V. Playing with Fire: The Cyprus Banking Crisis

A. Introduction

In 2012, an ailing Greek economy overwhelmed the Cypriot banking sector, forcing Cyprus to seek an international bailout.[1] European banks conditioned their financial assistance on Cyprus's strict adherence to financial reforms and capital requirements.[2] This article provides an in-depth perspective on the bailout process and surveys the pressures Cyprus faced in its recent banking crisis. Part B discusses the events leading up to the crisis and the initial demands made by the rest of Europe. Part C explains how the bailout was executed. Part D addresses the bailout's aftermath, describing its impact on the banking sector and Cyprus in general. Part E concludes by reviewing the bailout in the context of the larger euro zone.

B. Causes and Initial Demands

1. Exposure to the Greek Economy

Despite violent skirmishes that plagued the Turkish and Greek Cypriot communities for over thirty years,[3] Cyprus became a tourist destination for continental Europe.[4] On May 1, 2004, Cyprus joined the European Union.[5] A few years later, on January 1, 2008, Cypress joined the euro zone, adopting the euro as its currency.[6]

With the Greek economy's downturn in 2010, Cypriot banks lost large sums that were tied up in Greek investments.[7] In June

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[1] James Wilson, Daniel Dombey & Peter Spiegel, *Cyprus Requests Eurozone Bailout*, FIN. TIMES, June 26, 2012, at 8.

[2] *Memorandum of Understanding on Specific Economic Policy Conditionality*, POLITIS NEWS 1 (Nov. 30, 2012), http://www.politis-news.com/upload/20121130/1354292326-07337.pdf [hereinafter *Memorandum of Understanding*].

[3] *Timeline: Cyprus*, BBC NEWS (Dec. 13, 2011, 3:05 PM), http://news.bbc.co.uk/2/hi/Europe/1021835.stm.

[4] Rupert Neate, *Cyprus: Holiday Suntrap of Sea, Sun, Sand, Food Banks and Desperation*, THE OBSERVER, Aug. 17, 2013, at 38.

[5] *Timeline: Cyprus*, *supra* note 3.

[6] 2007 O.J. (C 146) 224.

[7] Michele Kambas, *Cyprus on Financial Brink from Greek Exposure*, REUTERS (Jun 6, 2012, 10:54 AM), http://www.reuters.com/article/2012/06/06/us-cyprus-eurozone-greece-idUSBRE8550SX20120606

2012, the ratings agency Fitch downgraded Cyprus's bonds to "junk" status.[8] The government in Cyprus, led by President Demetris Christofias, blamed this downgrade on the "negative spillover effects" from Cyprus's "large exposure in the Greek economy."[9] The downgrade in Cypriot bond status meant that the European Central Bank ("ECB") could no longer accept them as collateral for loans.[10] Thus, Cypriot banks that had borrowed from the ECB by putting such bonds up as collateral were in need of "emergency liquidity assistance" from the Central Bank of Cyprus.[11] As the banking crisis grew, it became clear that the central bank could not fulfill this demand, and on June 25, 2012 President Christofias asked Europe for financial assistance.[12]

2. The Memorandum of Understanding

In response to President Christofias' request, the ECB, the International Monetary Fund ("IMF"), and the European Commission drafted a Memorandum of Understanding on November 23, 2012.[13] The memorandum was created to "address short- and medium-term financial, fiscal and structural challenges facing Cyprus" and set specific economic policy goals as conditions for the bailout.[14] The key objectives for the memorandum were: (1) "restore the soundness of the Cypriot banking sector"; (2) "continue the ongoing process of fiscal consolidation"; and (3) "implement structural reforms to support competitiveness and balanced growth."[15]

("[T]hey lent money to the Greek government, and those assets became toxic . . . ." (quoting Fiona Mullen, an economist at Sapienta Economics)).

[8] Wilson, Dombey & Spiegel, *supra* note 1, at 8 ("Fitch's decision to cut Cyprus's sovereign rating to 'junk' status on Monday meant the country lost its investment grade status with all three of the largest rating agencies, highlighting the narrowing options for Mr. Christofias' government.").

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *The Economic Adjustment Programme for Cyprus*, EUR. ECON.—OCCASIONAL PAPERS 38 (May 2013), http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp149_en.pdf.

[14] *Memorandum of Understanding*, *supra* note 2, at 1.

