Banking Crisis, Sovereign Debt Restructuring, and Financial Stability Policies In Cyprus During 2012-13

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*The views presented in this Forum are those of the authors and do not necessarily represent those of the IMF, its Executive Board, or IMF Management.

Contents

Background

- Our presentation is based on a published paper that examines the causes, policies and outcomes of the recent Cyprus banking crisis and domestic restructuring (Asonuma, Papaioannou, and Tsuda, 2021, "Banking Crisis, Sovereign Debt Restructurings, and Financial Stability Policies in Cyprus During 2012-13, *Multinational Finance Journal*, Vol. 25, No. 3-4, pp. 163-186).
- This study tries to shed some light on the macroeconomic setting surrounding the episodes, analyze the instituted policies, and assess their implications for the Cyprus economy.
- In this context, our investigation intents to inform the relevant public debate and facilitate a broad discussion of related policy issues.

Prevailing macroeconomic setting

- In early 2013, government cash reserves were enough to cover only 2-3 months of financing requirements
- Market access had been lost for around 2 years
- Real economy was in deep recession, with unemployment having risen to unprecedented levels, and relatively large fiscal and external imbalances/deficits

Possible causes:

- ➢ Unsustainable credit expansion in the previous decade, resulting in property bubble
- ➢ Close financial links with Greece (bank loans to residents and holdings of GGBs)
- ➢ Extremely high recapitalization needs of Cyprus banks, and
- ➢ An unsustainable course in public finances due to lax fiscal policies

- The government requested financial assistance from the ESM and IMF in June 2012.

Prevailing macroeconomic setting (continued)

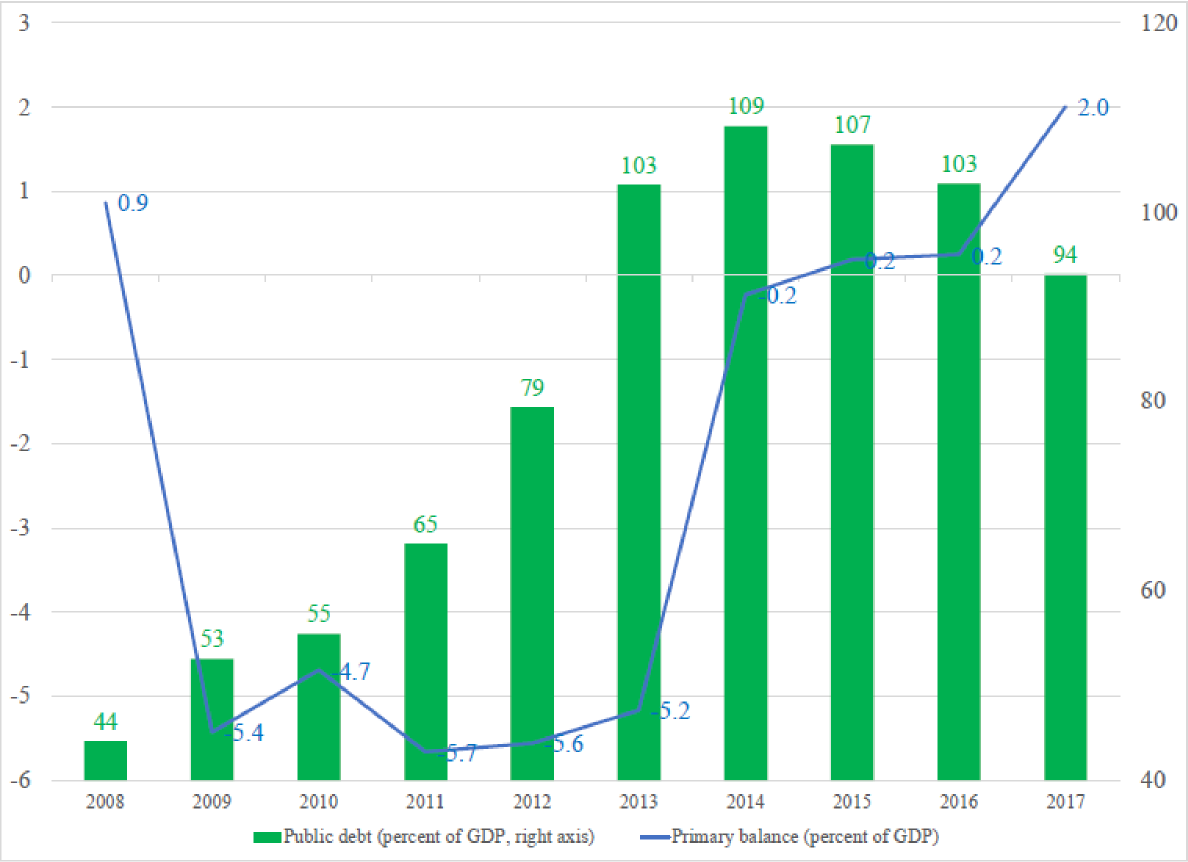

FIGURE 1. Cyprus Primary Balance and Public Debt (% of GDP)

