficiency of the loss absorbing capital involves the level of equity
and bail-inable debt needed to ensure adequate loss absorption based on the size and
risk of the institution in question (the minimum requirement for own funds and
eligible liabilities MREL), and its quality, i.e. the loss-absorption ability of the

---

28 Orphanides (2013), p. 4. If EFSF/ESM were available for direct recapitalization of banks instead of
asking each government to be responsible for the capitalization, the government losing access to the
markets would not have affected the banks in raising additional capital. However, in the absence of such
arrangements the adverse feedback loop existing between banks and sovereigns meant that removing the
possibility of the implicit guarantee made it practically impossible for banks to raise additional capital.
29 Ibid.
30 Ibid.
31 See Michaelides (2014).
32 Please refer to Peter Brierley’s paper in the same volume for an extensive account of resolvability.
33 Orphanides (2013), pp. 2, 49.
34 Or Total Loss Absorbing Capacity (TLAC) if the institution is considered to be a Globally Significant
Financial Institution (G-SIFI); See Krahnen and Moretti (2015), pp. 136, 142-146, while sympathising
with Admati and Hellwig (2013a) who argue for a 20-30% risk unweighted equity ratio to ensure a much
larger Loss Absorbing Capacity (LAC) in bank balance sheets, they emphasize the added value of having
bail-in debt as part of the LAC—in addition to equity.
The Myth of Cypriot Bank Resolution ‘Success’

245 banks’ subordinated creditors\(^{35}\) which ensures that a necessary bail-in can be carried out without the fear of systemic risk repercussions. This entails calibrating the risk of a bank run by the investors holding the loss absorbing capital by determining the equity and bail-in debt positions—i.e. determining which investors are long in these assets, whether they are located inside or outside the banking system, and whether there is any prospect of re-transferring the risk into the banking system.

It follows that establishing and monitoring the effectiveness of bail-in provisions requires strenuous supervisory action, and thus, has real and continuous costs.\(^{36}\) However, if resolvability is not established at the supervisory stage, formal resolutions will be avoided due to fears of their potential systemic repercussions. Such an effect would set back the Banking Union’s vision by paving the way for bailouts in the future. In fact, in order to avoid not only the moral hazard of informal resolutions and bailouts but also the moral hazard of formal resolutions as opposed to liquidations, the EBA’s Regulatory and Technical Standards on Resolution Planning\(^{37}\) and the Guidelines on measures to reduce or remove impediments on resolvability,\(^{38}\) propose that resolution authorities verify the feasibility and credibility of liquidation and its consistency with the public interest, before considering and ensuring resolvability.

2.1.3 Supervision: Avoiding Failures in the First Place

Clearly, the preference is that supervision is robust from the outset to help avoid and minimise the cost of resolution—a task which the Cypriot supervisory authorities failed spectacularly in fulfilling. While Cyprus is often quoted as a case of bank resolution success, it is also arguably a case of the greatest supervisory failure in terms of the supervision’s role in avoiding, or at least not intensifying, crises.

The four supervisory actions that seem to have negatively affected the cost of the eventual resolutions the most are: (a) policies inducing a surge in loans; (b) the Emergency Liquidity Assistance (ELA) provided to the two largest Cypriot banks by the Central Bank of Cyprus (CBC);\(^{39}\) (c) the approval of the merge of the Cypriot and Greek operations of the Laiki Bank effectively converting the Greek operations of Laiki from ‘subsidiary’ to ‘branch’ status in March 2011, and; (d) the delay of seeking assistance even after the Greek Private Sector Involvement (PSI).

2.1.3.1 CBC Policies That Allowed Surge in Real Estate Loans Between 2010-2012 the CBC relaxed the liquidity standards which allowed a dramatic increase in loans to real estate. Indicatively, in 2011 loans to the housing sector amounted to 150% of GDP, and were given based on collateral rather than on the...
cash flows of the borrowers. The CBC’s effort to counteract this dramatic increase by introducing a 10% increase in the down payment requirement on second homes in 2007 was condemned as limiting loans and growth. Consequently, it only lasted one year, limiting any potentially positive effects that it might have had and showcasing the political influence the CBC was under.

2.1.3.2 Emergency Liquidity Assistance In 2012, the amount of ELA provided to Laiki reached around 60% of the GDP. ELA continued to be provided to Laiki even though it was clear by 2012 that the bank was insolvent. Given that already since July 2012 the ECB had offered an opinion that resolution might be preferable for Laiki, one wonders how the CBC allowed ELA to reach 60% of GDP. The assertion of the governor of the central bank of Cyprus at the time, Panicos Demetriades, that Laiki was ‘dynamically solvent’ conditional on a program being signed, is not convincing given that the program was not signed until March 2013, nine long months after ELA was extended to an insolvent bank.

2.1.3.3 Merge of Greek and Cypriot Operations of Laiki The conversion of the Greek operations of Laiki from ‘subsidiary’ to ‘branch’ status in March 2011 moved regulatory responsibility from the Central Bank of Greece to the Central Bank of Cyprus. That meant that the Greek operations of Laiki did not benefit from the liquidity assistance that Greek banks benefited from post-PSI. While bringing the cross-border operations of the bank under the supervision of the Bank of Cyprus was thought to be a positive step for ensuring proper supervision of the bank as a whole, it later became clear that this had increased the systemic risk in Cyprus. In particular, it is argued that it materially increased the funding required to bail out Laiki Bank, given that following the merger, the CBC’s Supervisory Review and Evaluation Process (SREP) required Laiki to hold €1.56 billion of additional capital against its sovereign bond portfolio, and €2.1 billion against its loan portfolio—51% of which was concentrated in Greece.

While Alvarez & Marshall, a forensic experts firm solicited to investigate the matter by the CBC, found that it was the legislation that should be amended because it did not provide ‘sufficient support’ to the CBC where a Cypriot bank wishes to
convert an existing foreign subsidiary into a branch,\textsuperscript{45} it is argued that had the CBC
exercised its discretion with the minimization of the costs of the potential resolution
of the bank in the future and had the CBC been a truly independent institution free
from regulatory capture, political pressures and bank lobbying, it would have
intervened to stop the merger. This is especially clear when considering the warning
that the Central Bank of Greece issued to the CBC prior to the finalization of the
merger in March 2011 about the Greek subsidiary’s concentration and credit risk,
and the control weaknesses identified during its SREP review on the 31 December
2009 data.

