# Bailing-in depositors, the case of Cyprus


## Filip Keereman*

**DG ECFIN.E.2**


**High-Level Seminar on Bail-in and Deposit Insurance System Interaction**
**25-26 June 2014, Warsaw**

**Bank Guarantee Fund Poland, International Association of Deposit Insurers, National Bank of Poland**


*prepared with the help of Hana Genorio, James Hinton, Daniel Koerhuis, Rajko Vodovnik


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# Structure of presentation

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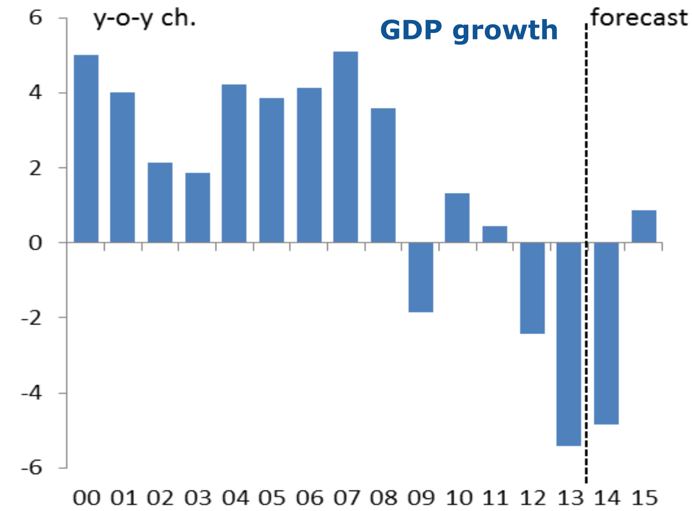
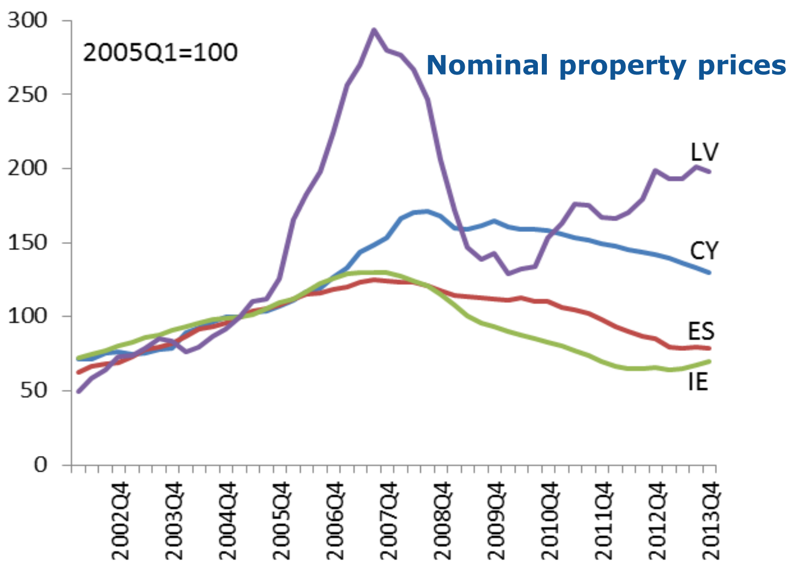
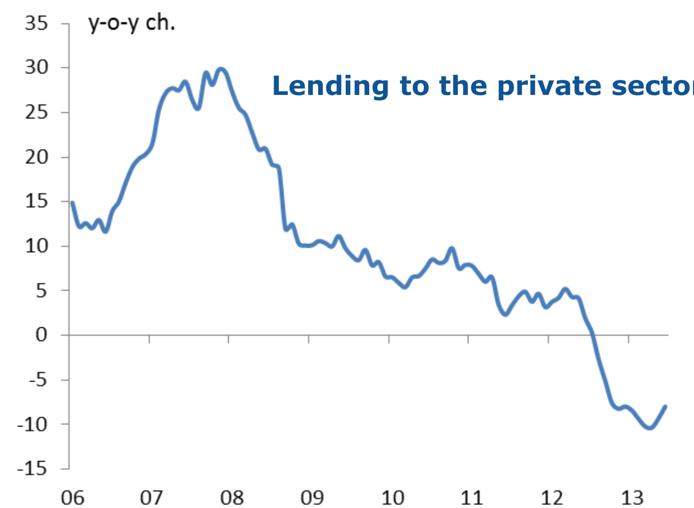
# Imbalances were building up