Cyprus’ domestic sovereign debt restructuring in June 2013

- Restructuring was undertaken in the context of the country’s economic adjustment programs to restore debt sustainability, agreed with the
- ➢ European Stability Mechanism (March 25, 2013, EURO9.0 billion), and
- ➢ International Monetary Fund (May 13, 2013, Extended Fund Facility, EURO 1.0 billion)
- ➢Both programs were concluded at end-March 2016
- The government agreed to a restructuring (roll-over) of EURO1 billion of domestic bonds, maturing within the program period (2013Q2-2016Q1) -- domestic public debt stood at EUTO15.5 billion at end-2012 (80% of GDP), with about 60% held by domestic institutions; and
- ➢ Implemented a number of frontloaded fiscal consolidation measures, mostly on the expenditure side

Domestic bond restructuring terms

- Five new EURO-denominated bonds, EURO1 billion, were issued
- No principal haircut
- Maturity extension by 6.3 years (maturities spanning 2019-23)
- No coupon rate reduction (fixed annual interest rate structure 4.5-6 %
- NPV haircut of 35.8% on average, using exit yields of 12.5-13.2%
- No use of CACs or exit consents (restructured domestic bonds were issued under Cyprus Law before EU CACs Model enacted on January 1, 2013)
- 100% participation rate in debt exchange of eligible bonds

Domestic bond restructuring terms (continued)

TABLE 1. Cyprus Commercial Debt Restructuring 2013: Deal Structure

	Old Instruments Domestic Bonds due 2013–16 4.5% – 6.0%	**New Instruments** Domestic Bonds due 2019–23 4.5% – 6.0%
Number of instruments	11	5
Face value haircut (euro millions)	1,002	1,002
Maturity	2013–15	2019–23
Remaining maturity (years)	0 – 2.7	6 – 10
Fixed coupon rate	4.5%, 4.75%, 5% 5.25%, 6%	4.5%, 4.75%, 5% 5.25%, 6%
Repayment profile	at maturity	at maturity
Present value on 7/2013 1/	100.9%	64.6%
NPV haircut (recovery rates) 2/	35.8% (64.2%)	
Face value haircut	0%	
Market haircut 3/	35.4% (64.6%)	
Exchange recovery rate 4/	84.0%	
Participation rate	100%	
CACs triggered	No	

Domestic bond restructuring terms (continued)