Following the above observation and the remarks of the Alvarez & Marshal
report, it is suggested that the reduction of restructuring options available in the
case of insolvency because of a merger should be of chief consideration for the
supervisor in approving the deal since the supervisor ‘should always consider the
full implications of any actions taken by the institutions it regulates, in relation
to all eventualities (including the possibility of that institution becoming
insolvent).’\textsuperscript{46}

2.1.3.4 The Greek PSI and Delays in Requesting Assistance This section argues
that the CBC could have done more with regards to managing and reducing the
BoC’s and Laiki’s high concentration to Greek Governmental Bonds (GGBs) prior
to the Greek PSI. Despite acknowledging that the local banking laws did not set
out formal asset concentration limits—meaning that the BoC’s and Laiki’s high
concentration of GGBs within their sovereign bond portfolio was not in breach of
any regulatory limits\textsuperscript{47} —the CBC’s actions with regards to managing a situation
which later incurred a number of fines for regulatory breaches by the Cyprus
Securities and Exchange Commission (CySEC),\textsuperscript{48} are regarded as largely
insufficient.\textsuperscript{49} This is because while the CBC formally requested information
regarding the BoC’s holdings of GGBs in March 2010,\textsuperscript{50} it did not follow up on

\textsuperscript{45} Alvarez & Marshal (2013b).
\textsuperscript{46} Ibid., p. 13.
\textsuperscript{47} Alvarez & Marshal (2013a), para. 2.9.2.
\textsuperscript{48} Both BoC and Laiki officials incurred substantial fines by the Cyprus Securities and Exchange
Commission (CySEC) for their actions with regards to GGBs breaching: the ‘Peqixsxm Pqānxm
FLO Pqorpxm pot jasvotm elpirsetsij1 pkqgouq1 jai sxm Pqānxm Veiqacxcgrg1 sg1
FL0 Acoq1 (Jasxqcr1 sg1 Acoq1) Mōlot o M.116(1)/2005 (Insider Dealing and Market Manipulation
Law), the ‘Peqixsxm Pqxtphīnxm Dianūme1 (Jimgsx Anē1 pqo1 Diapqcłāsetrg re
FL0 Qhltifolm Acoq1 Mōlot o M.190(1)/2007 (Securities Transparency Law), and the ‘Peqix Dglor1
FL0 Pqoruqα1 jai Emglqxsijot Deksiqt Mōlot o M.114(1)/2005 (Prospectus Law). Cyprus Securities
\textsuperscript{49} Alvarez & Marshal (2013a), para. 2.9.
\textsuperscript{50} Alvarez & Marshal (2013a), para. 2.8.1.3, referring to a letter dated 01/03/2010 sent by Mr Poullis
(Senior Director in Bank Supervision and Regulation of the CBC) to Cypriot Banks (including BOC)
regarding exposures to Government Bonds, and in particular GGBs requesting information on the strategy
of investing in GGBs and the risk mitigation measures taken
its written request on a timely basis\textsuperscript{51} even though it received no response from the BoC.\textsuperscript{52}

Michaelides suggests that, once again, political pressures from both the ECB and from Greek politicians seem to have influenced the CBC from taking more appropriate action such as forcing the BoC and Laiki to dispose of their GGBs in a timely manner.\textsuperscript{53} He cites fear for any negative consequences such action would have on the position of Cyprus in the diplomatic sphere as a cause of the inaction\textsuperscript{54}—even though ex post it is evident that such considerations are immaterial given the scale of the increase of the losses from 2010 to October 2011 (when the PSI terms were agreed upon).

Regardless of whether or not the CBC should have requested the sale of the Greek Governmental Bonds prior to the PSI, it is undisputable that it should have asked for support for its affected banks immediately after the PSI took place either through ESM assistance, or for restructuring the banks. The Greek debt holdings were publicly disclosed in the July EBA stress test so everyone could calculate what the haircut meant for the Cypriot banks. With the Cypriot government out of the markets,\textsuperscript{55} it was obvious that it would be impossible for the Cypriot banks to recover from the PSI and rebuild their capital base within 9 months as required. Nevertheless, Cyprus did not ask for assistance until the end of June 2012. In addition, the government did not negotiate a program until November 2012, when the ECB threatened to cut off liquidity, and did not conclude a Memorandum of Understanding (MOU) until December 2012\textsuperscript{56}—more than a year after the PSI’s terms were agreed upon.\textsuperscript{57}

It follows from all the above that while crises are very difficult to predict,\textsuperscript{58} the Cypriot authorities failed to detect obvious indicators signalling the imminent crisis,\textsuperscript{59} and failed to act expediently and instrumentally in the face of political short-termism and delays in producing the reports on the financial position of

\textsuperscript{51}FL01 Ibid., para. 2.8.1.4, reporting that a follow-up to the letter of 01/03/2010 was eventually sent to the BoC in February 2012—two years later.
\textsuperscript{51}FL02 Ibid., citing the report of the Cyprus Securities and Exchange Commission (2012) which highlighted that only a verbal conversation took place between ‘someone’ at BoC and the Governor of the CBC in response to the letter of 01/03/2010, and that the Board of Directors at BoC were never made aware of the letter.
\textsuperscript{52}FL01 See Michaelides (2014), p. 669 noting that ‘ECB President Trichet was very vocal against a Greek PSI, and one wonders what the response would have been if a central bank of a Euro-Area country advised, or forced, the sale of Eurozone sovereign bonds’.
\textsuperscript{54}FL01 Ibid.
\textsuperscript{55}FL01 Orphanides (2013), p. 4.
\textsuperscript{56}FL01 Orphanides (2013), p. 5.
\textsuperscript{57}FL01 The PSI terms had been agreed on since October 2011 and the PSI took effect since April 2012. See Hellenic Republic Ministry of Finance (2012), PSI Launch, press release 21 February for the final settlement of the PSI, see Hellenic Republic, Ministry of Finance 2012: press release 25 April.
\textsuperscript{58}FL01 Clerides (2015). See Pashardes and Pashourtidou (2013), p. 22; not in the context of Cyprus, see Boyd et al. (2005).
\textsuperscript{59}FL01 Clerides (2015), pp. 18, 24 noting that such indicators include widening current account deficits, rapid growth in domestic credit, inflated asset prices (property or equity) and non-performing loans.
Cyprus and its banking sector stalling the negotiations and leaving the vast domestic imbalances unaddressed.

These delays vastly aggravated the situation. It is indicative just to note that while the first draft adjustment program foresaw a total fiscal adjustment of 5.75% of GDP in July 2012, by the time a program was agreed in March 2013 the required adjustment had increased to 12% of GDP. This was despite the fact that a major part of the recapitalization was covered by the ‘internal rescue’ of the bank done through the bail-in and write-down of shareholders, bondholders and the uninsured depositors of Laiki Bank and Bank of Cyprus (the two resolved and restructured banks). Effectively, by delaying reaching a deal, a substantial amount of deposits had left the banking system, meaning that the haircut was higher for the deposits that stayed behind. All of the above increased the haircut on the remaining depositors within the Cypriot banking system.