***Cyprus enjoyed strong growth until 2008, fuelled by a property boom and buoyant lending***

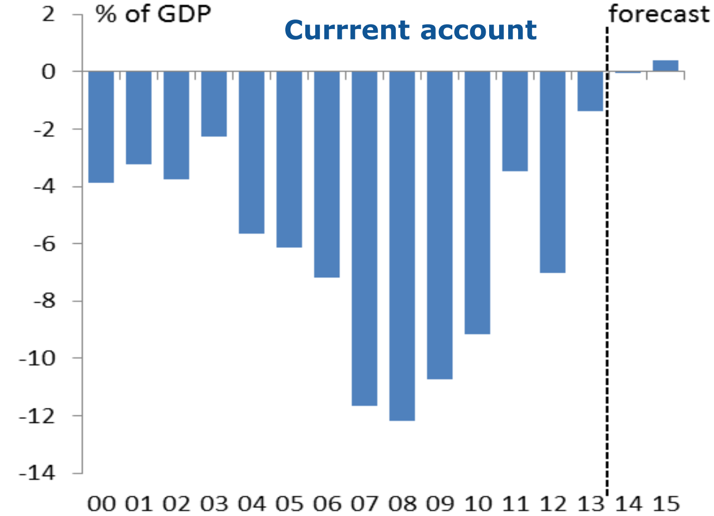


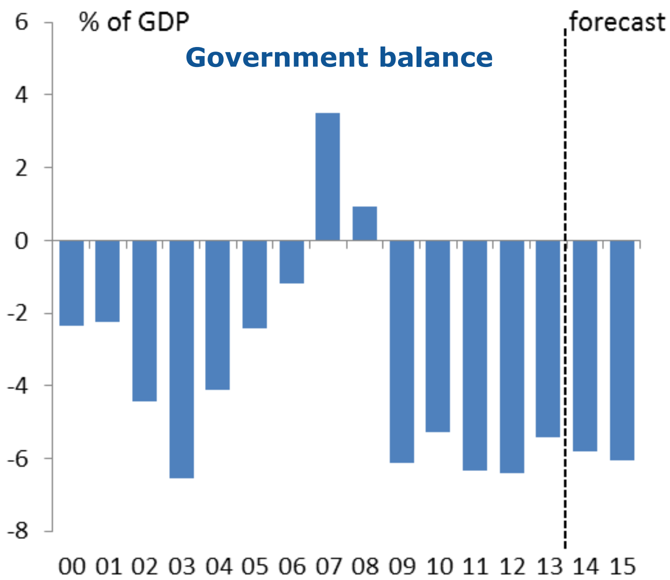



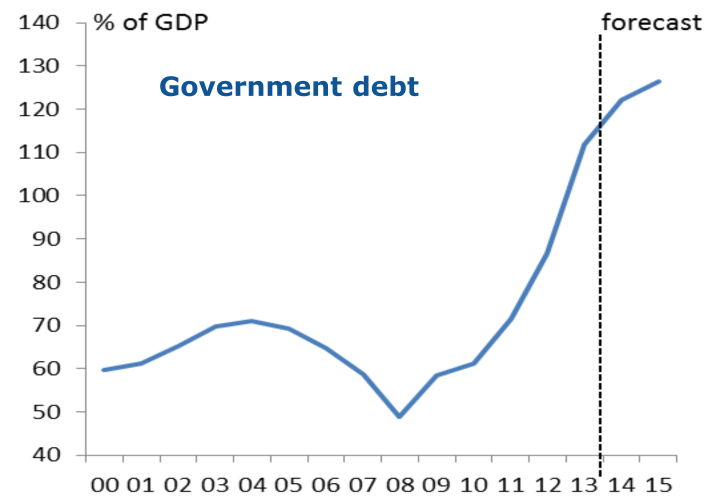



# Imbalances were building up

***The current account deteriorated sharply in 2008, the government deficit switched from surplus to deficit and public debt Jumped from below 50% of GDP in 2008 to 87% in 2012***



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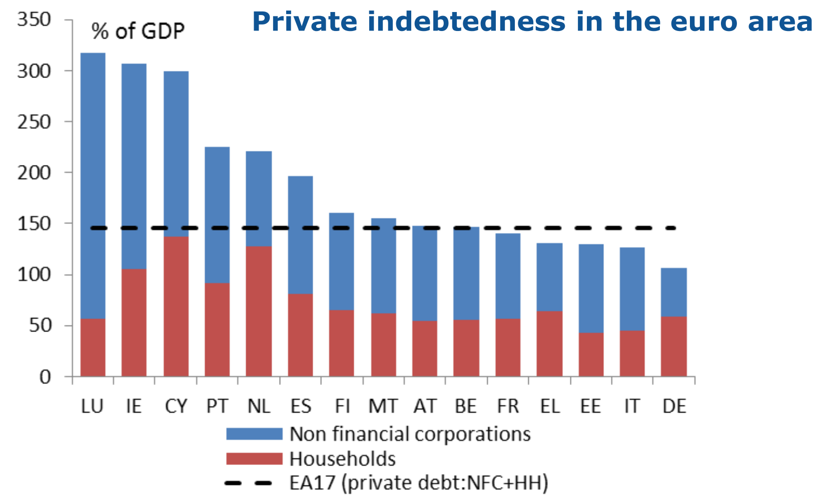
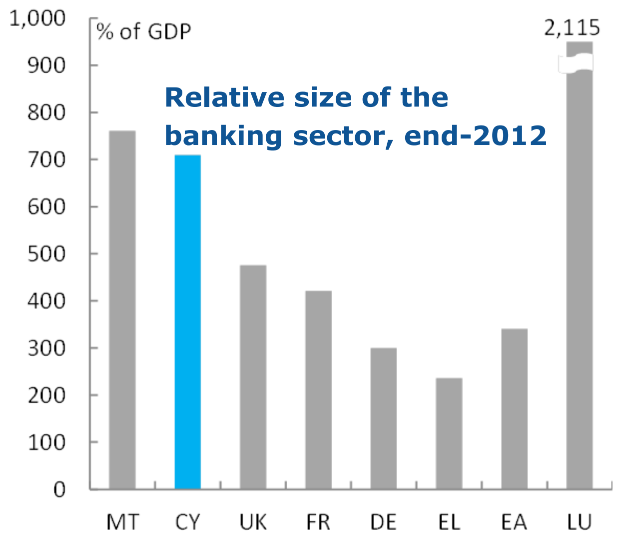
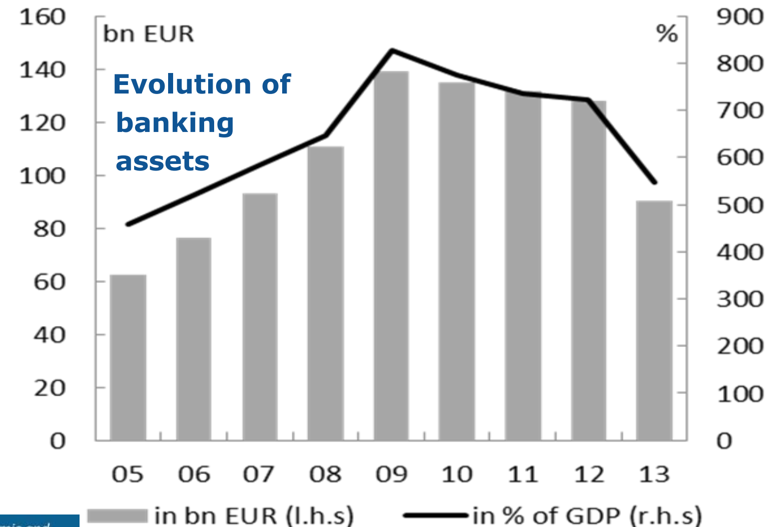
# Imbalances were building up

