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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.

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ARTICLE

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

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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.

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31 ## 1 Introduction

32 The experience of Cyprus with bank 'resolution'[1] in 2013,[2] 2014,[3] and 2015[4] carries
33 many lessons and insights with regards to the practical application of the bank
34 resolution regime as it currently stands in the Banking Union.[5] This paper focuses
35 on what is possibly the most important such lesson that emerged. Namely: the need
36 for reaping the advantages of the 'holistic' approach in bank regulation under the
37 Banking Union by exercising supervision, early intervention, resolution and post-
38 resolution in a way that seeks to collectively reduce the price of bank resolutions
39 from the outset and throughout each pillar, before a credit institution actually needs
40 to be recapitalised or resolved.
41 The Cypriot experience signals the passage from an era of bail-outs to an era of
42 bail-ins. Cyprus was the first case where a 'bail-in' was imposed within the
43 European Union, in the spirit of shifting the burden of dealing with troubled banks
44 onto the banks' creditors instead of the tax-payers. However, despite this shift in
45 burden, it is evident that failures in supervision and resolution still had a massive
46 impact not only on the bank's creditors who were called to recapitalise the banks
47 through the bail-in tool, but also on the economic output of the country, and, as
48 such, on the public.[6] Even if not directly taxed to bail out the banks, the public is
49 still burdened indirectly, either through the direct consequences to the country's
50 diminishing economic output such as perishing wages, increased prices, or

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1FL01 [1] Under the Bank Recovery and Resolution Directive (BRRD), Art. 1(1) 'resolution' is defined as the
1FL02 application of a resolution tool or a tool referred to in Art. 37(9) in order to achieve one or more of the
1FL03 resolution objectives referred to in Art. 31(2). For instance, the institution is failing but 'resolving it', as
1FL04 opposed to letting it fail under ordinary liquidation, is considered to be in the 'public interest' (a term that
1FL05 is explained later on); Boccuzzi (2016), p. 69 defines resolution as 'the set of tools aimed at reorganising
1FL06 and restructuring the bank'; Combining these definitions gives us that bank resolution provides
1FL07 administrative powers of intervention which are designed to either restructure a bank (e.g. by transferring
1FL08 assets and bailing-in its creditors and shareholders) or to effect its 'orderly' wind-down, i.e. its resolution
1FL09 'without severe systemic disruptions' and without socializing the losses of credit institutions through bail-
1FL10 outs. See Financial Stability Board, Preamble para. 1, p. 3.

2FL01 [2] The restructuring of the Bank of Cyprus and the resolution of Laiki Popular Bank through resolution
2FL02 and restructuring measures and the recapitalisation of Hellenic Bank and the Cooperative Banks through
2FL03 private and public funds respectively.

3FL01 [3] Resolution Decree of the Central Bank of Cyprus No. 356/14 issued on 21 July 2014 applying
3FL02 resolution measures in respect to the Cyprus Branch of FBME Bank Ltd after the US's FinCEN alleged
3FL03 that the FBME carried out money laundering operations through its branches in Cyprus.

4FL01 [4] With regards to the Cooperative Bank.

5FL01 [5] 'Banking Union' refers to the centralization of rule-making and decision-making instruments of
5FL02 banking policy on the supranational level. The Banking Union rests on four pillars. The first is the SSM
5FL03 which brings the supervision of euro area banks, directly or indirectly, under the auspices and control of
5FL04 the ECB and caters for early intervention measures to prevent future crises. The second is the Single
5FL05 Resolution Mechanism (SRM) which brings the resolution of euro area banks, directly or indirectly,
5FL06 within the competence of the Single Resolution Board (SRB) and establishes a Single Resolution Fund
5FL07 (SRF) to support resolution. The third is harmonised deposit guarantee scheme. The fourth is the Single
5FL08 Rulebook which includes the substantive rules of prudential regulation and resolution of credit
5FL09 institutions. See Grundmann (2015).

6FL01 [6] Indeed, output losses inflicted by banking crises on the economy are found to be generally vast (e.g.
6FL02 Boyd et al. (2005)), and often impossible to be regained (e.g. Cerra and Saxena (2008)).

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diminished supply of credit,[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.[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.[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

[7] 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.

[8] Baglioni (2016), p. 9.

[9] 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).

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87 be used to finance/recapitalise resolution and bank restructuring,[10] supervision,
88 early intervention, resolution, and post-resolution, all make up the eventual price of
89 bank resolution during and after its completion since decisions taken at each stage
90 can affect the level of the economic downturn and the percentage of bail-in needed
91 for recapitalizing/resolving the bank. As such, all the stages of the new regime
92 should work in concert to minimise the costs and losses.[11]

93 Cyprus exemplifies that not taking advantage of this concerted approach, and
94 relying instead excessively on the resolution stage to fix the problems after a trail of
95 supervisory and other failures, leads to an exponential increase of the losses which
96 in turn triggers the need for deeper haircuts to recapitalise and resolve the troubled
97 banks.[12] Just as an indication to that extent, after long delays in taking action to deal
98 with the failing banks (supervisory & institutional failures[13]), and limited and
99 ineffective use of early intervention and preventative measures in dealing with
100 troubled banks (supervisory failures), the percentage of bail-in imposed reached the
101 order of 47,5% of the uninsured depositors (the main creditor base) in the Bank of
102 Cyprus (the restructured bank), while uninsured deposits were wiped out in the
103 Laiki Bank (the resolved bank). These failures made resolution the best/cheapest
104 option by default—with no thorough assessment to that regard other than who was
105 to bear the costs directly.

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

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

10FL01 [10] See Hadjiemmanuil (2015); Hellwig (2014); Yiatrou (2016).

11FL01 [11] See Basel Committee on Banking Supervision (2015), stressing the need for: (i) early intervention and
11FL02 use of recovery and resolution tools; (ii) improving supervisory processes (e.g. incorporating macro-
11FL03 prudential assessments, stress testing and business model analysis); (iii) dealing with liquidity shortfalls,
11FL04 risk concentrations, and misaligned compensation schemes; and, (iv) further guidelines on information-
11FL05 sharing and cooperation of relevant authorities.

12FL01 [12] If formal resolution is to be considered at all at that point.

13FL01 [13] Institutional failure due to the lack of a pre-existing regime to deal with the crisis to enable prompt
13FL02 action.

14FL01 [14] See Clerides (2014), noting that supervision 'is not an exact science' and as such it cannot dodge all
14FL02 future bank failures. Therefore, focusing solely on supervision would also be insufficient.

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122 resolution and restructuring of their banks, and, as such, in achieving the objectives
123 of the Banking Union. To showcase how the regime can live up to the potential of
124 its intended holistic approach, the paper starts by examining how supervision, early
125 intervention, and resolution, respectively, can minimise the immediate and long-
126 term costs stemming from bank resolutions (Sect. 2). In doing so, examples of
127 actions and inactions that increased instead of decreased the costs in the Cypriot
128 banks' resolution are provided to argue that the Cypriot case failed to truly harvest
129 the benefits of such a holistic approach (Sect. 2). Section 3 then discusses on this
130 basis why Cyprus was unsuccessful in applying the holistic standard advocated.
131 Section 4 concludes.