Given these facts, the crucial importance of supervision in determining the eventual cost of a potential resolution is undisputable. Indeed, commentators have argued that if more appropriate policy action was taken earlier, perhaps with increased responsibility from the outside by a more experienced and less prone to...
domestic political capture supervisor, such as the ECB, bank resolution and restructuring involving a creditor bail-in in March 2013 in Cyprus, could have been avoided.\textsuperscript{64} This is why the ECB and the SRB must push for formal resolutions universally, from the outset of the Banking Union. This can be done either by using a certain number of ‘sticks’ such as the ECB taking over the direct supervision of a less significant institution, having on-site inspections, or ultimately threatening to withdraw a bank’s licence, or it can be done by specifying a more concrete set of triggers for the use of early intervention measures by supervisory authorities\textsuperscript{65} that do not only minimise the cost of an eventual resolution, but also the probability of said resolution from ever materialising.

2.2 Cost of Prevention: The Role of Early Intervention

Despite the aforementioned supervisory failures, the CBC did apply some early intervention measures by requiring additional capital of €2.1 billion against its consolidated loan portfolio after the merger of the Greek and Cypriot operations of the bank, and it also did replace the board of directors of Laiki. However, these measures lacked the strength required—perhaps due to a misled hope of resorting to ‘shadow resolutions’,\textsuperscript{66} inducing procrastination. Fortunately or unfortunately, such shadow resolution never came.\textsuperscript{67}

To avoid the procrastination of supervisory action observed in the case of Cyprus, the new supervisory regime caters for early intervention tools, such as appointing temporary administrators,\textsuperscript{68} which must be considered before considering triggering resolution. The use of these tools is instrumental for determining whether or not resolution will eventually need to be triggered.

The early intervention tools are entrusted with the discretion of the supervisory authorities based on a mixture of ‘soft’ and ‘hard’ triggers.\textsuperscript{69} If certain threshold

\textsuperscript{65} These triggers would be set by the EBA’s draft regulatory technical standards under Arts. 29(1) of the SRM Regulation and Art. 27(4) of BRRD; or at least in a softer manner by empowering the SRB to issue guidelines and instructions to NCAs to that regard under Art. 31(1)(a) of the SRM Regulation. See Enriques and Hertig (2015), p. 161.
\textsuperscript{66} I.e. resolutions through private sales and acquisitions or bail-outs instead of resolutions under the formal legislative framework, see Enriques and Hertig (2015), pp. 150-165 for an extensive analysis of the costs and benefits of shadow resolutions.
\textsuperscript{67} Enriques and Hertig (2015), p. 164 concluding that such shadow resolutions should not be favoured because they can harm the stability of a banking system: by exacerbating the moral hazard of the too-big-to-fail guarantee, increasing in turn systemic risk; by weakening healthy banks; distorting competitions, and; damaging the reputation of formal resolutions.
\textsuperscript{68} A temporary administrator is an early intervention measure (Art. 29 of the BRRD), under the responsibility of the supervisory authority, and is not to be confused with a special manager who is appointed in resolution, under the responsibility of the resolution authority. The temporary administrator might cooperate or replace the bank’s management aiming to reach a reorganisation solution and re-establish the safe and prudent management of the bank. The special manager is essentially the executor of the resolution authority’ resolution measures.
\textsuperscript{69} See supra n. 16, quoting Boccuzzi in defining ‘soft triggers’ as entailing a supervisory evaluation of actual or potential, current or prospective non-compliance with prudential standards, and; ‘hard triggers’ as an approach based on predefined quantitative technical thresholds not entailing an evaluation.
values are breached, such as the infringement of prudential requirements the supervisory authorities may intervene and impose corrective measures. The intervention however, is not mandatory and the corrective measures are not predefined. Instead, they are left to the NCAs’ discretion. As such, this decentralised system for early intervention preserves the necessary flexibility and adaptability to cater for the peculiarities of any given case. At the same time, by basing the intervention on the breach of predefined indicators, this solution gives greater certainty and protects the NCAs from potential complaints.

While early intervention is beneficial for keeping a troubling situation from deteriorating and thus minimising the costs of an eventual resolution or liquidation, at the same time, it risks having the trigger being pulled too early. Triggering resolution too early can be a real risk in countries that have already experienced resolution and want to avoid a repetition of the past from unfolding. However, such early triggering of resolution can severely damage the state of a healthy financial institution. This was the case with the early intervention tools adopted in the case of the FBME Bank in Cyprus.

FBME was a Tanzanian-based bank running three branches in Cyprus, which after allegations by the US FinCEN of connection with money laundering was promptly put under the management of a temporary administrator pursuant to Article 29 of the BRRD, as per the CBC’s decision, to ascertain the financial situation of the bank. It is interesting to note that Article 27 and Article 28, which require the raising of additional capital and the removal of the bank’s management respectively, and which are meant to apply prior to triggering Article 29, were not adopted in this case showcasing the discretion supervisory authorities hold depending on the situation they are facing. Shortly thereafter, Tanzania’s Central Bank took over the management of the bank’s branches in Tanzania as well. Subsequently, the bank’s licence was revoked, and an application was filed for the special liquidation of FBME Bank, the Tanzanian parent undertaking of the Cyprus Branch.

All these early interventions were taken ‘at a time when FBME’s financial position [was] sound and fully in line with all relevant capital adequacy and
solvency requirements of the European Central Bank’. Indeed, prior to the Central Bank of Cyprus’s (CBC) announcement, the FBME’s short term liquidity ratio was 104%—sufficient to cover all depositors if required. However, because of the CBC and the US Treasury’s announcement, FBME started experiencing difficulties, for good reasons, in accessing financial markets via its correspondent banks.

It is most intriguing that money laundering, i.e. one of the alleged justifications used just a year earlier for applying the steep bail-in in two badly capitalised banks, is now seen to justify intervention in a well-capitalised bank pursuant to the ‘infringement or potential infringement of the requirements of the relevant EU and national implementing legislation’ even in the absence of such indication in the overall SREP assessment of the bank, causing its financial position to deteriorate and thus opening the way for triggering resolution.

In addition, a further word of caution is the possibility of masking ‘shadow resolutions’ through private solutions as early interventions, by relying on the legal provisions stating a preference for pre-resolution alternative private sector measures. This is particularly relevant for national competent authorities (NCAs) which are more likely to continue to prefer shadow resolutions, possibly in order to cover supervisory mistakes that might pre-date the Banking Union, due to national political pressures. That problem might indeed be intensified within the Banking Union when it comes to resolving smaller banks, which is still at the discretion of the NCAs (if resorting to the Single Resolution Fund (SRF) is not necessary), as member states cannot anticipate whether their peers will opt for formal or shadow resolutions and no member state will want to be stigmatised as the one having formally failing banks.

2.3 Cost of Resolution: The Role of Triggering Resolution

In Cyprus, the restructurings and resolutions of 2013 were not triggered until a financial assistance program was agreed with the Troika (the Commission, the IMF, and the ECB) which had as a condition the restructuring and resolution of the two biggest banks in Cyprus.

