Cyprus after the 2013 Banking Crisis: The Journey towards Recovery

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Abstract

This chapter focuses on assessing the resolutions provided to financial institutions in the EU and the reasons that triggered the Cypriot banking crisis of 2013. Although Cyprus is considered to have an advanced economy since 2001,[1] Cyprus is the second country with the most non-performing loans (NPLs) in Europe.[2] The economic stability of Cyprus in 2013 was vulnerable, which due to various reasons, led to a domino effect that caused the liquidation of The Cyprus Popular Bank (Laiki) and the urgent initiation of the unprecedented tool of bail-in. Cyprus provides a useful example of a crisis-ridden economy that required a range of financial and legal measures to abate the effect of the crisis.

This chapter also considers the issue of NPLs to establish whether Cyprus has dealt effectively with the reduction of NPLs. The corollary is to evaluate whether the remedies provided through the Resolution of Credit Institutions and Investment Firms Law 22(I)/2016 (subject to the Bank Recovery and Resolution Directive)[3] are efficient in dealing with bank stability/insolvency in a time-critical scenario. This chapter examines the impact of these measures on the banking system of Cyprus, as the banking crisis of Cyprus was used as a paradigm for informing European Union legislators on the final version of the Bank Recovery and Resolution Directive. Any economy – whether developing or developed – needs an operational infrastructure that could deal with banking crises in time-sensitive fashion and in a manner that aptly captures critical stakeholder interests.

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[1] International Monetary Fund (IMF), 'World Economic Outlook Database' <https://www.imf.org/external/pubs/ft/weo/data/changes.htm> accessed 11 April 2022.

[2] European Banking Authority (EBA), 'RISK DASHBOARD-DATA AS OF Q4 2021' <https://www.eba.europa.eu/sites/default/documents/files/document_library/Risk%20Analysis%20and%20Data/Risk%20dashboard/Q4%202021/1029360/EBA%20Dashboard%20-%20Q4%202021%20for%20publication.pdf> accessed 10 April 2022.

[3] COM/2016/0852 final - 2016/0362 (COD) amending Directive 2014/59/EU.

1. Introduction

The general proposition of this chapter is that "banks fail, and should be allowed to fail"[4] as long as it does not have a contagious effect.[5] To achieve this, however, a structured system and options for prompt resolution need to be in place. This is an important issue since banking crises can have a grave impact on economies.[6] In 2013, Cyprus had an unhealthy economy that affected the stability of the banking system and vice versa.[7]

As per the International Monetary Fund (IMF), up until 2001, Cyprus was included in the Middle East and Europe under Developing Countries but, since then, it has been considered as a developed country.[8] The events that led Cyprus into a crisis that endangered the solvency of the whole country, which could have resulted in turning it from a developed country back into a developing country. Although Cyprus may no longer be classed as a developing country, i economy has been plagued by severe crises that necessitated the initiation of unorthodox measures to deal with the crisis. As there was a "too-big-to-fail" perception in Cyprus, the seriousness of the situation was not realised on time which caused a further deterioration of the economy. Arguably, if Cyprus was not part of the European Union (EU), the events of 2013 would have resulted in a sovereign default.

This chapter considers how this problem was dealt in Cyprus which is important for determining the effectiveness of the bank resolution tools for resolving, and, possibly, precluding, bank insolvencies. Lessons that arise from the Cypriot banking crisis experience can be instrumental to both developed and developing countries as well as to regulators. Regulators should focus on creating a safe space for banking systems and allow systemic financial institutions to methodically fail.[9] Non-viable banks could obstruct the development of other banks therefore, such banks should have the option of liquidation, which could facilitate the creative destruction principle.[10] The creation of an effective framework is a

[4] Tobias Asser, *Legal Aspects of Regulatory Treatment of Banks in Distress* (IMF 2001) 15.
[5] The contagion risk is often described as systemic risk. See more about this: Rosa Maria Lastra, 'Systemic risk, SIFIs and financial stability' (2011) Capital Markets Law Journal 6(2) 97-213.
[6] John Boyd, Sungkyu Kwak, Bruce Smith 'The real output losses associated with modern banking crises' (2005) Journal of Money, Credit and Banking 37(6) 977–999; Valerie Cerra, Sweta Chaman Saxena, 'Growth dynamics: the myth of economic recovery' (2008) American Economic Review 98(1) 439–457.
[7] This was also seen in the 1997 Asian crisis, where a banking crisis was affected by exogenous economic circumstances; Asser (n 3).
[8] IMF (n 1).
[9] Thomas Philippon, Aude Salord, 'New ICMB/CEPR Report: Bail-ins and Bank Resolution in Europe' (August 2017) <https://voxeu.org/article/new-icmbcepr-report-bail-ins-and-bank-resolution-europe> accessed 11 April 2022.
[10] James White, 'Death and Resurrection of Secured Credit' (2004) 12 American Bankruptcy Institute Law Review 139, 151.

difficult task for regulators as they need to ensure that effective tools – that can prevent and deal with a bank failure – are in place and simultaneously promote an innovative and a competitive banking system.

Simple insolvency procedures are not usually suitable to solve problems of financial institutions as their failure can have an irretrievable hit on a country's economy.[11] Circa 2012-2013, Cyprus needed immediate attention as the economy was on the edge of catastrophe. The only option of Cypriot banks at the time was the corporate liquidation procedure. The Cypriot insolvency law framework was not in effect at the time as it was initiated in 2015 through the Insolvency Law 2015 N. 65(I)/2015. During 2013, Basil III was in force that has as a purpose mitigating risks for banks[12] but, there was not an EU legislation that dealt specifically with the resolution of a banking crisis. There is a need to create an infrastructure for financial institutions that can circumvent loss of confidence. This is because deposit runs can lead to broad systemic risks that could cause the devastation of a nation's economy. As such, normal insolvency procedures are not capable of dealing with the contagion risks[13] since financial institutions need early intervention and speed, something that normal insolvency procedures will struggle to provide.[14]

Bail-out which is an option that was used in the past in countries like Greece was not favoured as it creates a moral hazard and burdens taxpayers. Bail-out is financial assistance that is traditionally given by the government of a country, which is borne by the taxpayers. Bailing out the distressed banks as a sole tool was not enough and will arguably never be enough. The tools that were included in the Bank Recovery and Resolution Directive (BRRD)[15] (that was at its drafting stages) became useful for dealing with the crisis. These tools were developed as a response to the 2007-2008 global financial crisis as there was a need for strategies and mechanisms capable of dealing with imminent crises. Bail-in was the main innovative tool used in Cyprus and was also included in the BRRD. The use of bail-in impacted the decision of adopting it officially in the BRRD that became available right after the Cypriot

[11] Ross Cranston et. al. *Principles of banking law* (3rd edn, OUP, 2018) 171.
[12] This can be for example the maintenance of leverage ratios and to upheld particular capital levels. This could have helped to avert failure but not to address a banking crisis.
[13] Contagion risks describe a situations where the financial distress of one institution could spread to another causing a knock-on effect.
[14] European Commission, 'Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms' 2012/0150' 6 June 2012, 5 <https://eur-lex.europa.eu/LexUriServ/%20LexUriServ.do?uri=COM:2012:0280:FIN:EN:PDF> accessed 11 April 2022.
[15] Now Directive 2014/54/EU that was amended by Directive 2017/1132.

banking crisis. A resolution authority will impose a bail-in on certain financial institutions and this aims at making it financially stable through recapitalising it and effectively dealing with the reasons that led to the failure. Bail-in converts uninsured deposits into equity or writes-off a part of the deposits on a going-concern basis to achieve the aforementioned. The Cypriot experience illustrates that a bail-out should be used as a method of last resort to avoid using public support that could drain the finances of that country or of the European Union. As such there could be an introduction of a new norm through the bail-in tool which is an alternative to government-funded rescues. There was a public outcry in Cyprus when the decision to use the bail-in tool was taken. Although the purpose of moving from bailouts to bail-ins is to minimise the burden on the public, the tools can be affected in different ways. The caution against bailouts can be seen from judicial decisions that have been taken right after bail-in came into play.[16]

The events that led to the banking crisis and the measures enforced to deal with the crisis can be used as a paradigm for imitation and possibly aversion. Non-performing loans (NPLs) that are often a result of poor banking regulation produces instability to the banking system and to the country's financial system as a whole. The corollary is to explore the bail-in tool and the other steps taken to minimise the risk of having an increased number of NPLs in Cyprus as well the measures that have been proposed by the EU that were introduced to avert a possible contagion. In more detail, this chapter will examine whether the bail-in tool of the Resolution of Credit Institutions and Investment Firms Law 22(I)/2016 (Resolution Law 2016), which transposed the BRRD, is capable of evading and/or dealing with an imminent banking crisis.

