EU POLICY AND THE CYPRUS BAIL-IN: HAIRCUT OF DEPOSITS

Costas Apostolides, Economist
Chairman of EMS Economic Management Ltd

This article has been prompted by the announcement by one of the senior economists of the Ministry of Finance before the Commission of Inquiry into the causes of Cyprus Economic Crisis, that he was not aware that the Euro Group would insist on a haircut of bank deposits until the 14th March 2013, that is the day before the crucial Euro Group meeting. If that is the case it was too late for the Government to be properly informed or prepared. My general view is that the government officials going before the Commission of Inquiry are in general anxious to cover their backs and avoid blame, shifting the issue to one of political incompetence and not technocratic failings, a view that is supported by news reports during the second part of 2012 and measures being taken by the EU which began in 2011. Someone was not doing their job at the civil service level, and the blame seems to be in the Finance Ministry and the Ministry of Commerce, Industry and tourism.

In November 2011 the European Commissioner for the Internal Market Michel Bernier announced the appointment of a High-level Expert Group on "possible reforms to the structure of the EU banking sector", and in agreement with European Commission President he appointed Erkii Liikanen Governor of the Bank of Finland as the Chairman of the Group. Its mandate was "to determine whether, in addition to on-going regulatory reforms, structural reforms of EU banks would strengthen financial stability and improve efficiency and consumer protection, and if that is the case make proposals as appropriate."

The Chairman of the Group submitted the report to the Internal Market Commissioner on 2nd October 2012, more than five months before the crucial Euro group meeting and stated the following: "The report contains recommendations for further reforms of the banking sector, including structural reform. “He added that the group’s recommendations would if implemented provide for a safer, more stable and efficient banking system …”. In brief the Group recommended the following:

- Mandatory separation of proprietary trading and other high risk trading activities.
- Possible additional separation of activities conditional on the recovery and resolution plan (resolution implies bankruptcy and closure).
- Possible amendments to the use of bail-in instruments as a resolution tool.
- A review of capital requirements on trading assets and real estate related loans.
- A strengthening of governance and control of banks.

Therefore, the bail in involving banks in difficulties taking funds from deposits was on the cards at least since October, covered by a comprehensive report of high level experts. Throughout the period 2011 to 2012 the Group of Experts was in contact with banks and officials and had an open consultation on bank restructuring with special emphasis what happens when a bank “too big to fail” actually does fail. Recall that in Cyprus the two biggest banks are involved.

More specifically Governor Erkki Liikanen recommended the following:
“The use of designated bail-in instruments is strongly supported by the Group. The position of bail-in instruments within the hierarchy of debt commitment in a bank’s balance sheet must be clear so that investors know the eventual treatment in case of a resolution.”

Therefore it was clear that the EU as a whole was considering the bail in as a way of reducing possible government support measures that would increase government debt. Why were the officials in Cyprus caught out and failed to advise properly the Government?

The strange thing about all this is that it was undertaken by the Commissioner on the Internal market not the Commissioner on Economic Policy and Monetary matters. In the Cyprus context this would mean that the Ministry of Finance would not be directly involved. It would be a matter for the then Ministry of Commerce and Industry and Tourism (now energy, commerce has been left out) but they may have seen it as a banking matter not under their jurisdiction and not informed the Central Bank and the Ministry of Finance.

In 2003 and 2004 we undertook a project with the British High commission on how to coordinate the civil service one Cyprus was in the EU. In the UK coordination is under the Prime Minister's office and it works very well. It is recommended that the Government of Cyprus re-examine the recommendations made 10 years ago, and get Cyprus coordinated properly for the EU. The Planning Bureau has already recommended a restructuring, and the unit set up for the EU Presidency also supported the Planning Bureau's ideas. Let's hope that they all get their act together. In the meantime last week it seems that the bail-in that was supposedly unique to Cyprus was made adopted as EU policy. Obviously the EU understands nothing about banking psychology.