74 This was announced in the bank’s website that is no longer accessible since the bank closed in January 2016.

75 This is to a great extent due to the vast presence of outside the euro are non-resident depositors. Indicatively in 2012, 30% of all deposits in the banks were from non-residents outside the euro-area. Also Cyprus became the second largest foreign direct investment into Russia and local professional financial and legal services were used by Russian companies: see European Commission (2013), p. 5; As such, regardless of whether money laundering was taking place the global public opinion was that the bail-in would mostly involve Russian oligarchs’ money and not domestic savers’ money: See Avgouleas and Goodhart (2015), pp. 12-13.

76 According to the EBA such indication of infringement is to be based on the overall SREP assessment of the bank. See: EBA 8 May 2015, p. 3.

77 See Enriques and Hertig (2015), p. 160; BRRD Art. 32, Recitals 46 and 53; Arts. 16(1)(b) and 18(2)(b), Recitals 16, 260, 27A and 29 SRM Regulation.


79 Ibid.
This is no longer the case since resolution is meant to be triggered under the BRRD if a bank is deemed as satisfying three caveats under Article 32, namely: (a) the bank is failing or likely to fail (to be determined by the supervisory authority in consultation with the resolution authority);\textsuperscript{80} (b) lack of a reasonable prospect for an alternative private sector action—including supervisory action (such as early intervention measures or the write-down or conversion of capital instruments) that would prevent the failure within a reasonable time frame;\textsuperscript{81} (c) the resolution action is thought to be in the public’s interest.\textsuperscript{82}

While the triggering of resolution is on the resolution authority’s discretion—\textsuperscript{83}—in a soft-triggers-fashion, based on its evaluation of the lack of adequate private or supervisory measures and of the existence of public interest—the determination of whether a bank is failing or likely to fail is normally taken by the supervisory authority.\textsuperscript{84} Whether a bank is failing or likely to fail is dependent on a narrow set of parameters. Namely, that the bank infringes or might infringe the requirements for the authorisation to a significant extent, for example, its losses will deplete all or a significant amount of its capital; the assets of the bank are (or will become) less than its liabilities; the bank is not (or will not be) able to reimburse its debts or other liabilities as they fall due; the bank needs extraordinary public financial support.\textsuperscript{85}

In this way the ECB, as the ultimate supervisory authority, can potentially coerce NCAs in triggering formal resolutions by using the ultimate weapon in its arsenal: asking national authorities to withdraw the authorisation of the credit institution under Article 14(5), 16(3) and ultimately under Article 84(1) of the SSM Regulation, which would at the very least discourage acquisitions for shadow resolutions.\textsuperscript{86} Shadow resolutions are thought to distort competition since they weaken healthy banks and increase systemic risk by intensifying the too-big-to-fail problem to the detriment of the overall stability of the banking system.\textsuperscript{87}

2.4 Cost of Resolution: The Role of a Liquidation vs. Resolution Evaluation

All three caveats for triggering resolution mentioned are based on the assessment that liquidation would have such disruptive effects that it might jeopardise the continuity of the bank’s essential functions, the financial stability of the banking
system or the pursuit of other significant public interests, and as such, should be avoided (resolution should be preferred).

It follows that the comparison of liquidation’s effects against resolution’s effects is of core importance in deciding to trigger resolution, and, clearly, for determining the eventual costs of dealing with the troubled institution as well as for determining whether the creditors are better off in resolution than under ordinary liquidation. This is especially the case if the adoption of the Deposit Guarantee Schemes Directive leads to a restrictive interpretation of the instances in which the DGS could be used outside ordinary liquidation. However, assessing whether resolution or liquidation is more appropriate can be very difficult given that it entails calculating losses that have not yet occurred and quantifying systemic risk—an unpriced, and therefore unconsidered, side effect of the day-to-day operations of banks.

2.4.1 Which Comes First? Liquidation or Resolution?

The matter of whether resolution or liquidation should be considered first has attracted considerable confusion because they both have the same starting point, namely that the bank is failing or is likely to fail with no realistic alternative solutions to remedy it. This may cause one to think that the two alternatives are to be considered simultaneously.

Confusion is further compounded by the fact that the decisive element for choosing between the two appears to be that the resolution is thought to be in the ‘public interest’. I.e. it ‘achieves and is proportionate to one or more of the resolution objectives specified in Article 31’—such as ensuring the continuity of essential functions, maintaining the stability of the financial system, protecting depositors etc.—where ordinary insolvency proceedings would not meet said resolution objectives to the same extent. Under this definition the resolution...
The Myth of Cypriot Bank Resolution ‘Success’

authorities are entrusted with considerable discretion to prioritise the various
resolution objectives, and thus determine the existence of a public interest.

This confusion could, as professor Boccuzzi points out, lead resolution
authorities to construe resolution as proceedings prior to liquidation, i.e. a form
of early intervention to insolvency given that the effects of liquidation can strain
public interest. If this view is to be followed, liquidation would only occur as a
solution of last resort, when a restructuring operation is inadequate or unfeasible.
Indeed, that appears to have been the case in the Laiki Popular Bank’s resolution in
Cyprus where the resolution consisted of a mixture of the sale of vital parts of the
bank and the wind-down of the rest of it under ‘special’ liquidation.

However, the BRRD seems to take the exact opposite view. Namely, liquidation
has to be considered first, and only if ‘the liquidation of those assets under normal
insolvency proceedings could have an adverse effect on one or more financial
markets’ should resolution be considered. To the same extent, the SRM Regulation Recital 59 also suggests that liquidation should be considered first, and
the resolution option only considered if liquidation would impact the markets
negatively.

In this author’s opinion, the answer to whether it is ‘better’ for liquidation or
resolution to go first must be determined on a case by case basis. This is simply
because while liquidation and resolution have the same starting point, they have
completely different end objectives. Liquidation is primarily focused on safeguarding
the creditors’ interests and deepening the pool of assets to be distributed to
creditors. Resolution, on the other hand, is only interested with protecting depositors
within the pool of creditors—specifically guaranteed depositors if the case of Laiki
Bank is of any indication—and cares primarily for safeguarding financial stability
and upholding the public interest. As such, in each case one has to decide whose
interests are to be safeguarded in order to choose between triggering liquidation or
resolution first. Simply put, the choice between liquidation and resolution must be
made by determining who it is supposed to benefit. And then one must act
accordingly.

Indeed, Boccuzzi (2016), writes: ‘the reference to the effects on financial stability could suggest that
the size of a bank might be a condition for whether or not to start resolution.’ However, that is not the
only parameter since the other objectives are not necessarily associated with the systemic importance of
the bank and should stand in principle at equal significance.

Boccuzzi (2016), p. 170 noting that this is ‘albeit on the basis of pre-determined technical
requirements’.

Ibid., p. 169.

Instead of ‘ordinary’ i.e. the immediate realisation of assets.

For example, this is the case in Italy, see Boccuzzi (2016), p. 171.

Art. 42 para. 1 on the resolution authorities’ power to transfer assets, rights or liabilities. See EBA 20
May 2015, setting out three elements that should be considered by resolution authorities when assessing
the market situation for the assets concerned and the potential direct and indirect effects on financial
markets: (a) whether the market for these assets is impaired; (b) the impact of a disposal of these assets on
the markets where they are traded; (c) the situation of the financial markets and the direct and indirect
effects of an impairment on the markets for these assets.