132 2 Cost of Banking Resolution: A Holistic Approach

133 The objectives of the Banking Union are to establish a single regulatory,
134 supervisory, and bank resolution structure that minimises the likelihood and
135 severity of future banking crises—thus lessening their potential impact on EU
136 economies and taxpayers, while at the same time increasing banking competitive-
137 ness by reducing fragmentation and maintaining the stability of the financial
138 system—and, in turn, restores confidence in the financial sector to contribute to
139 economic recovery.[15] In other words, they are essentially already prescribing the
140 advocated holistic approach for minimising the costs of a potential bank resolution.
141 In order to achieve these objectives, the regime allows ample room for discretion,
142 whether at the national or at the European level, by adopting a minimum
143 harmonisation approach with 'soft triggers'[16] instead of outright 'hard triggers'[17] for
144 many critical decisions. In particular, soft triggers are adopted for the triggering of
145 resolution, and a mixture of soft and hard triggers are adopted for early intervention
146 measures.[18] It follows that, discretion in the decision-making at all the stages of the
147 new regime is instrumental in shaping the aggregate costs of resolution, and as such
148 in achieving the holistic approach prescribed to limit the costs from the outset,
149 leading to more efficient future resolutions with less casualties. For instance, the
150 decisions of the supervisory authorities for early intervention measures can avoid an
151 eventual resolution altogether; the discretion in the evaluation of whether
152 liquidation or resolution are more beneficial for the public interest will determine
153 what the ultimate losses on the creditors will be; the evaluation of whether creditors
154 are better or worse off in resolution than under ordinary liquidation will determine
155 whether the resolution fund will need to compensate creditors post resolution,
156 increasing as such the cost of resolution, etc.

15FL01 [15] European Commission (2014), p. 76.

16FL01 [16] Boccuzzi (2016), p. 66 defines a 'soft triggers' approach as an approach based on an evaluation of the
16FL02 supervisory authority with regards to current or prospective (actual or potential) non-compliance with
16FL03 prudential requirements—the same approach pre-existed under Art. 136 of the Credit Ratings Directive
16FL04 (CRD).

17FL01 [17] Ibid., in a 'hard triggers' approach only predefined quantitative thresholds signalling the bank's
17FL02 technical situation, such as capital, leverage, and liquidity, qualify as triggers for intervention.

18FL01 [18] Ibid., p. 168.

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157 This section explores the importance of discretion in supervision, early
158 intervention, triggering of resolution, choosing between liquidation and resolution,
159 and choosing the resolution tools to be applied in calibrating the price of bank
160 resolution not only prior and during resolution, but also in the aftermath of its
161 execution. As such, it provides a guide of how to use discretion to facilitate the
162 holistic approach advocated for. In doing so, it argues that, in the case of Cyprus,
163 discretion was regrettably used to exacerbate the costs and hide the failures,
164 bringing to the surface the adverse consequences of not following a holistic
165 approach in bank regulation.

166 2.1 Cost of Prevention: The Role of Supervision

167 Supervision is important for minimising costs and losses because it is responsible
168 for: ensuring resolvability and bail-in ability at all times in order to apply prompt
169 and smooth resolution minimising systemic ripple effects;[19] avoiding failures in the
170 first place; and, in the event that failures do occur, rebuilding the competitiveness of
171 the banking sector and reducing the long-term losses from resolution.

172 2.1.1 Supervision: Rebuilding Competitiveness of the Banking Sector

173 In post-restructuring and resolution countries, supervision is most important for
174 regaining the investors' trust in order to rebuild the banking sector's competitive-
175 ness. Regaining this trust however is an incredibly difficult task given that the same
176 supervisory authority has already proven itself to be incapable of effectively
177 supervising the banks it was responsible for.
178 To re-establish competitiveness in a 'crisis' country, supervision must actively
179 and vigorously apply the relevant international and European standards[20] to the
180 fullest effect in order to benefit from the levelled playing field, integrity, and
181 stability that regulatory convergence (i.e. one-size-fits-all) can offer. Therefore,
182 demanding requirements and capital buffers that can achieve competitiveness are
183 not treated with hostility. On the contrary, setting such vigorous standards is
184 welcomed given how crucial it is for countries that restructure their banks to get it

19FL01 [19] Krahnen and Moretti (2015), p. 147; Joosen (2015), pp. 175-235.

20FL01 [20] Said standards are provided under the array of rules which govern the prudential regulation of credit
20FL02 institutions under the single banking rule-book. These substantives rules are already contained in the
20FL03 Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR)—both
20FL04 implementing Basel III. See Directive 2013/36/EU (CRD IV) [2013] OJ L 176/338 and Regulation (EU)
20FL05 No. 575/2013 (CRR) [2013] OJ L 176/1. According to Professor Grundman the Single Rulebook, on the
20FL06 basis of EU regulations and directives, is aimed at a truly uniform supervisory practice, akin to a
20FL07 handbook on uniform supervision practice. See Grundmann (2015). See also Reports on the Observance
20FL08 of Standards and Codes (ROSCs), which summarize the extent to which countries observe certain
20FL09 internationally recognized standards and codes. The IMF has recognized 12 areas and associated
20FL10 standards as useful for the operational work of the Fund and the World Bank. These comprise of:
20FL11 accounting; auditing; anti-money laundering and countering the financing of terrorism (AML/CFT);
20FL12 banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and
20FL13 creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and
20FL14 securities regulation.

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right, since ‘failure would throw all confidence-building measures into reverse, with incalculable consequences’.[21]

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%,[22] 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.[23]

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.[24] 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.[25] This meant that the Cypriot banks, which were deeply affected by the PSI[26] 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.[27] 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

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[21] Independent Commission on the Future of the Cyprus Banking Sector (ICFCBS) (2013), p. 39.

[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.

[24] Michaelides (2014), p. 667.

[25] EU Council on 26-27 October 2011.

[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, ‘[t]his is not true in the case of Cyprus’; 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.’

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216 2009, 2010 and even as late as early 2011, much harder.[28] This combination of
217 the haircut and the stress test left the two largest Cypriot banks in need of about
218 2 billion euro of additional capital.[29] Since the banks had just lost more than 4.5
219 billion in the Greek PSI, it is evident that the banks did not require assistance
220 before these badly-timed regulatory interventions.[30]

221 To sum up, while one-size-fits-all policies are beneficial counter-cyclically,
222 especially for increasing competition in post-crisis countries by earmarking
223 regulatory convergence, one-size-fits-all policies do not actually fit all when
224 fragility is present. Thus, discretion should be exercised to avoid unintended
225 consequences from the application of one-size-fits-all policies during crises.[31]

226 2.1.2 Supervision: Ensuring Resolvability[32]

227 Resolvability rests largely upon three factors. Firstly, on setting out and enforcing
228 sufficient capital requirements to ensure that the bank has enough capital to absorb
229 losses for financing its resolution and recapitalisation. Secondly, on drafting and
230 updating viable resolution plans to be followed swiftly if the need for resolution
231 arises. Thirdly, on the local government cooperating in supporting formal
232 resolutions and in keeping the costs of formal resolutions down by maintaining a
233 solid fiscal position and implementing structural adjustments if needed in order to
234 maintain confidence in its ultimate backstop abilities and enable the banks to build
235 up their capital cushion in case that becomes necessary—something that the Cypriot
236 government did not do.[33]

237 Supervisory and resolution authorities are crucial in conducting the ground work
238 for resolvability by calculating and assessing the level and quality of loss absorbing
239 capital for each bank supervised, as well as drafting viable resolution plans, so as to
240 credibly cater for the speedy application of a formal resolution, if need be, at a
241 future time. The sufficiency of the loss absorbing capital involves the level of equity
242 and bail-inable debt needed to ensure adequate loss absorption based on the size and
243 risk of the institution in question (the minimum requirement for own funds and
244 eligible liabilities MREL),[34] and its quality, i.e. the loss-absorption ability of the

28FL01 [28] Orphanides (2013), p. 4. If EFSF/ESM were available for direct recapitalization of banks instead of
28FL02 asking each government to be responsible for the capitalization, the government losing access to the
28FL03 markets would not have affected the banks in raising additional capital. However, in the absence of such
28FL04 arrangements the adverse feedback loop existing between banks and sovereigns meant that removing the
28FL05 possibility of the implicit guarantee made it practically impossible for banks to raise additional capital.

