



## *Cyprus: the stone on the beach*

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# Cyprus: the stone on the beach

## Introduction

So here we go again – the world's single biggest currency back in play.

Cyprus is a tiny economy but the treatment of its financial problems by the eurozone could have symbolic and far-reaching consequences. Cyprus is like a small stone on a big wide beach casting a long shadow all the way down the beach. It casts a long shadow because the sun over Europe is so low.

What happens in Cyprus has this shadow effect because potentially:

- It impacts on the attitude of depositors and capital market creditors in the eurozone generally and especially the countries with high debt ratios.
- It crosses the line of failing to protect deposits, thereby removing the confidence of depositors elsewhere in Europe.
- It causes creditors to question whether the eurozone assurances that Greece was a one-off are credible.
- It reduces the credibility of a banking union with EU-wide depositor insurance, EU-wide bank regulation and an EU-wide last resort new money facility for failing banks.
- There could be geopolitical consequences.

It would seem extraordinary to invite such perilous consequences for such a tiny amount of bailout cash.

## The levy on deposits

The eurozone proposed a levy (so far rejected by Cyprus) on both insured and uninsured deposits because they wanted depositors to contribute (especially Russian depositors) and:

- they did not want to use stigma terms like haircut or moratorium,
- they did not want to collide with the inconveniences of the Deposit Guarantee Directive 1994 as amended which requires member states to provide a deposit guarantee scheme for credit institutions for a minimum of EUR100,000, and

– they did not want to offend the provisions of the EU treaty banning capital controls.

But this levy is obviously not a tax as is normally understood and it is hard for euphemisms to obscure realities.

## Cyprus bank debt

Creditors of Cypriot banks have to accept that ultimately Cyprus can do what it likes, subject to some very basic thresholds, with creditors of Cypriot banks and have their action in most cases recognised elsewhere.

Deposits are likely to be governed by local Cyprus law: deposits usually do not state the governing law but case law suggest that in such a situation you apply the law of the branch. If Cyprus law applies, then Cyprus can change that law, e.g by imposing a levy or a moratorium or a haircut or a conversion into long term debt. The deposit is not insulated by a foreign law.

If it turns out that Cyprus law does not apply in a particular case, then Cyprus can pass a strong-arm bank resolution statute, deal with the creditors under a reorganisation measure pursuant to the resolution statute and have this recognised under the EU Directive on the Reorganisation and Winding Up of Credit Institutions of 2001. Under this directive, the bankruptcy law of the home state (Cyprus) applies throughout the EEA in the case of a bank, subject to various exceptions such as set-off (law of the claim owed to the bank), netting and repurchase agreements (law of the agreement) and various property rights of third parties, such as collateral and custodianship (generally where the property is located).

The same principles apply to bonds issued by Cypriot banks. If they are governed by local law, they are not insulated from local law changes. If they are governed by foreign law, then they could be brought within a new bank resolution statute which could give the authorities more or less a free hand.

In fact, the amount of Cypriot bank bonds held abroad is thought to be small.

## Sovereign debt

The loans held by Cypriot banks appear to be about seven times the country's GDP. Eurozone bailout money would be injected by lending to the government of Cyprus which would then use it to bail out the banks.

The amount of the sovereign debt of Cyprus is relatively small in absolute numbers. By reference to GDP at 86.5% it is not unusually high, but future budget deficits loom threateningly. However, with bailout package costs at EUR18 billion the sovereign debt would ultimately increase to about 140% of GDP.

The ability of Cyprus to deal with its sovereign debt is more limited than its ability to deal with bank debt. This is because the European recognition of bankruptcy measures in relation to banks does not apply to sovereign debt.

The broad position therefore is that Cyprus could offer to exchange sovereign debt governed by local law and, if the offer were not accepted, then Cyprus could theoretically pass a moratorium or rescheduling statute which would be absorbed into the Cyprus law bonds. Or they could adopt a half-way house and in an exchange offer include retrospective collective action clauses by statute allowing, say, two-thirds of the bondholders to bind the rest so that holdouts would be bound – as in Greece 2012.

As regards bonds governed by a foreign system of law (in our case English law), then the bondholders would not have to accept the offer of an exchange of a rescheduled bond but there are collective action clauses in the bonds which could be utilised.

All this is rather academic because it is understood that most of sovereign bonds are held by Cypriot banks and other Cypriot institutions so Cyprus would be taking away with one hand what must be given by another.

In addition, a haircut or moratorium in relation to the bonds, even though the amounts held by foreign holders are small, would deliver a highly prejudicial signal to capital markets and potentially let loose the hounds of contagion.