Section 2, which follows, is a pithy depiction of the historical economic background of Cyprus until the events that led the country to the verge of recession. Section 3 discusses the too-big-to-fail concept from the lens of Cyprus. Section 4 examines the effect of NPLs in a banking system and how Cyprus dealt with this menace. Section 5 analyses the resolution tools that were applied in the 2013 banking crisis of Cyprus as well as the importance of protecting secured depositors and the effect of capital controls. Section 6 scrutinises the BRRD with focus

[16] Nationally: Supreme Court of Cyprus 07/06/2013, Case No. 553/2013: *Myrto Christodoulou and Others v Kentriki Trapeza Kyprou and Others a.o.*; Supreme Court of Cyprus 09/10/2014, Case No. 1034/2013: *Vias Dimitriou and Others v Kentrikis Trapezas Kyprou and Others)*; EU: *Mallis v European Commission* (C-105/15 P) EU:C:2016:702; [2017] 1 C.M.L.R. 36; *Ledra Advertising Ltd v European Commission* (C-8/15 P) EU:C:2016:701; [2017] 1 C.M.L.R. 35.

on the bail-in tools. Section 7 concludes with identifying whether its application has worked for Cyprus.

2. Background: Economic History of Cyprus Until the Banking Crisis

After the independence of Cyprus in 1960,[17] there was steady economic progress. From focusing on the agricultural industry, Cyprus started dealing with real estate development, tourism and investments.[18] The war with Turkey in 1974 affected the upward development of Cyprus as it deteriorated the economy and left the country with unemployment rates that reached 30 per cent.[19] From 1977, with the trend of offshore companies – that is now abolished due to the entrance of Cyprus to the EU in 2004 – Cyprus managed to revive and its economy flourished again.[20]

The financial problems that followed in the subsequent years were, perhaps unintendedly, driven by the EU membership of Cyprus it led to overconfidence, under-estimation of risks and reckless decisions.[21] Bad corporate governance decisions and operations generated most of the problems that led the banks in distress.[22] From a corporate law and governance perspective much of this at EU level is left to member states through the use of directives thus, perhaps Cypriot legislators should have done more. This is also closely aligned with the too-big-to-fail problem that is discussed further in the next section. Cyprus' new status as a member state of the EU was responsible for the foreign capital inflow that went into Cyprus' banks and the property market.[23] As a result of the rapid credit growth and the unmaintainable property bubble, the financial stability of the Cypriot economy became unbalanced.[24]

[17] Treaty Concerning the Establishment of The Republic Of Cyprus, No. 5476., 16 August 1960 <https://peacemaker.un.org/sites/peacemaker.un.org/files/CY_600816_TreatyNicosia.pdf> accessed 24 October 2021.
[18] Costas Stamatiou, 'Cyprus's bank resolution framework: tested in the fire' (2015) 30 J.I.B.L.R. 171.
[19] Republic of Cyprus, *About Cyprus* (Press and Information Office 2001) 151.
[20] Elias Neocleous, 'Cyprus: The Offshore Regime And Cyprus' Accession To The European Union - The Offshore Regime of Cyprus' 3 December 1997, <http://www.mondaq.com/cyprus/x/3199/Environmental+Law/The+Offshore+Regime+And+Cyprus+Accession+To+The+European+Union+The+Offshore+Regime+of+Cyprus> accessed 07 November 2021.
[21] Panicos Demetriades, 'Political economy of a euro area banking crisis' Cambridge Journal of Economics 2017, 41, 1249–1264, 1257.
[22] Demetra Arsalidou, Maria Krambia-Kapardis, 'Weak corporate governance can lead to a country's financial catastrophe: the case of Cyprus' (2015) JBL 4, 361-382, 363.
[23] Demetriades 'Political economy of a euro area banking crisis' (n 21).
[24] The hypothesis of financial instability in similar circumstances was first laid down by Minsky: H.P Minsky 'The Financial Instability Hypothesis' (1992) Levy Economics Institute of Bard College, Working Paper No. 74.

The worldwide economic crisis of 2008 minimally affected Cyprus and this continued during the 2009 recession. Although the impact on Cyprus was not direct, there was an indirect influence from the problems that the Greek economy was facing.[25] In June 2012, Cyprus applied for financial assistance from Europe and the IMF. Several events caused a delay in reaching an agreement and what followed was the financial turmoil of the two largest banks of Cyprus, which led to a sovereign debt crisis.

In March 2013, the Eurogroup[26] and the IMF made the decision that public funds were not capable of saving the banks as the public funds of Cyprus were already stretched.[27] This was a major problem for Cyprus given that the capital of €5,8 billion, which was the shortfall, had to be raised internally. This led to a discussion on the options that Cyprus had to cover this amount. An agreement was reached between the Eurogroup and the Cypriot government on the 16th March 2013 on how to generate revenue to recapitalise the distressed banks. The agreement – that was subject to approval by the Cypriot Parliament – included a bank deposit levy of 9.9 per cent for deposits over €100.000 and of 6.75 percent of deposits below €100.000 on all Cypriot banks. In the meantime, all of the banks remained closed, and restrictions were put on cash withdrawals through capital controls. The Parliament rejected this agreement after the vast outcry that was created both nationally and in the EU.

In the early hours of 25th March 2013, the discussions on how to raise the capital of €5,8 billion continued. Without an agreement the banks could not open as if they reopened without an agreement this would have been with a new currency, which would not have allowed Cyprus to remain in the EU. With the default of the sovereign the consequences could have been disastrous.[28] Hence, the European Commission, the European Central Bank and the IMF (Troika) finally agreed on an economic adjustment programme with Cyprus, which stopped the breakdown of the euro and the default of Cyprus. This consisted of an international bail-out of approximately €10 billion as long as several conditions were fulfilled.[29] These requirements included, *inter alia*, a bail-in of 47.5 per cent on deposits beyond €100.000 at the

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[25] David Lascelles, David Green, George Charalambous, Pier De Weck, 'Independent Commission on the Future of the Cyprus Banking Sector: final report' 31 October 2013, 23 <https://www.centralbank.cy/images/media/pdf/LSE_ICFCBS_Final_Report_10_13.pdf> accessed 26 October 2021 (ICFCBS report).

[26] Group comprised by Ministers of Finance in Member States that have the Euro as their currency.

[27] Panicos Demetriades, *A Diary of the Euro Crisis in Cyprus: Lessons for Bank Recovery and Resolution* (Palgrave Macmillan, 2017) 84.

[28] Demetriades 'Political economy of a euro area banking crisis' (n 21) 1257.

[29] Costas Xiouros, 'Handling of the Emergency Liquidity Assistance of Laiki Bank in the Bailout Package of Cyprus' (21 April 2013) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2254499> accessed 11 April 2022.

Bank of Cyprus (BoC)[30] and extinguishing deposits over €100.000 at the Cyprus Popular Bank (Laiki).[31] Laiki was liquidated with the good part of it being merged with the BoC. A security on deposits below €100.000 was triggered although in the initial negotiations there was an offer having a bail-in on all deposits.[32] Depositors were left unsettled throughout Europe (especially in Greece and Slovenia) due to the outcome of the negotiations between Cyprus and Troika.[33] The criticisms regarding bail-in and the near bail-in on secured deposits is a vital part of the discussions in this chapter.[34]

Following the memorandum of understanding between Cyprus and Troika, the incorporation of an effective insolvency regime in Cyprus prevailed to be necessary hence, the Insolvency Law 2015 N. 65(I)/2015 was enforced with examinership being introduced. The Troika officials argued that the inauguration of rescue culture within the Cypriot insolvency regime was inevitable. As a result, the examinership procedure was initiated and there were changes on the liquidation procedure, schemes of arrangement and receivership.