29FL01 [29] Ibid.

30FL01 [30] Ibid.

31FL01 [31] See Michaelides (2014).

32FL01 [32] Please refer to Peter Brierley's paper in the same volume for an extensive account of resolvability.

33FL01 [33] Orphanides (2013), pp. 2, 49.

34FL01 [34] Or Total Loss Absorbing Capacity (TLAC) if the institution is considered to be a Globally Significant
34FL02 Financial Institution (G-SIFI); See Krahnen and Moretti (2015), pp. 136, 142-146, while sympathising
34FL03 with Admati and Hellwig (2013a) who argue for a 20-30% risk unweighted equity ratio to ensure a much
34FL04 larger Loss Absorbing Capacity (LAC) in bank balance sheets, they emphasize the added value of having
34FL05 bail-in debt as part of the LAC—in addition to equity.

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

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

263 2.1.3 Supervision: Avoiding Failures in the First Place

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

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

276 2.1.3.1 CBC Policies That Allowed Surge in Real Estate Loans Between
277 2010-2012 the CBC relaxed the liquidity standards which allowed a dramatic
278 increase in loans to real estate. Indicatively, in 2011 loans to the housing sector
279 amounted to 150% of GDP, and were given based on collateral rather than on the

35FL01 [35] Ibid., p. 142.
36FL01 [36] Ibid., pp. 125-126.
37FL01 [37] EBA (2014a), p. 3.
38FL01 [38] EBA (2014c), p. 10.
39FL01 [39] An application to ELA becomes the subject of examination by the central national bank and is required
39FL02 to be approved by the ECB Governing Council with two-thirds majority.

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280 cash flows of the borrowers.[40] The CBC's effort to counteract this dramatic increase
281 by introducing a 10% increase in the down payment requirement on second homes
282 in 2007[41] was condemned as limiting loans and growth. Consequently, it only lasted
283 one year, limiting any potentially positive effects that it might have had and
284 showcasing the political influence the CBC was under.

285 2.1.3.2 Emergency Liquidity Assistance In 2012, the amount of ELA provided
286 to Laiki reached around 60% of the GDP. ELA continued to be provided to
287 Laiki even though it was clear by 2012 that the bank was insolvent. Given that
288 already since July 2012 the ECB had offered an opinion that resolution might be
289 preferable for Laiki, one wonders how the CBC allowed ELA to reach 60% of
290 GDP. The assertion of the governor of the central bank of Cyprus at the time,
291 Panicos Demetriades, that Laiki was 'dynamically solvent' conditional on a
292 program being signed, is not convincing given that the program was not signed
293 until March 2013, nine long months after ELA was extended to an insolvent
294 bank.[42]

295 2.1.3.3 Merge of Greek and Cypriot Operations of Laiki The conversion of the
296 Greek operations of Laiki from 'subsidiary' to 'branch' status in March 2011
297 moved regulatory responsibility from the Central Bank of Greece to the Central
298 Bank of Cyprus.[43] That meant that the Greek operations of Laiki did not benefit
299 from the liquidity assistance that Greek banks benefited from post-PSI. While
300 bringing the cross-border operations of the bank under the supervision of the
301 Bank of Cyprus was thought to be a positive step for ensuring proper
302 supervision of the bank as a whole, it later became clear that this had increased
303 the systemic risk in Cyprus. In particular, it is argued that it materially increased
304 the funding required to bail out Laiki Bank,[44] given that following the merger,
305 the CBC's Supervisory Review and Evaluation Process (SREP) required Laiki to
306 hold € 1.56 billion of additional capital against its sovereign bond portfolio, and
307 € 2.1 billion against its loan portfolio—51% of which was concentrated in
308 Greece.
309 While Alvarez & Marshal, a forensic experts firm solicited to investigate the
310 matter by the CBC, found that it was the legislation that should be amended because
311 it did not provide 'sufficient support' to the CBC where a Cypriot bank wishes to

40FL01 [40] European Commission (2013).
41FL01 [41] Michaelides (2014).
42FL01 [42] Michaelides (2014), p. 673; Orphanides (2013) argues that the delays in asking for assistance were due
42FL02 to the communist government at the time not wanting to impose structural changes.
43FL01 [43] The recapitalization exercises and European decisions do require recapitalization of either subsidiaries
43FL02 or branches to happen at the group level, as decided at the PSI October 2011 meeting (para. 4 in annex 2):
43FL03 'National supervisory authorities […] must ensure that banks' plans to strengthen capital […] [take] into
43FL04 account current exposure levels of the group including their subsidiaries in all Member States…'.
44FL01 [44] Which the Cypriot government provided with a surge of € 2.5 billion following the losses sustained by
44FL02 the PSI

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convert an existing foreign subsidiary into a branch,[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).'[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[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),[48] are regarded as largely insufficient.[49] This is because while the CBC formally requested information regarding the BoC's holdings of GGBs in March 2010,[50] it did not follow up on

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[45] Alvarez & Marshal (2013b).

[46] Ibid., p. 13.

[47] Alvarez & Marshal (2013a), para. 2.9.2.

[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 'Peqí sxm Pqánexm Pqorxpxm pot jasévotm elpirsetsijéi pkgqouoqíei jai sxm Pqánexm Veiqacxcgrgi sgi Acoqái (Jasávqgrgi sgi Acoqái) Mólot o M.116(I)/2005 (Insider Dealing and Market Manipulation Law), the 'Peqí sxm Pqotpohérexm Diauámeiai (Jimgséi Anúei pqoi Diapqaclásetrg re Qthlifólemg Acoqá) Mólot o M.190(I)/2007 (Securities Transparency Law), and the 'Peqí Dglória Pqoruoqái jai Emgleqxsijoú Deksíot Mólot o M.114(I)/2005 (Prospectus Law). Cyprus Securities and Exchange Commission (2014), p. 3.

[49] Alvarez & Marshal (2013a), para. 2.9.

[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

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339 its written request on a timely basis[51] even though it received no response from
340 the BoC.[52]
341 Michaelides suggests that, once again, political pressures from both the ECB and
342 from Greek politicians seem to have influenced the CBC from taking more
343 appropriate action such as forcing the BoC and Laiki to dispose of their GGBs in a
344 timely manner.[53] He cites fear for any negative consequences such action would
345 have on the position of Cyprus in the diplomatic sphere as a cause of the
346 inaction[54]—even though ex post it is evident that such considerations are immaterial
347 given the scale of the increase of the losses from 2010 to October 2011 (when the
348 PSI terms were agreed upon).
349 Regardless of whether or not the CBC should have requested the sale of the
350 Greek Governmental Bonds prior to the PSI, it is undisputable that it should have
351 asked for support for its affected banks immediately after the PSI took place either
352 through ESM assistance, or for restructuring the banks. The Greek debt holdings
353 were publicly disclosed in the July EBA stress test so everyone could calculate what
354 the haircut meant for the Cypriot banks. With the Cypriot government out of the
355 markets,[55] it was obvious that it would be impossible for the Cypriot banks to
356 recover from the PSI and rebuild their capital base within 9 months as required.
357 Nevertheless, Cyprus did not ask for assistance until the end of June 2012. In
358 addition, the government did not negotiate a program until November 2012, when
359 the ECB threatened to cut off liquidity, and did not conclude a Memorandum of
360 Understanding (MOU) until December 2012[56]—more than a year after the PSI's
361 terms were agreed upon.[57]
362 It follows from all the above that while crises are very difficult to predict,[58] the
363 Cypriot authorities failed to detect obvious indicators signalling the imminent
364 crisis,[59] and failed to act expediently and instrumentally in the face of political
365 short-termism and delays in producing the reports on the financial position of

51FL01 [51] Ibid., para. 2.8.1.4, reporting that a follow-up to the letter of 01/03/2010 was eventually sent to the
51FL02 BoC in February 2012—two years later.

