The Cypriot Banking Sector During the Financial Crisis and Its Reforms: An Examination in Light of the Case of the UK

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Abstract

The article focuses on the role of banks in the financial crisis and compares the UK and Cyprus, since the banking sector of the latter was founded on the former's model when it was a British colony. However, Cyprus' financial sector has been influenced by its accession to the EMU, while the UK remains outside the eurozone. The article begins with the theoretical background, namely the 'too-big-to-fail' theory, the deficient banking corporate governance and the ineffective supervision of banks, and how they affected the UK and eurozone crises. Afterwards, the measures imposed by the UK government on its banking sector and the corresponding EU financial measures are discussed. A brief evaluation of the causes of the crisis in Cyprus follows. The article concludes that Cyprus can follow the UK's example and focus its efforts on bank supervision to improve the financial industry and to avoid a future financial crisis.

Keywords: banking supervision; regulation; too-big-to-fail; Twin Peak; European Banking Union; bail-in; deposit guarantee

Introduction

Financial crises, and especially bank crises, are not novel phenomenona, since banking systems are vulnerable across the world, irrespective of the type of financial system.[1] This vulnerability results from the very nature of a bank's operation, which depends on liquidity due to deposits and investments, and which is threatened by the possibility of depositors collectively withdrawing their savings. The collapse of one bank can be likened to unbalancing a domino piece which ends up collapsing the whole system. Moreover, the recent global character of the financial environment increases the risk that a financial crisis is more likely to be forwarded from one state to another

1 See Levine, R. (2002), 'Bank-based or market-based financial systems: Which is better?' NBER Working Paper Series, Working paper 9138 http://www.nber.org/papers/w9138, accessed 10 December 2016.

with unpredictable consequences. The decisive role of banks in the incidence and transmission of financial crises renders it essential to initially prevent or settle a banking crisis to resoluve a financial crisis.[2]

The objective of this study is to assess whether UK banking reforms could also apply to Cyprus in order to handle its current disastrous financial reality. The choice to examine Cyprus is because its legal system and banking industry were developed based on English foundations when Cyprus constituted part of the British Empire.[3] As a result, the two countries share some pillars relating to the operation and legal regulation of banks and the financial system in general.[4] It should not be ignored that Cyprus is a member of the eurozone, and therefore its financial sector is part of the EU banking union, with all the obligations and limitations that this membership encompasses. Thus, any recommendations made should take into account the limitations that the eurozone imposes, in the sense that Cyprus does not enjoy the same degree of freedom as the UK. It emerges that if Cyprus shifts its focus to bank supervision, following the example of the UK government, in conjunction with other recommended measures, the current situation of the island could improve. The conclusions present proposals aiming towards the solution of the existing financial turbulences in Cyprus and the prevention of similar situations in the future.

Following the defined purposes, this paper is organized accordingly: The first part is composed of a critical analysis of three of the most cited theories of how banks can initiate a financial crisis. These three main arguments are also examined as to whether they apply to the UK's 2007 financial crash and the euro area's crisis. The reform measures adopted in the UK and in the EU respectively will be presented in the second part. The case of Cyprus follows in the third part, which incorporates a timeline of the crisis on the island and an examination of its causes, taking into account the role of banks. The goal of the analysis conducted in the current paper is to discover whether and how the measures enforced in the UK could also be implemented in Cyprus. Additionally, the paper aims to explore what other measures could be adopted to deal with the crisis.

The main point of this paper is to underline that a future financial crisis can only be avoided by improving risk management, enhancing corporate governance of banks, implementing effective resolution and support facilities, and establishing macro-prudential oversight systems.

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2 Andries, A. M. (2009), 'What Role Have Banks in Financial Crises?', *Review of Economic and Business Studies*, Vol. 2009, No. 3, pp. 149-159.

3 1878-1960.

4 After Cyprus' accession to the EU in 2004, the government was obliged to accede to the EMU and to adopt the euro as its national currency. Cyprus joined the eurozone in 2008, thus, its banking system is also affected by European Central Bank policy.

Theories on the Role of Banks in a Financial Crisis

Excessive loans, the growth of financial innovations and risky speculations, the relaxation of regulations and the ceaseless efforts of investors to gain large profits constituted signals for the global financial crisis of 2007.[5] Among the various theories that have been developed, three were analyzed and supported: the 'too big to fail' theory, the deficient corporate governance of banks and the lack of effective supervision of banks.

Too Big to Fail (TBTF)

The phenomenon where the bankruptcy of one bank causes the bankruptcy of another if they constitute counterparties to each other is known as the 'risk of contagion'. Particularly, at the EU level, the concept of the single market increases the contagion of bank failures due to the abolition of internal borders within the Union for the free movement of goods and services.[6] Further, in an effort to promote the model of 'one market, one money' in the context of the EMU,[7] the eurozone countries became interdependent, and the risk of contagion became permanent. According to Snell, '[I]f there are question marks over the health of the banks of one country, markets quickly become worried about the financial institutions of other countries as well; if the ability of one Member State to stay within the euro is questioned, the markets quickly start to worry about the other countries.'[8]

If this risk of contagion is considered so high that the government is ready to take any measures to prevent it from failing, then the bank is regarded 'too big to fail' (TBTF).[9] In 1984, C.T. Conover stated that US federal regulators would prevent the largest 'money center banks' from failing,[10] thus a new regulatory principle was conceived, and according to Stewart McKinney, 'We have a new kind of bank. It is called "too big to fail" and it is a wonderful bank'.[11] The contribution of the TBTF

5 Andries, A. M. (2009), 'What Role Have Banks in Financial Crises?', *Review of Economic and Business Studies*, Vol. 2009, No. 3, pp. 149-159

6 In the Commission White Paper ('Completing the internal market', COM(85) 310 final) the internal market is defined as 'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured'.

7 Directorate-General for Economic and Financial Affairs, 'One market, one money. An evaluation of the potential benefits and costs of forming an economic and monetary union', *European Economy* 44, October 1990).

