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Cypriot Banking System: At the Point of No Return

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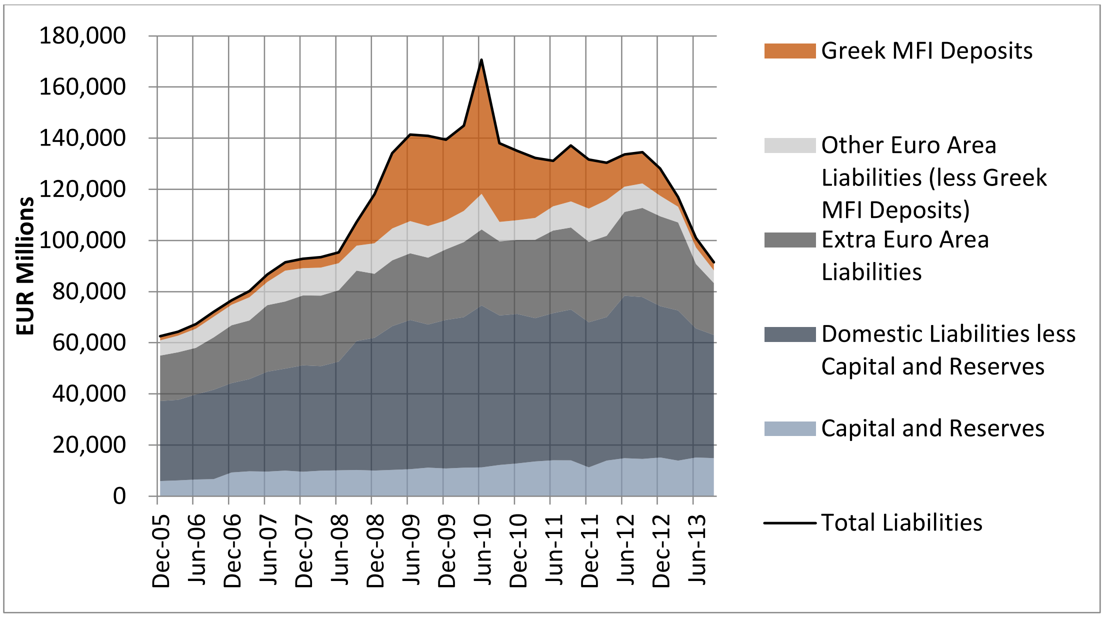
Entry into the EMU in 2008 followed by the Eurozone crisis after 2010 laid the ground for the Cypriot banking crisis. Euro entry facilitated a vast inflow of funds, above all from Greek banks as they absorbed increased flows from banks of the Eurozone core. This soon turned to bust as the Eurozone crisis took hold: Cypriot banks made catastrophic losses on Greek Government Bonds and as funds fled from Greece, Greek deposits fled from Cyprus. Figure 1 shows that domestic balances of Cypriot banks as well deposits from outside the Eurozone began react late in 2012, only after the banks had registered losses on Greek assets. The rest of this note looks more closely at developments in late 2012 and in 2013.

Figure 1 Cypriot Bank Liabilities - cumulative (Dec 2005 – Sept 2013)