52FL01 [52] Ibid., citing the report of the Cyprus Securities and Exchange Commission (2012) which highlighted
52FL02 that only a verbal conversation took place between 'someone' at BoC and the Governor of the CBC in
52FL03 response to the letter of 01/03/2010, and that the Board of Directors at BoC were never made aware of the
52FL04 letter.

53FL01 [53] See Michaelides (2014), p. 669 noting that 'ECB President Trichet was very vocal against a Greek PSI,
53FL02 and one wonders what the response would have been if a central bank of a Euro-Area country advised, or
53FL03 forced, the sale of Eurozone sovereign bonds'.

54FL01 [54] Ibid.

55FL01 [55] Orphanides (2013), p. 4.

56FL01 [56] Orphanides (2013), p. 5.

57FL01 [57] The PSI terms had been agreed on since October 2011and the PSI took effect since April 2012. See
57FL02 Hellenic Republic Ministry of Finance (2012), PSI Launch, press release 21 February for the final
57FL03 settlement of the PSI, see Hellenic Republic, Ministry of Finance 2012: press release 25 April.

58FL01 [58] Clerides (2015). See Pashardes and Pashourtidou (2013), p. 22; not in the context of Cyprus, see Boyd
58FL02 et al. (2005).

59FL01 [59] Clerides (2015), pp. 18, 24 noting that such indicators include widening current account deficits, rapid
59FL02 growth in domestic credit, inflated asset prices (property or equity) and non-performing loans.

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366 Cyprus and its banking sector[60] stalling the negotiations[61] and leaving the vast
367 domestic imbalances unaddressed.[62]
368 These delays vastly aggravated the situation. It is indicative just to note that
369 while the first draft adjustment program foresaw a total fiscal adjustment of 5.75%
370 of GDP in July 2012, by the time a program was agreed in March 2013 the required
371 adjustment had increased to 12% of GDP. This was despite the fact that a major part
372 of the recapitalization was covered by the 'internal rescue' of the bank done through
373 the bail-in and write-down of shareholders, bondholders and the uninsured
374 depositors of Laiki Bank and Bank of Cyprus (the two resolved and restructured
375 banks).[63] Effectively, by delaying reaching a deal, a substantial amount of deposits
376 had left the banking system, meaning that the haircut was higher for the deposits
377 that stayed behind. All of the above increased the haircut on the remaining
378 depositors within the Cypriot banking system.
379 Given these facts, the crucial importance of supervision in determining the
380 eventual cost of a potential resolution is undisputable. Indeed, commentators have
381 argued that if more appropriate policy action was taken earlier, perhaps with
382 increased responsibility from the outside by a more experienced and less prone to

60FL01 [60] It is indicative to note that Cyprus asked for help (25 June 2012) at about the same time as Spain (21
60FL02 May 2012). While Spain's stress tests took two months to complete altogether (Oliver Wyman completed
60FL03 a top-down stress test for Spain's banking system within one month (21 May 2012 to 21 June 2012) and
60FL04 the bottom-up stress test was completed by September 2012) in Cyprus, the PIMCO analysis was not
60FL05 officially submitted until February 2013—8 painful months afterwards.

61FL01 [61] Eighteen months as opposed to the two and three week-timelines that other assistance requesting
61FL02 countries experienced like Greece, Portugal, Ireland and Spain, see Michaelides (2014), p. 643;
61FL03 Orphanides (2013), p. 4 in fact argues that if the ECB had suspended its rules making non-investment
61FL04 grade sovereign debt ineligible for collateral following the downgrading of sovereign debt below
61FL05 investment grade in late June 2012 (as it had done for the cases of Greece, Portugal and Ireland) Cyprus
61FL06 banks could continue to buy treasury bills and continue financing the needs of the country for some time
61FL07 aggravating further their own financial position. That was a way for the ECB to strong arm the Cypriot
61FL08 government to make structural adjustments and fiscal adjustments and by that point in June, get into a
61FL09 program.

62FL01 [62] See Clerides (2014), explaining that 'for four consecutive years, 2007-2010, the external balance
62FL02 deficit was at or exceeded 10%'—an extraordinarily high level of deficits that should have alarmed the
62FL03 authorities well before the crisis hit. 'By the time assistance was sought public deficit rose to 6.3% of
62FL04 GDP and public debt increased to 86% of GDP.' In 2013, the public debt rose further due to recapitalizing
62FL05 the Co-operative Bank by injecting € 1.5 billion of capital—equivalent to almost 10% of GDP. See
62FL06 ICFCBS (2013), p. 26 noting that 'this failure was reinforced by surprisingly encouraging reports from
62FL07 the international agencies which scrutinized Cyprus' financial condition' For instance, as late as February
62FL08 2011, the IMF's Art. IV report on Cyprus concluded that 'The Cypriot banking system has weathered the
62FL09 economic difficulties well and appears to be in sound overall condition. It has benefited from reliance on
62FL10 deposits rather than less stable sources of financing, conservative lending practices, close attention to
62FL11 capital and liquidity buffers, and vigilant supervision. These factors have helped shield the banking
62FL12 system from the pressures that are prevalent in many other countries. The ongoing risks in international
62FL13 financial markets call for a continuation of conservative balance sheet management and careful
62FL14 supervision.' This striking conclusion gave the authorities considerable comfort at the time.; One can
62FL15 argue that perhaps such misleading conclusions would have been avoided if asset quality reviews and
62FL16 stress tests such as the one undertaken by the ECB in 2014 had been undertaken earlier, during a non-
62FL17 crisis period and after having first specified the workings of recapitalization and resolution, especially
62FL18 how to find resources for the recapitalization which is still a work in progress: see Orphanides (2015) to
62FL19 that regard, and Orphanides (2013), p. 4, quoting Mario Draghi.

63FL01 [63] Charalambous (2015), p. 25.

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383 domestic political capture supervisor, such as the ECB, bank resolution and
384 restructuring involving a creditor bail-in in March 2013 in Cyprus, could have been
385 avoided.[64] This is why the ECB and the SRB must push for formal resolutions
386 universally, from the outset of the Banking Union. This can be done either by using
387 a certain number of 'sticks' such as the ECB taking over the direct supervision of a
388 less significant institution, having on-site inspections, or ultimately threatening to
389 withdraw a bank's licence, or it can be done by specifying a more concrete set of
390 triggers for the use of early intervention measures by supervisory authorities[65] that
391 do not only minimise the cost of an eventual resolution, but also the probability of
392 said resolution from ever materialising.

