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Europe

Cyprus

Uninsured Depositors Hit By Major Losses

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- A bailout deal was finally reached last night involving a major u-turn on the proposed bank deposit levy announced just a week ago. Last night it was agreed instead a major overhaul of Cyprus' two largest lenders, with all their creditors, bar insured depositors, taking losses ranging from at least 30% to 100%, so that the two banks are not receiving any bailout money. The Greek branches of the two lenders have been taken over by a Greek bank. In exchange, the Eurogroup agreed to lend the Cyprus government "up to €10bn" via the ESM, probably including a contribution from the IMF and possibly from Russia. The funds will mainly cover the government financing needs and possibly will be used to recapitalise other domestic institutions.

- We believe the deal reduces the near-term risk of disorderly bank defaults in Cyprus – which would have occurred if the ECB had stopped the ELA provided by the Cyprus central bank – and hence of a possible imminent Cyprus exit from EMU. Moreover, having all uninsured creditors and shareholders bearing the losses is a more straightforward way, in our view, of dealing with insolvent (or nearly insolvent) banks rather than spreading the costs through the whole banking sector with a generalized deposit levy, on insured and uninsured deposits, which was more similar to a wealth tax than a deposit bail-in. The new deal reinforces an important lesson from the Cyprus case: bail-ins of bank creditors of oversized banking systems has entered the main toolkit of the eurozone crisis management. Despite all talks about Cyprus' uniqueness, the Eurogroup head Dijsellbloem said today that *"the Cyprus bank restructuring plan should be seen as template for the rest of the euro zone"*. This should help reduce the costs for the sovereigns to bailout domestic banks. Would this option have been pursued by Ireland in 2010, its public debt would have probably remained below 100% of GDP.

- However, the situation in Cyprus itself remains highly fragile. Additional capital needs for the surviving banks may emerge as the economy will likely shrink fast and large deposit outflows are likely to emerge when capital controls are lifted. Additional bank capital needs may lead to more bail-ins of bank creditors – and if there are not enough of those to ensure sustainability – additional liabilities may add on to the government's balance sheet. We believe government public debt, currently at 90% of GDP, is likely to reach levels which may create concerns around its sustainability. Some form of government debt restructuring could eventually become necessary in our view.

- Moreover, the Cyprus deal may leave profound scars on the whole euro area. First, risks of deposit flights in other fragile banking sectors have likely increased. Second, an extreme measure such as heavy capital controls in a member of the monetary union – even if for a "very special case" like Cyprus – may ultimately undermine the credibility of the EMU itself. Third, the degree of risky brinkmanship from all sides of the Cyprus deal may have jeopardised the willingness to cooperate of some euro area countries, some European institutions and the IMF in any future bailout process.

The Cyprus Deal: the Details

- **Major overhaul of the Cyprus two largest banks.** Cyprus second largest bank, Cyprus Popular Bank (or Laiki – total loans: €25.5bn; total deposits: €17.9bn; total NPLs: €7bn as of end Sept-12[1]) will be closed and its "good" assets and insured depositors (i.e., below the €100k deposit guarantee limit) will be transferred into Bank of Cyprus, the country's largest lender. The Greek branches of Bank of Cyprus and Laiki (accounting for ½ and 1/3 of their loan books, respectively) are being sold to a Greek bank. *All* equity shareholders and *all* bondholders in both banks will be fully bailed in. Insured deposits in both banks are to be safeguarded. Uninsured deposits in Laiki will be fully bailed in, while uninsured deposits in Bank of Cyprus will be converted into equity and suffer major, but still undefined, losses (estimates in the press range from 30% to 50%). These losses will be targeted to ensure that the bank capital ratio ultimately is brought to 9%. Moreover, it has been agreed that Bank of Cyprus will take over the €9bn of ELA liability which Laiki had towards the Cypriot central bank – apparently a major stumbling bloc in the negotiations on which Cyprus had to agree, in line with IMF requests.