***High private indebtedness and an oversized banking sector (700% of GDP in 2012)***

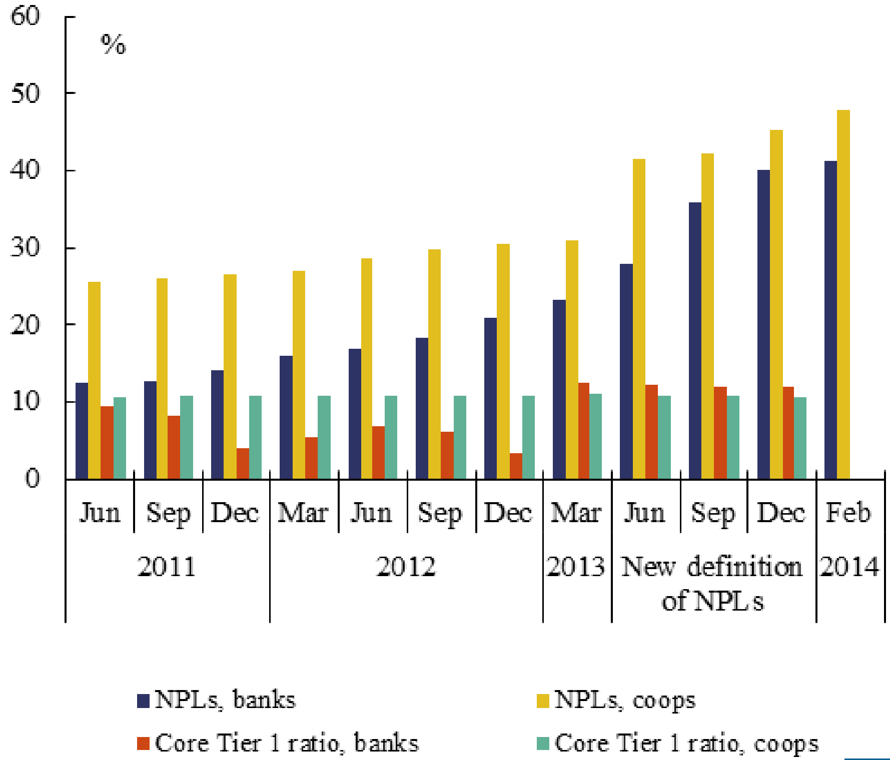


# Several weaknesses in the financial sector

*Financial stability indicators*

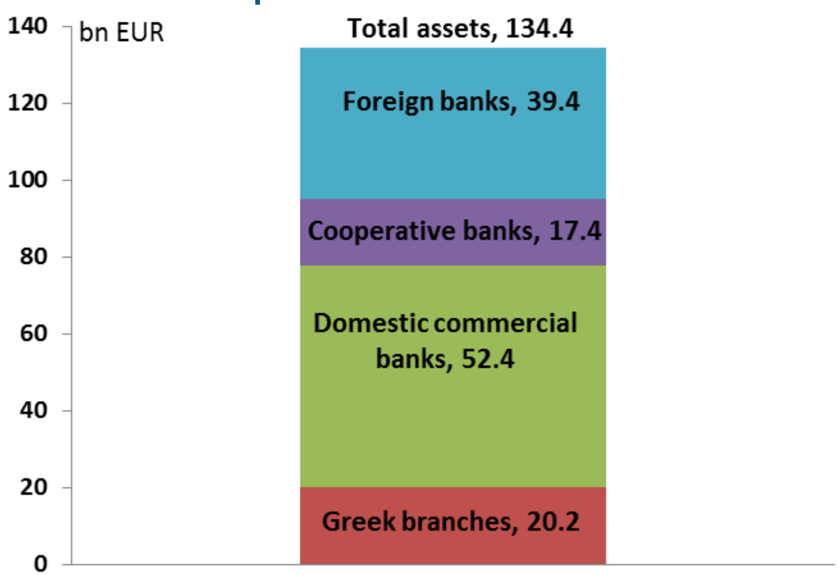



- **Average NPL ratio at 25% in 2012, increased to close to 50% in 2014**
- **Loan portfolio in Greece (EUR 19 bn, 111% of GDP) suffering from a NPL ratio at 42%**
- **Declining coverage ratio from around 70% to 50%**
- **Exposure to Greek government (EUR 5 bn, 30% of GDP, 74% haircut in PSI)**
- **big losses (EUR 5 bn in 2011)**
- **Core tier 1 ratio below the regulatory minimum (8%) in December 2012**
- **Loopholes in prudential oversight**

