Considerations about Methods of Rescue for Financial Institutions: the Case of Cyprus

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Abstract: *The paper presents some aspects regarding adoptată strategy to resolve the crisis in Cyprus financial system and the effects of such approaches used the euro area, but especially on the banking sector in the European Union. From our perspective we considered as an important thing to understand what happened in Cyprus, how to intervene in this crisis to be able to appreciate necessary changes (if they are really necessary) in the banking system construction, so that banks can adopt such measures by the resolution of future banking crises in the euro area and improving of banking system situation, in the sense that it have not to be necessary a new intervention into the future.*

Cuvinte-cheie: banks, crisis, bail-in, unsecured deposits, liabilities

JEL Classification: G01, G21

1. Introduction

Year 2013 marks a particular approach in solving the financial crisis in eurozone. We refer to Cyprus salvation problem, in the sense that the investors (owners of stocks and bonds) and the holders of uninsured deposits (over 100,000 euros) support the solving of banks. The strategy used in Cyprus demonstrates a change in relation to the solutions adopted in the European Union in recent years because it doesn't requires the mobilization of funds from the state budget or government guarantees, but the costs of banking restructuration are borne by shareholders, bonds holders and depositors.

Although it looked like a "revolutionary" solution in the banking system, it was applied until now in the U.S., Canada and New Zeelandă.

We believe that such approach (knew as "bail-in" accord) is risky and put under question the principle of bank deposits' guarantee and deposit contracts. Even if such a solution would solve temporary financial balance problem, certainly not that kind of solution should be approached in the medium and long term, because it will suffer the entire European Banking System.

On the other hand, a severely control of the capital affects confidence in the financial principles of the monetary union, and the market reacts to uncertainty by raising interest rates, which deepens the recession and encourage the migration of capital from countries less developed of the European Union (those from south, here including Ireland, even if it is inside the north-west of EU) to the developed countries (so-called "center").

2. Methodology and objectives of research

This article includes an analysis of method implementation-related events "agrees bail-in" in Cyprus and the above mentioned countries, the causes that led to the adoption of this solution, and about principles on which is based the process. We will also study the aspects of real application of measures that we suppose to be taken in this rescue process of banks.

Although in the first part of 2013, the problem of Ciprus' banking rescue using, in principal, funds derived from taxation of deposits over 100,000 euros was very known, in the second half of this year did not appear any proof regarding the application of “bail-in” mesures (including by adopting of a special legal packet) and the results obtained. However, the silence on this subject says that situation is under control and there was not strong instability in financial balance phenomena or bank failures. This fact makes us dificulties in our analysis (since we haven't more data), but they give us some time to better put in place the adopted measures for banking system developement.

Along this article, we put some questions to which, we hope, it find good answers by using methodology that will implement, the reference being more for the euro area.

3. What happened in Cyprus?

Cyprus has requested a loan of 10 billion euros from the European Central Bank, the European Commission and IMF enough to save it from bankruptcy, in exchange for an economic action plan (tax increases and privatization) and a drastic restructuring of its financial sector. They were required, also, control measures for capital, which could take years. Since Cyprus is part of the euro area, applying these measures is more difficult than in other cases (eg economies of Asia, Latin America or Iceland, the country where control of capital flows remain valid for five years, after banking fall from 2008), because the money can be taken out of the country without them devalue. We believe that in order to be effective, the control of capital flows must to be stricte.

Rescue Agreement of Cyprus is the first which imposes limits in movement of money, and a tax for bank deposit over 100,000 euros. Failure of these conditions would involve leaving of Cyprus from eurozone, especially an instantly loss of access to liquidity from the European Central Bank, and therefore, a likely bankruptcy of Cyprus credit institutions.

The fact that the Cyprus economy (18 billion euros) is known as one fragile, and it is the third most smaller in eurozone. Cyprus economy is sustained by a "developed" banking sector (assets are seven times higher than GDP) due to money coming, in very large part, of Russia; Russian depositors have about a quarter of total deposits (about 31 billion euros).

In recent months, however, Russian businessmen have replaced Cyprus with the British Virgin Islands. Thus, Russia's direct investment in Cyprus has decreased 10 times, from 21.13 billions dollars in the last quarter of 2012 to 2.72 billions dollars at the end of the first quarter of 2013. In the same period, in British Virgin Islands, direct investment of Russian businessmen have increased eightfold, until to 31.7 billions dollars in the first quarter of 2013, comparative to 4 billions dollars, as represented in the last quarter of 2012.