8 Snell, J. (2014), 'The Internal Market and the Philosophies of Market Integration' in Barnard C. and Peers S. (eds), *European Union Law*, Oxford: Oxford University Press, pp. 300-324, at 314.

9 Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (2011), *The Financial Crisis Inquiry Report*, Official Government Edition, p. 431.

10 Kaufman, G. G, (2004), 'Too big to fail in U.S. banking: Quo vadis?' in Benton, E. Gup (ed.) *Too Big to Fail: Policy Practices in Government Bailouts*, London: Praeger Publishers, pp. 153–167.

11 Financial Crisis Inquiry Commission (2010), *Preliminary Staff Report: Too-Big-to-Fail Financial*

concept to the financial crisis was determinant, since a bank being labelled 'TBTF' could readily take risks which it would otherwise have avoided, and a government would be an implied pillar or guarantor to its creditors.[12] This means that governments encourage banks to take risks that could pay large dividends and remuneration in periods of success, but could make losses which taxpayers would cover.[13] Evidently, the financial crash beginning in 2007 led governments to take extraordinary measures to avoid the collapse of TBTF banks. Meanwhile, numerous smaller banks were allowed to go bankrupt because of their negligible importance to the economy.

This vertical scale of support for the banking sector is clearly evident in the UK, where GBP 1,000 billion were spent as loans and equity investment, which is equal to two-thirds of the annual output of the country's whole economy.[14]

According to Mervyn King, governments can deal with TBTF by either admitting that some banks are TBTF and diminishing the threat of their failure or by refusing to acknowledge that a bank is so important that the entire society would bear the costs of its failure.[15] In essence, the first option is to reduce the possibility of a large bank collapsing by enforcing it to maintain capital requirements with regard to their risk-taking policies. Notably, Basel III requires banks to create a buffer against adverse consequences,[16] which 'would offer banks a greater ability to survive the strains of a crisis',[17] provide more protection for taxpayers and hopefully prevent the bank from failing, which could trigger government intervention.[18] Although capital requirements lessen a bank's need for taxpayer support, it can still be made available, and the amount of capital and liquidity might change from day to day partly due to the variation of market expectations. In other words, even if contingent capital is reduced, when a TBTF bank is threatened by bankruptcy, the government would still provide some insurance to prevent it from failing.

The second option shifts the focus to separating banking activities. The payment for goods and services by households and companies and the intermediate flow of savings

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Institutions, p. 7. Available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0831-Governmental-Rescues.pdf, accessed 10 December 2016.

12 Mervyn King, Governor of the Bank of England, speech to Scottish business organisations, Edinburgh, 20 October 2009. Available at http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech406.pdf, accessed 10 December 2016.

13 *Ibid.*

14 *Ibid.*

15 *Ibid.*

16 The Basel Accord III 2011 implemented counter-cyclical capital buffers and systemic group buffers.

17 Barth, J. R., Prabha, A. and Swagel, P. (2012) 'Just how big is the too-big-to-fail problem?', (2012) *Journal of Banking Regulation*, Vol. 13, No. 4, pp. 265-299, at 280.

18 Yan, M., Hall, M. J. B. and Turner, P. (2012) 'A cost-benefit analysis of Basel III: Some evidence from the UK', *International Review of Financial Analysis*, Vol. 25, pp.73-82.

to fund investment are essential activities for a country's economy, therefore it is in the public's interest to maintain them. In contrast, activities like proprietary trading entail greater risk. Thus, as was supported by John Kay, the provision of payment services could be separated from the creation of risky assets in order to protect deposits.[19] Alternatively, proprietary trading could be separated from retail banking in accordance with Paul Volcker's view.[20] Both views aim at limiting government guarantees to utility banking. Using the same rationale, the EU Commission proposed the structural reform of banks, which would prevent the biggest banks from engaging in proprietary trading[21] by forcing these big banks to separate their risky trading activities from their deposit-taking business in order to protect depositors and preserve financial stability. However, separation of activities does not totally eliminate banks' incentives, and governments will still support financial institutions which do not operate in the utility banking sector due to the harmful consequences for the entire economy should they fail.[22]

Corporate Governance

Except for the issue of executive remuneration, corporate governance of banks was mostly ignored during the crisis[23] until the OECD Steering Group on Corporate Governance authorized a study on some of the key areas of corporate governance of the banking industry.[24] In 2009, the G20[25] and the De Larosière Report conceded that corporate governance failures were one of the causes of the financial crisis.[26] In

19 Kay, J. (2009) 'Too big to fail is too dumb an idea to keep', *Financial Times*, 28 October 2009. Available at http://www.johnkay.com/2009/10/28/too-big-to-fail-is-too-dumb-an-idea-to-keep, accessed 10 December 2016.

20 G30 report, former Chairman of the Federal Reserve.

21 European Commission (2014b) 'Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions', COM/2014/043 final - 2014/0020 (COD).

22 Speech by Mervyn King, Governor of the Bank of England, to Scottish business organisations, Edinburgh, 20 October 2009. Available at http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech406.pdf, accessed 10 December 2016.

23 Mülbert, P. O. (2009) 'Corporate Governance of Banks', European Business Organization Law Review, Vol. 10, No.3, pp. 411–436.

24 OECD (2009) 'Corporate Governance and the Financial Crisis: Key Findings and Main Messages', pp. 1–58. Available at http://www.oecd.org/corporate/ca/corporategovernanceprinciples/43056196.pdf, accessed 10 December 2016.

25 Group of Twenty Working Group (2009) Enhancing Sound Regulation and Strengthening Transparency. http://www.gfintegrity.org/storage/gfip/documents/g20%20working%20group%201%20report.pdf, accessed 10 December 2016.