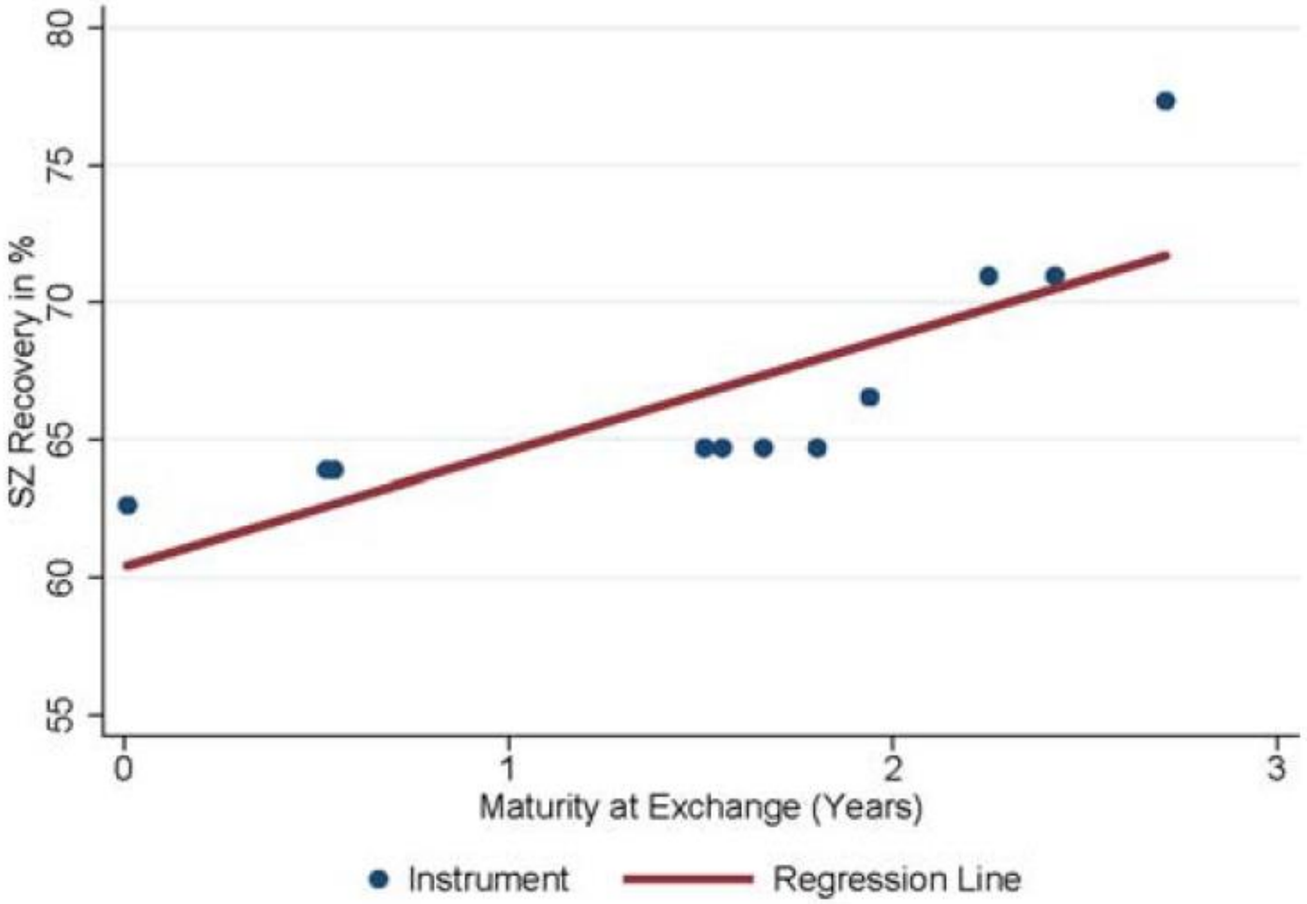

FIGURE 3A. SZ NPV Recovery Rates (%)

Domestic bond restructuring terms (continued)