Cyprus economy is considered as a "financial casino" and, because the banking system being of seven times the GDP, unsustainable, but this report should be reduced to three until 2018. The Financial Industry in Cyprus ensures tens of thousands of places of work, for some of the 860,000 inhabitants, of which is registered a 15% unemployment rate. Following the banking crisis, to avoid the fall of financial system, Popular Bank (Laiki) was liquidated, and deposits greater than $ 100,000 are used to recapitalize the financial system. The bigger bank of Cyprus, Bank of Cyprus, took the deposits less than 100,000 euros from Laiki, and is included in a restructuring and recapitalization program, financed by the deposits higher of 100,000 euros. Larger deposits of € 100,000 will contribute with 4.2 billions euros for a rescue program of Cyprus financial system, and depositors receive compensation in banking stocks. For many depositors we believe that "taxing" of them was a good offer because, in such situations, they could lose everything, respectively over 100,000 euros. Thus, a tax equivalent to 8% of total liabilities (mesure which implemented immediately), and a support from other sources (up to 5% of total liabilities) may be used only with approval from Brussels.

Why did it get here? Local banks adopted very risky investment policies and they were poorly supervised and poorly capitalized, particularly by domestic shareholders funds. When they have lost their investments, Cyprus banks were unable to engage new capital, so they were virtually bankrupt.

In January 2014, Cyprus will waive all restrictions on capital movements and it will try to stabilize and to heal the financial system and economy, that recorded (in the second quarter of 2013) the largest annual decline since the mid of 70's (GDP decreased 5.9% in this period, compared to the same period of 2012). According to analyst estimates from international financial institutions, the Cyprus economy is expected to register a decrease of 8.7% in 2013, and 3.9% in 2014, and it begin to grow up in 2015.

After passing in summary of these data, we analyze the process named "bail-in" for rescue of banks.

4. Methods for rescue of bank-financial institutions

Most of regulators initially have developed only two options for troubled institutions in 2008, respectively using taxpayer money (bail-out method) or risk of a systemic collapse of the banking system. Now, the "bail-in" method became third way, by recapitalization from interior of the troubled bank or financial institution, creditors (holders of shares, bonds or deposits) agreeing to postpone their application (to be returned their money) and engage in restructuration of financial company in difficulty.

Here comes the first question: *the creditors are consented or they are forced by law, to do this?* Cyprus reality shows clear that pressure exercised by international financial institutions was to adopt variant to compel creditors to accept a tax on deposits to request bank and not to regulate the process by which creditors were questioned and then would have consented about the solutions to rescue of bank.

Another aspect to be discussed is about institutions responsible to manage the rescue plan. The response, is simple, but from it appears another question. Let's start with the response: rescue plan will apply under the direction and supervision of financial regulators. And we come to the fundamental question: *Why?*

Is obviously that entrance into difficulty for a bank stems from poor management and, also, from a bad supervision that did not report on time the real state of bank. Basically, bank's risk indicators and financial performance, taking into account both by bank management and supervisory institution, didn't report the real situation or have not received an adequate response in the sense of improving of bank activity. When we refer to entering a bank in difficulty we think that it doesn't pay the liabilities, the loans, and the bond at maturity or cash withdrawals from banking deposits.

Preservation of the same team to lead can ensure a rescue of the bank?

It is clear that is not. Money taken (and here comes a new emerging issue in the sense if money must or not be returned) may represent a rescue only if they are managed effectively, otherwise we do than to postpone bankruptcy over a period of time.

In the United States, for example, the approach to rescue banks in case if doesn't adopt the support of taxpayers through the government, imply Federal Deposit Insurance Corporation (FDIC), which pays claims of insured depositors with the deposit in the amount of 250.000 USD. Uninsured deposits are the responsibility of the banking institution in difficulty. In this case, depositors may suffer losses, also shareholders, and owners of bonds, preferred stock and others. By this dual system is trying to consolidate banking institutions. However, most bank failures in the U.S. are resolved by fusions.

Practically in a Friday afternoon, after the program, the FDIC chooses a bank. Lists of shareholders are destroyed, and bank books and records are maintained with care so that they can be transformed and the new bank opens for business on Monday morning. Insured deposits are fully covered, and the transition is almost perfect.

