Box 1

DEVELOPMENTS IN CYPRUS AND THEIR IMPACT ON FINANCIAL STABILITY IN THE EURO AREA

The financial sector in Cyprus harboured many vulnerabilities, predominantly in the two largest domestic banks which held total assets with a value equalling almost four times the country's GDP. In particular, the financial sector was characterised by high exposures to Greek sovereign bonds (and the associated private sector involvement) and the private sector in Greece. Together with a significant deterioration of the quality of domestic bank assets, this eroded the banks' capital. Ultimately, the capital needs of major Cypriot banks rose to almost €9 billion,[1] equivalent to 50% of Cypriot GDP. These vulnerabilities had been highlighted by the European Commission and the IMF in their regular country monitoring reports, and in the EU Capital Exercise undertaken by the European Banking Authority.

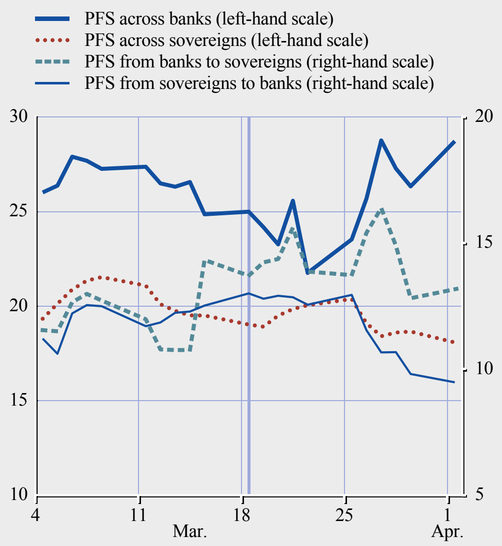
Against this background, on 25 March, the Eurogroup approved an adjustment programme of €10 billion which stipulated that the financial sector needs would be addressed, to a large extent, by means of a bail-in of uninsured creditors of the two largest Cypriot banks. To mitigate the risk of broad-based outflows from domestic banks, the authorities introduced temporary restrictions on domestic and cross-border transfers and payments.

Providing solvency support for Cyprus' very large banking system would immediately have called into question the sustainability of its public finances. The country stood in marked contrast to other euro area Member States with respect to the size, international significance and capital needs of its largest banks. The bail-in of uninsured creditors was thus the only viable strategy

1 See PIMCO, "Independent Due Diligence of the Banking System of Cyprus – February 2013", report published by the Central Bank of Cyprus on 19 April 2013.

Chart A The impact of Eurogroup's first Cyprus-related decision on the potential for spillover (PFS) index and its components

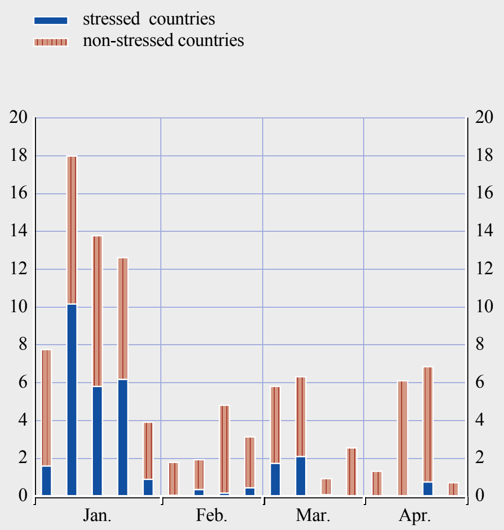
(20-day window around the Cypriot event)



Sources: CMA, Bloomberg and ECB calculations.
Note: Technical details of this methodology can be found in Box 5, entitled "Gauging the potential for sovereign and banking sector spillovers in the euro area", in ECB, *Financial Stability Review*, December 2012.

Chart B Weekly issuance of medium and long-term debt by euro area banks in 2013

(Jan. 2013 – Apr. 2013; EUR billions)



Source: Dealogic.
Notes: Retained deals are excluded. Stressed countries are Italy, Spain, Ireland and Portugal.

that could ensure both the sustainability of public debt and the protection of insured depositors. It nonetheless came as a surprise for market analysts, and was erroneously interpreted by some as a possible template for future bank resolutions in the euro area.

The spreading of contagion to other euro area markets, however, appears to have been largely contained in most cases. According to data provided by the Bank for International Settlements (BIS), euro area banks' exposure to Cyprus is limited (around €18 billion in December 2012). Perhaps most susceptible to direct contagion were banking sectors where Cypriot banks had operations, most notably Greece. This was addressed in the programme by ring-fencing the Greek operations of Cypriot banks to this end, and in line with the Eurogroup agreement, assets and liabilities of the Cypriot banks' branches operating in Greece were transferred to a Greek bank. Contagion would have been conceivable also through other channels, including confidence. However, no evidence of elevated deposit outflows were witnessed outside Cyprus – reinforcing the view that Cyprus is a unique case. More generally, market-based data suggest some limited spillovers in terms of only bank-specific risk (not sovereign risk), with the potential for spillovers (PFS) index rising for banks (see Chart A).[2]

Such concerns may also help to explain the limited deterioration in funding conditions for euro area banks. As shown in Chart 3.20, weekly issuance of medium and long-term debt by euro area banks fell to relatively low levels after a strong start into the year – with banks in countries under stress being affected most (see Chart B).

2 The potential for spillovers (PFS) index captures the potential impact of shocks to sovereign and bank credit default swap (CDS) spreads. See also Box 5 in ECB, *Financial Stability Review*, December 2012.

Notwithstanding the limited impact, the idiosyncratic aspects of the bail-in of uninsured depositors in Cyprus may raise concerns for some investors. To this end, further progress towards the establishment of an EU banking union, including a clear and consistent EU-wide approach to bank restructuring and resolution, is important to further limit any prospective contagion. This approach should be completed by an EU-wide single resolution mechanism to provide the required funding ex ante, without jeopardising the sustainability of the public finances of the Member States.[3]

3 See also Y Mersch, "The Banking Union – a European perspective: reasons, benefits, and challenges of the Banking Union", speech presented at the seminar "Auf dem Weg zu mehr Stabilität – Ein Dialog über die Ausgestaltung der Bankenunion zwischen Wissenschaft und Praxis" (Along the path towards greater stability – a dialogue on the design of the banking union between science and practice) organised by *Europolis* and the *Wirtschaftswoche*, Berlin, 5 April 2013.