26 High-Level group on Financial Supervision in the EU. (2009, February 25) *The Report of the High-Level Group on Financial Supervision in the EU*. The group was chaired by Mr Jacques de Larosière:

the UK, Sir David Walker was mandated to independently evaluate that aspect in the its banking sector.[27] According to the Walker Review, 'the fact that different banks operating in the same geography, in the same financial and market environment and under the same regulatory arrangements generated such massively different outcomes can only be fully explained in terms of differences in the way they were run.'[28]

The lack of corporate governance during the last couple of decades has been illustrated by the collapse or near collapse of some large financial institutions worldwide,[29] in which the main flaws were: bank boards that could not manage risk properly and could not control executive management; shareholders; stakeholders who remained passive while their boards decided to expand the operations; and a corporate culture which gave high remuneration for short-term profits. The same defects were recognized by the EU Commission and the De Larosière Report, which said, '[B]oards and senior management of financial firms failed to understand the characteristics of the new, highly complex financial products they were dealing with… The "herd instinct" prevailed too often driving many firms into a race to inflate profit without paying proper attention to risk. In many cases, board oversight or control of management was insufficient and non-executive directors "absent" or unable to challenge executive directors... Inadequate remuneration structures for both directors and traders led to excessive risk-taking and short-termism.'[30]

Considerable remuneration schemes, risk management, the fitness of the Combined Code on Corporate Governance, the composition and conduct of banks' boards and the relationship with shareholders were the key areas of the Walker Review.

Regulation – Supervision

Arguably, many nations' regulatory and supervisory agencies have not managed 'to keep abreast of the rapidly evolving development of the financial industry and its myriad products and practices'.[31] Slack regulations in the banking industry have significantly contributed to the development of high-risk lending and investment practices, which have led to financial turbulences.

The de Larosière Report.

27 Walker, Sir D. (2009) 'A review of Corporate Governance in UK Banks and Other Financial Industry Entities', HM Treasury (The Walker Review).

28 *Ibid.*

29 Tomasic, Ro. and Akinbami, F. (2011) 'Towards a new corporate governance after the global financial crisis', *International Company and Commercial Law Review*, Vol. 22,No. 8, pp. 237-249.

30 European Commission (2010) 'Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices' *SEC* 669, 3.

31 Teakdong, K., Bonwoo, K. and Minsoo, P. (2013) 'Role of financial regulation and innovation in the financial crisis', (2013) *Journal of Financial Stability*, Vol. 9, No. 4, pp. 662-672.

The financial crisis of 2007, described as the most calamitous in recent years, belongs to 'a series of boom-bust-regulate-deregulate-boom-bust' cycles.[32] Lenders' and borrowers' ambitions to assume risk grow with the manifest force of the circular upturn, constituting the 'boom' process, which is 'driven by leverage, speculation and rapid credit growth', and which often climaxes in an expensive 'bust'.[33] Apart from the catalytic role of regulations, their implementation by supervisory authorities was also weakened. For instance, the UK Financial Services Authority (FSA) has been heavily criticised for its risk-based approach to regulation after UK banks failed and were subsequently nationalised.[34] The supervisory authorities of Iceland and Ireland were similarly disreputable when their banking sectors had to be dismantled.[35] Thousands of Irish protested against the public sector's spending cuts in order to save Anglo Irish Bank, which was the victim of deficient corporate governance.[36]

The regulatory structure of the UK was tripartite, consisting of the FSA, which was the foundation of this system and the supervisory body for banks, the HM Treasury and the Central Bank. The FSA's responsibilities were the regulation and prudential supervision of financial institutions. The HM Treasury was authorized to oversee the whole regulatory structure and to approve any support operation in case of financial crisis. Finally, the Central Bank was mandated to preserve steady monetary and financial systems.

Despite the initial financial stability achieved by the newborn tripartite system, the collapse of Northern Rock Bank in September 2007 indicated there was weak supervision by the FSA. More importantly, it was unclear which regulatory body was responsible to immediately handle the crisis.[37] The subsequent bankruptcies of RBS and Lloyds Bank confirmed the shortcomings of that system.

The Turner Review, being considered the most thorough analysis of these financial turbulences, classified several factors which contributed to the crisis,[38] among which

32 O'Brien, J. (2010) 'The Future of Financial Regulation: Enhancing Integrity through Design', *Sydney Law Review*, Vol. 31, No. 1, pp. 63-85.

33 White, W.R. (2014) 'The Prudential Regulation of Financial Institutions: Why Regulatory Responses to the Crisis Might Not Prove Sufficient', *OECD Economics Department Working Papers*, No.1108, OECD Publishing.

34 O'Brien J. (2010), 'The Future of Financial Regulation: Enhancing Integrity through Design', *Sydney Law Review*, Vol. 31, No. 1, pp. 63-85.

35 International Monetary Fund (2009), 'Crisis Creates Testing Times for Europe's Policymakers', *IMF Survey Magazine*. Available at http://www.imf.org/external/pubs/ft/survey/so/2009/CAR061009A.htm, accessed 10 December 2016.

36 Wall M. and Collins S. (2009), 'Change to Cuts Strategy Ruled Out as Protests Seek "Fairer" Way', *Irish Times* (Dublin), 7 November 2009.

37 Cox, L., Dorudi, B., et al. (2012) 'United Kingdom regulatory reform: emergence of the twin peaks', Compliance Officer Bulletin, Vol. 95, pp. 1-33.

38 FSA (2009) *The Turner Review, a regulatory response to the global banking crisis*. London: FSA.

were macro-economic imbalances, financial innovation without social worth and serious flaws in decisive bank capital and liquidity regulations. The Review also included factors such as the expansive involvement of commercial banks in trading activities, which lowered confidence in the banking system, and insufficient capital buffers, which had not allowed banks to continue their lending activities since the downturn.[39]

Following the identification of the crisis' causes, the Turner Review made numerous recommendations for improving the regulatory system and preventing future crises. In essence, it strongly recommended the FSA be reconstructed to primarily supervise business strategies and the system-wide risks of banks, and then to supervise their internal processes and structures, as 'the approach has to build on a system-wide perspective: failure to look at the big picture was far more important to the origins of the crisis than any specific failures in supervising individual firms.'[40]

The UK Reform Measures

The aforementioned theories have obliged the UK government to acknowledge the urgency to reform the existing banking industry regime and to decide how to handle these arguments.