[15] *Id.*

The memorandum sought to restore soundness to the banking sector through various fiscal measures. One provision required the Central Bank of Cyprus to invest half its required liquidity in "instruments of high credit quality with a maturity of up to [three] months."[16] In addition, the memorandum increased capital ratios from 8% to 9%.[17] The memorandum also recommended that the Cypriot government undertake measures to increase financial transparency.[18]

To achieve fiscal consolidation, Cypriot banks needed to obtain a balance of 4% of Cyprus's gross domestic product ("GDP") by 2016, up from a deficit of 6.3%.[19] In order to reduce the government deficit, the memorandum recommended laying off at least five thousand government workers.[20] Related reforms included freezing Social Security pensions from 2013 through 2016, and adjusting the pension program itself in order to "address the high projected increase in pension spending."[21]

In order to "support competitiveness and balanced growth," the memorandum favored new wage indexation and incentives to "take up work," largely by cutting unemployment.[22] "Reinvigorat[ing]" tourism competition was a primary goal.[23] Finally, the memorandum called for the privatization of government industries.[24] President Christofias, a communist, disapproved strongly of this provision: on January 2, 2013, he suggested that the memorandum "would have to wait for the next government to sign it."[25]

3. The Elections

Nine days after President Christofias criticized privatization in the bailout deal, European leaders arrived in Nicosia, Cyprus's

[16] *Id.* at 2.
[17] *Id.* at 3.
[18] *Id.* at 7.
[19] *Id.* at 10.
[20] *Id.*
[21] *Id.* at 16.
[22] *Id.*
[23] *Id.* at 27.
[24] *Id.* at 20–21 (discussing "State-Owned Enterprises and privatization").
[25] Menelaos Hadjicostis, *Cyprus President: No Privatization in Bailout Deal*, ASSOC. PRESS (Jan. 2, 2013, 9:40 AM), http://bigstory.ap.org/article/cyprus-president-no-privatization-bailout-deal.

capital city, to support his opposition, Nikos Anastasiades.[26] German Chancellor Angela Merkel spoke against President Christofias, saying Cyprus would need to accept the reforms in order to receive a bailout."[27] At this point, it was estimated that Cyprus needed seventeen billion euros, which amounted roughly to the size of the small nation's entire economy.[28]

On February 24, 2013, Anastasiades was elected the new President in a run-off election.[29] Shortly after his election, the president-elect vowed to reach a deal with European lenders, in contrast to the communist predecessor Christophani's preference for Russian aid.[30] Anastasiades's substantial victory demonstrated Cypriot support for "an aggressive, pro-bailout approach."[31] One of Anastasiades first tasks was to appoint a new Finance Minister to lead the negotiations with the European Union.[32] Anastasiades chose former finance minister and senior economist with the World Bank Michael Sarris for the position.[33]

C. The Bailout

The new Cypriot government immediately began to negotiate a bailout for their troubled economy.[34] Two weeks after taking office, on March 15, 2013, Cyprus reached a bailout agreement.[35] Christine Lagarde, managing director of the IMF, sought a "durable" and "sustainable" plan, saying, "we don't want a

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[26] *Merkel: Cyprus Must Embrace Reforms to Get Bailout*, ASSOC. PRESS (Jan. 11, 2013, 9:31 AM), http://bigstory.ap.org/article/merkel-cyprus-must-embrace-reforms-get-bailout.
[27] *Id.*
[28] Michele Kambas & Deepa Babington, *After Election Win, Anastasiades Faces Cyprus Bailout Quagmire*, REUTERS (Feb. 24, 2013, 6:42 PM), http://www.reuters.com/article/2013/02/24/us-cyprus-idUSBRE91N00220130224.
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] Michele Kambas, *Cyprus Appoints Economist Sarris Finance Minister*, REUTERS (Feb. 25, 2013, 1:46 PM), http://www.reuters.com/article/2013/02/25/us-cyprus-finmin-idUSBRE91O0YO20130225.
[33] *Id.*
[34] Kambas & Babington, *supra* note 28.
[35] James Kanter, *After Negotiations, Cyprus Agrees to a Euro Zone Bailout Package*, N.Y. TIMES, Mar. 16, 2013, B6.

