Cyprus: Deal raises new problems for the future

Cypriot and EU policymakers have agreed a last-minute deal to inflict heavy losses on uninsured depositors in exchange for a €10bn bailout package. The deal is an improvement on the original plan, as the €100k deposit guarantee threshold has been upheld. But the Cypriot economy will suffer and another bailout will likely be needed in the future.

The deal also sets some dangerous precedents for the wider Eurozone concerning the resolution of failing banks. Senior bondholders and uninsured depositors will now no longer be protected from losses, which threatens to undermine the recent improvement in bank funding conditions and deposit flows in the periphery. Confidence in the ability of EU policymakers to tackle crises has also been further damaged.

Cyprus has secured a €10bn bailout...

After lengthy discussions, Cyprus clinched a last-minute deal with international lenders on 25th March to secure a €10bn bailout for budgetary financing. But the most important aspect of the deal – and the key issue for the rest of the Eurozone – concerned the new strategy employed by the EU-IMF ‘troika’ toward failing banks. The European Central Bank (ECB) reportedly threatened to cut off liquidity support to Cypriot banks unless the government agreed measures to raise the €5.8bn needed to recapitalise the country’s lenders and avoid a disorderly collapse of the financial sector. Banks in Cyprus were closed for more than a week as politicians debated how to raise the funds needed to qualify for the rescue package. An alternative was needed after an earlier plan for an across-the-board levy on all deposits was rejected by the country’s parliament.

...but the attached conditions are onerous

Below are the key features of the new bailout deal between Cyprus and the troika:

- All insured deposits (those under €100,000) will be protected but large losses (reportedly up to 40%) will be forced on uninsured deposits in the country’s two largest lenders. The final figure will partly depend on how the government decides to protect pension savings.

- The second-largest lender – Popular Bank of Cyprus (also known as Laiki) - will be closed and insured deposits transferred to its larger competitor, Bank of Cyprus (BoC).

- Uninsured deposits from Laiki will be used to create a “bad bank” that will be run down over time.

- BoC will be recapitalised through a deposit-to-equity conversion of its uninsured deposits with equity shareholders and bond holders having their investments wiped out - senior unsecured debt was bailed in for the first time since 2008. Uninsured deposits in BoC will remain frozen until the recapitalisation is complete.

The country is expected to continue some controls on the movement of money when banks reopen to prevent a run on the banks. Such controls would normally contravene EU law on the free flow of capital, but they can be legally justified on the grounds that they are needed to maintain financial stability. The exact nature of the capital controls has yet to be revealed, but it is likely to include restrictions on sending money abroad or moving it between domestic banks. Restrictions are also likely to prevent depositors from rearranging their accounts to escape the levy that will be imposed on deposits totaling more than €100,000.

Deal sends a tough signal to investors...

Given the small size of Cyprus, the other Eurozone governments could easily have financed a larger share of the deal. However, that seems to have been politically unacceptable and it would have pushed the public debt ratio in Cyprus to a very high level. The arrangements also confirm that the use of the European Stability Mechanism (ESM) to bail out banks (rather than governments) is completely off the table. This had been suggested in the past and now cannot be doubted. The lesson to private creditors from the troika would seem to be that things are getting back to normal and they believe that markets are strong enough to absorb this lesson in creditor responsibility. Indeed, Jeroen Dijsselbloem, president of the Eurogroup, has said that the Cyprus deal should act as a “template” for future Eurozone bailouts, and that European leaders are now committed to “pushing back the risks” of those rescues on to private sector creditors.
The new deal will not be put to a vote in the Cyprus parliament, as legislation is already in place (although it will still require parliamentary approval in a number of other Eurozone countries). Although the agreement is an improvement on the original plan in that it respects the deposit guarantee, the country’s offshore financial business is likely to be badly damaged as trust in the financial system has been destroyed.

…and the Cypriot economy will suffer

The damage to the economy also extends far beyond the financial sector. Although many large-scale depositors are Russian (estimates suggest Russian deposits account for a third of total deposits in Cypriot banks), local businesses will also be hit by the levy. Capital controls will also make it very difficult for these domestic businesses to operate and it is unclear how soon these restrictions will be lifted. The impact on the Cypriot economy is therefore likely to be even more severe than the effect on Greece following its bailout package; a sharp contraction in Cypriot GDP of around 10-20% is likely in 2013/14 with only a weak recovery thereafter. The collapse in economic activity will in turn also damage the country’s ability to repay its lenders.

Indeed, it is difficult to avoid the conclusion that Cyprus will require additional bailouts in the future when one considers that the €10bn package (equivalent to 56% of GDP in 2012) will raise public debt levels to around 140% of GDP. This debt burden does not appear sustainable, especially as the deepening recession is likely to contribute to a further rise in the debt-ratio in the near term. Moreover, any future sovereign debt restructuring will be complicated by the fact that Cypriot banks are large holders of domestic sovereign debt and a large share of the foreign-held securities are so-called Euro Medium-Term Notes that have been issued under English Law and are therefore difficult to restructure. The level of sovereign debt in Cyprus is likely to remain an issue for some time.

Broader implications for the Eurozone

More generally, the deal has set some dangerous precedents for the wider Eurozone. It demonstrates that banks that are not considered systemically important can no longer expect to be bailed out with Eurozone funds and senior bondholders should expect to shoulder losses in future rescues. Since 2008, senior bondholders had been shielded from losses during bank rescues as Eurozone policymakers wanted to avoid unsettling the markets. With this protection having been removed, investors may be more cautious when lending to non-systemically important banks in the Eurozone. There is a risk that this could deter investors that had recently returned to periphery bank debt markets, potentially reversing some of the recent improvement in wholesale funding conditions in the region.

