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Walking Back From Cyprus

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On Friday night, March 15, 2013, European leaders trespassed on consecrated ground. They insisted that Cyprus impose losses -- euphemistically dubbed a "solidarity levy" -- on insured depositors with Cypriot banks as a condition to receiving EU/IMF bailout assistance. Entering Friday's meeting, the leaders had four options on the table, none of them pleasant:

(i) Give Cyprus a complete bailout (estimated to cost €18 billion).

(ii) Restructure the outstanding Cypriot bonds, €4.4 billion of which are governed by Cypriot law and €3.8 billion by English law.

(iii) Haircut excess deposits in the Cypriot banking system; that is, deposits in excess of the €100,000 minimum covered by the local deposit insurance scheme. These represent about half of the total deposit base.

(iv) Haircut the insured deposits.

The European leaders chose options (iii) and (iv). Insured depositors will suffer a 6.75% loss on their deposits; amounts in excess of that level will be subject to a solidarity contribution of 9.9%. Holders of Cypriot sovereign bonds will emerge unscathed. The next bond maturing on June 3, 2013 in the amount of €1.4 billion -- a large chunk of which is reputed to have been bought by international hedge funds over the last six months at prices ranging from 70-75 cents on the euro -- will be paid out at 100 cents on the euro in about ten weeks. Each depositor in a Cypriot bank, large and small, will be making a solidarity contribution toward that payment to bondholders.

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Friday night's decisions will send two regrettable, and apparently already regretted, messages. First, that deposit insurance schemes may protect you if your bank manager absconds with your money but not if your own government takes it. Second, that, yes indeed, peripheral Eurozone sovereign bonds do benefit from an implicit northern European guarantee.

How might it have been different? Here is a sketch of an alternative approach had Friday's priority between insured depositors and bondholders been inverted:

1. All insured depositors to be protected. Indeed, the public announcement of the bailout package would liberally sprinkle adjectives such as "sacred" and "inviolable" in front of the words "insured deposits" wherever they appear.

2. Holders of deposits in excess of the insured €100,000 minimum would receive, at par, interest-bearing bank certificates of deposit for those excess amounts. Depositors would be given the option of taking CDs of, say, five or ten years' duration, with differing interest rates designed to encourage a longer stretch out. Also, to encourage a take-up of the longer dated CDs, the Government could offer a limited recourse guarantee on the ten-year CDs benefiting from a pledge of a portion of the Cypriot gas revenues that should come on line when those CDs mature. The CDs would be freely tradable and liquid in the hands of the holders.

3. The maturity dates of all sovereign bonds would be extended by a fixed number of years, let's say five years. By our reckoning, this would reduce the total amount of the required official sector bailout funding during a three-year program period by about €6.6 billion.

The benefits? Terming out excess deposits will effectively lock in that funding to the banks for many years. The alternative (debiting 9.9 percent now and watching the balance of 90.1 percent get out of Dodge when the banks reopen) may easily require the bailout package to be reworked in a month's time.

Rescheduling the maturity dates of outstanding sovereign bonds -- with no haircut to principal or interest rate -- would avoid the need to have those maturities repaid out of official sector bailout funds. A principal extension of this kind is the most clement of the three tools in a sovereign debt restructurer's tool box, the other two are surgeon's saws labeled, respectively, "principal" and "interest".

The objections?

- "The banks still need to be recapitalized." Answer -- true. But an institution, one-half of whose funding has been locked in at a fixed rate for a decade, is a whole lot easier and cheaper to stabilize than one whose funding (or at least 90.1% of it) is hourly at risk of departure.

- "The sovereign bonds are not the problem." Answer -- partially true. Unshackled from its submerged banking sector, the Cypriot sovereign is not in such bad shape. The immediate objective, however, is to bring the aggregate size of the bailout package down to a level that will be tolerable in the eyes of northern European Parliaments. Removing the bond maturities from the program window should shave €6.6 billion from that tab, well above the €2.8 billion that Friday's plan expects to extract from the reluctant pockets of retail depositors.

- "The Cypriot banks own most of the bonds; it will be like punching a pillow." Answer -- largely irrelevant. With half of their liabilities stretched out for many years, stretching out a portion of their assets is less worrisome.

- "The holdouts in a bond restructuring will eat you alive." Answer -- maybe so, but probably not. Slight more than half of the bonds are under Cypriot law and these can be dealt with by a retrofit collection action clause à la grecque. Each of the English law bonds contains its own collective action clause. We have elsewhere speculated on a broader measure that the Eurozone could take to discourage prospective holdouts.[1]

There are no painless or riskless options in Cyprus. But the decisions of Friday night should stand for the proposition that some options are incandescently more painful and risky than others.

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[1] *See* Lee C. Buchheit, Mitu Gulati & Ignacio Tirado, *The Problem of Holdouts in Eurozone Sovereign Debt Restructurings* (January 2013) (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2205704).