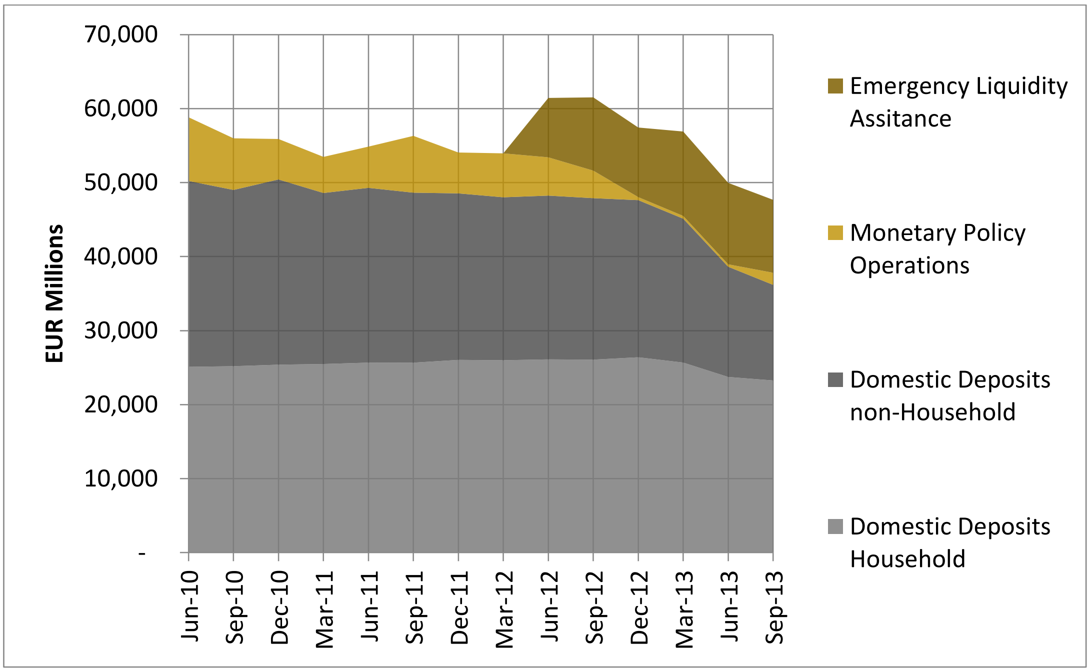


Source: Author calculations from Central Bank of Cyprus and ECB data

Domestic liabilities are the most significant group of liabilities for Cypriot banks as Figure 1 shows. They are also perhaps the most complex. As is shown in Figure 2, following the write down in Greek Government Bonds (after March 2012) the first significant change in domestic liabilities was actually an increase. This came about thanks to the provision of 8bn EUR of Emergency Liquidity Assistance (ELA) by the central bank between March and June 2012 (Figure 2 & Figure 3). It is worth noting that the balance of Greek securities also increased by 1.6bn EUR during the same period – it is not unlikely that Cypriot banks, at least in the first instance, invested ELA funds in Greek Government Bonds.