Taking into consideration the Turner Review, the UK government decided to abolish the FSA,[41] and in his 2011 Mansion House speech, Chancellor George Osborne declared that the original tripartite system belonged to the past.[42] Three years later, on 1 April 2013, the FSA was replaced by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), which were mandated to observe banks' health and to supervise financial institutions' conduct. Moreover, the Financial Policy Committee was established within the Bank of England to diagnose and deal with financial risks to the system's stability.

In essence, the FCA has inherited most of the Financial Services Authority's tasks to regulate market conduct, including monitoring all firms' conduct in relation to retail customers, wholesale financial markets and their comprehensive market conduct.[43]

39 *Ibid.*
40 *Ibid.*
41 *Ibid.*
42 Chancellor of the Exchequer George Osborne, speech on 15 June 2011. Available at <https://www.gov.uk/government/speeches/speech-by-the-chancellor-of-the-exchequer-rt-hon-george-osborne-mp-at-the-lord-mayors-dinner-for-bankers-and-merchants-of-the-city-of-london-mansi, accessed 10 December 2016.
43 Perry, J., Moulton, R. et al. (2011) 'The new UK regulatory landscape', *Compliance Officer Bulletin*, Vol. 84, pp. 1-33.

FCA's objective is to strengthen 'confidence in the UK financial system by facilitating efficiency and choice in services, securing an appropriate degree of consumer protection, and protecting and enhancing the integrity of the UK financial system'.[44] The PRA, a separate legal entity and subsidiary of the Bank of England, assumes responsibility over the micro-prudential regulation and daily supervision of those financial institutions that are subject to significant prudential regulation, namely banks, insurers and major investment firms.[45] The fundamental objective of this authority is to promote 'the stable and prudent operation of the financial system through the effective regulation of financial firms, in a way that minimizes the disruption caused by any firms that do fail'.[46] Finally, the FPC exercises macro-prudential regulation to strike a balance between financial stability and sustainable economic development.[47] The FPC's objectives are to improve financial stability by improving the flexibility of the financial system, identifying its vulnerabilities, and improving macroeconomic stability.[48]

The new structure of the regulatory system has given rise to certain concerns, particularly with regard to the danger of creating 'regulatory underlap' and duplication.[49] Remarkably, Hector Saints commented that 'any structure which is anything other than a monolithic organisation, across the whole spectrum of regulation, is going to have fault lines. And where you have a fault line, you have a coordination risk'.[50] In response to these arguments, the government emphasised that the FCA and the PRA enjoy the same status and flexibility to engage with each other,[51] but if they disagree, the PRA would prevail and prevent the FCA from exercising a function if there is a high risk a firm could fail.

44 HM Treasury (2011) 'A new approach to financial regulation: building a stronger system', p. 5. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81411/consult_newfinancial_regulation170211.pdf, accessed 10 December 2016.

45 Perry, J., Moulton R. et al. (2011), 'The new UK regulatory landscape'.

46 *Ibid.*

47 *Ibid.*

48 *Ibid.*

49 *Ibid.*

50 Thomson Reuters Newsmaker Event, December 2010. Available at http://live.reuters.com/Event/TRNewsmaker?Page=0, accessed 10 December 2016.

51 HM Treasury (2011) 'A new approach to financial regulation: building a stronger system'. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81411/consult_newfinancial_regulation170211.pdf, accessed 10 December 2016.

The EU Approach

While the UK attributed the failure of its financial sector primarily to improper and inadequate supervision of banks and the market in its entirety, the EU preferred a different tack by prioritising 'the increased control of the market by extending the scope of regulation; curbing specific "undesirable" behaviours; protecting consumers and taxpayers; and enhancing eurozone solidarity'.[52] The focus shifted to protecting consumers and taxpayers rather than re-empowering market forces; thus, instead of the EU reviewing supervisory measures, it reinforced the regulatory system initially.

Among the Union's responses to the crisis, including instances of quick intervention to stabilise some euro countries that were heavily affected,[53] and measures of budgetary surveillance and economic coordination,[54] various reforms were made to create a more powerful and steadier financial framework, and a so-called European banking union.[55] The idea of creating a European banking union was first introduced by the President of the EU Council in June 2012,[56] consisting of three pillars, namely a 'single supervisory mechanism', a harmonized recovery and resolution framework and a common deposit guarantee scheme for all the eurozone states.

A. Single Supervision Mechanism (SSM)

Article 127(1) TFEU establishes that the primary objective of the European System of Central Banks is the maintenance of price stability, and, for this purpose, the range of powers of the ECB includes setting interest rates and suppling liquidity to the banking system. In addition to these tasks, in 2013, the ECB became responsible for the prudential supervision of banks and other financial institutions[57] and it now

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52 Europe Economics (2014) 'EU Financial Regulation: A report for Business for Britain', p. 24. Available at http://forbritain.org/EUFinancialReg.pdf, accessed 10 December 2016.

53 Loan facilities, such as the European Financial Stability Mechanism and the European Financial Stability Fund, were created to deal with the urgent sovereignty debt crises of Ireland and Greece in 2010.

54 The so-called Six Pack package of measures was adopted in November 2011 to improve budgetary surveillance and economic policies. That surveillance was further strengthened in May 2013 by the Two-Pack. Moreover the Treaty on Stability, Coordination and Governance was entered into force on 1 January 2013 dealing with budgetary discipline, economic convergence and cooperation and euro governance.

55 See Hinarejos, A. (2014), 'Economic and Monetary Union' in Integration', in Barnard, C. and Peers, S. (eds), *European Union Law,* Oxford: Oxford University Press, pp 567-590.

56 President of the European Council (2012 June 26) 'Towards a Genuine Economic and Monetary Union'. Available at: http://ec.europa.eu/economy_finance/focuson/crisis/documents/131201_en.pdf, accessed 10 December 2016.