The resolution framework adopted by Cyprus in March 2013[35] was certainly "tested in fire".[36] Cyprus gradually started recovering as the economic adjustment program was exited in 2016.[37] This chapter examines whether the recovery of the Cypriot economy is attributable to the resolution tools used during the banking crisis.

3. The too-big-to-fail concept

Too-big-to-fail financial institutions tend to receive advantages that other smaller financial institutions do not receive. The largest banks of a country are usually perceived as too-big-to-fail as the stability of the economy is on a certain extent depending on them. The failure of a too-big-to-fail institution may have a domino effect and as a result cripple the country's

[30] The largest bank of Cyprus in 2013. Initiated through the Regulatory Administrative Act No 103, EE, Annex III(I), No 4645, 769–80, 29 March 2013 (Decree 103) that was adopted by Resolution of Credit and Other Institutions Law 17(I)/2013.
[31] The second largest bank of Cyprus in 2013. Initiated through Regulatory Administrative Act No 104, EE, Annex III(I), No 4645, 781–88, 29 March 2013 (Decree 104) that was adopted by Resolution of Credit and Other Institutions Law 17(I)/2013.
[32] Andrew Campbell, Paula Moffatt, 'Protecting Bank Depositors after Cyprus' (2013) 1 NIBLeJ 4.
[33] Demetriades 'Political economy of a euro area banking crisis' (n 21) 1249.
[34] Sections 5 and 6 of this chapter.
[35] Resolution of Credit and Other Institutions Law 17(I)/2013.
[36] Stamatiou (n 18) 171.
[37] A post-surveillance program was activated until 2029 provided that the 75 per cent of all debt is repaid: 'Post-Programme Surveillance Report Cyprus', Autumn 2018 <https://ec.europa.eu/info/sites/info/files/economy-finance/ip092_en.pdf> accessed 12 April 2022.

economy therefore, the government will subsequently support the financial institution.[38] When the national economy is at stake the government's involvement in funding the financial institution is inevitable.[39] Too-big-to-fail is classified as a common problem in banking as the health of large banks is linked with the national economy. As such, large financial institutions receive the guarantee of a bail-out in times of distress. This expectation that the government will rescue these financial institutions incentivises them to expand their balance sheet through leverage and to take more risks including precarious assets.[40] These institutions can exploit the position to the maximum advantage, which is arguably what happened in Cyprus.

The banks in Cyprus before the 2013 banking crisis were thought to be too-big-to-fail, which created a moral hazard.[41] Often this happens to large banks and that was the case for the BoC and Laiki that were the two largest banks in Cyprus at the time. For a bank to be classed as systemic its balance sheet should exceed the 20-30 per cent of the country's Gross Domestic Product (GDP). BoC reached 211 per cent of Cyprus' GDP while Laiki reached 190 per cent.[42] Demetriades stated "When it is 200% of GDP, it is not just systemic. It is controlling. An entire society was completely captured".[43] Namely, the whole economy of Cyprus was dependent on these banks.

Financial instability is closely linked with the phenomenon of too-big-to-fail.[44] The Cypriot banks expected that they would have been bailed-out by the government therefore, they had taken excessive risks and wasted resources. The years 2004-2010 was the period that stigmatised these banks as during this period there was a dangerous rapid growth. This overconfidence led to branches spreading, mainly in Greece and East Europe. The failure of these banks is associated *inter alia*, with poor governance, the exposure to the Greek Government bonds, from giving high deposit rates and having lax lending standards that led to

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[38] Peter Lim Felton, 'Too Big to Manage: A Case for Stricter Bank Merger Regulation' (2012) 52 Santa Clara Law Review 1081.
[39] Ross Cranston et. al. *Principles of banking law* (3rd edn, OUP, 2018) 11.
[40] Gara Afonso, Joao Santos, James Traina, 'Do "Too Big To Fail Banks Take on More Risk?' (2014) 20 Federal Reserve Bank of New York, Economic Policy Review, Special Issue: Large and Complex Banks 1-18, 1.
[41] Excessive risk-taking without considering the adverse consequences as there is a feeling that a safety net is in place.
[42] Demetriades, *A Diary of the Euro Crisis in Cyprus* (n 27) 54.
[43] Ibid 55.
[44] ICFCBS report (n 25).

an excessive amount of NPLs.[45] Public authorities also did not do anything to stop the harm from spreading as they did not realise the danger that these banks had put themselves in.[46]

A massive risk that the Cypriot banks had taken was the investment in the Greek Government Bonds that amounted to almost €5.8 billion.[47] In 2011, a levy was imposed on the Greek Government Bonds, which generated a massive loss of 4.5 billion for Cypriot banks. This was the beginning of the end of Laiki as it was the bank that invested the most in the Greek Government Bonds. There was excessive risk taking and reckless decisions regarding the purchase of Greek Government Bonds from Cypriot banks. For instance, in December 2009, the BoC sold Greek Government Bonds worth €1.7 billion (which left them with an exposure of only €0.1 billion), yet without wasting any time BoC began to purchase Greek Government Bonds worth approximately €2.4 billion by June 2010.[48] There is the counterargument that government bonds do not carry any risks according to requirements set by Basel.[49] The amount of the investment in Greek Government Bonds suggests otherwise as the amount lost equates to 25 per cent of the GDP of Cyprus.[50]

The moral hazard becomes a vaster problem when uninsured creditors are supported in an extensive grade. After the levy on Greek Government Bonds Laiki was in need of Emergency Liquidity Assistance (ELA).[51] The guarantee that Laiki provided were discounted assets. The crisis led Laiki in securing €2.5 billion of ELA in October 2011.[52] By January 2012, the ELA amount that Laiki received reached €3.7 billion, while the ELA amount increased to €5.7 billion by May 2012. The continuous injections of liquidity from ELA signalled the concerning state of Laiki. In June 2012, the amount that was injected by ELA totalled to €8 billion. It was obvious that Laiki was insolvent, but the liquidity injections continued as in July 2012 the total of ELA was at €9.6 billion. The ELA to Laiki went beyond €11 billion by the time Laiki was liquidated.[53] The economic problems that Laiki was facing were so vast which

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[45] Ibid.
[46] Ibid.
[47] PIMCO, ''Independent due diligence of the banking system of Cyprus' March 2013 <http://ftalphaville.ft.com/files/2013/04/reportasws.pdf.pdf> accessed 12 April 2022.
[48] Alvarez and Marsal 'Investigation Report, Bank of Cyprus – Holdings of Greek Government Bonds'26th March 2013 <https://www.news.cyprus-property-buyers.com/wp-content/uploads/2013/04/April04_2013_AM.pdf> accessed 12 April 2022.
[49] Alexander Michaelides, 'Cyprus: from boom to bail-in' (2014) Economic Policy 29(80) 639–689, 670.
[50] Ibid.
[51] The Central Bank of Cyprus grants liquidity to the bank through ELA only if the bank is solvent.
[52] Antonis Antoniou, 'Λαϊκή: Καταστροφή εξ Ελλάδος' 15 April 2013 <https://www.sigmalive.com/inbusiness/news/business/40289/laiki-katastrofi-eks-ellados> accessed 12 April 2022.
[53] ICFCBS Report (n 25) 23.

thus necessitated the bail-out injection by the government that reached €1.8 billion in mid-2012.[54]

There was the perception that whatever happened the default of the biggest bank would not have been allowed as public funds (ie. ELA and the bail-out in 2012) would always support those banks. This made risk taking not that risky in the banks' perspectives as they believed that the government would not let them fail as that would have affected the national economy. This is the epitome of the too-big-to-fail problem, which is why the Eurogroup in March 2013 wanted to put an end to this. This was because the banks were not only too-big-to-fail but also too-big-to-save, as a taxpayer bail-out would have gotten the sovereign debt out of control, which could have resulted in the country's bankruptcy.[55] The amount that the banks needed to recapitalise the banks was €13.5 billion (this was the 80 per cent of Cyprus' GDP at the time). It was the fact that it was systemic that safeguarded the country from exiting the Eurozone.

As such, the harsh tool of bail-in was implemented with the hope of introducing a framework that would put an end to moral hazard and maybe eliminate the too-big-to-fail problem. The purpose was not only to eliminate the problem in Cyprus but to send the message to other Member States of the EU as well. That said, policymakers who are in favour of the bail-in tool are incentivised by the possibility of putting an end to the too-big-to-fail problem. This is a significant option for the banks to recapitalise and resolve the crisis themselves without putting the responsibility on the taxpayers, but on the investors, when the banks reach the point of non-viability.[56] The effects of the bail-in tool as well as to whether it reduces the risk of contagion is discussed further.