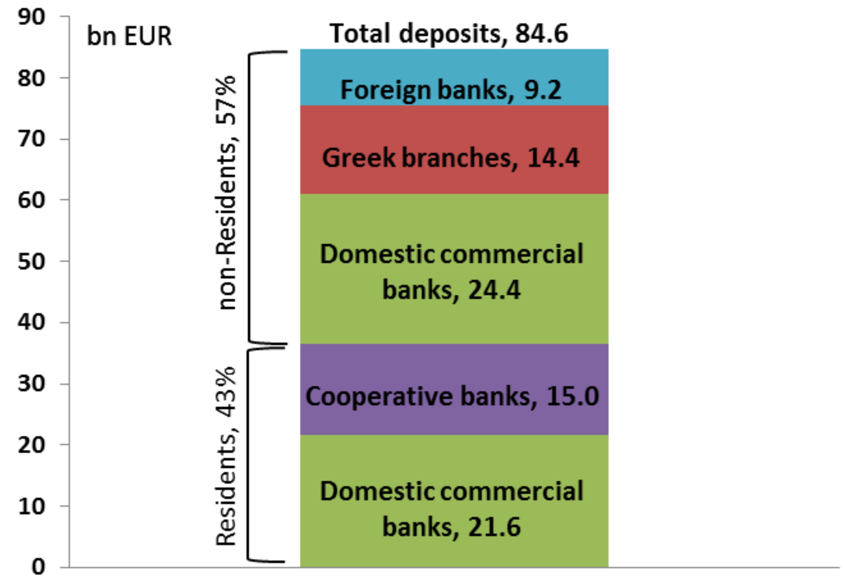
# Several weaknesses in the financial sector

**A complex bank structure, with 3 distinct segments posing each specific problems (end-2012)**

- **Foreign subsidaries (mainly Greek) and branches with few links to domestic economy**
- **Cooperative banks with 95 affiliated to Central Coop. Bank and one independent (Limasol); CYGGG (EUR 2bn); separate supervisor**
- **Commercial banks (BoC, CPB, HB): systemic in CY and EL (through the branches) and strong international expansion**




**Deposits an important funding source with a large contribution from non-residents attracted by a favourable tax regime and high deposit rates, making the deposit base sensitive to the international investor climate**



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I. Background: why did we end up with a programme ?

**II. Addressing the challenges in the financial sector**

III. Debt sustainability and minimising the cost for the tax payer

IV. The determination of the bailinable deposits

V. Administrative measures to maintain liquidity

VI. Concluding remarks

Annex

# A comprehensive programme for addressing the challenges in the financial sector

## I. Resolution, restructuring, recapitalisation

1. Debt sustainability and mininimising the cost for the tax payer: bailing-in depositors
2. Downsizing the banking sector: resolution of Laiki and Bank of Cyprus and carving out the Greek assets
3. Restructuring and recapitalisation of Hellenic Bank
4. Restructuring and recapitalisation of cooperative banks

## II. Maintaining liquidity: capital controls

## III. Regulation and supervision

1. Strengthening regulation
2. Strengthening supervision
3. Monitoring corporate and household debt
4. Increasing financial transparency

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remainder of the presentation

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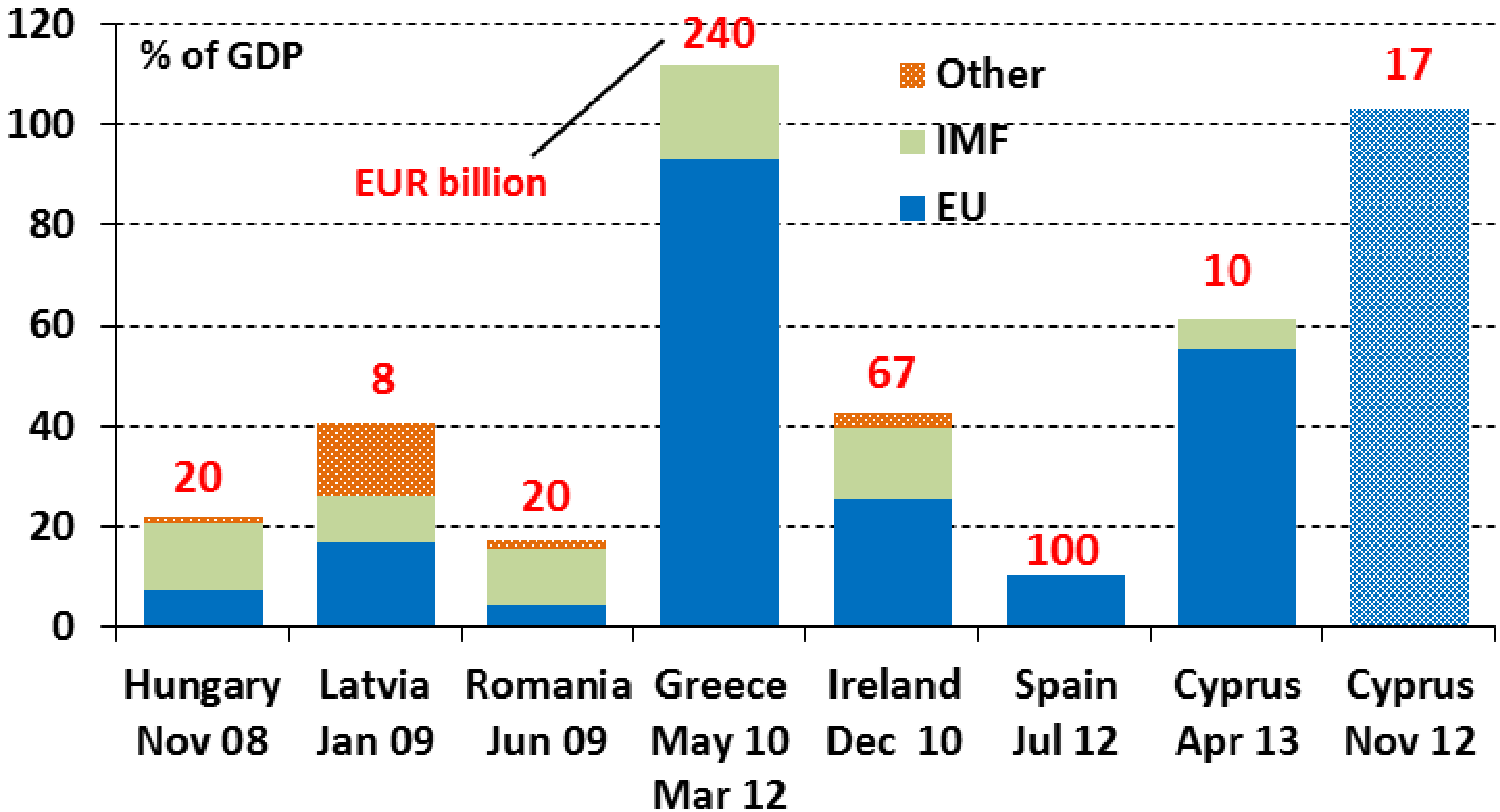
# From programme money over deposit levy to bailing-in depositors

