"Europe and the Cyprus Crisis"
– Lecture by Panicos Demetriades, Former Governor of the Central Bank of Cyprus

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The crisis in Cyprus was a traumatic one, both for the country and former Central Bank Governor, Panicos Demetriades. Professor Demetriades was the Governor of the Central Bank of Cyprus from March 2012 to April 2014 and is currently the Professor of Economics at the University of Leicester.

March 2013 was a time of turbulence. The Euro, especially Cyprus, was at breaking point. In fact, Cyprus was closer to an exit from the European Union than Greece. It had come to the point where the European Central Bank had cut off liquidity to the Central Bank of Cyprus. The first step to recovery was the signing of the resolution law.

The primary causes of the crisis in Cyprus were the enormous banking system (953% of GDP), large exposure of Cypriot banks to Greece, and high public and private debt ratios (71% and 286% of GDP respectively). It did not help that high risk concentrated collateral-based lending and massive investments in Greek government bonds exacerbated the problem in Cyprus.

Number	Bank	Bank assets/GDP
1	*Bank of Cyprus Group*	*211.1%*
2	*Cyprus Popular Bank Group*	*189.7%*
3	*ING Bank*	*176.7%*
4	*Nordes Bank Finland Group*	*152.5%*
5	*Rabobank*	*128.4%*
6	*Dexia*	*111.6%*
7	*Bank of Valetta*	*110.2%*
8	*Banque et Caisse d'Epargne de l'Etal*	*101.4%*
9	*HSBC Malta*	*100.3%*

Table 1. Bank of Cyprus had the highest bank assets/GDP ratio in the Euro Area

The first challenge for Governor Demetriades was to prepare ground for a bailout application. Moreover, he had to convince President Christofias to seek the EU/IMF for help while simultaneously managing the fragile liquidity situation of Laiki. Exit from the Euro Area would have meant automatic exit from the European Union, which meant serious political consequences in its wake. On the 25th of March 2014, an unprecedented amount of bank restructuring was accomplished by the central bank in its role as resolution authority. Capital controls were implemented to protect the fragile banking system.

The underlying causes of the crisis were weak corporate governance, 'soft' regulation and infrequent monitoring. The euphoria of joining the European Union and the Euro Area fuelled capital inflows, inflating the real estate bubble. Excessive emphasis on collateral resulted in lax lending standards.

Since then, several regulatory responses have taken place. New directives, such as the new corporate governance directive and the new loan origination directive, give greater security that risks will be more strictly controlled. Furthermore, more real-time monitoring of banks will ensure that the banks do not operate beyond their capacity. The most important implementation was the Single Supervisory Mechanism, which grants the European Central Bank a supervisory role to monitor the financial stability of banks in the Euro Area. The broad lessons to be learnt include promoting financial structure that is diverse in ownership and size, to reduce systemic risk, and developing appropriate micro and macro-prudential tools to deal with larger banks.

Overall, the fundamental cause of the crisis in Cyprus was the two largest Cypriot banks becoming too big to fail, to save and to regulate. The risks undertaken were not carefully assessed, allowing the bubble to inflate rapidly. The bailout by the EU and IMF prevented bankruptcy and the subsequent Euro exit. However, the trade-off was harsh terms leading to an unintended erosion of Central Bank independence. The political economy foundations of the crisis will be difficult to address. Nevertheless, the creation of the severance of links between banks and their national supervisors under the Single Supervisory Mechanism remain important to the stability of the modern European economy.