4. The NPL menace in the Cypriot banking system

Certain events led to liquidation of Laiki and the restructuring of BoC through the bail-in tool on bank deposits. As discussed above, in 2011 the excessive exposure to the Greek economy – as Cypriot banks overinvested in Greek Government Bonds – impacted the economic stability

[54] Ibid.
[55] Demetriades, *A Diary of the Euro Crisis in Cyprus* (n 27) 197.
[56] Thomas Huertas, 'Will bust banks be born again by bail-in?' (2019) 4 JIBFL 224.

of Cyprus[57] and the first recession made its appearance.[58] The failure of a bank is closely connected with NPLs hence, NPLs of the banking system of Cyprus had a major impact on the banking crisis.[59] According to the European Banking Authority (EBA), Cyprus is currently still the second in Europe with most NPLs, with Greece being the first.[60] NPLs are an endogenous factor that makes banks susceptible to financial instability and possible failure; therefore, the increase of NPLs in 2013 impacted the banking crisis of 2013.

Statistics conducted by the European Banking Authority (EBA) regarding NPLs indicate that in 2013 the ratio was 38.5 per cent[61] which was disproportionate with the 2011 ratio that reached 9.9 percent. EBA has logged in September 2019 that the average percentage of NPLs in the EU is 2.9 percent and simultaneously in Cyprus the ratio reached 21.1 percent.[62] Per the EBA statistics in December 2020, the NPLs ratio in Cyprus was at 11.5 percent that is a significant drop since in March 2020 the ratio was at 20.1 percent.[63]

Campbell emphasises that a key to an effective system is the decrease of NPLs, as excessive NPLs can be a profound menace to the banking infrastructure of Cyprus, and it can subsequently have macroeconomic reverberations.[64] The target of the policy makers and banks post-2013 was to introduce measures that would alleviate the NPL predicament in Cyprus. This could have the reflection of a control system and the efficacy of enforcement proceedings.[65] The options that banks can choose are the debt-to-asset swap (dtas), cash payment, sale of business and/or assets and enforcement/insolvency proceedings. In Cyprus, as regards to the enforcement/insolvency procedure the most prevalent are liquidation, receivership, foreclosure and examinership. In August 2018, BoC announced the initiation of the Helix project with

[57] Daniel Stavárek, 'Lessons Learned from the 2013 Banking Crisis in Cyprus' (2013) Proceedings of the 10th International Scientific Conference 10-11 June 2013.
[58] Elias Neocleous, Maria Kyriacou, 'Cyprus: A Colonial Inheritance' 11 March 2013, <http://www.mondaq.com/cyprus/x/226084/offshore+financial+centres/A+Colonial+Inheritance> accessed 12 April 2022.
[59] Leslie Teo et al. (ed.), 'Financial Sector Crisis and Restructuring Lessons from Asia' (2000) International Monetary Fund, Occasional Paper No. 188.
[60] EBA (n 2).
[61] The World Bank, 'Bank nonperforming loans to total gross loans (%) – Cyprus' <https://data.worldbank.org/indicator/FB.AST.NPER.ZS?locations=CY> accessed 8 April 2022.
[62] European Banking Authority, 'RISK DASHBOARD-DATA AS OF Q4 2020' <https://www.eba.europa.eu/sites/default/documents/files/document_library/Risk%20Analysis%20and%20Data/Risk%20dashboard/Q4%202020/972092/EBA%20Dashboard%20-%20Q4%202020.pdf> accessed 10 April 2022.
[63] Ibid.
[64] Andrew Campbell, 'Bank insolvency and the problem of non-performing loans' (2007) 9 (1) Journal of Banking Regulation, 28.
[65] Ibid.

Apollo Global Management LLC in which €2.7 billion of NPLs were sold.[66] In June 2021, the completion of the Hellix Project 2 was announced by BoC that sold portfolios of loans of which €1,311 million were NPLs.[67] These agreements targeted the reduction of NPLs and the amelioration of the asset quality that are retained by banks.[68]

It is important to understand the reasons that led to a vast percentage of NPLs in order to circumvent that from happening again both in Cyprus and internationally. All start from the lax corporate governance of the Cyprus banks and the deficient lending practices that were facilitated from the legal and regulatory framework. Pre-2014 the practices were sufficiently different from the norms in other European countries.[69] There was a discrepancy of the definitions that Cyprus, other European and international countries had, on NPLs. The Central Bank of Cyprus (CBC) defined NPLs as loans that are past due 90 days but excluded loans that were fully secured by tangible collaterals.[70] Another issue was that banks allowed loan modifications, which deemed problematic loans as performing. European and international norms define all loans that are 90 days delinquent as NPLs. By 2015 Cyprus also adopted this definition that EBA uses.[71] The balance sheet of the banks during the years of 2007-2011 was weakened as a consequence of their practices.

The years before the banking crisis there was a property bubble and an overinvestment in property and real estate construction that had its input on increased NPLs.[72] In particular, the 72,4 per cent of construction loans were NPLs.[73] An excessive credit growth had appeared as the value of collaterals was constantly rising. The banks had neglected the possible risks though and this is also because they overly relied on collaterals and guarantees rather than establishing a mechanism to determine whether the borrowers are able to repay their loans.[74] The fact that banks allowed collateral arrangements involving excessive cross-collateralisation

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[66] Bank of Cyprus, 'Agreement for sale of a portfolio of non-performing loans' (28 August 2018) <https://www.bankofcyprus.com/globalassets/investor-relations/press-releases/eng/20180828-helixannouncement_eng_final.pdf> accessed 11 April 2022.

[67] Bank of Cyprus, 'Completion of Project Helix 2 (Portfolios A and B) - Sale of non-performing loans' 28 June 2021 <https://bankofcyprus.com/globalassets/investor-relations/press-releases/eng/20210628-helix-2_completion_announcement_eng_final.pdf> accessed 11April 2022.

[68] Cat Rutter Pooley, Robert Smith, 'Bank of Cyprus sells €2.7bn bad loans to Apollo' Financial Times (28 August 2018) <https://www.ft.com/content/25cb5846-aa8b-11e8-89a1-e5de165fa619> accessed 11April 2022.

[69] PIMCO (n 47) 12

[70] Demetriades, *A Diary of the Euro Crisis in Cyprus* (n 27) 188.

[71] IMF, 'Cyprus' November 2018 < https://www.imf.org/~/media/Files/Publications/CR/2018/cr18338.ashx> accessed 11April 2022.

[72] Sofronis Clerides, 'The Collapse of the Cypriot Banking System: A Bird's Eye View' (2014) Cyprus Economic Policy Review 8(2) 3-35, 25.

[73] Ibid.

[74] Demetriades, *A Diary of the Euro Crisis in Cyprus* (n 27) 188-189.

worsened the situation. Another collateral arrangement that complicated matters was when a group of companies was concerned, which meant that this involved cross-shareholdings, cross-pledges, cross-guarantees and floating charges. The balance sheet of the banks was gravely affected after the declining value of real estate as this also had a major impact on the value of collaterals.

When the GDP of Cyprus dropped in 2012, the unemployment rates rose, and real estate prices dropped aggressively that had an impact on the increasing NPLs. This did not immediately alarm the borrowers as they were aware of the lax legal framework of foreclosure. During the time the foreclosure procedure was time-consuming[75] which disincentivised borrowers to repay their debts. The banks hesitated to use foreclosure due to the lengthy process and that led to unpropitious reverberations on recovery.

The procedure of foreclosure that allows private auctions was implemented in 2014 in Cyprus through the Immovable Property (Transfer and Mortgage) Law 142(I)/2014 following the Memorandum of Understanding with Troika. The reinvigorated foreclosure procedure targeted the reduction of NPLs. An evaluation expert is needed to estimate the open market value (OMV) of the assets before the commencement of foreclosure. At the first auction the 80 per cent of the OMV should be reserved, where the bank is forbidden from bidding.[76] If the result of the auction is unsuccessful, a second auction can occur in which the bids cannot be lower than the decreased value of 50 per cent of the OMV.[77] If six months have passed since the first auction with the assets not being sold, the bank will have the opportunity to credit the bid provided that it is at an OMV.[78]

Politicians described this tool as draconian and that it could cause grave consequences in society.[79] These new laws are to some degree oppressive to debtors as the sale of their assets is forced. Nevertheless, foreclosure is not the prevalent option since banks are in preference of using other alternatives first thus, this tool is merely utilised when the debtor has failed to fulfil his/her liabilities. In fact, this means that the assertions of politicians could be an exaggeration.