- **Approval process.** The Cypriot parliament had approved on Friday last week legislation that introduces a bank resolution regime. This crucially allows the government to implement the decisions taken last night without further parliamentary approval being required. The Cypriot parliament will still have to pass the overall Memorandum of Understanding of the bailout programme – final approval is expected by third week of April. The deal still involves what was agreed last week in terms of higher tax rates on corporate profits and capital income as well as the implementation of an anti-money laundering framework, involving Moneyval alongside with a private international audit firm. All this still has to go through the Cyprus parliament. We think the package is unlikely to pose any major problem in passing through parliaments of the main creditor countries (in Germany, in particular, given the final deal seems to reflect closely the initial German position).

- **Bailout financing.** The resolution of Laiki is reportedly set to raise €4.2bn, while the contribution of uninsured depositors in Bank of Cyprus has been left uncapped in order to ensure that all losses of the new merged lender are covered. In quite stark contrast with previous bailouts, no bailout money will go for the recapitalisation of these two banks (although some resources may still be needed for the smaller banks). Therefore the total contribution of depositors may well be above the original figure emerged from last week's deal of €5.8bn – the head of the Eurogroup Dijsellbloem said last night that that figure should be disregarded. The €10bn external financial assistance will come primarily via the ESM, with the Russian involvement probably meaning some maturity lengthening of a 5-year loan for €2.5bn loan given to Cyprus in 2011 and coming to maturity in 2016. It is our understanding that the extension of Russian loan – if agreed – may reduce the contribution of the ESM below €10bn. The IMF will also likely contribute for a small amount out of the €10bn envelope.

- **A u-turn relative to last week's proposal.** The deal reached last night completely overthrows the agreement of one week ago, which had envisaged an across-the-board deposit levy on all deposits (insured and uninsured) and all banks (solvent and insolvent) – something half-way between a deposit bail-in and a wealth tax[2]. The new deal sees a major downsizing of Cyprus two major, and most troubled, lenders but aims at preserving all insured depositors. Having uninsured depositors (together with all other bank creditors) to shoulder all the losses is a much more straightforward way of dealing with the situation of insolvent banks rather than having the costs spread throughout the whole banking system in our view.

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[1] See "Cyprus Bailout & the Banks – Alert: Bailout Agreed – Haircuts on Large Deposits & Bank Restructuring" Citi Research, 25 March 2013.

[2] See "Euro Economics Weekly – Cyprus and Contagion", Citi Research 22 March 2013.

- **Where does the deal leave Cyprus?** However, with confidence in the Cyprus banking sector severely hit, the risk of major deposit outflows when capital controls are eventually removed (or softened) remains high, in our view, especially with about 40% of deposits held by foreigners. Large outflows may eventually require more funds to strengthen the surviving banks' capital position. Additional capital needs may also emerge as the economy will likely enter a severe recession, as a result of abrupt private deleveraging (Cypriot private sector debt is the second largest in the eurozone after Ireland) and sharp contraction of the financial sector (it accounts for 9.3% of GDP, versus 4.9% for the euro area average). Additional bank capital needs may lead to more bank creditor bail-ins and, if there are not enough uninsured creditors to restore sustainability, they may add on to the government's liabilities. The government public debt currently stands already at 90% of GDP (at a much higher level than for example at the time when Ireland had to first bailout its banks). With the economy contracting sharply and the deficit still at around 6% of GDP, the debt ratio is likely to quickly raise doubts of fiscal sustainability even if the deal ensures that most of the bank recapitalization costs are mostly shouldered by the bank creditors. After Greece, some government debt restructuring could eventually become necessary also in Cyprus.

- **Scars for the monetary union.** All uninsured deposits in Bank of Cyprus will be frozen during the process of merging with Laiki; major liquidity restrictions and capital controls are being put in place to preserve the financial stability of the rest of the banking sector and we think they are likely to remain in place for some time, in our view. It is not clear when Cypriot banks will open again, although the Eurogroup head Dijsellbloem said authorities would assess the situation today before taking a decision. We think that an extreme measure such as heavy capital controls in a member of the monetary union – even if for a *"very special case"* like Cyprus – may ultimately undermine the credibility of the EMU itself. The risk of deposit flights in other euro area peripheral countries has increased, in our view, due to the recent policy decisions in Cyprus. Finally, we think the degree of risky brinkmanship from all sides of the Cyprus deal may have damaged some relationships among euro zone members, European institutions and probably the IMF, possibly jeopardizing their ability to cooperate in any future bailout process.

Appendix A-1

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