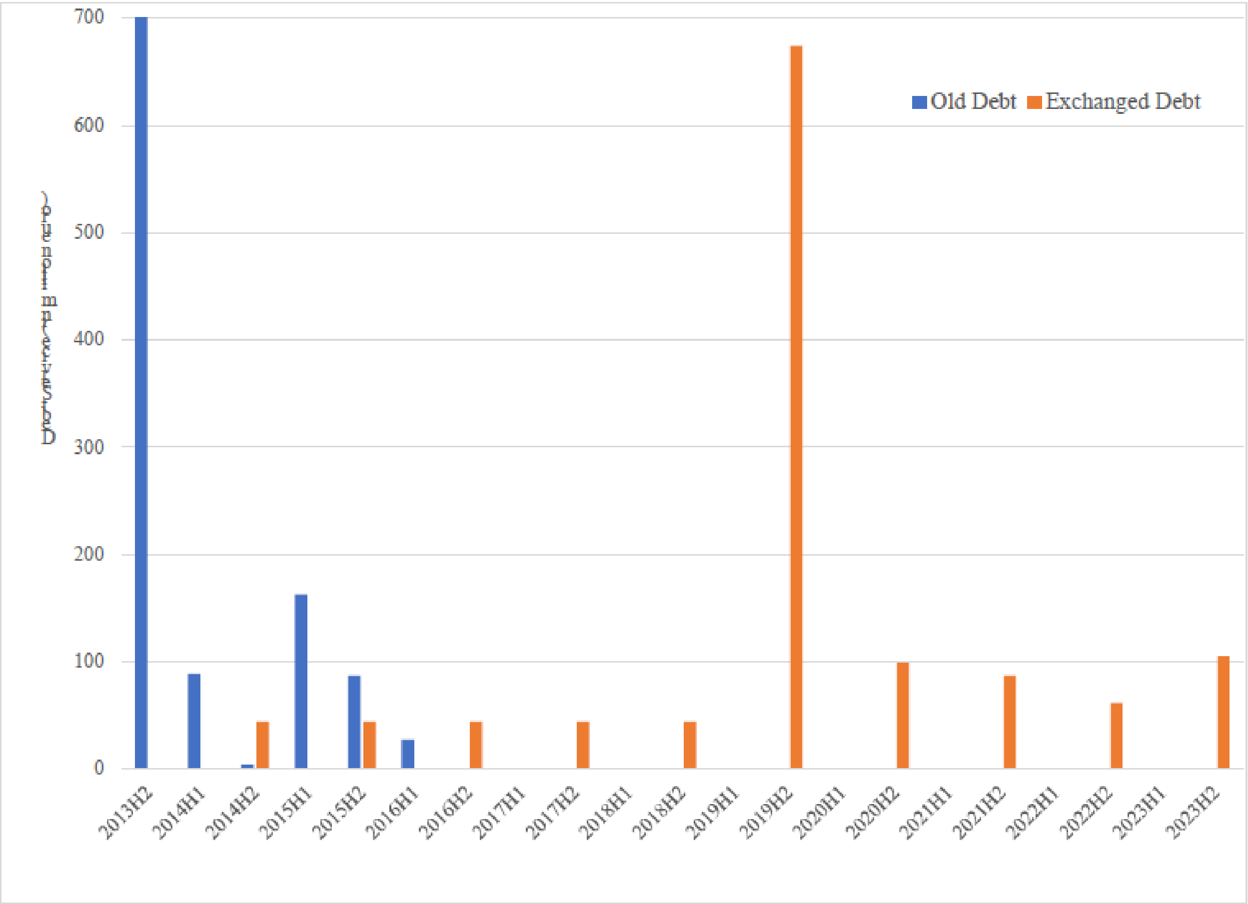

FIGURE 4. Cyprus Domestic Debt Restructuring, 2013–23: Debt Service (in millions of euro)

Banking crisis

Along with the fiscal consolidation policies, the adjustment programs required a banking sector restructuring and recapitalization, along with a prudent risk-based approach to lending:

- Cyprus Popular Bank (CPB), the second-largest bank, was closed
- A unique bail-in mechanism was applied, with a one-time bank deposit levy (haircut) used to cover the cost of bank recapitalization and imposed on:

➢ all uninsured deposits of CPB, and on

➢ 47.5 percent of uninsured deposits of the Bank of Cyprus (BOC), the largest commercial bank

➢ No insured deposit of EURO 100,000 or less were affected

- Orderly resolution of the Cyprus Cooperative Bank and creation of an Asset Management Company that acquired its bad loans
- NPLs declined significantly in absolute and in percentage terms

Financial stability policies

- Weaknesses in the banking sector had negatively affected the real economy, and ultimately the fiscal accounts and debt sustainability
- At end-2011, NPLs reached 10% of the total bank-lending portfolio
- At end-June 2011, Cyprus banks' holdings of (i) Greek loans amounted to about 130% of GDP and (ii) GGBs to about 40% of GDP

➢ Given these exposures, the Greek PSI in March 2012 eroded the confidence in Cyprus banks, triggering the burst of the asset bubble

➢ While the Central Bank of Cyprus provided emergency liquidity for some time to BOC and CPB, these banks experienced deposit outflows and were declared insolvent in March 2013

- Under these conditions, a restructuring of banks was undertaken in the context of the ESM-IMF programs, as detailed in the previous slide, while a restructuring of the domestic sovereign debt was undertaken to restore debt sustainability further undermining the already-weak banks balance sheet

Outcomes

- The debt restructuring was successful in
  - ➢ attaining substantial debt relief, reducing Cyprus' debt-to-GDP ratio, and
  - ➢ restoring financial stability (bank consolidation and NPL reduction)
- But at high cost for depositors
- The bail-in of both resident and non-resident depositors helped mitigate the burden of high bank recapitalization for the general public
- The economy recovered within two years, credit rating returned to investment grade, and market access was restored in March 2014

Lessons learned

- The aims of today's presentation were to,
  - first, hear in retrospect the views of the top policy makers and market participants involved in the crisis, what policies were right and what wrong, and thus contribute to the accurate account of events
  - second, draw lessons from the Cyprus experience for countries facing similar situations in the future and, thus, develop broad guidelines of dos and don'ts in dealing with analogous crises
- From the Cyprus experience, we draw the following important lessons:
  - As in other sovereign debt restructurings, the cause of the 2013 Cyprus domestic sovereign debt restructuring was excessive fiscal deficits and the accumulation of high debt levels over a prolonged period
  - The economic crisis that led to the 2013 Cyprus restructuring involved also a financial crisis, with the weak state of Cypriot banks being burdened by their exposure to overleveraged local property companies, the Greek government-debt crisis, and the reluctance of the government to restructure the problematic financial sector

Lessons learned (continued)

- ➢ The Cypriot fiscal adjustment package was comprehensive, with the fiscal adjustment being front-loaded with long-term anchors. The consolidation measures, along with the domestic sovereign debt restructuring, to restore debt sustainability and the banking resolution measures to reinstate financial stability ensured sustainable growth.

- Also, our analysis indicates that
- ➢ The authorities' seeking of assistance from the ESM and IMF helped in achieving relatively quick debt and banking resolutions, with substantial debt relief and rapid restoration of market access, and
- ➢ The institutional measures on banks helped enhance the efficiency and competitiveness of banks and restore financial stability

Thank you!