BRRD Art. 42(14), Recitals 45-46.

See Boccuzzi (2016); Hadjiemmanuil (2015), p. 23.
2.4.2 Comparing the Losses of Liquidation with the Losses of Resolution

Regardless of which must be considered first (liquidation or resolution), it is essential that the losses under ordinary liquidation are compared against the losses of resolution, even if only after the resolution has taken place, in order to ascertain whether the creditors are indeed better or worse off than under ordinary liquidation.

This element has received no attention in the case of Cyprus. Despite the fact that the bail-in tool was used, no evaluation of the cost of resolution as opposed to the potential cost of ordinary liquidation has been undertaken to this author’s knowledge—neither prior nor post the implementation of the resolution measures. As such, it has not actually been determined whether the creditors were in fact better or worse off under ordinary liquidation.

The only studies of some relevance are an independent assessment by PIMCO which estimated as a base scenario total losses incurred by the banking sector by 2015 at just under €14bn, and Pashardes and Pashourtidou (2013) who provide estimates of output losses for the period 2012-2020 associated with the economic crisis in Cyprus, which can largely be attributed to the banking crisis. Nevertheless, none of these studies provide an estimate of the potential losses under an ordinary liquidation scenario. In addition, in the case of Pashardes and Pashourtidou, the losses calculated are of the output GDP—losses also caused by accumulated excessive public deficits, which undermined the role of government as guarantor of the banking system, and structural weaknesses of the Cyprus economy, which limited the capacity of the economy to react swiftly so as to dampen the negative impact of the crisis. Despite being very relevant to the banking crisis as they limited the banks’ ability to raise their capital, these figures might still be unsuitable for the purposes of comparing solely the losses from resolution as opposed to a potential liquidation.

While these studies are important, especially in evaluating the aftermath losses of bank resolution, more studies are needed to help determine whether the creditors are better or worse off, and under which scenarios the creditors would have been better off if different actions were taken.

If there was ever truly a case where such an evaluation would be of absolute necessity, it would be the case of Cyprus. Apart from the complete disregard of creditor protection rights that often carry exceptional gravity in liquidation proceedings, the eventual bail-in imposed was outrageously steep. While it is true that under ordinary liquidation the creditors should accept the probability that they might lose all their credit, resolution is meant to take place at a point prior to liquidation, presumably when the bank’s finances are at a better state. This author is at the very least unsympathetic towards just assuming that the resolution left every creditor better off than ordinary liquidation, without a proper assessment. As such, it is utterly disappointing that in its recent decision in the Ledra case the European

102FL01 Independent Commission on the Future of the Cyprus Banking Sector (2013), p. 25; PIMCO (2013), p. 16, para. 3.12. A more pessimistic ‘adverse scenario’ forecasts total losses by 2015 of €18.5bn, implying a capital gap of €8.9bn. Losses of this order, which did not materialize in reality, would amount to more than Cyprus’ total GDP.
Court of Justice held that the ‘measures [bail-in] do not constitute a disproportionate and intolerable interference impairing the very substance of the appellants’ right to property’ partly because of the ‘imminent risk of financial losses to which depositors with the two banks concerned would have been exposed if the latter had failed’ invoking as such the ‘no creditor worse off’ principle of the BRRD without basing that conjecture on any material study of the potential losses that the creditors in question would have faced had the bank been liquidated. This is despite the fact that the judgement was delivered two years after the bail-in had applied.\footnote{FL04}{Joined Cases C-8/15 P to C-10/15 P Ledra Advertising Ltd and Others v. European Commission and European Central Bank (ECB), ECLI:EU:C:2016:701, para. 74.}

On this point, determining the specific moment for evaluating whether creditors are better or worse off, is also crucial. Article 73 of the BRRD instructs that the potential losses of liquidation should be calculated as if the institution would have entered normal insolvency proceedings at the time when the resolution decision was taken and disregard any provision of extraordinary public financial support to the institution under resolution.\footnote{FL05}{This evaluation should be undertaken promptly after the resolution action has been implemented; Similarly, this point in time is chosen for evaluating the extent of the detrimental effects of liquidation for triggering the sale of business tool See Boccuzzi (2016), p. 91 clarifying that the no-worse-off principle is met for the non-transferred assets if immediately before the transfer the assets would not be better off under ordinary liquidation.} However, having as a point of reference the moment in which the resolution is triggered for comparing the losses of liquidation and resolution could create the distorted incentive to postpone the resolution as much as possible so that the finances of the credit institution deteriorate to such an extent that liquidation would be of such detrimental consequences that resolution is always justified and no compensation is ever due under the ‘no creditor worse off’ principle. This outcome is perhaps foreseen by the BRRD, which requires the resolution authorities to minimise the cost of resolution whilst pursuing resolution objectives, as the next section discusses.

2.5 Cost of Bank Resolution: The Role of the Choice of Resolution Tools

Overall, the resolutions and restructurings that took place in Cyprus included: a steep creditors’ bail-in including unsecured depositors (47.5% for BoC depositors), shareholders and bondholders (Bank of Cyprus, Laiki Popular Bank); bail-in of shareholders and subordinated bondholders (in this case 99% of the shares was held by the Republic of Cyprus and, as such, amounted to an indirect bail-out) to qualify for state aid prior to the 2016 entry into force of the BRRD (Co-operative Bank); state aid of €175 million from Cyprus’ newly created resolution fund (Co-operative Bank); the split of good bank-bad bank (Laiki Popular Bank); the sale of a part of a bank tool (Laiki Popular Bank); the liquidation of parts of a bank while writing off completely all uninsured creditors, including uninsured depositors (Laiki Popular Bank); the special liquidation of a bank (FBME); €1.5 billion public bail-out through ESM funds (Co-operative bank);\footnote{FL06}{February 2014 on the basis of a restructuring plan.} and, private funding (Hellenic Bank).

In addition, suspension of business, revocation of bank licence, and the appointment
of a special administrator (FBME), were sought to strengthen the effectiveness of resolution.

This section focuses on the measures that attracted the most attention: the bail-in tool\textsuperscript{107} and the haircut of uninsured creditors and shareholders on such a vast scale. Bail-in essentially is the tool that grants the resolution authorities the power to unwind a distressed financial institution by allocating losses to the claims of unsecured creditors and converting debt claims to equity. For Laiki Bank, all deposits over €100,000 have been written down in full. For Bank of Cyprus, the holders of ordinary shares and debt securities issued by the Bank have contributed to the recapitalisation of the Bank through the absorption of losses by being written down.\textsuperscript{108} In addition, eligible uninsured deposits have been converted to equity at the shocking rate of 47.5%.