| (EUR billion) | Aug-13 KPMG | Apr-13 MoU | Mar-13 1rst EG | Nov-12 PIMCO |
|---|---|---|---|---|
| **Fiscal needs** | **6.5** | **6.4** | **6.4** | **7.1** |
| Debt redemption | 3.8 | 5.2 | 5.2 | 5.2 |
| Deficit | 3.6 | 3.1 | 3.1 | 1.9 |
| Gold sales, privatization, domestic rollovers | -0.9 | -1.9 | -1.9 | 0.0 |
| **Financial sector needs** | **1.5** | **1.2** | **3.7** | **9.9** |
| Banks | 9.1 | 9.1 | 8.1 | 8.1 |
| CPB bond | 1.9 | 1.9 | 1.9 | 1.8 |
| Coops | 1.5 | 1.2 | 1.2 | 1.2 |
| Bail in | -9.1 | -9.1 | -1.7 | -1.2 |
| junior debt | -1.2 | -1.2 | -1.7 | -1.2 |
| senior debt | -0.1 | -0.3 | 0.0 | 0.0 |
| deposits | -7.8 | -7.6 | 0.0 | 0.0 |
| conversion rate BoC | 47.5% | 37.5% | 0.0% | 0.0% |
| equity buffer | | 22.5% | 0.0% | 0.0% |
| Rollover of CPB bond | -1.9 | -1.9 | 0.0 | 0.0 |
| Levy on deposits | | | -5.8 | |
| insured deposits (EUR 27bn) à | 6.75% | | -1.8 | |
| uninsured deposits (EUR 40bn) à | 9.90% | | -4.0 | |
| **General buffer** | **2.0** | **2.4** | **0.0** | **0.0** |
| **Total financing needs** | **10.0** | **10.0** | **10.1** | **17.0** |
| % of GDP | 61% | 61% | 61% | 103% |
| **Debt as % of GDP in 2016** | **122.5%** | **121.9%** | **122.0%** | **136.1%** |
| in 2020 | 105% | 105% | 100% | 119% |

- **PIMCO capital need calculation following formal assistance request of 25 June 2012**
- **EUR 10 bn under stress, 6% core tier I**
- **Bail-in of junior debt ahead of DG COMP communication of 1 August 2013**
- **Total programme envelope: EUR 17 bn (103% of GDP)**
- **Public debt in 2020: 119% of GDP**
- **Debt sustainability not ensured**
- **Cyprus delays (presidential elections in Feb 2013)**

# Cyprus' financial assistance would have been relatively large if all would have come from a programme



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- **1rst Eurogroup meeting of 16 March 2013**
- **Deposit levy of 6.75% and 9.9% on residents and non-residents**
- **Greek carve-out**
- **Total programme envelope reduced to EUR 10bn (61% of GDP)**
- **Public debt target in 2020: 100% of GDP**
- **Cypriot parliament rejected**

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- **2nd Eurogroup meeting of 25 March 2013**
- **Resolution of Laiki and Bank of Cyprus (without programme money)**
- **Transfer of the insured deposits on 26 March 2013 and ELA in Laiki to BoC and the Cypriot assets; the uninsured deposits (> EUR 100,000) remain in the legacy vehicle**
- **37.5% of BoC uninsured deposits converted into equity; 22.5% equity buffer; 30% of uninsured deposits frozen for liquidity reasons**
- **Capital controls**

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- **Due diligence by KPMG**
- **Valuation of assets and liabilities of Bank of Cyprus and Laiki to verify the Pimco capital needs for banks in resolution and in worse macro scenario**
- **Following KPMG, 10%-point of equity buffer was used to ensure that BoC has 9% core tier I ratio during the programme, bringing conversion rate to 47.5%**
- **The remainder of the equity buffer was partly released at the end of the resolution (31 July 2013) and partly frozen in deposits**