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[75] Scott Brown, Demetra Demetriou, Panayiotis Theodossiou, ‘Banking Crisis in Cyprus: Causes, Consequences and Recent Developments’ (2018) Multinational Finance Journal 22(1/2) 63–118, 99.
[76] Immovable Property (Transfer and Mortgage) Law 1965 (9/1965) Part VIA, s 44E (1).
[77] Ibid Part VIA, s 44E (4).
[78] Ibid Part VIA, s 44D (1), s 44IA (1).
[79] Maria Kyriacou, ‘Supreme Court's role in reviewing proposed legislation’ (2014) International Law Office <https://www.neocleous.com/publications/reviewing-proposed-legislation-pdf> accessed 12 April 2022.

This procedure is principally designed for defaulters who are not in agreement with any consensual arrangements that were previously offered to them by creditors.

Creditors tend to go for dtas before they decide to use foreclosure but if the director is not in consent, this will no longer be an option. While directors can initially not be in acquiesce to a dtas, they can be forced into it through foreclosure. Albeit a dtas could have taken place without foreclosure, the fact that the director was not concurring with the creditor to have a dtas had as an outcome a non-consensual dtas through foreclosure. One could argue that a consensual solution could be more profitable for both sides since the foreclosure expenditures could have been avoided and the value of the assets could have been kept maximised.

The contrasting procedures of examinership[80] and foreclosure were recommendations of Troika hence, one could question the simultaneous implementation of both. On one hand foreclosure goes against the axiom rescue culture that Troika aimed to incorporate within the Cypriot jurisdiction. One the other hand, rescue culture and foreclosure are intertwined in the sense that foreclosure should exist for corporate rescue to have a sustainable development. With the hope of having some of their debt deducted, some debtors become strategically in default. The existence of foreclosure can possibly operate as a menace to those debtors provided that this tool generates an efficacious infrastructure to minimise NPLs.

Foreclosure has the purpose of being less time-consuming from other available enforcement processes and also to speed up the process of decreasing NPLs. However, the course of action of several cases is postponed owing to the legal challenges that are brought to the court by the directors. These delays defeat one of the main benefits of foreclosure; thus, it was decided by the Parliament that foreclosure necessitated an enhancement, which took place in 2018.

The 2018 amendments include the elucidation and the restriction of circumstances in which the directors can make objections against foreclosure to the court. The justification of introducing e-auctions is to make auction routes less burdensome to use. While the banks were able to bid within 12 months since the first auction, the time was lessened to 6 months. Even though this could be criticised as a creditor-oriented amendment it made the procedure more accessible and minimised the impediments that foreclosure previously comprised. The purpose of those amendments was to ease the access to foreclosure. The attempt to ameliorate

[80] Examinership is the first procedure that was introduced in Cyprus that has as a purpose the corporate rescue. The initiation of an insolvency law framework and of the rescue option for distressed companies was in the requirements of Troika in 2013.

foreclosure was legitimate however, it is still in the early stages of its implementation thus, the effect is still uncertain as statistical importance is not effectuated yet.

On another note Arsalidou and Kambia-Kapardis argue that the main cause of the banking crisis was the poor corporate governance that also extends to the cause of the increased NPLs.[81] They also highlight that: "The interwoven relationships and strong connections that exist between politicians and businesses, the failure to control the phenomenon of the "revolving doors'", as well as the expectation that banks will voluntarily comply with corporate governance codes in a culture where the prevailing attitude is that of the "old boys' network", are signs of corporate governance gone wrong".[82] Due to those relationships the corporate governance of Cypriot banks did not convey the spirit of meritocracy, accountability and support. There was too much political interference in banks that were supposed to be private. Proof of the poor corporate governance and the lax lending practices that led to the catastrophe of the Cypriot banking system can be seen from some examples that were identified at the Investigative Committee of the Cypriot banking crisis.[83] The first is that a member of the BoC board and the remuneration committee obtained loans from the bank that amounted to 27 million and if that was not shocking enough, in the second example, the BoC's chairman obtained loans that reached approximately 319 million over a period of less than 20 years.[84]

5. Developments in Cyprus after the resolution measures were imposed

5.1 What happened in Laiki and Bank of Cyprus after the economic adjustment programme

The Resolution of Credit and Other Institutions Law 17(I)/2013 (2013 Resolution Law) was enacted to restructure, recapitalise and revive BoC and Laiki. There was no legislation that was dealing with the resolution of banks prior to this. The 2013 Resolution Law originates from an early draft of the BRRD that arose out of the global financial crisis of 2008.[85] This means that to a certain extent the Cypriot banking crisis informed the last version of the BRRD of 2014.

[81] Demetra Arsalidou, Maria Krambia-Kapardis, 'Weak corporate governance can lead to a country's financial catastrophe: the case of Cyprus' (2015) JBL 4, 361-382.
[82] Ibid.
[83] G Pikis, A Kramvis, E Nicolaou, 'Three-Member Investigative Committee on the Banking and Finance of the Republic of Cyprus' 28 September 2013 <https://www.stockwatch.com.cy/media/announce_pdf/Report_Committee_Ypourgiko_3.10.2013.pdf> 11 April 2022.
[84] Ibid.
[85] Christian Duve & Philip Wimalasena, 'Who decides whether bail-in is legal? What comes after Cyprus and Greece?' (2015) Law and Financial Markets Review 9(3) 177-186.

The 2013 Resolution Law gave the power to the CBC to become a resolution authority which meant that they gained the ability to impose measures on credit, banking and cooperative institutions.

The agreement that was negotiated did not come without consequences since an unprecedented restructuring and resolution was expected that had to be conducted swiftly to circumvent the banks and the economy from facing further deterioration. The first action that was taken was to ring-fence the Cypriot banking system from the Greek banking system through selling the branches that Laiki and BoC had in Greece.[86] This had as a purpose the avoidance of a contagion to Greece, which could have impaired the Greece economy even further.

Part of the agreement in the Eurogroup and of the resolution plan of Cyprus was to divide Laiki into 'good' bank and 'bad' bank. The 'good' bank included NPLs, insured deposits and the ELA that Laiki borrowed from the CBC. The remaining assets like subsidiaries in other countries, uninsured deposits and other creditors were placed into the 'bad' bank, or in other words, the legacy bank.[87] Whatever remained from the legacy bank was finally liquidated while the 'good' bank was merged with the restructured BoC. The bailout of Troika as well as the bail-in on uninsured bank deposits recapitalised BoC. Uninsured amounts that exceeded €100.000 were converted into equity, which necessitated the increase of the share capital of BoC. In July 2017, it was decided that the 47,5 per cent of deposits beyond €100.000 was going to be bailed-in which generated media, citizen and political scrutiny. The 81 per cent of the share capital was being held by bailed-in depositors.[88] The deposits that were transferred from Laiki to BoC reached €4.5 billion.[89]

The essence of the bail-in at the BoC was that it converted the uninsured deposits into equity. Those bailed-in amounts were the internal funds that were used to recapitalise BoC. In this way the bank did not become a burden to the taxpayer directly. The rationale behind bail-ins is to not externalise the need for funds and to not rely on public subsidy.[90] It was believed that the taxpayers could not afford a bail-out that reached the amounts needed. The target of

[86] Gikas Hardouvelisa, Ioannis Gkionis, 'A Decade Long Economic Crisis: Cyprus versus Greece' (2016) Cyprus Economic Policy Review 10 (2) 3-40, 16; Demetriades, *A Diary of the Euro Crisis in Cyprus* (n 27).
[87] Demetriades 'Political economy of a euro area banking crisis' (n 21) 1260.
[88] Bank of Cyprus, 'Recapitalisation through Bail-in and Resolution Exit Bank of Cyprus Announcement' < https://www.bankofcyprus.com/en-GB/Start/News_Archive/Recapitalisation-through-Bail-in-and-Resolution-Exit-Bank-of-Cyprus-Announcement/> accessed 12 April 2022.
[89] Brown, Demetriou and Theodossiou (n 75) 85.
[90] Thomas Huertas, 'The Case for Bail-ins' in A Dombret, P Kenadjian (ed), *The Bank Recovery and Resolution Directive* (De Gruyter 2013) 4.