It is argued that the choice of resolution tools for these two banks has maximised the costs of resolution for the bank’s creditors and, as such, that it contradicts Article 31(2) para. 2 of the BRRD which requires the resolution authority, when pursuing resolution objectives, to minimise the cost of resolution. This argument is based on the fact that the level of the bail-in ultimately applied in the Bank of Cyprus was deeply affected by distorted incentives for avoiding compensating the depositors of Laiki, which led to a ‘strange’ choice of resolution tools for Laiki. In Laiki’s case, in order to avoid triggering the use of the deposit guarantee scheme,\textsuperscript{109} which was completely empty and would therefore have needed backing from the government which was also in a bad fiscal position,\textsuperscript{110} Laiki’s depositors were sold off to the Bank of Cyprus (the restructured bank) as part of its resolution. This sale was made through the issuing of equity to Cyprus Popular Bank Public Co Ltd (Laiki Bank), by the Bank of Cyprus, for the acquisition of certain assets and liabilities, including insured deposits, pursuant to the Sale of Certain Operations of Cyprus Popular Bank Public Co Ltd Decrees of 2013.\textsuperscript{111} Consequently, the depositors were not resolved/liquidated with the remaining assets of Laiki and there was no need to compensate.

\textsuperscript{107} See ‘Bail-in clauses’ 128 claiming that conceptually, the bail-in tool is the most important tool in the BRRD.

\textsuperscript{108} Based on ‘the Bailing-in of Bank of Cyprus Public Company Limited Decree of 2013’ pursuant of ‘the Resolution of Credit and Other Institutions Law, 2013’—both adopted after the decision to impose bail-in for a going concern bank for the first time.

\textsuperscript{109} The deposit guarantee scheme law has existed in Cyprus since 2000.

\textsuperscript{110} Note that in the Icesave case the EFTA Court held that Art. 7 of the Directive 94/19/EC does not lay down an obligation on Member States and its authorities to ensure compensation if a Deposit Guarantee Scheme (hereafter ‘DGS’) is unable to compensate depositors in the event of a systemic crisis. See Case E-16/11, EFTA Surveillance Authority v. Iceland (Icesave), Judgment of the EFTA Court of 28 January 2013, para. 144; Hanten and Plaschke (2014), pp. 295-310, 295-296; Icesave, para. 149. The obligation on EEA States was limited to providing for a mandatory and effective procedural framework for DGS, including time limits for the pay-out, giving no conclusive evidence on the state aid issue which arises if the public sector provides assistance to DGS at least for EEA states (under Art. 61 of the EEA Agreement); Although the position of the sovereign on making up for lack of funds in deposit guarantee is contested, as noted above, the ruling in Icesave referred to the European Commission’s view indicating that prohibiting the state from stepping in to provide assistance in emergency situations of exceptional gravity does not seem fitting: see para. 166 of the judgement referring to pp. 8-9 of the Commission’s impact assessment in European Commission (2010) Staff Working Document.

\textsuperscript{111} Bank of Cyprus Share Capital Issue for Compensation of Cyprus Popular Bank Ltd Decree of 2013.
them through the non-existing deposit guarantee scheme. Instead, they maintained
their claims by being sold to the Bank of Cyprus; a sale paid during the
recapitalisation of the Bank of Cyprus and financed through a steep haircut on its
uninsured creditors. Shockingly, the uninsured depositors, bondholders and
shareholders of Bank of Cyprus therefore essentially acted as the deposit guarantors
for insured deposits of Laiki Bank, a bank that was being resolved/liquidated.\footnote{Zenios (2014) explains why various stakeholders in the new Bank of Cyprus (BoC) were not treated equitably by pointing out that ‘[t]he bailed-in depositors of BoC contributed € 3.806 billion in cash and received 3.806Bn shares, i.e. € 1.00 per share. Laiki contributed net assets € 425 million and received 844Mn shares at € 0.503 per share. The capitalisation of the old shareholders of BoC was € 371.95M at the time of restructuring and they received 18M shares at € 20.66 per share. If all stakeholders were given shares at the same price in proportion to their capital contribution, the capital structure of the restructured BoC would have been 82.7% bailed-in depositors, 9.2% ex-Laiki and 8.1% old BoC shareholders. Instead, the current allocation stands at 81.5%, 18.1% and 0.4% respectively. This is preferential treatment of ex-Laiki at the expense of old BoC shareholders.’}

To showcase the absurdity of this action, it is worth noting that this was not the
approach taken subsequently for the sale of deposits of the Cooperative Bank of
Peloponessie to the National Bank of Greece in December 2015. In this case the

Furthermore, this was not the only measure that increased the level of bail-in
to be ultimately applied. Another controversial measure was the cross-border
element of Laiki’s resolution (arising from the prior merger of the Greek and the
Cypriot operations of the bank as explained in Section 2.1.3.3, which
basically consisted only of the sale of the Cypriot branches operating in Greece
at a massive undervalue. This excluded them as eligible liabilities for the bail-in,
increased the losses instead of minimising them, and increased the amount to be
written-down. Importantly, the € 15 billion deposits in the Cypriot branches in
Greece were left untouched by being sold off to Piraeus Bank—for a big profit
for the latter.\footnote{Michaelides (2014), pp. 668, 674 writing that: ‘In March 2013, Piraeus Bank reported an one-off capital gain of € 3.4 billion’ because of ‘regulatory arbitrage across valuation methodologies.’}

Bail-in is meant to recapitalise the failing bank itself, not depositors of other
financial institutions. On the contrary, deposit guarantee schemes are meant to help provide liquidity and assistance in resolution, at least up to the point where they would be needed to compensate the insured depositors. In addition, the costs of bank resolution have to be minimised as far as possible by the Resolution authorities and their choice of resolution tools pursuant to the BRRD.\footnote{Art. 31(2) para. 2.} However, that was not the way the regime was applied in Cyprus, leaving a big question-mark over the choice of resolution tools and the level of bail-in ultimately applied.
3 Success?

The fact that Cyprus was the first country that applied the bail-in at such a great scale and has managed to bounce back from the crisis much quicker than expected—with the full lifting of capital controls in April 2015, having stabilised the total bank deposits,\textsuperscript{116} and having reduced its reliance on Emergency Liquidity Assistance (ELA) to € 3.3 billion from its peak of € 11.2 billion in April 2013\textsuperscript{117}—has led many to praise the ‘success’ of the application of the bail-in tool. However, such praising of success should not be warranted so easily.