Band-Aid."[36] Though Cyprus originally requested a bailout of seventeen billion euros, the final deal called for ten billion euros.[37]

The deal was negotiated by European finance ministers, the ECB, and the IMF.[38] It placed much of the economy's burden on bank depositors, creating a "one-time tax of 9.9 percent" on bank deposits over 100,000 euros, and a 6.75 percent tax on other deposits.[39] Critics called this solution a "disastrous precedent."[40] Sir Howard Davies, the former head of Britain's Financial Services Authority, criticized the terms of the bailout, saying that it was "too big an ask" to tax deposit holders.[41] Some argued that European Union deposit insurance would now be worth less in the future, since the "solemn and governmental promise" that depositors were insured up to 100,000 euros "has been shown to be false."[42] A higher risk of bank runs was another possibility, since one purpose of deposit insurance is to prevent runs on banks.[43] Such uncertainty has led to a direct decline in tourism.[44]

Other provisions of the deal included raising the corporate tax rate from 10 to 12.5 percent, privatization, and scrutinizing banks for any incidence of money laundering.[45] The ECB set March 25, 2013 as the deadline to accept the bailout deal.[46]

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[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] Tim Worstall, *The Cyprus Bank Bailout Could Be a Disastrous Precedent: They're Reneging On Government Deposit Insurance*, FORBES (Mar. 16, 2013, 10:19 AM), http://www.forbes.com/sites/timworstall/2013/03/16/the-cyprus-bank-bailout-could-be-a-disastrous-precedent-theyre-reneging-on-government-deposit-insurance.
[41] Graeme Wearden, *Cyprus Crisis: MPs Approve Bank Restructuring and Solidarity Fund—as it Happened*, THE GUARDIAN (Mar. 22, 2013, 10:21 PM), http://www.theguardian.com/business/2013/mar/22/eurozone-crisis-cyprus-bailout-russia-vote.
[42] Worstall, *supra* note 40.
[43] *Id.* ("By promising that depositors (up to some level) cannot lose money . . . a run does not form and become self-fulfilling.").
[44] Neate, *supra* note 4 ("They're scared to come here after the TV reports showing people not being ablen to get money out of the banks." (quoting Chris Georgeo, a taxi driver in Cyprus)).
[45] Kanter, *supra* note 35.
[46] Wearden, *supra* note 41.

D. Bailout Aftermath

On the morning of March 22, the Cypriot Parliament began a marathon session to find a way to meet the requirements of bailout deal.[47] Before Cyprus could approve the deal, it required six billion euros to fund its share of the bailout.[48] Shortly after the session began, Germany became frustrated with the debate: coalition leader in the German Parliament, Volker Kauder, said that Cyprus was "playing with fire," and emphasized the need to find viable means to supply the Cypriot portion of the total amount.[49] Additionally, the terms of the bailout required Parliament to establish capital controls and place other limits on depositors.[50] If no deal was reached, the IMF and the ECB would "withdraw liquidity support" on March 25.[51]

1. Capital Controls and Restructuring

The capital controls bill would create several new regulations and restrictions, including "[r]estrictions on daily withdrawals"; "[r]estrictions on use of debit, credit or prepaid debit cards"; "[b]an or restriction on cashing in checks"; "[r]estrictions on movements of capital, payments, transfers"; in addition to several others.[52] Almost twelve hours after the session began, the capital controls bill passed through Parliament.[53]

Banking sector employees formed a protest outside the Parliament building in Nicosia during the March 22 session.[54] Many feared they would lose their jobs should Laiki Bank, the second largest bank in Cyprus, require restructuring.[55] Nevertheless, the Cypriot parliament approved legislation that would permit a restructuring of the banking sector.[56] As the session closed for the day, the London press reported that Cyprus had taken "a significant

[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*

step towards securing its desperately needed bailout" but "still need[ed] to meet the demands of international lenders."[57]

The Cypriot Parliament accepted the bailout deal on the morning of Monday, March 25, 2013.[58] The government extended the banking shutdown through Thursday, March 28, and imposed capital controls in an attempt to prevent bank runs.[59] Daily withdrawals were limited to 300 euros per day.[60] When the banks finally reopened, the government conceded that the strict capital controls would remain in place for more time than anticipated.[61] Foreign Minister Ioannis Kasoulides stated that the capital controls would be lifted gradually over the next month, which was much longer than the week that was originally promised.[62]

The final deal closed Laiki, inflicting severe losses on large Russian depositors.[63] The deposits in Laiki above 100,000 euros were not guaranteed, and moreover, were frozen in order to "recapitalize" Cyprus's largest bank, the Bank of Cyprus, "through a deposit/equity conversion."[64] This "raid" on depositors raised just over 4 billion euros of the nearly 6 billion euros that comprised Cyprus's allotted share of the bailout.[65]

2. Impact on Cyprus

The economic situation continued to grow worse in the wake of the bailout. A formal investigation into the bailout began on April

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[57] *Id.*

[58] *The Cyprus Bail-out: A Better Deal, but Still Painful*, THE ECONOMIST (Mar. 25, 2013, 4:34 PM), http://www.economist.com/blogs/charlemagne/2013/03/cyprus-bail-out.