Similar strategies have been used in the aviation industry to maintain the company during bankruptcy proceedings or the occurrence of serious financial problems. In these scenarios, companies are able to reduce payments to creditors in exchange for shares in the reorganized company, enabling the rescue of creditors who can lose their investments, so that companies stay afloat.

Some features of bail-in rescue plan are following:

- The method involves rescue of bank by using of bank liabilities (deposits of 100,000 euros or the equivalent in dollars, respectively 132.000 USD, bonds, shares);
- Implementation in practice is fast and WITHOUT an accord of deposits' owners, and holders of bonds or shares involved;
- The process of bank's rescue is very untransparent and in addition, the officials give us few data, usually only those that justifies the action.

In connection with the last characteristic, justification of taxation of deposits of 100,000 euros, refers to the fact that is an very important part (a quarter) of the depositors were Russians, and Europeans must imagine that they (Russians) have, to some extent, problems of a legal nature. However, there remain the three-quarters of which nothing was said about.

Another aspect to keep our attention is about the promotion of bail-in solution because is said about lenders that they support the plan thanks to the fact that, in this way, they save a part of the investment. It is however known that, in the case of bank failures, the investors recover some of the money, but the process, in this case, is longer and the outcome is unpredictable. For example, in Romania, the financial compensation, according to the current Civil Code, shall be granted for bankruptcy within three years for the account holder or his descendants.

The initiation of this model is the result of extremely high costs that states have used to pay for banks' rescue by capitalizing taxpayers' money (bail-out system). In the U.S., the amounts awarded for banks' rescue balance weighs heavily in debt of America, and the functioning of state institutions itself was severely damaged.

Basically, the first method to rescue of U.S. banks (bail-out) became impossible to apply, and the only possibility available was to "tax" the bank's deposits, respectively of those people at which banks have debts.

In addition, this solution is very easy to put in practice, since their money are right into the bank. But the solution is deeply immoral, and proves the cynicism of American financiers, but also of those who followed their example, by putting in practice of a legal system to not pay their debts.

After we can observe, in the first phase, the capitalization of banks in difficulty, with money from the budget, meant the transfer of financial problems of banks to the state institutions, and then, in a second phase, the financial-politicians have solved problem by giving laws which allow banks to not pay part of the debt. If the first phase of the banking system deficiencies were paid by all taxpayers, now entered its second phase in which those who have bonds and shares in respective banks will pay for rescue of banks.

We have two questions:

- Who will pay for the third phase?
- When will the bankers pay, however?

We put such questions because the problems which the big banks (TBTF) have themselves are so large that it clearly to appear questionable whether they will affect even more banks or the banking system as a whole. For example, a ranking of the most undercapitalized banks in Europe, presented by Goldman Sachs in late of 2012 (Durden, T., 2013), shows that the banks like Credit Agricole, Natixis and Deutsche Bank are in a very difficult situation.

Simple leverage in 2012, TA/TE
Total adjusted assets over Tangible Equity, FY 2012

Rank	Bank	TA/TE
1	Credit Agricole	46.7x
2	Natixis	35.2x
3	Credit Suisse	30.1x
4	Deutsche Bank	28.9x
5	Societe Generale	28.4x
6	Commerzbank	26.3x
7	Danske Bank	26.2x
8	EFG International	24.8x
9	SEB	24.6x
10	Santander	24.3x
11	Erste Bank	24.1x
12	SHB	23.4x
13	BNP Paribas	22.7x
14	Nordea	22.4x
15	Lloyds	22.3x
16	Barclays	22.3x
17	UBS	21.2x
18	Banco Popular	21.1x
19	Banco Popolare	19.8x
20	Bankinter	19.6x

TA over Basel III capital in 2012, TA/CET1
Total adjusted assets over Core Equity Tier Capital, FY 2012

Rank	Bank	TA/CET1
1	Natixis	46.3x
2	Credit Agricole	45.6x
3	Credit Suisse	40.0x
4	Sabadell	37.8x
5	Deutsche Bank	35.3x
6	Lloyds	33.8x
7	UBS	33.1x
8	Societe Generale	31.5x
9	EFG International	31.4x
10	Santander	30.3x
11	Danske Bank	28.5x
12	Bank Of Ireland	28.4x
13	SEB	27.2x
14	SHB	27.0x
15	Nordea	26.7x
16	Barclays	26.5x
17	Commerzbank	26.5x
18	Banco Popolare	24.4x
19	ING Bank	24.3x
20	CaixaBank	24.1x

Source: Goldman Sachs, taken from Durden, T. (2013) Europe Make Cyprus "Bail-In" Regime Continental Template

Thus, in this issue, the combined package of measures by the rescue bail-in and bail-out is not certain that it will give good results. However, the measures will take, but remains to see with how transparency, taking into account that states can adjust policies according to their own interests, but especially, by conviction power of banking system on politicians with influence.