In reality, adopting the unprecedented measure of bail-in to such an extent through an administrative action on an ex-post-factum legal basis (something that is now prohibited under Article 55 of the BRRD which exempts from the bail-in all liabilities issued or entered into before implementation of the bail-in in national legislation, and requires the creditors to contractually recognise that the liability may be subject to a write-down, conversion, modification or change in the payment of interest) has been detrimental to the confidence of all depositors, especially domestically, and not just of those affected by the bail-in. The resentment that the application of bail-in created was magnified due to the unfair way the haircut was applied. In effect, the bail-in spared depositors in foreign branches and depositors in other credit institutions in Cyprus, which received public money for their recapitalization.\textsuperscript{118}

As such, different troubled banks were treated differently within the Cypriot banking system. Specifically, the Greek branches of the Cypriot banks were sold, and the bank that acquired them was recapitalized with European Stability Mechanism funds. The Cypriot operations of Laiki and Bank of Cyprus were merged. This involved a partial and complete bail-in of the Bank of Cyprus’ and Laiki’s uninsured depositors respectively. On the other hand, the Co-operative societies and the Cypriot part of Hellenic Bank (the third largest bank) were bailed out with money given to Cyprus on the condition that the bail-in would be applied for Laiki Bank and the Bank of Cyprus.\textsuperscript{119} In addition, different creditors were also treated differently even within the restructured/resolved banks, and creditor seniority was not respected. For instance, the bail-in gave preferential treatment to ELA creditors (€ 9 billion, around 60% of GDP) of Laiki Bank\textsuperscript{120} who were

\textsuperscript{116} With an increase of € 2 billion in deposits in 2016 compared to the end of 2013, reaching € 49.1 billion. See Speech of the governor of the central bank of Cyprus; The capital controls were enforced under The Enforcement of Restrictive Measures on Transactions in case of Emergency Law of 2013, Law 12(I) of 2013 (the Restrictive Measures Law), which sets the legal framework under which the Minister of Finance, on the governor of the CBC’s recommendation, issues decrees restricting certain transactions for the purposes of protecting the stability of deposits in Cyprus banks following the adoption of bail-in measures in the course of resolution of two of the Cyprus banks in 2013.

\textsuperscript{117} € 3.3 billion in March 2016, from € 3.8 billion at the end of 2015 and from € 11.2 billion in April 2013.


\textsuperscript{119} Michaelides (2014), p. 674.

\textsuperscript{120} See supra n. 112, using Zenios’s (2014) numerical explanation of why treatment of various stakeholders in the new Bank of Cyprus (BoC) was not equitable.
transferred, along with the guaranteed deposits to the Bank of Cyprus, over the unguaranteed depositors. In addition, an interesting legal point is the fact that since the resolution regime as we know it today was not in place in 2013, the fact that the deposit guarantee scheme was not involved makes the disproportionate burden-sharing placed on unguaranteed depositors for the benefit of guaranteed depositors, strange. Why were the uninsured depositors less senior than insured depositors if the deposit guarantee was not triggered? Since the uninsured depositors were not less senior, it is argued that the principle of proportionality—that all depositors be treated equally as senior creditors—should have been applied. Instead, creditor priority was completely circumvented further increasing a sentiment of injustice.

The said negative sentiments created fear of a wide-scale bank run which led to the imposition of strict capital controls limiting the amounts that could be withdrawn from the Bank of Cyprus up until April 2015, two years after the triggering of the resolution and restructuring in the affected banks. This led to the argument that to avoid bank runs in the absence of capital controls, future bail-ins should avoid the inclusion of retail depositors.

However, that would not have ensured the effective recapitalisation of the bank in the case of the Bank of Cyprus, as this had a narrow capital structure. It is indicative just to note that post-resolution, bailed-in depositors hold around 81% of the Bank’s share capital, while the outstanding ordinary shares as of 29 March 2013 and the ordinary shares arising from the conversion of outstanding debt securities as of that same date, now account for less than 1% of the share capital of the Bank, highlighting the narrow nature of the bank’s capital. Narrow banking structures are quite common throughout different European countries whose financial systems tend to be dominated by banks rather than by the capital markets. A similar case is the case of Italy, although Italy traditionally had a much more developed retail bondholder base.

In this regard, it is important to note that depositors were not the only creditors with deeply traumatised confidence post-bail-in. Retail investors were also severely hit. Indeed, the application of the bail-in has brought to the surface a wide range of alleged mis-selling and undue duress in selling of securities (the Greek word used literally translating to ‘value bonds’ (axiografa)) to retail depositors, who then became holders of CoCos which were converted to shares at the triggering of resolution and qualified in their entirety for the haircut that contributed to the bank’s recapitalisation. The same emerged in Italy after the bail-in of many shareholders.

122Ibid. This point is discussed further in Jack and Cassels (2013), p. 4.
123Bank deposits amounted to four times the country’s GDP and the cushion between shareholders and depositors was very thin. At the time of the rescue, deposits amounted to €68bn compared to €1.4bn of bonds.
M. Yiatrou

and subordinated bondholders revealed that many retail investors had purchased subordinated instruments believing they were purchasing safe assets.

This reveals that the exemption of retail depositors only, and not of other retail creditors, could create distorted incentives in increasing the creditors base to be bailed-in by convincing retail depositors to be converted to retail investors, creating as such a loophole in increasing bail-inable liabilities by the banks without shifting the burden away from clients who are essentially depositors.

While losses deriving from the restructuring were covered by investors and creditors and not by taxpayers, this universal loss of confidence increased the funding cost, constrained credit availability, and fed bank runs both for depositors, and most importantly creditors and investors, thereby harming participation in the financial markets at a time that Cyprus savings market—both for personal savers and provident funds—had been deeply devastated by the haircut, and as such was in desperate need for rebuilding.126

In an interview with the Financial Times, the former governor of the Central Bank of Cyprus, Athanasios Orphanides, argued that the increase in the cost of funding will not be limited to Cyprus. Instead it will affect ‘any bank in any [weak] country’—meaning mostly the periphery of Europe—by increasing divergences and making the recession in the periphery even deeper. He concluded, ‘similar to the blunder in Deauville with PSI that injected credit risk into sovereign government debt…[t]he governments have created risk in what before last week were considered perfectly safe deposits’ by including them in the bail-in.127

In addition, the haircut and the sale of Laiki Bank to the Bank of Cyprus radically altered the shareholding structure of Bank of Cyprus, which now stands as the largest bank of the island with 81% retail shareholders.128 As such, while the conversion of old shareholders into non-preferential shareholders, (i.e. shareholders without voting rights), might mitigate the moral hazard of leaving voting rights with the old shareholders, it also delegates the voting rights to likely unsophisticated stakeholders who used to be depositors and who might have no interest in being involved in strategic decision-making or in altering the manner in which they finance the bank.129 This is indeed exemplified in the case of Cyprus, where converted creditors were required to register for the first time with the Cypriot Stock Exchange in order to manage their newly acquired shares, proof that a lot of these individuals had no prior participation in the financial markets, arguably signalling their lack of financial sophistication.