57 Regulation 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ 2 287/63, hereinafter SSM Regulation.

supervises approximately 150 eurozone credit institutions, which is equivalent to 80% of the banking assets in the euro area. The remaining banks, being regarded as 'less significant', are still supervised by their national competent authorities (NCAs).[58] The criteria for distinguishing 'significant' from 'less significant' banks are their size, importance for the economy of the Member State or the entire Union, the volume of their cross-border activities (if any) and the ranking amongst the three most important banks in the relevant Member State.[59] Such distinctions clearly reflect the Union's application of the TBTF theory.

Under the SSM, the ECB and the NCAs now share prudential supervision of banks, co-sharing in some areas and allocating exclusive competences in others. In particular, NCAs remain responsible for supervising bodies which are not covered by the EU's legal definition of credit institutions,[60] supervising payment services, consumer protection, protecting against money laundering and terrorist financing, as well as the 'low-level' aspects of prudential supervision such as dealing with matters of credit institutions' establishment and provision of services, supervising credit institutions from non-EU countries with branches or cross-border services within the Union, and assisting the ECB in its supervisory role.

The ECB's new role could be characterized as either increasing or weakening integration, since banking union introduces a level of integration for the banking sector within the eurozone.[61]

B. Single Resolution Mechanism (SRM)

In 2013 the European Commission drafted a regulation on uniform procedures for bank resolution within the Eurozone[62] to put nearly solvent banks into resolution 'with minimal costs to taxpayers and to the broader economy'.[63] This 'bail-in' method shares the burden of covering the losses and resolving a failing bank among shareholders, creditors and unsecured depositors. The SRM applies only to the banks that are also covered by the SSM, thus authorities on the same level perform supervision and management. In particular, the resolution of these 'significant' banks is transferred

58 SSM Regulation, Article 6.

59 SSM Regulation, Article 6(4).

60 Though they might be supervised as credit institutions under national law.

61 Andenas, M. and Chiu, I. H-Y (2013), 'Financial stability and legal integration in financial regulation', *European Law Review*, Vol. 38, No. 3, pp. 335-359.

62 European Commission (2013) 'Proposal for a Regulation establishing uniform rules and uniform procedures for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation 1093/2010' COM(2013) 520.

63 Alexander, K. (2015) 'European Banking Union: a legal and institutional analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism', *European Law Review*, Vol. 40, No. 2, p. 156.

from the national to the European level, and the 'less significant' credit institutions are still managed by their national resolution authorities (NRAs). Consequently, the consistency of the approach towards significant banks is ensured and the integrity of the single market is reinforced.

Under the SRM, which has been in full force from 1 January 2016, a Single Resolution Board (SRB) was established to achieve 'a coherent and uniform approach' to bank resolution, and a Single Resolution Fund was created with contributions from the banks that are under the scope of the SRM. The use of the bail-in tool depends on the discretion of the SRB, since the Bank Recovery and Resolution Directive[64] provides for the adoption of early intervention resolution methods. This function of the SRB provides the Union authorities with a methodical means to manage failures of banks and other financial institutions, which constitutes one of the SRM's objectives.

C. Deposit Guarantee Scheme

Regarding the third pillar of the EBU, the Deposit Guarantee Scheme Directive of 2014[65] provides for the protection of €100,000 of each retail depositor, with banks increasing contributions to a deposit guarantee fund in each State[66] in the event of a bank's resolution.[67]

Generally, implementing the SSM and the SRM, in the context of harmonized banking rules, intends to complete the EMU and ensure financial stability. Furthermore, the bail-in tool puts 'an end to the era of massive bailouts paid by taxpayers'[68] and enhances confidence in the banking industry and in the eurozone as a whole. Those purposes are achieved when the European banking union transmits the sovereignty from the national authorities of Member States to Union institutions in the sensitive area of banking supervision and resolution.

The Case of Cyprus

In March 2013, Cyprus dominated the news worldwide when the Eurogroup and the President of the Republic of Cyprus reached an agreement that would impose a bail-in of all insured and uninsured depositors in all banks of the country.[69] Such agreement

64 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ 2 173/190.

65 Directive 2014/49/EU on deposit guarantee schemes [2014] OJ 2 173/149I

66 *Ibid*. Article 10

67 *Ibid*. Article 6.

68 European Commission (2014) 'Banking Union: Restoring financial stability in the Eurozone', p. 2.

69 Eurogroup Statement on Cyprus (2013 March 16). Available at http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/136487.pdf, accessed 10 December 2016.

was described as 'a one-off, extraordinary measure that will not be repeated under any circumstances.'[70] However, the phenomenal financial crisis did not come out of the blue, rather it was the result of several failures. 'The combination of loose fiscal policies, ineffective supervision and the lack of formal arrangements to deal with a crisis opened the way to catastrophe'.[71] The Central Bank of Cyprus (CBC) appointed an Independent Commission on the Future of the Cyprus Banking Sector to identify weaknesses of the national banking system and to recommend ways to enhance the system's growth, stability and competitiveness.[72]

At the national policy level, the risk involved in operating a banking industry of such a size had not been properly estimated. In fact, banks were not well run and their activities lacked prudence, but the public erroneously believed that banks, through their international business, were contributing to the state's wealth. The highlight of this attitude was the lack of any interest towards formulating mechanisms to deal with a future financial crisis. The proof of that devaluation of risk was that Cyprus' two biggest domestic banks, the Bank of Cyprus and Cyprus Popular Bank (Laiki Bank), were highly exposed to Greek debt. Specifically, they held among the greatest proportions of Greek bonds in Europe and operated bank branches and subsidiaries in Greece. This disproportionate amount of Greek bonds held by the two aforementioned banks[73] could be partly attributed to the ECB, which allowed eurozone commercial banks to hold unlimited amounts of perilous government bonds.[74] The ECB's policy, in conjunction with the imprudent culture of the Cyprus' banking sector, resulted in Cypriot banks expanding to Greece between 2009 and 2010, which was arguably the worst time, since Greece was already in a deep recession, and financial assistance from international lenders was inevitable. Evidently, the amount of Greek bonds and companies held by Cyprus banks in 2010 exceeded 2.5 times the Cyprus' GDP.[75]

The fact that banks were not prevented from pursuing those expanding and precarious activities indicates regulatory weaknesses.[76] Generally, the Central Bank

70 Ministry of Finance (2013 March 18) Agreement for Financial Assistance to the Republic of Cyprus. Available at http://www.mof.gov.cy/mof/mof.nsf/All/BB670607715A44D6C2257B3200368FE9/$file/ agreemenfinancialassistance.pdf, accessed 10 December 2016.