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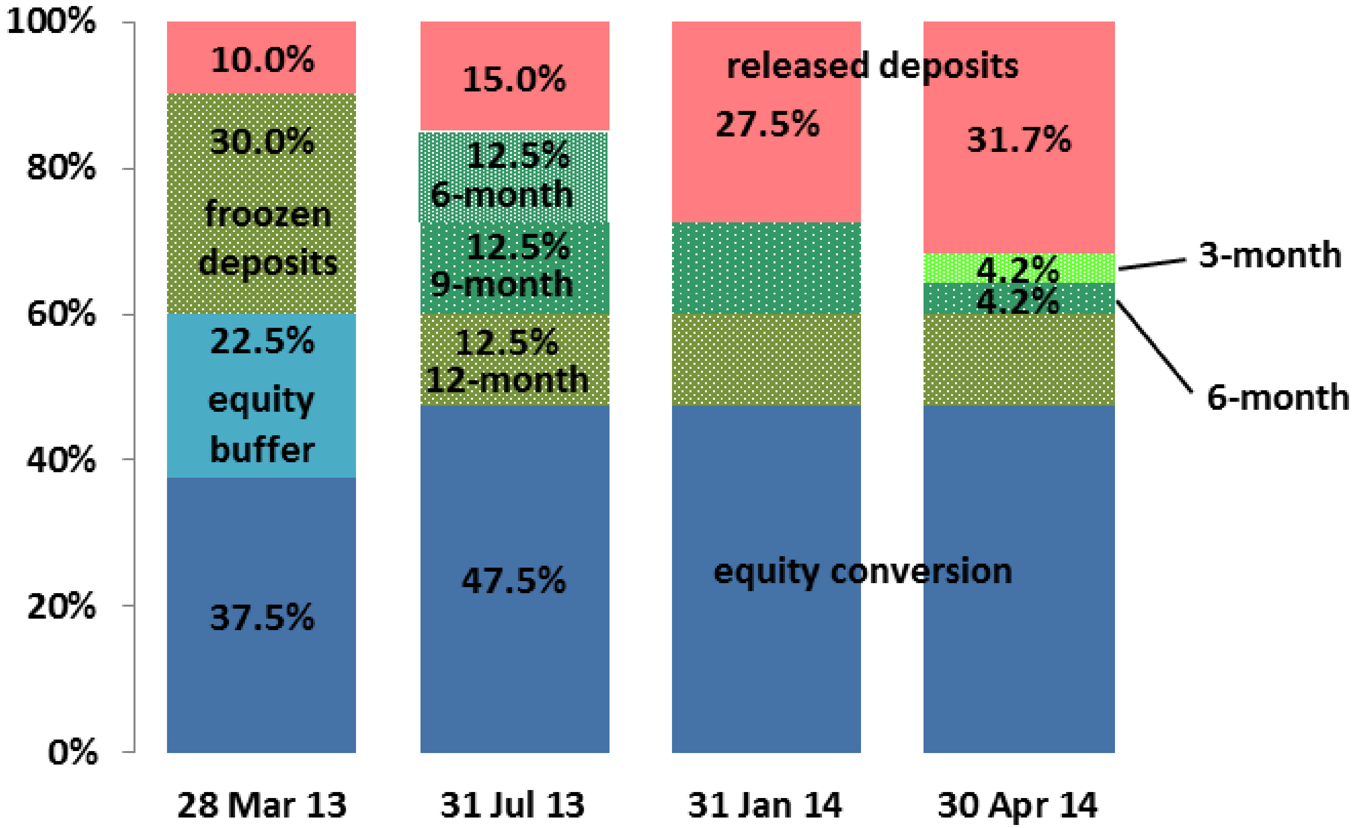
# Frozen deposits in Bank of Cyprus: gradual release



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# Different objectives for bail-in

- Maximise bailinable amount (minimise conversion rate), minimise further capital needs
- Avoid strategic defaults
- Protect EUR 100,000 of depositors
- Minimise intervention of DGS
- Respect the principle that no creditor is worse off than in liquidation
- Shrink balance sheet

# Bail-in and set-off

**Loans > deposits**

| (1000 EUR) | | Starting situation | No set-off | Full set-off | Partial set-off |
|---|---|---|---|---|---|
| 1 | **Deposits** | 120 | 100 | 0 | 100 |
| 2 | **Loans** | 150 | 150 | 30 | 130 |
| 3 | **Bailinable** | - | 20 | 0 | 0 |
| 4 = 1 - 2 | **Net weath** | -30 | -50 | -30 | -30 |
| 5 | **Strategic default** | 0 (up to 150) | 20 (up to 150) | 0 (up to 30) | 0 (up to 130) |
| 6 | **Balance sheet reduction** | 0 | 0 | -120 | -20 |
| 7 = -9% x 2 | **Capital need** | -13.5 | -13.5 | -2.7 | -11.7 |
| 8 = 4 + 7 | **Net capital need** | - | 6.5 | -2.7 | -11.7 |

- **No set-off**
- **Maximises bailinable amount, minimises further capital needs**
- **High risk of strategic default**
- **No balance sheet reduction**
- **If uninsuered deposits are left in Legacy Laiki, while assets are transferred to Bank of Cyprus, the principle that no creditor is worse off than in liquidation, would not be respected**

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- **Full set-off**
- **Minimises strategic default**
- **Maximises balance sheet reduction**
- **No bailinable amount**
- **No cash balances left**