moving from bail-outs to bail-ins was to minimise the too-big-to-fail issue, reduce the impact that a bail-out could have had in a real economy and to accelerate recovery. Another reason the decisions led to a bail-in of uninsured depositors was because most of the large depositors were non-residents with the majority of them being Russians.[91] Christine Lagarde[92] stated that "the authorities took bold steps to address the crisis, including the upfront resolution and restructuring of the two largest and insolvent banks at no fiscal cost, while protecting insured depositors. They also implemented ambitious fiscal consolidation measures. Nevertheless, challenges ahead are significant, including restoring credibility in the banking sector and reducing fiscal deficits and debt to sustainable levels."[93] The resolutions measures that were taken were undoubtedly audacious and for that reason it gained global media attention. The bail-in though safeguarded a vast majority of the taxpayers and thus future generations since most of the uninsured deposits did not belong to Cypriots. Through protecting public finances, the most financially vulnerable citizens were also protected as the bail-in focused on affecting the wealthiest citizens.

5.2 Protecting insured depositors

The fact that the Eurogroup entertained the possibility of bailing-in insured deposits from all the banks in Cyprus – even those that did not require intervention – should not be neglected. This decision would have created a dangerous precedent that could have caused runs on big deposits in other EU countries, which could have affected the stability of more banks in the EU. This caused a vast outcry in Cyprus as all depositors were going to be affected, which influenced the Parliament to reject that agreement of 16 March 2013. Although the deposits of insured depositors were not bailed-in, the confidence of depositors was blurred.[94] Insured depositors need to feel the safety that in an insolvency outcome, they will be prioritised over uninsured depositors.

Insured deposits are in this situation amounts that do not exceed €100.000, which means that that amount is safe even if the bank collapses. This practice transmits confidence and trust in the banking system.[95] There is an analogous protection through the Financial Services

[91] Maurice Mendelson, Martins Paparinskis 'Bail-ins and the international investment law of expropriation: in and beyond Cyprus' (2013) 28 Journal of International Banking and Financial Law 475-479, 475.
[92] Managing Director and Chair of the Board of the IMF.
[93] IMF, 'Press Release: IMF Executive Board Approves €1 Billion Arrangement Under Extended Fund Facility for Cyprus' 15 May 2013 < https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr13175> accessed 12 April 2022.
[94] Ian Jack and Tom Cassels, 'Cyprus: an analysis of the impact of the resolution methodology on stakeholders' claims including the emergency liquidity assistance' (2013) Capital Markets Law Journal 8(4) 450–463, 453.
[95] Campbell and Moffatt (n 32).

Compensation Scheme that safeguards deposits up to £85.000.[96] The Cypriot government did not contemplate the breadth of implications that this proposal could have had as it would have gone against the Cypriot depositor protection scheme. This was in accordance with the European Union Deposit Guarantee Schemes Directives. Directive 94/19/EC that was amended by Directive 2009/14/EC. There was criticism all over the EU on disregarding the Directive and that the outcome of these negotiations undermined the whole banking market of the EU.[97] These developments had as a result the fear that there would be deposit runs[98] – especially by the large depositors who would want to find a safe space for their money[99] – hence, the corollary was the introduction of capital controls.

5.3 The effect of capital controls

The measures taken to rescue the banks required intervention to avoid the runs on bank deposits that would further devastate them. This had as a result the initiation of several capital controls through The Enforcement of Restrictive Measures on Transactions in case of Emergency Law of 2013, Law 12(I) of 2013. These capital controls included amongst other things, the limit of withdrawing €300 cash per day, to not spend more than €2000 per day, the exportation of money abroad that had as a purpose an investment was restricted and the Central Bank of Cyprus had to grant their approval for transferring money beyond €5000.[100] Cyprus is the first Eurozone country that enforced capital controls, which was quite strict for a country that small.[101] The intentions were genuinely for safeguarding the banks but, this ultimately had some other consequences. Investments were vastly affected as the capital controls in Cyprus lasted for two years.

It is sensible to presume that anyone with large deposits would pursue to find a safe place for their money. If this had happened as a consequence of the measures that were taken to deal with the crisis, the injection of €10 billion to recapitalise the banking system would

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[96] Bank of England, ‘ Financial Services Compensation Scheme’ <https://www.bankofengland.co.uk/prudential-regulation/authorisations/financial-services-compensation-scheme#:~:text=Amounts%20of%20compensation%3A%20deposits,-Customer%20deposits%20held&text=The%20deposit%20protection%20limit%20applies,to%20two%20times%20%C2%A385%2C000.> accessed 13 April 2022.
[97] Niall Lenihan, ‘How Has the EU Protected Depositors in the Financial Crisis?’ Cambridge Yearbook of (2014) 16 European Legal Studies 289 – 312, 304.
[98] Andrew Campbell, Peter Cartwright, *Banks in Crisis* (Ashgate 2001) 193.
[99] Ibid.
[100] Brown, Demetriou and Theodossiou (n 75) 8.
[101] Ibid; Matthew Klein ‘How did Cypriots respond to the 2013 banking crisis?’ 20 March 20218 <https://www.ft.com/content/6c337371-0c34-38f4-9330-2ac88c0b7ce2> accessed 12 April 2022.

have been futile as without those deposits, the banking system would have collapsed in its totality. As such, capital controls were the necessary evil to keep BOC and the country going. These measures lasted for approximately two years that caused further implications to the Cypriot economy. Iceland was another country that applied capital controls in 2008 when the country was in distress. Danielson and Arnason described these measures as draconian as they violate civil rights and disturb national economic growth.[102]

These measures were introduced to avoid the destruction of the economy, but they do not come without consequences. Danielson shows his disapproval towards capital controls as he stated that capital controls are desperate measures that result from the loss of control of the national public authorities.[103] He also added that anyone who has massive bank deposits will find a way to take the money out of the country even if the route is not entirely legal.[104] The effects of capital controls include the deterioration of trust of national and international investors, increased risks regarding taking loans and investments and also the society loses its confidence in the system as they feel that their rights have been violated.[105] There have been debates on whether capital controls are legal.[106] There have been discussions of whether it comes into conflict with the fundamental principle of free movement of capital in the EU.[107] Article 65 clarifies that Member States of the EU are allowed "to take measures which are justified on grounds of public policy or public security". That said, Cyprus can enforce this to justify the legality of capital controls. As the trust on the banking system had almost vanished with the unorthodox bail-in tool, further safeguards for it to operate more effectively were necessary. This had as a result the disruption of the real economy,[108] which became more acute with their continuation for two years.

5.4 Judicial actions that followed the initiation of the bail-in tool

[102] Jon Danielsson, Ragnar Arnason 'Capital controls are exactly wrong for Iceland' 14 November 2011 <https://voxeu.org/article/iceland-and-imf-why-capital-controls-are-entirely-wrong> accessed 12 April 2022.
[103] Jon Danielsson, 'The capital controls in Cyprus and the Icelandic experience' 28 March 2013 <https://voxeu.org/article/capital-controls-cyprus-and-icelandic-experience> accessed 12 April 2022.
[104] Ibid.
[105] Ibid.
[106] Frances Coppola 'Capital Controls in the Eurozone: Restricting International Trade to Preserve It' 24 June 2019 <https://www.americanexpress.com/en-gb/business/trends-and-insights/articles/capital-controls-in-the-eurozone/> accessed 12 April 2022.
[107] Treaty on the Functioning of the European Union (TFEU), Article 63; Martin Sandbu 'Legal debate over Cyprus capital controls' 25 March 2013 <https://www.ft.com/content/a723d6e4-955a-11e2-a151-00144feabdc0> accessed 12 April 2022.
[108] Alexander Apostolides, 'Beware of German gifts near elections: how Cyprus got here and why it is currently more out than in the Eurozone' (2013) 8(3) Capital Markets Law Journal 300-318.