First, we consider it be just that the countries providing financial problems must reduce costs drastically and also increase taxes, without attempting a global solution, namely through resources developed above countries. At the same time, we must not forget that extension of recession generates instability, slowing or even blocking reforms, and, also, social tensions.

Contemporary consumer is selfish: he wants to live better "today". Tomorrow might be too late for him since he won't be in good health state, or he will be, possibly, an unemployed, or he will be too old. Therefore, he asks herself today, and it is difficult for governors to convince him, that taxpayers must sacrifice the present for experiencing a better future. That "tomorrow" promise is uncertain and have no guarantee that then will be better.

The experience of countries which applied economic austerity measure show that they have experienced social unrest, rising of unemployment and a continuing economic recession (we refer to Italy, Spain and especially Greece, the country where economic decline reached 25% in five years, and unemployment at 27%). In this context we ask ourselves if they were better to accomplish reforms and to consolidate the banking system, like in US after the crisis of 2008. The state apply austerity method focused on tracking nominal aspects of budgets instead of structural aspects - this fact conducting to a distortioned reality about the state of the economy and the actions needed. One thing is proved, in austerity while income is decreasing and consumption shrinks drastically, it is necessary to export. Because of the interdependence between nations, if all countries will adopt solution of austerity and export to resolve their financial difficulties, it would create a deadlock.

As previously stated, the rate of interest remained high, and the competitiveness gap in eurozone between the countries developed and poorly developed can not be corrected by the latter only through exports. We believe that the knowledge of the structure and dynamics of countries with financial problems would have led European financial institutions to finance large projects in southern Europe. Also, we believe that in the absence of harmonization of budgetary and financial sectors, in many countries are adopting measures which are palliative or particulary, from a country to another.

If we ask what is the situation in Romania, compared to Cyprus, we can say it is completely different: banks are well capitalized, mostly to foreign capital, there is an strict oversight by National Bank, and National Deposit Guarantee Scheme is functional, and, also, the bank system as a whole is an economic stabilizer. In Romania there are over 14 million bank accounts of which over half have about £ 100. Only 16,400 deposit accounts have more than 100,000 euros. However, a lesson to know is to learn from this experience: that people, instead to keep all the money in banks, should they invest it in their country on real economy, to realize small business, to buy real estate or securities titles.

5. Conclusions

Decisions imposed for Cyprus also worried other EU countries, where the imbalance between the banking sector and the GDP is much higher. For example, in Malta, the banking sector is higher relative to GDP than that of Cyprus, and Luxembourg has an imbalance level of 23 times (noting that banks are subsidiaries of large financial groups in Europe - especially in Germany and France, and the United States).

In the future, according to a European Commission legislative proposal, bank deposits over 100,000 euros from European Union could be used to recapitalize distressed banks. Moreover, Dutch Finance Minister said the agreement concluded with Cyprus, using "bail-in" method, should serve as a model for resolving future banking crisis in the eurozone. This perspective explains concern of countries as Malta, Cyprus, Luxembourg and Lichtenstein, which are the lowest in the European Union. Luxembourg is, however, the country with the highest per capita income in the euro area.

We believe that the one of the effects of what happens in Cyprus could be the impact on the euro, even if there economy of this country represents only 0.15% of euro area GDP. But more important is, though, is eroding of confidence in the banking sector in the European Union by creating this precedent - overtaxing of banking deposits by over-indebted governments, knowing anyway that deposits still has a lower interest rate (in many European countries it is negative in real terms). The states have colossal social commitments and debts, and their financial systems are poor condition because of loans. Under these conditions, undoubtedly, the savers will find other ways to invest their money, safer and more liquid. If this experiment will work, we wonder: will follow other bigger countries (Greece, Italy, Portugal, Spain etc.)?

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