# Bail-in and set-off

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- **Partial set-off**
- **Protects uninsured deposits**
- **Mitigates strategic default**
- **Small balance sheet reduction**
- **No bailinable amount**
- **Solution followed in Cyprus: double set-off, against insured deposits and loans (triple set-off, against also non-performing loans was not persued due to data uncertainty)**

# Bail-in and set-off

## Loans < deposits

| (1000 EUR) | | Starting situation | No set-off | Full set-off | Partial set-off |
|---|---|---|---|---|---|
| 1 | **Deposits** | 220 | 100 | 100 | 100 |
| 2 | **Loans** | 90 | 90 | 0 | 0 |
| 3 | **Bailinable** | - | 120 | 30 | 30 |
| 4 = 1 - 2 | **Net weath** | 130 | 10 | 100 | 100 |
| 5 | **Strategic default** | 0 (up to 90) | 90 | 0 | 0 |
| 6 | **Balance sheet reduction** | 0 | 0 | -90 | -90 |
| 7 = -9% x 2 | **Capital need** | -8.1 | -8.1 | 0 | 0 |
| 8 = 4 + 7 | **Net capital need** | - | 111.9 | 30 | 30 |

- **In case of set-off, if deposits are larger than loans by more than EUR 100,000 there is an bailinable amount**
- **Strategic default is limited as the loan is repaid contrary to a situation of no set-off**

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# Bail-in and exemptions

- Financial institutions
- The government, municipalities, public entities
- Insurance companies
- Charities, educational institutions
- JCC Payment Systems
- EU funds
- Pension fund deposits were not excluded (the pension fund deposits in Laiki  were treated as pension fund deposits in BoC, meaning 47.5% haircut rather than 100% write-down, EUR 400 million compensation was foreseen in programme for this).

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# Maintaining liquidity: administrative measures

**Legal form**

- Decrees issued by MoF: first on 28 March following on extended bank holiday 16-27 March; 30th on 30 May 2014

**Implementation principles**

- Minimise distortionary side effects and limit in time (roadmap for lifting the restrictions, see annex)
- Prohibiting capital transactions (bonds, shares, real estate, opening and alimenting bank accounts, …), while authorising current transactions (payments for goods, services, health care, salaries, …) subject to verification of the nature of the operation
- Stricter regime for international payments than for domestic payments; no restrictions on incoming flows received after implementation of controls
- Special (freer) regime for international banks from 26 April 2013 in dealing with non-residents (21th on 30 May 2014)

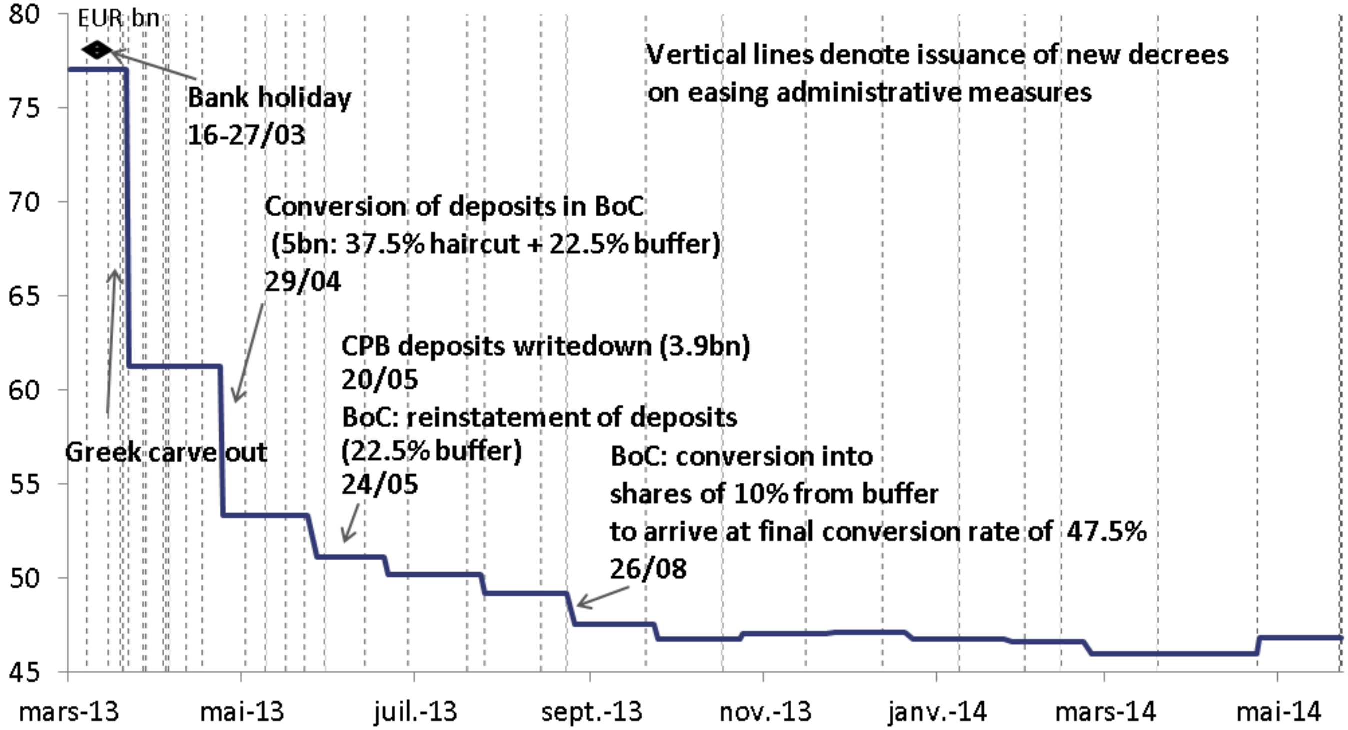
**Implementation parameters**

- Duration of Decree: gradual lengthening
- Authority for verification of supporting documents: increasingly delegated from Authorisation Committee in CBC to the banks
- Timing of verification: from ex ante to ex post
- Ceilings: gradual increase