393 2.2 Cost of Prevention: The Role of Early Intervention

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

401 To avoid the procrastination of supervisory action observed in the case of
402 Cyprus, the new supervisory regime caters for early intervention tools, such as
403 appointing temporary administrators,[68] which must be considered before consid-
404 ering triggering resolution. The use of these tools is instrumental for determining
405 whether or not resolution will eventually need to be triggered.

406 The early intervention tools are entrusted with the discretion of the supervisory
407 authorities based on a mixture of 'soft' and 'hard' triggers.[69] If certain threshold

64FL01 [64] See for example Clerides (2014), p. 32; ICFBCS (2013), p. 26; Orphanides (2013).

65FL01 [65] These triggers would be set by the EBA's draft regulatory technical standards under Arts. 29(1) of the
65FL02 SRM Regulation and Art. 27(4) of BRRD; or at least in a softer manner by empowering the SRB to issue
65FL03 guidelines and instructions to NCAs to that regard under Art. 31(1)(a) of the SRM Regulation. See
65FL04 Enriques and Hertig (2015), p. 161.

66FL01 [66] I.e. resolutions through private sales and acquisitions or bail-outs instead of resolutions under the
66FL02 formal legislative framework, see Enriques and Hertig (2015), pp. 150-165 for an extensive analysis of
66FL03 the costs and benefits of shadow resolutions.

67FL01 [67] Enriques and Hertig (2015), p. 164 concluding that such shadow resolutions should not be favoured
67FL02 because they can harm the stability of a banking system: by exacerbating the moral hazard of the too-big-
67FL03 to-fail guarantee, increasing in turn systemic risk; by weakening healthy banks; distorting competitions,
67FL04 and; damaging the reputation of formal resolutions.

68FL01 [68] A temporary administrator is an early intervention measure (Art. 29 of the BRRD), under the
68FL02 responsibility of the supervisory authority, and is not to be confused with a special manager who is
68FL03 appointed in resolution, under the responsibility of the resolution authority. The temporary administrator
68FL04 might cooperate or replace the bank's management aiming to reach a reorganisation solution and re-
68FL05 establish the safe and prudent management of the bank. The special manager is essentially the executor of
68FL06 the resolution authority' resolution measures.

69FL01 [69] See supra n. 16, quoting Boccuzzi in defining 'soft triggers' as entailing a supervisory evaluation of
69FL02 actual or potential, current or prospective non-compliance with prudential standards, and; 'hard triggers'
69FL03 as an approach based on predefined quantitative technical thresholds not entailing an evaluation.

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408 values are breached, such as the infringement of prudential requirements[70] the
409 supervisory authorities may intervene and impose corrective measures. The
410 intervention however, is not mandatory and the corrective measures are not
411 predefined. Instead, they are left to the NCAs' discretion. As such, this decentralised
412 system for early intervention preserves the necessary flexibility and adaptability to
413 cater for the peculiarities of any given case. At the same time, by basing the
414 intervention on the breach of predefined indicators,[71] this solution gives greater
415 certainty and protects the NCAs from potential complaints.[72]

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

424 FBME was a Tanzanian-based bank running three branches in Cyprus, which
425 after allegations by the US FinCEN of connection with money laundering[73] was
426 promptly put under the management of a temporary administrator pursuant to
427 Article 29 of the BRRD, as per the CBC's decision, to ascertain the financial
428 situation of the bank. It is interesting to note that Article 27 and Article 28, which
429 require the raising of additional capital and the removal of the bank's management
430 respectively, and which are meant to apply prior to triggering Article 29, were not
431 adopted in this case showcasing the discretion supervisory authorities hold
432 depending on the situation they are facing. Shortly thereafter, Tanzania's Central
433 Bank took over the management of the bank's branches in Tanzania as well.
434 Subsequently, the bank's licence was revoked, and an application was filed for the
435 special liquidation of FBME Bank, the Tanzanian parent undertaking of the Cyprus
436 Branch.

437 All these early interventions were taken 'at a time when FBME's financial
438 position [was] sound and fully in line with all relevant capital adequacy and

70FL01 [70] BRRD Art. 27 specifying that the trigger can be decided based on an actual or likely infringement of
70FL02 capital requirements, e.g. due to a deterioration in the bank's financial condition or a worsening of
70FL03 liquidity and leverage levels, or NPLs and exposure concentration, as assessed on the basis of a set of
70FL04 triggers which might include the institution's own funds requirements. See EBA (2015c), for the
70FL05 definition of the triggers for applying early intervention measures—The Guidelines do not establish any
70FL06 quantitative thresholds for indicators that could be perceived as new levels for regulatory requirements for
70FL07 capital or liquidity but clarify that they are closely interlinked to the SREP assessment indicating any
70FL08 threat to the viability of an institution including an actual or likely infringement of requirements in the
70FL09 relevant EU and national implementing legislation. See EBA/GL/2014/13, 19 December 2014.

71FL01 [71] Ibid. See also Art. 104 of Directive 2013/36/EU (Capital Requirements Directive) which includes a list
71FL02 of supervisory powers that competent authorities can apply at an early stage to address relevant problems
71FL03 faced by institutions based on the results of ongoing supervision (e.g. their SREP assessment).

72FL01 [72] Boccuzzi (2016).

73FL01 [73] On 15 July 2014 the Financial Crime Enforcement Network of the US Department of Treasury
73FL02 ('FinCEN') issued a Notice of Finding that reasonable grounds existed for concluding that FBME was a
73FL03 financial institution 'of primary money laundering concern' pursuant to Section 311 of the USA
73FL04 PATRIOT Act, codified at 31 U.S.C. § 5318A.

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439 solvency requirements of the European Central Bank'.[74] Indeed, prior to the Central
440 Bank of Cyprus's (CBC) announcement, the FBME's short term liquidity ratio was
441 104%—sufficient to cover all depositors if required. However, because of the CBC
442 and the US Treasury's announcement, FBME started experiencing difficulties, for
443 good reasons, in accessing financial markets via its correspondent banks.

444 It is most intriguing that money laundering, i.e. one of the alleged justifications
445 used just a year earlier for applying the steep bail-in in two badly capitalised
446 banks,[75] is now seen to justify intervention in a well-capitalised bank pursuant to the
447 'infringement or potential infringement of the requirements of the relevant EU and
448 national implementing legislation' even in the absence of such indication in the
449 overall SREP assessment of the bank,[76] causing its financial position to deteriorate
450 and thus opening the way for triggering resolution.

451 In addition, a further word of caution is the possibility of masking 'shadow
452 resolutions' through private solutions as early interventions, by relying on the legal
453 provisions stating a preference for pre-resolution alternative private sector
454 measures.[77] This is particularly relevant for national competent authorities (NCAs)
455 which are more likely to continue to prefer shadow resolutions, possibly in order to
456 cover supervisory mistakes that might pre-date the Banking Union, due to national
457 political pressures.[78] That problem might indeed be intensified within the Banking
458 Union when it comes to resolving smaller banks, which is still at the discretion of
459 the NCAs (if resorting to the Single Resolution Fund (SRF) is not necessary), as
460 member states cannot anticipate weather their peers will opt for formal or shadow
461 resolutions and no member state will want to be stigmatised as the one having
462 formally failing banks.[79]

463 2.3 Cost of Resolution: The Role of Triggering Resolution

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

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74FL01 [74] This was announced in the bank's website that is no longer accessible since the bank closed in January
74FL02 2016.