71 Independent Commission on the Future of the Cyprus Banking Sector (October 2013) *Final Report and Recommendations*, p. 31.

72 See http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12561&lang=en, accessed 10 April 2017.

73 Namely Greek government bonds worth around €6 billion.

74 Ioannou, Ch. and Emilianides, A. (2013) Πώς και γιατί η Κύπρος βυθίστηκε στην κρίση: Τα πραγματικά αίτια και οι ευθύνες', *Foreign Affairs, The Hellenic Edition*. Available at http://www.foreignaffairs.gr/articles/69205/xristina-ioannoy-kai-axilleas-aimilianidis/pos-kai-giati-i-kypros-bythistike-stin-krisi?page=show, accessed 10 December 2016.

75 *Ibid.*

76 Independent Commission on the Future of the Cyprus Banking Sector (2013 October) *Final Report*

of Cyprus (CBC) has to conduct 'micro-prudential supervision of banks, macro-prudential supervision, payment, clearing and settlement systems oversight and by acting as lender of last resort or through the resolution of distressed banks'.[77] However, the custodian of national financial stability proved unable to monitor banking risks. Nevertheless, at this stage, it should be underlined that the CBC cannot assume all responsibility, because the European Banking Authority (EBA) undertook the annual stress test in 2011 and determined that Cypriot banks had sufficient capital to withstand a financial crisis[78] while being aware of the near total collapse of the Greek economy and that Cypriot banks had purchased so many Greek bonds. The CBC's actions and omissions further challenged the independence of banking supervision and the lack of CBC's accountability to the government for its supervisory functions. Generally, the TFEU and the Protocol on the Statute of the European System of Central Banks and of the European Central Bank[79] preserve CBC's independence.[80] Just as EU law gives the CBC independence over monetary policy, national law protects its supervisory role.[81] After the country's accession to the EMU, the CBC's duty of establishing and implementing monetary policy was delegated to the ECB, and now the CBC's governor participates in the General Council and the Governing Council of the ECB as a permanent and ex officio member with the governors of all the other national central banks in the EU.[82]

Among the causes of the crisis in Cyprus was also the defective corporate governance of banks. Arguably, the boards of the country's big banks failed to implement appropriate mechanisms and procedures for monitoring risk and controlling executive directors. 'A culture of deference rather than challenge prevailed in the face of domineering chief executives who increasingly ignored their boards and bypassed what controls did exist'.[83] That kind of attitude was more perceptible in Laiki Bank and

and Recommendations, pp. 1-118.

77 Central Bank of Cyprus, https://www.centralbank.cy/en//financial-stability/macroprudential-strategy (accessed 10 December 2016).

78 See European Banking Authority, 2011 EU-wide stress test results. Available at http://www.eba.europa.eu/risk-analysis-and-data/eu-wide-stress-testing/2011/results and http://www.centralbank.gov.cy/nqcontent.cfm?a_id=11847&lang=en, accessed 10 December 2016.

79 Protocol (No 4) on the Statute of the European System of Central Banks and the European Central Bank as annexed to the consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union [2010] OJ 83/01, Chapter 3, Art.7.

80 Consolidated version of the Treaty on the Functioning of the European Union, Art.130 [2012] OJ C326/01.

81 Central Bank of Cyprus Laws of 2002-2007, part 2 section 7.

82 Core principles for Effective Banking Supervision, Basel Committee on Banking Supervision, September 1997.

83 Independent Commission on the Future of the Cyprus Banking Sector (October 2013) Final Report and Recommendations, p. 25.

the Bank of Cyprus, whose mere objective was to increase income so as to fund their expansive activities and 'meet their bonus targets'.[84] Apart from ensuring their bonuses, the directors' conflicting interests further injured the integrity and impartiality of the boards.

Remarkably, cooperative societies' position with regards their harmonization with EU law requirements remained unclear for many years. Initially, cooperatives did not constitute credit institutions so they were not bound by the relevant Banking Directive,[85] which the banks had to implement after the country acceded to the EU in 2004. After long negotiations, it was decided that cooperatives should fully comply with EU law, and thus, the Cooperative Societies Law, which regulates the establishment and operation of cooperative banks, was appropriately amended to implement the acquis communautaire in relation to credit institutions.[86]

The weaknesses of the national banking system should be considered together with EU legislation on this matter, which was incomplete at that time. In essence, while the first signals of the financial crisis appeared in the country, EU legislation regarding corporate governance and bank supervision was still being formulated. Notably, the SSM and the SRM were established in 2013 and 2015 respectively, thus, it could not be argued that Cyprus made tragic omissions, but rather that the EU framework was not comprehensive at that time, although it was necessary due to the failure of the corresponding national frameworks.

The Troika first proposed that 'all bank deposits to bear the brunt of the haircut',[87] obliging all depositors in Cyprus to save their economy by handing over their own assets. Such a measure is unprecedented in the history of modern banking. Paradoxically, while other countries were given a debt haircut, Cyprus was given a deposit haircut, with it being presented as necessary due to the small number of bondholders in Cypriot banks who were unable to assume all the losses on their own.[88] The Eurogroup president commented, 'Cyprus is a specific case with exceptional challenges'.[89] The relevant Eurogoup statement explained that the measures included 'the introduction of an up front one-off stability levy applicable to resident and non-resident depositors... the

84 *Ibid.*

85 Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions [2000] OJ 2 126/1.

86 Cooperative Societies Law (No. 22 of 1985 and 68 of 1987 as amended), https://tinyurl.com/y8h5v7vc, accessed 10 December 2016.

87 Georgiou, G. C. (2013), 'Cyprus's Financial Crisis and the Threat to the Euro', *Mediterranean Quarterly*, Vol. 24, No. 3, pp. 56-73.