Another consequence of the bail-in was the commencement of several national judicial actions as well as EU judiciary actions. These actions challenged the legality of bail-ins through arguing that it went against particular domestic and EU norms. None of the actions have been successful either for technical reasons or due to the fact that these measures were necessary to avert a sovereign default.

The domestic actions heard by the Supreme Court of Cyprus focused on requesting the annulment of Decrees 103 and 104 that triggered the resolution measures on both Laiki and BoC.[109] The cases argued that the decrees should be annulled for certain reasons that included the infringement of property rights[110] and that decrees impinge the principle of non-discrimination and equal treatment.[111] The Supreme Court held that this was not a public matter since the depositors that lost part of their deposits could not directly challenge those decrees. In other words, the decrees were directed at Laiki and BoC which meant that a judicial review claim could only be brought by the banks and not individuals. As such, the Supreme Court directed the applicants to bring an action under private law rather than public law as their application did not fall within the spectrum of judicial review.[112]

A group of depositors brought actions to the General Court (GC) of the EU. In *Mallis v European Commission,*[113] the action targeted the annulment of the Eurogroup's decision on the 25th March 2013 and in *Ledra Advertising Ltd v European Commission,*[114] it was argued that some provisions regarding the bail-in in the Memorandum of Understanding (MoU) should be annulled.[115] They also claimed compensation for the losses that the depositors faced, which were caused by the bail-in. The applicants of *Ledra* requested compensation that equalled their losses from the bail-in. As the applicants believed that there was a breach of primary EU Law, they tried to rely on Articles 263, 268 and 340, TFEU. Breach of the right of property was one of the main arguments used. In *Mallis* the applicants argued that the decision of the Eurogroup was in reality of the Commission's and the European Central Bank's (ECB). The GC held that

[109] Supreme Court of Cyprus 07/06/2013, Case No. 553/2013: *Myrto Christodoulou and Others v Kentriki Trapeza Kyprou and Others a.o.*; Supreme Court of Cyprus 09/10/2014, Case No. 1034/2013: *Vias Dimitriou and Others v Kentrikis Trapezas Kyprou and Others).*

[110] Constitution of Cyprus, Article 23.

[111] Constitution of Cyprus, Article 28.

[112] For a criticism of the Supreme Court's decision see: Jenny Giotaki, 'The Cypriot "bail-in litigation": a first assessment of the ruling of the Supreme Court of Cyprus' (2013) 8 JIBFL 485.

[113] (C-105/15 P) EU:C:2016:702; [2017] 1 C.M.L.R. 36.

[114] (C-8/15 P) EU:C:2016:701; [2017] 1 C.M.L.R. 35.

[115] Ibid para 24.

the Commission and the ECB were not allowed to enforce their decisions at the Eurogroup. As a result, the *Mallis* case was dismissed.

The GC clarified that the MoU was incorporated by the European Stability Mechanism (ESM) and Cyprus and not by the Commission. The MoU was signed by the president of the Commission but on behalf of the ESM and not of the Commission. The action of Ledra to the GC was based on the lawfulness of the MoU, which meant that they did not have the jurisdiction to annul any of its provisions since the ESM or Cyprus were not an institution, body, office or agency in accordance with Article 263(1), TFEU. They also added that it was the decrees that triggered the bail-in and not the MoU, which are subject to domestic law and not EU law.[116]

Both *Mallis* and *Ledra* went to the Court of Justice of the European Union (CJEU). In *Mallis* the applicants adhered to their argument about the admissibility of the Eurogroup. The CJEU agreed with the GC by stating that the role of Commission and ECB at the Eurogroup was merely informative. The applicants further argued that the Eurogroup's decision was ultra vires and that it infringed the right of property. The CJEU rejected this since the Eurogroup was not within the definition of an EU body under Article 263, TFEU and they also clarified that the Eurogroup and the Council of Ministers were completely separate.[117] In *Ledra* the applicants were not just restricted under a judicial review under Article 263, TFEU as they sought damages from the Commission and ECB under Articles 268 and 340, TFEU. To answer whether damages should be given under Article 340, TFEU, the CJEU had to conclude whether the bail-in was lawful. The GC rejected the claim under Article 340 TFEU, but the CJEU dealt with it differently.

The CJEU accepted that the bail-in breached the applicants' right of property. These issues invariably infringe property rights, and this would be permissible as long as it they are proportionate or justifiable in the sense that there were no alternative measures to achieve the intended policy objective. The rules of the game change when in a distressed scenario could be in itself a justification.[118] The most important part of the decision was the following: "In view of the objective of ensuring the stability of the banking system in the euro area, and having regard to the imminent risk of financial losses to which depositors with the two banks

[116] Ibid paras 57-58.
[117] In their decision they applied the logic from the *Thomas Pringle v Government of Ireland and Others* (C-370/12) ECLI:EU:C:2012:756.
[118] Charter of Fundamental Rights of the European Union (2010/ C 83/02) OJ EU 30.3.2010 C83/389, Article 52.

concerned would have been exposed if the latter had failed, such measures do not constitute a disproportionate and intolerable interference impairing the very substance of the appellants' right to property. Consequently, they cannot be regarded as unjustified restrictions on that right."[119] The CJEU indicates that even though the bail-in breaches some fundamental rights provided by the EU legislation, it is justifiable as it safeguards the public through preserving the stability of banks. The assumption that the depositors would have been in a worse position if both banks were liquidated is questionable though as the 'no creditor worse off' has not substantially been explored by the case.[120] However, in practice it could have been problematic to predict the consequences for creditors in a hypothetical scenario. As the only option at the time was the normal liquidation procedure, the CJEU would have to evaluate the outcome for creditors if that route was followed. This might have not been appropriate for the CJEU to address as the conclusions would largely be based on mathematical and economic scenarios that are normally not within the expertise of the judiciary.[121]

6. BRRD and the effects of bail-in

As there was a crisis in several EU Member States, the introduction of harmonised bank resolution tools was going to help with addressing the flaws of previous regimes. The purpose of the BRRD was to circumvent spill-overs all over the EU, to enhance market discipline, reduce the need for governmental bailouts and to decrease moral hazard.[122] Early intervention and resolution are key aspects behind the initiation of the BRRD toolkit. The toolkit does not only facilitate the continuance of the financial institution as a going concern but also ensures that the institution is liquidated in a methodical manner.[123] To initiate any of the resolution tools, there should be a public interest concern.[124] If the financial institution is not systemic, normal insolvency procedures will apply instead of the resolution tools.[125] A key consideration

[119] *Ledra*, para 74.
[120] Mikaella Yiatrou, 'The Myth of Cypriot Bank Resolution 'Success': A Plea for a More Holistic and Less Costly Supervision & Resolution Approach' (2017) 18(3) European Busines Organisation Law Review 503-533.
[121] Napoleon Xanthoulis, 'ESM, Union Institutions and EU Treaties: A Symbiotic Relation' (2017) 1 International Journal for Financial Services 21-33.
[122] Michael Schillig, *Resolution and insolvency of banks and financial institutions* (OUP 2016) 54-55.
[123] BRRD, Recitals 5-14.
[124] BRRD, Article 32(1)(c); Resolution Law 2016, Article 42(1)(c).
[125] BRRD, Articles 31, 32(5); Single Resolution Mechanism Regulation, Article 18(5); Resolution Law 2016, Article 42(3).

is that shareholders and creditors should be in a better position under a resolution rather than in a direct liquidation or another insolvency procedure.

The resolution authority – which is CBC in Cyprus – is required to evaluate whether the financial institution is in a non-viability state. An independent evaluator is appointed to aid the resolution authority, who needs to consider the following important points: (1) establish when it is best to intervene to facilitate the reduction of possible losses; (2) ensure that creditors will be in a better position than in liquidation; (3) consider the priority claims;[126] (4) make sure that the financial institution value is maintained.

The resolution toolkit is (a) the sale of business tool;(b) the bridge institution tool; (c) the asset separation tool and (d) the bail-in tool. The first three were traditionally used in the past even though the BRRD was not in force. For the resolution of the Cypriot banks all the aforementioned tools were used with the true innovation being the bail-in tool, which is the reason that this section is focusing on the bail-in tool. To gain some context on the resolution tool, the first three tools are briefly discussed.