[59] Michele Kambas & Karolina Tagaris, *Cyprus Banks Remain Closed to Avert Run on Deposits*, Reuters (Mar. 25, 2013, 7:44 PM), http://www.reuters.com/article/2013/03/25/us-cyprus-parliament-idUSBRE92G03I20130325.

[60] Karolina Tagaris & Michele Kambas, *Cyprus Bank Controls to Last a Month, Minister Says*, REUTERS (Mar. 28, 2013, 1:19 PM), http://www.reuters.com/article/2013/03/28/us-cyprus-parliament-idUSBRE92G03I20130328.

[61] *Id.*

[62] *Id.*

[63] Kambas & Tagaris, *supra* note 59.

[64] *Id.*

[65] *Id.*

2, 2013.[66] As a result, Cyprus finance minister Michael Sarris resigned, a mere six weeks after accepting the position.[67]

While there had not been a run on the banks, statistics show that international depositors withdrew eighteen percent of their funds from Cyprus in February, due to speculation about further taxes on bank accounts.[68] The 300 euro cash withdrawal limit, or the government's decision to ban check cashing, may also have prevented bank runs.[69] The government authorized customs officers at airports to seize cash in amounts greater than 1,000 euros from passengers.[70]

While banks began stabilizing in Cyprus, the cash reserves continued to run critically low.[71] Additionally, tourism has suffered, as visitors the following summer fell by 6.6% to a mere 308,000.[72] With the lack of tourism, employers cut seasonal wages for the summer months.[73] Unemployment in July rose to 17.5%, becoming the third highest rate in the European Union.[74] Youth unemployment has risen to 37.8%, well above the 13.8% long-term average.[75] Cyprus's GDP has declined 5.4%—likely due to the decline in tourism, which represents nearly a third of Cyprus's economy.[76]

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[66] Jill Treanor, *Cyprus Finance Minister Michael Sarris Resigns as Blame Game Begins*, THE GUARDIAN (Apr. 2, 2013, 1:30 PM), http://www.theguardian.com/world/2013/apr/02/cyprus-finance-minister-resigns.
[67] *Id.* ("[Sarris] said his previous role as chairman of Laiki . . . was likely to be subject to scrutiny. 'I believe that in order to facilitate the work of [investigators] the right thing would be to place my resignation at the disposal of the president of the republic, which I did,' said Sarris.").
[68] Tagaris & Kambas, *supra* note 60.
[69] *Id.*
[70] *Id.*
[71] Menelaos Hadjicostis, *Bank of Cyprus Depositors Lose 47.5% of Savings*, USA TODAY (July 29, 2013, 11:57 AM), http://www.usatoday.com/story/money/business/2013/07/29/bank-of-cyprus-depositors-lose-savings/2595837.
[72] Neate, *supra* note 4.
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.*

E. Conclusion

Cyprus's continued economic turmoil has shown that the bailout plan was not entirely successful. The continuity of global financial markets throughout the crisis suggests that the situation did not have a large impact on the rest of Europe.[77] Furthermore, compared to the bailouts of Greece, Portugal, and Ireland, Cyprus's comparatively smaller bailout may suggest a more precarious status as a member of the euro zone.[78] Thus, while the banking crisis in Cyprus may have averted a complete collapse in 2013, the economy is still suffering and will likely continue to struggle to regain the trust of investors as time goes on.

Michael Kaplan[79]

[77] Larry Elliot, *Five Lessons from a Week of Confusion in Cyprus*, THE GUARDIAN, Mar. 22, 2013, at 13 ("[F]inancial markets . . . have so far been profoundly relaxed about events in Cyprus. . . . [T]here has been no upward spike in the interest rates on Italian, Spanish or Portuguese debt—the key indicator of contagion risk.").
[78] *Id.*
[79] Student, Boston University School of Law (J.D. 2015).