➡ Restrictions on exports of cash, opening accounts, using term deposits at maturity, cashing cheques, credit card payments, transfers (see annex)

# Maintaining liquidity

## Outflow of deposits is abating, but has not stopped



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# Concluding remarks

- In the medium-term make sure there are sufficient bailinable instruments and step up financial literacy in this respect
- Touching senior creditors (bondholders and uninsured depositors) is a painful experience
- Be prepared and informed about the level of insured and uninsured deposits, also determined by the chosen method of setting off against loans, loans in arrears and the degree of depositor protection offered as well as the institutions excluded from bail-in
- Bail-in at systemic banks may have considerable confidence effects requiring drastic measures to preserve the liquidity of the banking sector

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# Roadmap for the liberalisation of the administrative measures

| Stage of the roadmap | **Milestone** *(between bracket and in italics: implementation date)* | **Relaxation if milestone is met** |
|---|---|---|
| 1st | (1) Completion of the recapitalisation and resolution of Bank of Cyprus *(July 2013)*<br><br>(2) Completion of the Coops recapitalisation and restructuring strategy *(July 2013)* | (1) Allowing the opening of fixed-term deposit account, for non existing customer created with funds from cash. *(August 2013)*<br>(2) Allowing the opening of current account linked to new credit facilities granted to non-existing customer. *(August 2013)*<br>(3) Abolition of the requirement for the presentation of justifying documents for transfers above EUR 300000 within the Republic. *(August 2013)*<br>(4) Increasing the limit for transfers abroad to EUR 1000000 for normal business activity and upon presentation of justifying documents. *(October 2013)* |

# Roadmap for the liberalisation of the administrative measures (continued)

| Stage of the roadmap | Milestone *(between bracket and in italics: implementation date)* | Relaxation if milestone is met |
|---|---|---|
| 2nd | (1) Recapitalisation of Hellenic Bank *(September 2013)*<br><br>(2) Disbursement of funds under the macroeconomic adjustment programme for the recapitalisation of the Coops. *(January 2014)*<br><br>(3) Submission of the Coops restructuring plan to the European Commission. *(January 2014)*<br>(4) Approval of Bank of Cyprus' restructuring plan by the Central Bank of Cyprus. *(December 2013)* | (1) Abolition of the restrictive measures relating to fixed term deposits. (*March 2014* )<br>(2) Abolition of the current limit related to transfers within the Republic, regardless of the purpose. *(5 May 2014)* |

# Roadmap for the liberalisation of the administrative measures (continued)

| Stage of the roadmap | **Milestone** *(between bracket and in italics: implementation date)* | Relaxation if milestone is met |
|---|---|---|
| 3rd | (1) Completion of the coops mergers *(30 March 2014)* | (1) Abolition of the restrictive measures relating to cash withdrawals *(March 2014)* and the cashing of cheques. *(5 May 2014)* |
| | (2) Tangible progress in the implementation of Bank of Cyprus' restructuring plan. *(May 2014)* | (2) Abolition of the restrictive measures prohibiting the opening of new accounts. *(30 May 2014)* |
| 4th | (1) Progress in implementation of the macroeconomic adjustment programme. | (1) Abolition of all restrictive measures relating to the transfer of funds outside the Republic. |
| | (2) Restoration of depositors' confidence in the Cyprus banking system. | (2) Abolition of the restrictive measures imposed on international banks, included in the catalogue of the relevant Decree for international banks. |

# The administrative measures were very strict in the beginning

***Limits on cash withdrawals***

- ***Max EUR 300 per day (cumulative), increased to EUR 500 for legal persons***

***Limits on cash exports***

- ***Max EUR 1000 per person, per journey, increased to EUR 3000***
- ***Max EUR 300 per day towards Turkish Cyprus, eased for salary payments to Turkish Cypriots***

***Cashing of domestic cheques is forbidden***

***Card payments***

- ***In Cyprus allowed***
- ***Max EUR 5,000 per person per month for international payments with cards issued in Cyprus***

# The administrative measures were very strict in the beginning (continued)

***Accounts***

- ***Opening of new account is forbidden unless alimented from abroad or the natural person did not have any account with any bank and subject to approval***

- ***Termination of fixed term deposits is forbidden, but***

  ***at maturity part can be used EUR 5,000 or 10% (eased to 20%) of principal, with maturity extended by 1 month for remaining amount***

  ***early termination is possible to repay loan in same bank***

# The administrative measures were very strict in the beginning (continued)

***Transfers***

- ***Free salary payments***
- ***Max EUR 5,000 per quarter for student living expenses***
- ***"Within the normal business and upon presentation of supporting documents"***

***no approval needed by CBC: < EUR 5,000 per day per account***

***later changed to no approval needed by CBC: < EUR 300,000 per transaction; presentation of documents to banks, later only on request***

***international transactions:***
***no approval needed : < EUR 500,000 per transaction; presentation of documents to banks***

***special regime for international banks: branches and subsidiaries in Cyprus, because not weighing on domestic liquidity and important for economy:***

- ***Exemption for international clients (= non-resident or in case of firm 90% foreign owned): treated like foreign account holders***
- ***Bank has to submit request to be excluded and maintain separate list of domestic and international clients***