88 *Ibid.*

89 Statement by the Eurogroup President on Cyprus (25 March 2013). Available at http://www.consilium.europa.eu/press/press-releases/2013/03/pdf/Statement-by-the-Eurogroup-President-on-Cyprus/, accessed 10 December 2016.

increase of the withholding tax on capital income, a restructuring and recapitalisation of banks, an increase of the statutory corporate income tax rate and a bail-in of junior bondholders'.[90] A record 12-day banking holiday and rigorous capital controls followed.[91]

After the Cypriot Parliament rejected the first proposal, 'the race was on to reach a solution to what was turning out to be a bigger problem than any of the negotiating parties had bargained for'.[92] The Eurogroup's take-it-or-leave-it approach compelled the government to accept the terms of a revised bailout on 25 March 2013. What changed was that a haircut would be imposed only on Laiki Bank and Bank of Cyprus depositors, and deposits of less than 100,000 euros would be guaranteed.[93] Laiki Bank was put under resolution, so it was forced to close and to be replaced by a 'good bank' and a 'bad bank'. As with Northern Rock Bank, the bad bank absorbed all toxic assets, that is, deposits of more than 100,000 euros, and non-performing loans. The good bank consisted of all the guaranteed deposits and became a part of the Bank of Cyprus. In addition, Laiki's ELA was restructured and downsized, and its Greek branches ceased operation.

Admittedly, the rescue package prevented the entire country from defaulting. However, its effects went 'well beyond the shores of this small island nation'.[94] The idea of a state guarantee for bank deposits first appeared in 1929 when the US stock market crashed and banks failed.[95] A similar mechanism applies in the EU.[96] Although the existence of such mechanisms illustrates that maintaining banking confidence lies at the heart of banking authorities worldwide, Cyprus' bailout agreement seems to have destroyed this pillar of modern banking, since the savings of a considerable number of depositors were uninsured by the state and were consequently lost.[97] In fact, the bail-in

90 Eurogroup Statement on Cyprus (16 March 2013). Available at http://www.consilium.europa.eu/en/press/press-releases/2016/03/07/eurogroup-statement-cyprus/#. accessed 10 December 2016.

91 Treanor, J., Smith, H. and Moulds, J. (2013), 'Cyprus banks reopen – but stock exchange will remain closed', *The Guardian*, http://www.theguardian.com/business/2013/mar/28/cyprus-reopen-banks-stock-market-closed (accessed 10 December 2016). In July 2015, Greek banks broke a world record with a 3-week banking holiday and strict capital controls until Greece reached a new bailout deal with Troika.

92 Georgiou, G. C. (2013), 'Cyprus's Financial Crisis and the Threat to the Euro', *Mediterranean Quarterly*, Vol. 24, No. 3, p. 63.

93 Eurogroup Statement on Cyprus (25 March 2013). Available at http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/136487.pdf accessed 10 December 2016.

94 Georgiou, G. C. (2013) 'Cyprus's Financial Crisis and the Threat to the Euro', *Mediterranean Quarterly*, Vol. 24, No. 3, p. 66.

95 FDIC.gov, Timeline, available at http://www.fdic.gov/about/history/timeline/1920s.html, accessed 10 December 2016.

96 In the EU, bank deposits are guaranteed up to 100,000 euros per account.

97 Georgiou G. C. (2013) 'Cyprus's Financial Crisis and the Threat to the Euro', pp. 56-73.

tool used in Cyprus expedited the finalisation of the Deposit Guarantee Scheme, with the relevant directive being implemented one year later,[98] and subsequently, the bail-in tool was introduced as a concept in EU legislation.[99] Banking confidence was further damaged because transferring the burden of rescuing a bank to the depositors creates uncertainty as to whether deposits have become money available to taxpayers' money whenever there are emergency conditions. As long as governments can legally annul the guarantee of deposits, then 'nobody's money is safe from the tax collector'.[100] In other words, the seizure of private property ad lib would be legally allowed.

The reaction of financial observers in the US was also intense, as for the first time in history 'someone has found the courage to execute a credible solution to large bank failure that is not backstopped by taxpayers'.[101] While the US government preferred to rescue their banks during the crisis of 2007 by applying the TBTF theory, the Eurogroup supported that Cyprus' largest banks were not worth rescuing[102] since they could not bring down the whole eurozone system. In particular, the Eurogroup did not agree that Cyprus' banks fell under the EU's TBTF category, even if the two banks with the greater risk of failing were the largest of the island. However, the fact that these two banks were forced to apply such measures, irrespective of their size and importance for the local economy, demonstrates that the TBTF principle can be abandoned. It could be concluded that if a small and economically weak country has the courage to subject its two largest banks to such strong measures, the same process could be used in any other large and economically well developed country.

Recommendations for Cyprus

The temporary nature of the rescue package, which aimed at preventing the whole country from collapsing, renders the radical reform of Cyprus' banking sector necessary. However, the Memorandum of Understanding did not operate as a proposal for permanent reform of Cyprus' banking industry, but focused only on the management of the particular crisis, and therefore a complete reconsideration of the banking system within the EU context is urgent so to prevent similar crises in the future. Undeniably,

98 Directive 2014/49/EU on deposit guarantee schemes [2014] OJ 2 173/149 was implemented on 16 April 2014.

99 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ 2 173/190 was implemented on 15 May 2014.

100 Georgiou, G. C. (2013) 'Cyprus's Financial Crisis and the Threat to the Euro', p. 67.

101 Bennetts, L. (2013) 'The Cyprus 'Bail-In' Exposes as 'Too Big To Fail' As All Too Timid', *Forbes*. Available at http://www.forbes.com/sites/realspin/2013/04/18/the-cyprus-bail-in-exposes-too-big-to-fail-as-all-too-timid/, accessed 10 December 2016.