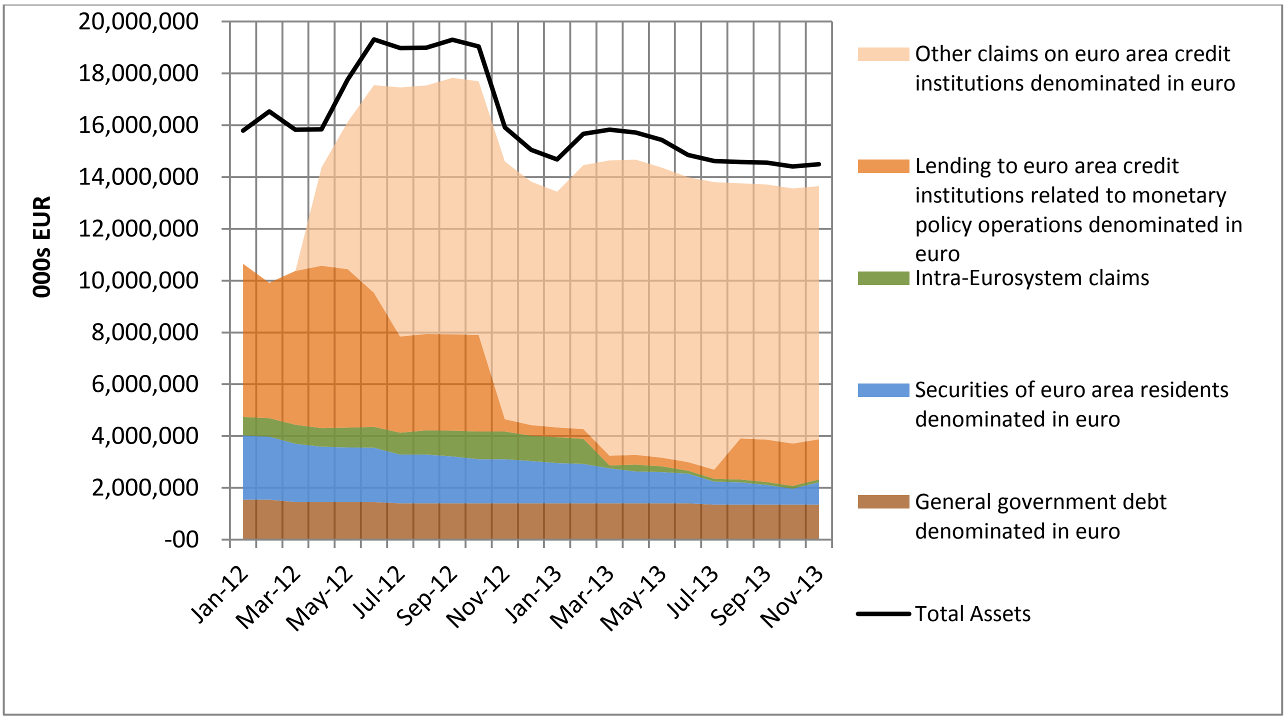
The subsequent collapse in domestic and indeed in overall Cypriot bank liabilities actually began in November 2012 with a withdrawal of liquidity by the central bank that reached almost 4bn EUR between Sept and Dec 2012 (Figure 2 & Figure 3). It is only in the first quarter of 2013 that domestic deposits finally cracked and started to fall. The decline accelerated in the second quarter of 2013 after the intervention of the troika in March 2013. Among domestic deposits the share of firms had been falling since 2010; firm deposits fell faster than household deposits after the troika's intervention (Figure 2).