For the sale of business tool, there is a transfer of ownership, assets and liabilities of the financial institutions to a purchaser.[127] The sale consists of a valuation and a conduct of a marketing process that includes the assets, rights and liabilities of the institution. The consent of shareholders is not required, which makes the process quicker. At the same time, the interests of the shareholders need to be considered. Through a bridge institution tool, a bridge bank absorbs the critical functions of the distressed financial institution.[128] The resolution authority bears the responsibility of deciding whether a bridge bank should be formed without the necessity of having shareholder consent. The bridge bank will consequently be merged with another bank through the usage of the sale of business tool. Therefore, the bridge bank vanishes after the sale is formulated. From the perspective of Cyprus, the bridge bank was the ‘good’ bank of Laiki that ceased to exist after it was merged with BoC. The asset separation tool has the power of dividing assets, rights or liabilities of the institution to either resolution or bridge bank or to other asset management vehicles.[129] This means that this tool separates non-viable assets and liabilities from the viable ones. Again, an equivalent tool was used in Cyprus to

[126] BRRD, Article 36(8); Resolution Law 2016, Article 47(8)(a).
[127] BRRD, Article 38(1); Resolution Law 2016, Article 48.
[128] BRRD, Article 40; Resolution Law 2016, Article 50.
[129] BRRD, Article 42; Resolution Law 2016, Article 52.

divide Laiki into a ‘good’ and ‘bad’ bank. These three tools have been in place for a long time, and they do not carry any controversial features like the bail-in tool.

Having already discussed aspects of the bail-in tool throughout this chapter, this section focuses on criticising further this tool. To recap some of its main components, the way to achieve its purpose is through recapitalising the financial institution internally. The bail-in tool and the BRRD more generally, target to ensure financial stability and to gain confidence in the banking sector through considering the possible effects on the society when a banking crisis emerges.[130] Huertas characterised bail-in as “a heart transplant” because it is equivalent to putting a new heart in a body where its heart is shutting down.[131] This will carry the possibility of rejecting the transplant, which means that even if everything is correctly applied there is still a chance of failure.

Bail-in allows the write-down of equity and debt instruments as well as the conversion of debt instruments into equity.[132] The legislation prohibits the bail-in of deposits protected under the Deposit Guarantee Scheme.[133] A further criticism on the resolution of banks in Cyprus was that pension scheme accounts were either wiped-out if they belonged to Laiki or bailed-in if they were in BoC. Consequently, the population’s trust and confidence in the banking system was further disintegrated. The BRRD attempts to deal with this through giving the discretion to the resolution authorities to decide the type of deposits that they would allow to be bailed-in.[134]

The thinking behind the bail-in was to circumvent a contagion and they also argued that depositors received a better outcome than if the banks were directly liquidated. The BRRD conveys that the BRRD tools are prioritised over governmental assistance, that should be a measure of last resort. As such, bail-in and the other resolution tools are capable of dealing with the moral hazard that has been caused by the perception of too-big-to-fail.[135] The tools aid the bank to liquidate without the need for a bail-out. If bail-out was the first line of defence, the taxpayer would have paid the price through further austerity measures.

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[130] Andromachi Georgosouli, ‘The transnational governance of bank resolution and the treatment of national regulatory variation in the E’ (2021) C.L.J. 80(1) 74-100, 75.
[131] Thomas Huertas, ‘Necessary but not sufficient: stay upon resolution via bail-in’ (2020) 4 JIBFL 235.
[132] BRRD 43(2)(a) and (b); Resolution Law 2016, Article 53(1)(a) and (b).
[133] BRRD 44(2)(a)-(g); Resolution Law 2016, Article 54(2)(a)-(g).
[134] BRRD 44(3); Resolution Law 2016, Article 54(6).
[135] Emilios Avgouleas, Charles Goodhart, ‘Critical Reflections on Bank Bail-ins’ (2015) Journal of Financial Regulation 1, 3–29.

Early intervention is key to applying bail-in effectively as a lesser amount will need to be bailed-in to recapitalise the bank. As such, as the exposure of depositors and other creditors will not be extensive, a knock-on effect is averted. With early intervention, the value of the assets of the bank are retained to an extent, which signals that the no creditor worse off principle is sufficiently applied and not breached, since when a bank is extensively deteriorated its value is reduced even further.[136] There will be an outcry when applying such a tool very early, but if the application is structured and methodical, contagion risks may be reduced. This is where the Cypriot case departs from this as early intervention was not the case when contemplating that Cyprus asked for financial assistance in mid-2012. By the time Cyprus requested that, the banks were already in a deteriorating state. There was procrastination involved and a moral hazard, which delayed a resolution. The BRRD and subsequently the Resolution Law 2016, dealt with this through officially incorporating an article that has as a requirement of early intervention.[137] Early intervention is also essential for reducing the costs of the resolution or liquidation. There could be a drawback to this as the resolution could be accessed too early therefore, the resolution authority should be cautious about this. This is the thinking behind the temporary appointment of an administrator to determine whether a resolution is compatible with the circumstances.[138]

7. Conclusions: Lessons learnt from Cyprus

The number of NPLs – that went out of control a few years before the bank resolution occurred – had an input towards the further deterioration of the banks as they were a burden to the banks' balance sheet. It is important to create a system in which NPLs are restricted from increasing. The authorisation of loans in Cyprus used to be very flexible as simple guarantees or assets that were already collateralised were enough. Currently the regulations regarding the obtaining of loans are stringent, which is disincentivising investment that could have a negative impact on the economy. The ideal would be to identify the golden mean as too flexible or too strict are both not desirable. Introducing procedures that are working effectively can also motivate debtors to keep up with their repayments.

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[136] This is further supported in Regulation 806/2014 Article 15(1)(g); See also the following: J. Doyne Farmer, Charles Goodhart, Alissa Kleinnijenhuis, 'The current bail-in design does not resolve the too-big-to-fail problem' 01 October 2021 < https://voxeu.org/article/current-bail-design-does-not-resolve-too-big-fail-problem> accessed 12 April 2022.

[137] BRRD, Article 27; Resolution Law 2016, Articles 23-29.

[138] BRRD, Article 29; Resolution Law 2016, Articles 46 (called special administrator by this legislation).

As a result of the bail-in tool in Cyprus, the lack of confidence was widespread throughout Europe. Investments were gravely affected after the shock of the bail-in tool, and there was the near collapse of the Euro currency in Cyprus, which could have led to the exit from the EU and there were capital controls in place for approximately two years.[139] There were other factors that affected the trust of depositors with the bail-in being the strongest one.

Bail-in should not be treated as a panacea since its role is to deal with financial institutions after distress had occurred rather than avert it. The purpose of the existence of the bail-in tool and the other resolution tools cannot be neglected as the too-big-to-fail perception is a main factor for the distress of most systemic banks. As a result, the resolution tools can restore the balance of the market since it motivates creditors to initiate a monitoring function.[140] The reduction of the need for state aid was spread in the Eurozone after the Cypriot crisis as well as the initiation of the BRRD. A caveat is that bail-ins do not completely evaporate the need for a bail-out.

Lessons learnt from the CJEU decisions is that the implementation of the bail-in tool needs to be proportional as it breaches property and equality rights. This means that the bail-in should only be available if it is in the interests of the public. The alternative would be to use the normal insolvency procedures rather than the resolution tools. Therefore, the resolution tools cannot be extended as it would be in breach with property rights.[141] Schillig argues that the resolution tools should not be *ultima ratio* by stating: "if the default option is likely to be unsuccessful – in other words, less effective for achieving the legitimate aim of protecting depositors – why retain it at all?". Schillig further suggests that through removing the need for public interest, investment will be encouraged, prices will be fixed and there will be more certainty to the system in which creditors would benefit from.

The hardest part would be to convince the public that the effects of the bail-in can have positive effects and not to make them lose trust in the system. Evidence has been produced that under certain circumstances the bail-in can work and it is also producing optimistic results only through its existence. There was a chaotic implementation of the bail-in tool in Cyprus but, against all odds it did aid BoC to overcome its difficulties. If it was applied earlier, then the position of both Laiki and BoC could have been more favourable. The important issue is to

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[139] Brown, Demetriou and Theodossiou (n 75).
[140] Avgouleas and Goodhart (129).
[141] Michael Schillig, 'EU bank insolvency law harmonisation: What next?' (2021) International Insolvency Review 1-28, 13-15.

keep the banking system credible and effective thus, be cautious about the extension of the resolution tools in general.