102 Georgiou, G. C. (2013) 'Cyprus's Financial Crisis and the Threat to the Euro', pp. 56-73.

Cyprus should implement EU recommendations regarding corporate governance of banks and cooperate effectively with EU authorities on bank supervision within the framework of the European banking union to strengthen its banking sector to achieve financial stability and to avoid a recurrence of the current financial crash.

Cyprus, acting within the EBU framework, can follow the example of the UK, which commenced its reform by restructuring bank supervision, and can consider proposals for improving its financial supervisory structure. Cyprus legislation authorizes the CBC to be the competent authority to supervise and license banks[103] in accordance with the guidelines issued by the EBA, and the Directions and Regulations adopted by the EU. Until recently, banks were supervised by the CBC,[104] and cooperative credit institutions were supervised by the Cooperative Societies' Supervision and Development Authority.[105] Insurance companies are under the responsibility of the Superintendent of Insurance,[106] investment firms are monitored by the Cyprus Securities and Exchange Commission,[107] and firms which deal with pension funds fall under the supervision of the Registrar of Occupation Retirement Benefit Funds.[108] The implementation of the SSM Regulation introduced some changes to the national system of supervision, and now, the Bank of Cyprus, the Cooperative Central Bank, the Hellenic Bank and the Russian Commercial Bank (RCB) are supervised by the ECB. The IMF characterised the former structure as fragmented and that the supervision of domestic financial institutions could not be effective and unified.[109]

It is interesting to examine whether the 'twin peaks' model that was adopted in the UK would be viable in Cyprus. Following the UK's example, banking regulation could be divided into monitoring banks' conduct, which is done by the FCA, and prudential supervision, which is the responsibility of the PRA. The former would deal with banks' relationship with their retail customers and their general market conduct, and the latter would administer the soundness of the financial system. However, the establishment

103 Central Bank of Cyprus Law 2002-2007, Banking Law 1997-2009

104 Central Bank of Cyprus, https://www.centralbank.cy/en/home, accessed 10 December 2016.

105 Ministry of Energy, Commerce, Industry and Tourism, 'Cooperative Societies' Supervision and Development Authority'. Available at http://www.mcit.gov.cy/mcit/mcit.nsf/dmlinspection_en/dmlinspection_en?OpenDocument, accessed 10 December 2016.

106 Ministry of Finance, 'Insurance Companies Control Service'. Available at http://mof.gov.cy/en/directorates-units/insurance-companies-control-service, accessed 10 December 2016.

107 Cyprus Securities and Exchange Commission, https://www.cysec.gov.cy/el-GR/home/?aspxerrorpath=/default_en.aspx/, accessed 10 December 2016.

108 Ministry of Labour and Social Insurance (n.d.) 'Occupational Retirement Benefit Funds'. Available at http://www.mlsi.gov.cy/mlsi/sid/sidv2.nsf/page43_en/page43_en?OpenDocument, accessed 10 December 2016.

109 Orphanides, A. and Syrichas, G. (2012) *The Cyprus Economy: Historical Review, Prospects, Challenges*, Central Bank of Cyprus. Available at http://www.centralbank.gov.cy/media/pdf/CBC_book_EN.pdf, accessed 10 December 2016.

of two peaks of regulation 'would be excessive in a country of Cyprus' size and would also create an additional regulatory interface for the firms themselves'.[110] A country's size is defined in terms of its banking industry and its general economy. It is necessary to ensure that the country's supervisory authorities deal with banks' conduct and their micro-prudential regulation and daily supervision. However, the size of Cyprus' economy enables the same authority to perform both functions.

Focusing on restructuring its supervisory mechanism could constitute the best approach for Cyprus to follow. Although various models are used worldwide, the most suitable and streamlined for Cyprus is the integrated structure. Under the Single Supervisory Mechanism, both the ECB and the CBC could assume the responsibilities of the four existing components of the supervisory system, thus becoming more efficient and strict. This authority must have complete legal and financial independence to supervise banks' conduct and compliance with prudential rules, such as the FCA and the PRA have in the UK. The 'one-stop-shop' model of financial supervision is already supported by numerous countries[111] as a means to avoid any overlap between various authorities and to provide the regulators with a thorough view of a country's financial sector. Moreover, it is argued that countries like the US, which have specialist supervisors, lack efficiency and effectiveness. Furthermore, a sole supervisory authority could operate more independently and thus provide 'a bulwark against political interference'.[112]

After improving bank supervision, Cyprus must also implement other recommendations. Most importantly, the country should reevaluate its philosophy regarding the role of banks and financial services. Cyprus' dependency on its banking system for financial services is extraordinarily high, and it is essential that the government implement a financial services strategy to guarantee the banking industry's continuous development. By fully appreciate their dependency on banks, the government will be able to monitor their operations more carefully. On the other hand, the government must quickly reinforce the banking system's autonomy. 'Cultural change of this kind would transform the banking industry in all the necessary ways, by delivering better governance, sounder banks, and greater trust internationally'.[113]

Furthermore, the corporate governance of banks should be improved to prevent boards from mismanaging banks and rewarding excessive bonuses to those who take excessive risks. Raising the standards of bank management should include ensuring that banks' boards of directors are independent, selecting directors on a merit basis,

110 Independent Commission on the Future of the Cyprus Banking Sector (October 2013) Final Report and Recommendations, p.70.

111 *Ibid.*

112 *Ibid.*

113 *Ibid.*

increasing the number of non-executive directors to counterbalance the executive directors, and regularly assessing the boards' performance.[114]

Finally, the Cypriot government could focus on effectively implementing the principles established in the Basel III framework which augment regulation and risk management of the banking industry. In that way it can enhance the banks' ability 'to absorb shocks arising from financial and economic stress whatever the source, improve risk management and governance and strengthen banks' transparency and disclosures'.[115] In practice, banks must raise their capital levels and curtail their debt levels, and macro-prudential regulation must ensure that the banking sector can tolerate higher risks, and micro-prudential regulation must become more rigorous in times of stress.

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114 *Ibid.*

115 Walker, G.A. (2010) 'Basel III Market and Regulatory Compromise', *Journal of Banking Regulation*, Vol. 12, No. 2, pp. 1-5.

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