Figure 2 Domestic liabilities – cumulative (June 2010 – Sept 2013)



Source: Author calculations from Central Bank of Cyprus and ECB data

Figure 3 Selected Central Bank Assets

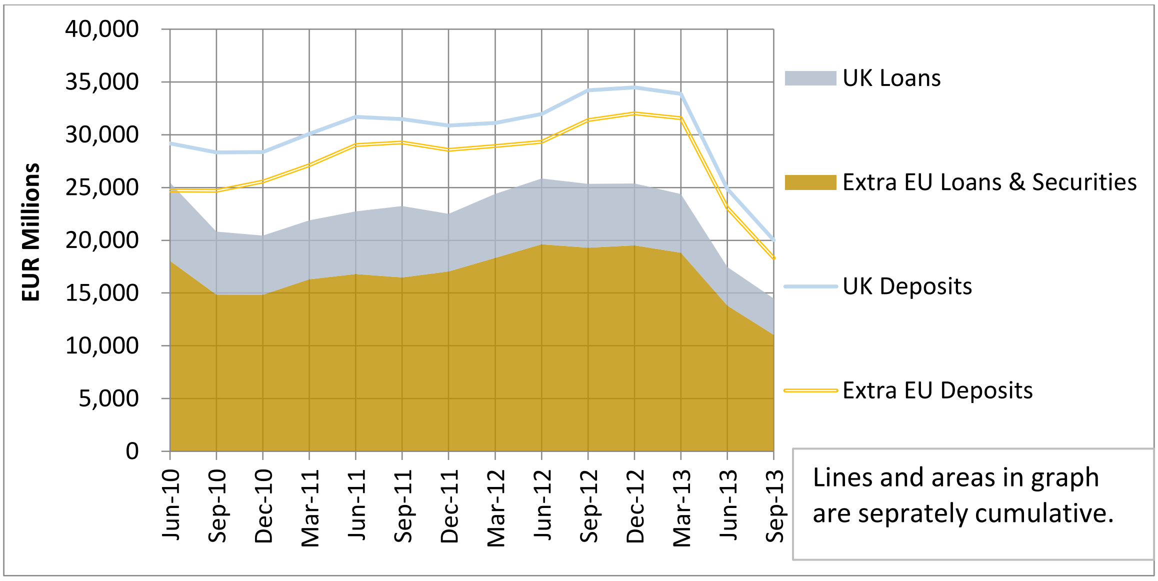


Source: Author calculations from Central Bank of Cyprus and ECB data

Thus, the decisive event in the unfolding of the crisis was actually the "rescue" put together the troika of the EU Commission, the ECB and the IMF. By now it is well documented that this was a bungled affair, above all, due to the initial proposal to "tax" all depositors which served only to further undermine confidence in Cypriot banks. This proposal was eventually rejected to be replaced with a milder version, which also involved the winding up of Laiki bank. A consequence of that has been to concentrate around 50% of Cyprus' banking in one bank, the Bank of Cyprus.

Finally, liability holders from outside the Eurozone, including of course Russian depositors, proved the most resilient of all. Deposits from outside the Eurozone began to fall only *after* the troika's intervention (Figure 4 below). Indeed extra-EU area deposits continued to grow as late as Dec 2012. It is only with the disastrous tax on depositors agreed upon in March 2013 that this group has the value of its deposits cut and subsequently flees, in spite of capital controls.

Figure 4 Extra Euro Area liabilities (June 2010 - Sept 2013)



Source: Author calculations from Central Bank of Cyprus and ECB data

To sum up, the worst phase of the Cypriot banking crisis sprang out of losses on Greek Government Bonds, the associated loss of liquidity from Greek banks and the subsequent extension of ELA. The sequence of crisis then appeared to be: (i) withdrawal of Central Bank of Cyprus liquidity, (ii) loss of confidence by domestic depositors, (iii) bungled intervention by the troika, (iv) loss of confidence by extra-Eurozone depositors. It seems clear that, far from helping an already difficult situation, official intervention by the Troika provoked an exacerbation of the crisis.

Where have these developments left Cypriot banking as we enter 2014? Before the adoption of the euro the most important clients of Cypriot banks were domestic and extra-Euro clients, with other Euro area depositors a poor third, as was shown in Figure 1. Well, that situation has returned today, following the intervention by the troika.

The latest data suggests that capital controls have succeeded in slowing down the outflow of deposits. However, it remains hard to predict how Russian and other extra-EU depositors will react if and when capital controls are lifted. It would not be at all surprising if Cyprus's offshore banking industry has been permanently damaged by the EU's bungled crisis management. In this case it is reasonable to expect that extra-Eurozone balances will dwindle to insignificance. On the other hand, one consequence, (presumably unintended) of the depositor bail-in was to make Russians important shareholders in Cypriot banks. They are important enough, for example, for 6 of 16 board members of Bank of Cyprus are Russian.[1] Moreover, whether offshore banking continues to be important will also depend on events outside Cyprus and beyond Cypriot control.

Domestic banking also looks set to shrink as the deep recession leads to losses on domestic lending. The resultant restriction of bank credit will further harm the wider economy, and thus bank's assets. Deposits are still shrinking despite restrictions, not least as loans are repaid and the economy de-leverages. In addition the rescue package has left Cypriot banking highly concentrated with 50% of banking in the hands of Bank of Cyprus and the rest mostly divided between a handful of commercial banks and the co-operative sector, itself undergoing restructuring and concentration.

Finally, it is hard to see how central bank liquidity support can be removed under the current circumstances. Given the current trend of banks de-leveraging, central bank liquidity looks set to become a relatively larger part of banks' balance sheets.

It seems clear that Cypriot banking cannot easily - or even at all - return to what it was prior to the country's disastrous entry into the EMU. Once the wreckage stabilises, it is likely that, first, clients from the rest of the Eurozone will be unimportant, second, there will remain only a pale shadow of the previous offshore business and, third, the domestic banking sector will face prolonged domestic de-leveraging with increasing dependence on central bank liquidity. A banking system in such a state will not be able to support rapid economic recovery. This realisation should form the basis for economic policy and planning in the Cyprus.

[1] http://www.dw.de/russias-rich-dominate-cyprus-largest-bank/a-17146540