On the other hand, the likelihood that investors would eventually have to shoulder losses on these instruments was already becoming accepted. In part, this reflects the fact that Eurozone banks have roughly €650bn of unsecured debt outstanding, making this market more than four times the size of the €150bn in junior or subordinated bank debt. Imposing losses on senior bondholders would therefore provide policymakers with greater capacity to avoid taxpayer-funded rescues in the future. The European Commission had targeted 2018 as the date when regulators would gain these bail-in powers in its proposals for a bank resolution regime, but the German, Dutch and Finnish governments had pushed to accelerate the loss-sharing rules to 2015 during meetings in January this year. To the extent that investors understood that policymakers in the Eurozone were pushing for senior debt bail-in, this should mitigate the effect on markets, although there is still likely to be some upward pressure on funding costs for weaker banks.

Amount of non-insured deposits (above €100k)

<table>
<thead>
<tr>
<th>Country</th>
<th>% of total deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>37.1</td>
</tr>
<tr>
<td>France</td>
<td>27.6</td>
</tr>
<tr>
<td>Germany</td>
<td>23.3</td>
</tr>
<tr>
<td>Netherlands</td>
<td>15.2</td>
</tr>
<tr>
<td>Belgium</td>
<td>17.0</td>
</tr>
<tr>
<td>Spain</td>
<td>13.0</td>
</tr>
<tr>
<td>Greece</td>
<td>10.6</td>
</tr>
<tr>
<td>Slovenia</td>
<td>8.7</td>
</tr>
<tr>
<td>Italy</td>
<td>5.9</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>4.7</td>
</tr>
<tr>
<td>Malta</td>
<td>3.1</td>
</tr>
</tbody>
</table>

Source: European Commission (2007 data)

Perhaps a greater surprise was that uninsured bank deposits over €100,000 were actually left unprotected. Although uninsured deposits are always vulnerable in a bank resolution, it was believed that this risk would evolve
more gradually. Recent statements from the European Commission have also now identified uninsured deposits as potentially eligible instruments for bail-in under a draft law on bank resolution currently under discussion. Although the number of uninsured accounts represents a small percentage of the total, their overall value is much more significant. Amongst peripheral economies such as Greece and Spain, for example, deposits above the €100k threshold represent around 15% of the value of total deposits.

It should be recognized that Cypriot banks were rather unique in that they had very little outstanding equity and debt instruments, so uninsured depositors will not be at the same risk of losses elsewhere in the Eurozone. Nevertheless, these developments are likely to make savers across the Eurozone much more sensitive to the €100,000 deposit insurance threshold. Large (foreign) investors will also be far more nervous about placing their money in any Eurozone bank that appears vulnerable. The immediate focus of concern will therefore be on banking systems that are already under pressure from deposit outflows, such as Portugal. The Slovenian banking system also looks at risk, given recent difficulties there.

Retail deposits at Eurozone banks*

![Retail deposits at Eurozone banks graph]

Although the finance minister of Cyprus has announced that the country’s banks will reopen on 28th March, this will be subject to capital controls. Assurances were given that confidence in the banking system would quickly return with the injection of EU bailout funds over the next few weeks, but this remains uncertain. Iceland sets an ominous example, where capital controls remain in place five years after its banking crisis. Parallels have already been drawn with Argentina’s “corralito” - the economic measures taken in Argentina at the end of 2001 that almost completely froze bank accounts for a year. The corralito spawned a sizeable avoidance industry, as well as numerous legal challenges. Although capital controls will hopefully prove more transitory in Cyprus, this precedent nevertheless appears to undermine a key principle of monetary union – that the currency is worth the same, wherever it is held. This will further erode confidence and it may make bank runs more likely in other member states with weak banking systems.

**Significant risk of financial contagion**

Cyprus accounts for less than one quarter of 1% of Eurozone GDP, so the short-term implications for the rest of the Eurozone from this deal are not huge. But there is clearly a risk that the precedents set by Eurozone policymakers in tackling failing banks in Cyprus could undermine confidence in vulnerable banking systems in other member states. Developments in this regard will therefore have to be watched closely in coming weeks.

A massive credit crunch is the most immediate risk if depositors withdraw their savings from banks in peripheral Eurozone countries such as Spain and Italy, fearing that their deposits are no longer guaranteed. We have used Oxford Economics’ Global Economic Model to quantify the impact of such a credit crunch. If deposit withdrawals force banks to tighten credit conditions as much as they...
did after the collapse of Lehman Brothers, funding costs would rise and Eurozone GDP would shrink by around 3% below our baseline forecast. This is the equivalent of wiping almost €300 billion off output to raise under €6 billion from depositors in Cypriot banks.

And the consequences may not end there: rising unemployment and increased social unrest could yet trigger a Eurozone break-up. This would be far more costly, cutting as much as 10% off Eurozone GDP.

Even if Eurozone policymakers are correct in assuming that there will not be a substantial hit to depositor confidence in other member states, the handling of the Cypriot bailout is likely to make future bank rescues more difficult to manage. Confidence in the ability of Eurozone policymakers to tackle crises in a swift and effective manner has suffered a further setback.