75FL01 [75] This is to a great extent due to the vast presence of outside the euro are non-resident depositors.
75FL02 Indicatively in 2012, 30% of all deposits in the banks were from non-residents outside the euro-area. Also
75FL03 Cyprus became the second largest foreign direct investment into Russia and local professional financial
75FL04 and legal services were used by Russian companies: see European Commission (2013), p. 5; As such,
75FL05 regardless of whether money laundering was taking place the global public opinion was that the bail-in
75FL06 would mostly involve Russian oligarchs' money and not domestic savers' money: See Avgouleas and
75FL07 Goodhart (2015), pp. 12-13.

76FL01 [76] According to the EBA such indication of infringement is to be based on the overall SREP assessment
76FL02 of the bank. See: EBA 8 May 2015, p. 3.

77FL01 [77] See Enriques and Hertig (2015), p. 160; BRRD Art. 32, Recitals 46 and 53; Arts. 16(1)(b) and
77FL02 18(2)(b), Recitals 16, 260, 27A and 29 SRM Regulation.

78FL01 [78] See Enriques and Hertig (2015), p. 161.

79FL01 [79] Ibid.

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

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

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

494 2.4 Cost of Resolution: The Role of a Liquidation vs. Resolution Evaluation

495 All three caveats for triggering resolution mentioned are based on the assessment
496 that liquidation would have such disruptive effects that it might jeopardise the
497 continuity of the bank's essential functions, the financial stability of the banking

80FL01 [80] BRRD Art. 32(1)(a).

81FL01 [81] BRRD Art. 32(1)(b).

82FL01 [82] BRRD Art. 32(1)(c).

83FL01 [83] Of course the SRB's decision has to be approved by the Commission. As such, the Commission is the
83FL02 authority actually placing a bank into resolution.

84FL01 [84] The supervisory authority has all the information and expertise to judge the bank's solvency, both
84FL02 currently and prospectively. However, under Art. 32(2) the resolution authority can also determine the
84FL03 bank's solvency, in consultation with the supervisory authority (if the resolution authority is adequately
84FL04 informed and capable).

85FL01 [85] BRRD Art. 32(4); See EBA (2015b) on the 'triggers' which signal that an institution shall be
85FL02 considered as 'failing or likely to fail'.

86FL01 [86] See Enriques and Hertig (2015), pp. 161-163 for a more extensive account of the available options that
86FL02 the ECB and the SRB have to coerce national authorities into applying formal resolutions.

87FL01 [87] Ibid.

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498 system or the pursuit of other significant public interests,[88] and as such, should be
499 avoided (resolution should be preferred).
500 It follows that the comparison of liquidation's effects against resolution's effects
501 is of core importance in deciding to trigger resolution, and, clearly, for determining
502 the eventual costs of dealing with the troubled institution as well as for determining
503 whether the creditors are better off in resolution than under ordinary liquidation.
504 This is especially the case if the adoption of the Deposit Guarantee Schemes
505 Directive leads to a restrictive interpretation of the instances in which the DGS
506 could be used outside ordinary liquidation.[89] However, assessing whether resolution
507 or liquidation is more appropriate can be very difficult given that it entails
508 calculating losses that have not yet occurred and quantifying systemic risk—an un-
509 priced, and therefore unconsidered, side effect of the day-to-day operations of
510 banks.[90]

511 2.4.1 Which Comes First? Liquidation or Resolution?

512 The matter of whether resolution or liquidation should be considered first has
513 attracted considerable confusion[91] because they both have the same starting point,
514 namely that the bank is failing or is likely to fail with no realistic alternative
515 solutions to remedy it.[92] This may cause one to think that the two alternatives are to
516 be considered simultaneously.
517 Confusion is further compounded by the fact that the decisive element for
518 choosing between the two appears to be that the resolution is thought to be in the
519 'public interest'. I.e. it 'achieves and is proportionate to one or more of the
520 resolution objectives specified in Article 31'—such as ensuring the continuity of
521 essential functions, maintaining the stability of the financial system, protecting
522 depositors etc.—where ordinary insolvency proceedings would not meet said
523 resolution objectives to the same extent.[93] Under this definition the resolution

88FL01 [88] BRRD conditions for placing a bank in resolution.

89FL01 [89] See Boccuzzi (2016).

90FL01 [90] Krahnen and Moretti (2015), pp. 125-126.

91FL01 [91] Practical experience with resolution in the case of Cyprus seems to favour the position that resolution
91FL02 comes before liquidation as a form of early intervention measure as noted below in the same section. This
91FL03 practice seems to corroborate the observations of Boccuzzi (2016). However, the BRRD (Recitals 45-46),
91FL04 the SRMR (Recital 59), the EBA (2014a), p. 3, and EBA (2014b), p. 10, take the opposite view. Also to
91FL05 that effect, the bad bank-good bank separation tool, can only be used if liquidation of the assets through
91FL06 ordinary insolvency proceedings could negatively impact financial markets and if the transfer is deemed
91FL07 necessary to ensure the correct functioning of the bank under resolution (or of the bridge bank) or for
91FL08 maximising the proceeds of liquidation. See EBA (2015a).

92FL01 [92] See Boccuzzi (2011), pp. 15-21; and Boccuzzi (2016), pp. 54-55 'insolvency or near-insolvency is a
92FL02 more advanced stage of distress that can be defined as a profound alteration in the economic, financial and
92FL03 patrimonial conditions of the bank, which requires appropriate and timely interventions to remove the real
92FL04 causes and minimise its negative effects to depositors and other relevant stakeholders'.

93FL01 [93] Art. 32(5).

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524 authorities are entrusted with considerable discretion to prioritise the various
525 resolution objectives,[94] and thus determine the existence of a public interest.[95]
526 This confusion could, as professor Boccuzzi points out, lead resolution
527 authorities to construe resolution as proceedings prior to liquidation, i.e. a form
528 of early intervention to insolvency given that the effects of liquidation can strain
529 public interest.[96] If this view is to be followed, liquidation would only occur as a
530 solution of last resort, when a restructuring operation is inadequate or unfeasible.
531 Indeed, that appears to have been the case in the Laiki Popular Bank's resolution in
532 Cyprus where the resolution consisted of a mixture of the sale of vital parts of the
533 bank and the wind-down of the rest of it under 'special'[97] liquidation.[98]
534 However, the BRRD seems to take the exact opposite view. Namely, liquidation
535 has to be considered first, and only if 'the liquidation of those assets under normal
536 insolvency proceedings could have an adverse effect on one or more financial
537 markets'[99] should resolution be considered.[100] To the same extent, the SRM
538 Regulation Recital 59 also suggests that liquidation should be considered first, and
539 the resolution option only considered if liquidation would impact the markets
540 negatively.[101]
541 In this author's opinion, the answer to whether it is 'better' for liquidation or
542 resolution to go first must be determined on a case by case basis. This is simply
543 because while liquidation and resolution have the same starting point, they have
544 completely different end objectives. Liquidation is primarily focused on safeguard-
545 ing the creditors' interests and deepening the pool of assets to be distributed to
546 creditors. Resolution, on the other hand, is only interested with protecting depositors
547 within the pool of creditors—specifically guaranteed depositors if the case of Laiki
548 Bank is of any indication—and cares primarily for safeguarding financial stability
549 and upholding the public interest. As such, in each case one has to decide whose
550 interests are to be safeguarded in order to choose between triggering liquidation or
551 resolution first. Simply put, the choice between liquidation and resolution must be
552 made by determining who it is supposed to benefit. And then one must act
553 accordingly.