## The implications of a currency union

One of the routine and standard consequences of a currency union is that, if the members of a currency union wish to protect the currency from collapse or disintegration, they very often have to rescue regions or members of the currency union who become bankrupt. They have to do this because in some circumstances markets will trash the currency if they do not. Currency unions are therefore transfer unions.

Just about all countries of any size are currency unions and therefore transfer unions. The amounts of ordinary transfers from rich regions to poor regions are typically very substantial: they come in the form of expenditure for defence, for law and order, for social services, for education, for health, that is, for all of the public sector expenses of a modern state, anywhere between 30% and 60% of GDP. Over the years, the rich states in the United States have transferred enormous amounts to the poor states. The south in the United Kingdom has transferred enormous amounts to the north. In Italy the transfers have been from north to south, in China the amounts paid from the rich provinces to the poor provinces have been huge. Recently Abu Dhabi paid large sums to Dubai in order, amongst other

things, to protect the UAE currency. Within Europe West Germany made colossal transfers to East Germany after 1989.

It follows therefore that if regions want a common currency – and this is an eminently sensible aspiration – then it is not possible to have the good bits without the bad, the cherry without the pip, the rose without the thorn. Sometimes it seems as if Europeans either do not know this or have forgotten it.

## The nature of bankruptcy

Bankruptcy is remorseless, relentless. Debt fall due and if they are not paid the sovereign or the banks are bankrupt.

A bankruptcy would be highly undesirable for a member of the European Union and a member of the eurozone, as would the collapse of a EU banking system.

Bankruptcy does not wait upon morality. It is impervious to sermonising about discipline or frugality or thriftiness or good governance or to a lecture denouncing prodigality, lack of control or taking in muddy money. It presents sharp choices.

In the case of Greece, the failure of the eurozone to bailout Greece immediately and in full at the very beginning probably cost or will cost the eurozone twice or three times as much as it would have had to spend and had a seriously prejudicial effect on Europe. This was, however, the first case and everyone was new to the issues. Policy-makers in Europe today have the benefit of this experience and it would be bizarre if they were to make the same mistake again, especially with such a small amount involved.

## Complexity does not make the choices less stark

The Cypriot banking system has received a number of criticisms. This in turn has led to comments on the absence of controls on it in the past and lack of clear proposals about its future. The banking system did grow massively with assets over seven times the country's GDP. Its capital structure is heavily reliant on ephemeral deposits with little committed long-term senior debt or loss-absorbing subordinated funding. Its generosity in rates to depositors led to a reach for yield that is only found in riskier assets. Overexposure to Greek sovereign bonds and other Greek assets resulted in large losses and provisions after the Greek bond reorganisation in 2012 and the economic downturn in Greece.

Some may or ought to have seen some of these problems. Today hindsight may make everything clear, but does not change the available options. The immediate choice for Cyprus and the eurozone is between bankruptcy and defence of the euro.

## Other points worth considering

These are some other important points which might be relevant, depending on what happens:

- Cyprus is in a zone of geopolitical importance. For example, a country like Russia might well have many interests worth protecting in Cyprus. Important factors are that the UK has a major military base in Cyprus, focused on the Middle East. Cyprus has recently made a major gas discovery in offshore fields adjoining discoveries offshore by Israel. Historically, Cyprus has for many centuries played a pivotal role in Mediterranean politics and far beyond.
- If Cyprus were to introduce exchange controls, then, apart from the EU treaty and the consent of EU member states, it would be necessary to consider the recognition of the exchange controls. This usually hinges upon governing law but article VIII 2(b) of the IMF agreement (recognition of exchange controls) would also be relevant.
- Any bilateral investment treaties there may be between Cyprus and other countries could be relevant. These typically contain much tougher protections against expropriation and the like than are available under public international law. It is believed that Cyprus has a bilateral investment treaty with Russia.
- If negotiations go off the rails, either the eurozone or Cyprus might prefer to redenominate their currency back into Cypriot pounds, which would also require exchange controls. For a discussion of the complex issues involved in a currency redenomination, see the Intelligence Unit papers "The euro and currency unions" and "The euro: the ultimate crib" – [www.allenoverly.com/intelligenceunit](http://www.allenoverly.com/intelligenceunit) or our [sovereign debt and eurozone developments](#) website.
- Cyprus has an important shipping registry.
- The quarrel with Turkey is unresolved.

## Conclusion

In June 2012 the eurozone declared that it was "imperative to break the vicious circle between banks and sovereigns". This heralded the policy of doing "whatever it takes" to preserve the common currency. In Cyprus this policy now faces its most difficult challenge.

Cyprus is a small stone on the beach. But if things go wrong this could be the eurozone's Sarajevo moment.

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