In addition, the merger of Cyprus Popular Bank with Bank of Cyprus leaves Cyprus with one very large bank controlling half the market, leaving the structure of the new Cyprus banking industry in a far from optimal state in terms of ensuring competition.130 This dominant bank structure risks over-concentration and loss of competition—essential parameters for setting the service quality, the cost, and the

128FL01 128 ICFCBS (2013), p. 28, para. 4.3.
129FL01 129 Ibid.
130FL01 130 Ibid., para. 11.19.
availability of important banking services such as business credit. As such, there is the risk that, once it has recovered completely, the Bank of Cyprus will dominate the market while simultaneously being ‘too big to fail’, presenting Cyprus with ‘the worst of both worlds’ in harming competition and financial stability.\textsuperscript{131}

Therefore, although the Asset Quality Review (AQR),\textsuperscript{132} the early withdrawal from the ESM program, and the higher setting of the countercyclical capital buffer for O-SIFIs all seem to have contributed to the regaining of trust of international investors and foreign direct investment, the domestic stakeholders have not demonstrated the same belief and commitment.\textsuperscript{133} The lack of trust and co-operation of domestic stakeholders is evident through the persistence of the level of NPLs at 47%—the highest in Europe—which impedes lending by tying up a significant part of banks’ capital, despite the implementation of a new foreclosure and insolvency framework to pursue sustainable restructurings to minimise the problem.

Apart from the fact that domestic stakeholders have been directly hit from the bail-in tool and the capital controls, they also have suffered from the effects of the diminishing competition in the banking system.\textsuperscript{134} Despite the low interest rates the banks enjoy in Europe currently, borrowing costs have not been reduced, but paradoxically deposit interest rates have not increased. A balancing act whereby deposit rates are set high enough to attract and retain deposits and low enough to make borrowing affordable, while also leaving the banks with a sufficient margin in between to service their capital, is essential.\textsuperscript{135} But it is a difficult task which arguably encapsulates ‘the theory of everything’ of banking: the need to stop deposit flight, to allow the banks to make a fair profit, and to keep loan rates at affordable levels.\textsuperscript{136}

\section*{4 Conclusion}

Overall, while the resolution in Cyprus arguably can be seen to satisfy many of the objectives of resolution under Article 31 of the BRRD (i.e. ensuring the continuity of critical functions; avoiding significant adverse effects on financial stability; minimising

\textsuperscript{131}Ibid., p. 28.
\textsuperscript{132}In 2014, when the first data were collected for the AQR of the ECB, Cyprus was in the worst place with 6%. Nevertheless, all its banks managed to pass the ECB’s stress testing by 2015, and by 2016 the island managed to exit the memorandum, without having used, in fact, all of the money that it was promised from the ESM. One can potentially infer from that that by following the resolution measures as instructed, even with the massive lag by the Central Bank of Cyprus in placing the banks into resolution and increasing their debt in the meantime (don’t forget that this is the pre-SSM, pre-SRM era) Cyprus managed to recover, its banks managed to regain their investors trusts, in fact since 2013 Cypriot banks have attracted the highest level of foreign investment in the history of the Cypriot banking system, showing that by following the program strictly and being determined to recover might work after all.
\textsuperscript{134}Ibid.
\textsuperscript{135}ICFCBS (2013), p. 50, para. 10.7.
\textsuperscript{136}Ibid.
reliance on public funds; protecting guaranteed depositors and clients’ own assets), it has not done so in a way that transparently satisfies the general principles of resolution under Article 34 of the BRRD. In particular, it has not satisfied the principle that creditors belonging to the same class must be treated equally; the principle that no creditors shall bear greater losses than they would have borne in the case of the bank being liquidated; and the principle that safeguards must be applied for stakeholders who suffered worse treatment than under ordinary insolvency.

Therefore, it is important to qualify what the ‘success’ in the ‘success story’ of Cyprus really is. The experience with bank resolution in Cyprus was successful in the sense that it helped the banking sector recover from a deeply detrimental position. However, it was not successful in the sense of being optimal either in respecting the general principles laid down in the BRRD, or in minimising the immediate and long-term losses from bank resolution as illustrated above.

Now the BRRD-style resolution is to be applied universally across Europe. This means that countries will have to put their banks through the resolution process without having the benefit of using such obedience to resolution to bargain for financial assistance, as in the case of Cyprus in 2013 and Greece in 2012, where private sector burden-sharing by creditors (‘bail-in’), and bank resolution, formed part of the financial assistance programmes.\(^\text{137}\)

This role of inducing compliance through financial assistance is arguably filled by the mutualisation of the national resolution funds under the Single Resolution Fund (SRF)\(^\text{138}\) under the new regime. The fact that, in the future, every significant use of the resolution fund (e.g. liquidity support exceeding 20% of the capital paid into the fund, or bank recapitalisation exceeding 10% of the funds and any decision requiring the use of the fund once a total of €5bn has been reached in a given year) is under the responsibility of the plenary session of the resolution board, which has to decide with a two-thirds majority, means that every bank in need of SRF money to finance resolution will be subject to the Single Resolution Board’s control. Simply put, access to SRF funds is likely to be used to compel the obedience of the national resolution authorities— withholding as such the resolution funds in a quid pro quo fashion in case of insubordination.

Crucially, the Cypriot experience with resolution highlights that supervision should always work in concert with resolution in order to avoid output losses related to the banking sector’s size, bank recapitalisation costs incurred by the government, and to the amounts of liquidity injected in the banking sector by the central bank.\(^\text{139}\) Supervision should be constantly evaluating how its decisions might affect the costs of a potential resolution. Resolution planning should depend upon thorough calculation of the cost of each resolution measure to be adopted at the time the measure is applied, and on a longer-term scale.\(^\text{140}\) Arguably, the bank regulatory

---

137FL01 See Memorandum of Understanding (2013), paras. 1.23 to 1.27.
138FL01 Art. 67 of the SRM Regulation.
139FL01 Boyd et al. (2005).
140FL01 The public capital injected into EU banks over 2008–2012 is estimated to be in the region of €413.2 billion, amounting to 3.2% of EU GDP in 2012 and the costs of bank rescue represented more than 10% of GDP in Ireland, Greece, and Cyprus. See European Commission (2014), p. 74.
regime as it currently stands within the Banking Union can already be seen to be prescribing a holistic approach. Nevertheless, a more spelled-out approach—akin to that introduced by Article 31(2) para. 2 of the BRRD, which requires the resolution authority to minimise the cost of resolution when pursuing resolution objectives, and which requires both supervisory and resolution authorities to actively consider how their decisions affect the costs and losses of a potential future resolution throughout the supervisory/resolution regime in the Banking Union—would be clearer to that regard.

Only after following a holistic approach to minimising costs and losses from a potential resolution from the outset, starting with supervision and early intervention, or even starting with choosing the capital structure of the bank, can a true comparison of the cost of ordinary liquidation and bank resolution be undertaken; and not after a series of detrimental actions and inactions essentially removing the possibility to truly choose between resolution and liquidation by rendering the triggering of resolution indispensable.

References


Hanten M, Plaschke M (2014) EU law impact on deposit protection in the banking union. LSE Law, Society and Economy Working Papers no 6


Hellwig M (2014) Yes Virginia, there is a European banking union! But it may not make your wishes come true. Max Planck Institute for Research on Collective Goods, Bonn


The Myth of Cypriot Bank Resolution ‘Success’…