94FL01 [94] Indeed, Boccuzzi (2016), writes: 'the reference to the effects on financial stability could suggest that
94FL02 the size of a bank might be a condition for whether or not to start resolution.' However, that is not the
94FL03 only parameter since the other objectives are not necessarily associated with the systemic importance of
94FL04 the bank and should stand in principle at equal significance.

95FL01 [95] Boccuzzi (2016), p. 170 noting that this is 'albeit on the basis of pre-determined technical
95FL02 requirements'.

96FL01 [96] Ibid., p. 169.

97FL01 [97] Instead of 'ordinary' i.e. the immediate realisation of assets.

98FL01 [98] For example, this is the case in Italy, see Boccuzzi (2016), p. 171.

99FL01 [99] Art. 42 para. 1 on the resolution authorities' power to transfer assets, rights or liabilities. See EBA 20
99FL02 May 2015, setting out three elements that should be considered by resolution authorities when assessing
99FL03 the market situation for the assets concerned and the potential direct and indirect effects on financial
99FL04 markets: (a) whether the market for these assets is impaired; (b) the impact of a disposal of these assets on
99FL05 the markets where they are traded; (c) the situation of the financial markets and the direct and indirect
99FL06 effects of an impairment on the markets for these assets.

100FL01 [100] BRRD Art. 42(14), Recitals 45-46.

101FL01 [101] See Boccuzzi (2016); Hadjiemmanuil (2015), p. 23.

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554 2.4.2 Comparing the Losses of Liquidation with the Losses of Resolution

555 Regardless of which must be considered first (liquidation or resolution), it is
556 essential that the losses under ordinary liquidation are compared against the losses
557 of resolution, even if only after the resolution has taken place, in order to ascertain
558 whether the creditors are indeed better or worse off than under ordinary liquidation.
559 This element has received no attention in the case of Cyprus. Despite the fact that
560 the bail-in tool was used, no evaluation of the cost of resolution as opposed to the
561 potential cost of ordinary liquidation has been undertaken to this author's
562 knowledge—neither prior nor post the implementation of the resolution measures.
563 As such, it has not actually been determined whether the creditors were in fact better
564 or worse off under ordinary liquidation.
565 The only studies of some relevance are an independent assessment by PIMCO
566 which estimated as a base scenario total losses incurred by the banking sector by
567 2015 at just under € 14bn,[102] and Pashardes and Pashourtidou (2013) who provide
568 estimates of output losses for the period 2012-2020 associated with the economic
569 crisis in Cyprus, which can largely be attributed to the banking crisis. Nevertheless,
570 none of these studies provide an estimate of the potential losses under an ordinary
571 liquidation scenario. In addition, in the case of Pashardes and Pashourtidou, the
572 losses calculated are of the output GDP—losses also caused by accumulated
573 excessive public deficits, which undermined the role of government as guarantor of
574 the banking system, and structural weaknesses of the Cyprus economy, which
575 limited the capacity of the economy to react swiftly so as to dampen the negative
576 impact of the crisis.[103] Despite being very relevant to the banking crisis as they
577 limited the banks' ability to raise their capital, these figures might still be
578 unsuitable for the purposes of comparing solely the losses from resolution as
579 opposed to a potential liquidation.
580 While these studies are important, especially in evaluating the aftermath losses of
581 bank resolution, more studies are needed to help determine whether the creditors are
582 better or worse off, and under which scenarios the creditors would have been better
583 off if different actions were taken.
584 If there was ever truly a case where such an evaluation would be of absolute
585 necessity, it would be the case of Cyprus. Apart from the complete disregard of
586 creditor protection rights that often carry exceptional gravity in liquidation
587 proceedings, the eventual bail-in imposed was outrageously steep. While it is true
588 that under ordinary liquidation the creditors should accept the probability that they
589 might lose all their credit, resolution is meant to take place at a point prior to
590 liquidation, presumably when the bank's finances are at a better state. This author is
591 at the very least unsympathetic towards just assuming that the resolution left every
592 creditor better off than ordinary liquidation, without a proper assessment. As such, it
593 is utterly disappointing that in its recent decision in the Ledra case the European

102FL01 [102] Independent Commission on the Future of the Cyprus Banking Sector (2013), p. 25; PIMCO (2013),
102FL02 p. 16, para. 3.12. A more pessimistic 'adverse scenario' forecasts total losses by 2015 of € 18.5bn,
102FL03 implying a capital gap of € 8.9bn. Losses of this order, which did not materialize in reality, would
102FL04 amount to more than Cyprus' total GDP.

103FL01 [103] Pashardes and Pashourtidou (2013), p. 18.

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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.[104]

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.[105] 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);[106] and, private funding (Hellenic Bank). In addition, suspension of business, revocation of bank licence, and the appointment

[104] 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.

[105] 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.

[106] February 2014 on the basis of a restructuring plan.

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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[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.[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,[109] which was completely empty and would therefore have needed backing from the government which was also in a bad fiscal position,[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.[111] Consequently, the depositors were not resolved/ liquidated with the remaining assets of Laiki and there was no need to compensate

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[107] See 'Bail-in clauses' 128 claiming that conceptually, the bail-in tool is the most important tool in the BRRD.

[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.

[109] The deposit guarantee scheme law has existed in Cyprus since 2000.

[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.

[111] Bank of Cyprus Share Capital Issue for Compensation of Cyprus Popular Bank Ltd Decree of 2013.

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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.[112] 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 Peloponnese to the National Bank of Greece in December 2015. In this case the tender was financed by the Greek resolution fund.[113]

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.[114]

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.[115] 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.

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[112] 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.'

[113] See European Parliament, '"Bail-ins" in recent banking resolutions and state aid cases' (7 July 2016) PE 574.395, http://www.europarl.europa.eu/RegData/etudes/IDAN/2016/574395/IPOL_IDA(2016)574395_EN.pdf (accessed 27 April 2017).

[114] 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.'

[115] Art. 31(2) para. 2.

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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,[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[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.[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.[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[120] who were

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[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.

[117] € 3.3 billion in March 2016, from € 3.8 billion at the end of 2015 and from € 11.2 billion in April 2013.

[118] Charalambous (2015), p. 33; ICFCBS (2013).

[119] Michaelides (2014), p. 674.

[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.

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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?[121] 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 had been applied.[122] 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.[123] 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.[124] 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.[125] The same emerged in Italy after the bail-in of many shareholders

[121] See Michaelides (2014), p. 676.

[122] Ibid. This point is discussed further in Jack and Cassels (2013), p. 4.

[123] Bank 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.

[124] See Bank of Cyprus (2013) Recapitalisation through bail-in and resolution exit Bank of Cyprus Announcement, available at http://www.bankofcyprus.com/en-GB/Start/News_Archive/Recapitalisation-through-Bail-in-and-Resolution-Exit-Bank-of-Cyprus-Announcement/ (accessed 20 November 2016).

[125] See Michaelides (2014), p. 661.

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753 and subordinated bondholders revealed that many retail investors had purchased
754 subordinated instruments believing they were purchasing safe assets.
755 This reveals that the exemption of retail depositors only, and not of other retail
756 creditors, could create distorted incentives in increasing the creditors base to be
757 bailed-in by convincing retail depositors to be converted to retail investors, creating
758 as such a loophole in increasing bail-inable liabilities by the banks without shifting
759 the burden away from clients who are essentially depositors.
760 While losses deriving from the restructuring were covered by investors and
761 creditors and not by taxpayers, this universal loss of confidence increased the
762 funding cost, constrained credit availability, and fed bank runs both for depositors,
763 and most importantly creditors and investors, thereby harming participation in the
764 financial markets at a time that Cyprus savings market—both for personal savers
765 and provident funds—had been deeply devastated by the haircut, and as such was in
766 desperate need for rebuilding.[126]
767 In an interview with the Financial Times, the former governor of the Central
768 Bank of Cyprus, Athanasios Orphanides, argued that the increase in the cost of
769 funding will not be limited to Cyprus. Instead it will affect 'any bank in any [weak]
770 country'—meaning mostly the periphery of Europe—by increasing divergences and
771 making the recession in the periphery even deeper. He concluded, 'similar to the
772 blunder in Deauville with PSI that injected credit risk into sovereign government
773 debt…[t]he governments have created risk in what before last week were considered
774 perfectly safe deposits' by including them in the bail-in.[127]
775 In addition, the haircut and the sale of Laiki Bank to the Bank of Cyprus radically
776 altered the shareholding structure of Bank of Cyprus, which now stands as the
777 largest bank of the island with 81% retail shareholders.[128] As such, while the
778 conversion of old shareholders into non-preferential shareholders, (i.e. shareholders
779 without voting rights), might mitigate the moral hazard of leaving voting rights with
780 the old shareholders, it also delegates the voting rights to likely unsophisticated
781 stakeholders who used to be depositors and who might have no interest in being
782 involved in strategic decision-making or in altering the manner in which they
783 finance the bank.[129] This is indeed exemplified in the case of Cyprus, where
784 converted creditors were required to register for the first time with the Cypriot Stock
785 Exchange in order to manage their newly acquired shares, proof that a lot of these
786 individuals had no prior participation in the financial markets, arguably signalling
787 their lack of financial sophistication.
788 In addition, the merger of Cyprus Popular Bank with Bank of Cyprus leaves
789 Cyprus with one very large bank controlling half the market, leaving the structure of
790 the new Cyprus banking industry in a far from optimal state in terms of ensuring
791 competition.[130] This dominant bank structure risks over-concentration and loss of
792 competition—essential parameters for setting the service quality, the cost, and the

126FL01 [126] See ICFCBS (2013); Orphanides (2013), p. 6.
127FL01 [127] Orphanides (2013), p. 6.
128FL01 [128] ICFCBS (2013), p. 28, para. 4.3.
129FL01 [129] Ibid.
130FL01 [130] Ibid., para. 11.19.

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793 availability of important banking services such as business credit. As such, there is
794 the risk that, once it has recovered completely, the Bank of Cyprus will dominate
795 the market while simultaneously being 'too big to fail', presenting Cyprus with 'the
796 worst of both worlds' in harming competition and financial stability.[131]
797 Therefore, although the Asset Quality Review (AQR),[132] the early withdrawal from
798 the ESM program, and the higher setting of the countercyclical capital buffer for
799 O-SIFIs all seem to have contributed to the regaining of trust of international investors
800 and foreign direct investment, the domestic stakeholders have not demonstrated the
801 same belief and commitment.[133] The lack of trust and co-operation of domestic
802 stakeholders is evident through the persistence of the level of NPLs at 47%—the
803 highest in Europe—which impedes lending by tying up a significant part of banks'
804 capital, despite the implementation of a new foreclosure and insolvency framework to
805 pursue sustainable restructurings to minimise the problem.
806 Apart from the fact that domestic stakeholders have been directly hit from the bail-
807 in tool and the capital controls, they also have suffered from the effects of the
808 diminishing competition in the banking system.[134] Despite the low interest rates the
809 banks enjoy in Europe currently, borrowing costs have not been reduced, but
810 paradoxically deposit interest rates have not increased. A balancing act whereby
811 deposit rates are set high enough to attract and retain deposits and low enough to make
812 borrowing affordable, while also leaving the banks with a sufficient margin in between
813 to service their capital, is essential.[135] But it is a difficult task which arguably
814 encapsulates 'the theory of everything' of banking: the need to stop deposit flight, to
815 allow the banks to make a fair profit, and to keep loan rates at affordable levels.[136]

816 4 Conclusion

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

131FL01 [131] Ibid., p. 28.

132FL01 [132] In 2014, when the first data were collected for the AQR of the ECB, Cyprus was in the worst place
132FL02 with 6%. Nevertheless, all its banks managed to pass the ECB's stress testing by 2015, and by 2016 the
132FL03 island managed to exit the memorandum, without having used, in fact, all of the money that it was
132FL04 promised from the ESM. One can potentially infer from that that by following the resolution measures as
132FL05 instructed, even with the massive lag by the Central Bank of Cyprus in placing the banks into resolution
132FL06 and increasing their debt in the meantime (don't forget that this is the pre-SSM, pre-SRM era) Cyprus
132FL07 managed to recover, its banks managed to regain their investors trusts, in fact since 2013 Cypriot banks
132FL08 have attracted the highest level of foreign investment in the history of the Cypriot banking system,
132FL09 showing that by following the program strictly and being determined to recover might work after all.
132FL10 Something that is not engraved in the Cypriot culture.

133FL01 [133] Governor of the Central Bank of Cyprus (2016) State of Play of the Banking Sector in Cyprus,
133FL02 available at http://www.centralbank.gov.cy/media/pdf/26_05_2016_gov_speech.pdf (accessed 20
133FL03 November 2016).

134FL01 [134] Ibid.

135FL01 [135] ICFCBS (2013), p. 50, para. 10.7.

136FL01 [136] Ibid.

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820 reliance on public funds; protecting guaranteed depositors and clients' own assets), it has
821 not done so in a way that transparently satisfies the general principles of resolution under
822 Article 34 of the BRRD. In particular, it has not satisfied the principle that creditors
823 belonging to the same class must be treated equally; the principle that no creditors shall
824 bear greater losses than they would have borne in the case of the bank being liquidated;
825 and the principle that safeguards must be applied for stakeholders who suffered worse
826 treatment than under ordinary insolvency.

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

833 Now the BRRD-style resolution is to be applied universally across Europe. This
834 means that countries will have to put their banks through the resolution process
835 without having the benefit of using such obedience to resolution to bargain for
836 financial assistance, as in the case of Cyprus in 2013 and Greece in 2012, where
837 private sector burden-sharing by creditors ('bail-in'), and bank resolution, formed
838 part of the financial assistance programmes.[137]

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

851 Crucially, the Cypriot experience with resolution highlights that supervision
852 should always work in concert with resolution in order to avoid output losses related
853 to the banking sector's size, bank recapitalisation costs incurred by the government,
854 and to the amounts of liquidity injected in the banking sector by the central bank.[139]
855 Supervision should be constantly evaluating how its decisions might affect the costs
856 of a potential resolution. Resolution planning should depend upon thorough
857 calculation of the cost of each resolution measure to be adopted at the time the
858 measure is applied, and on a longer-term scale.[140] Arguably, the bank regulatory

137FL01 [137] See Memorandum of Understanding (2013), paras. 1.23 to 1.27.

138FL01 [138] Art. 67 of the SRM Regulation.

139FL01 [139] Boyd et al. (2005).

140FL01 [140] The public capital injected into EU banks over 2008-2012 is estimated to be in the region of € 413.2
140FL02 billion, amounting to 3.2% of EU GDP in 2012 and the costs of bank rescue represented more than 10%
140FL03 of GDP in Ireland, Greece, and Cyprus. See European Commission (2014), p. 74.

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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.

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