SARTHI
Bridging the Gap

INFO BYTE

Cyprus Crisis

Headlines

This weekend, a group including the European Central Bank (ECB), the European Commission, the International Monetary Fund (IMF) and the government of Cyprus announced that the small island nation was on the brink of crisis, and needed to be bailed out.

But while most previous euro zone bailout have been financed by rich Northern European countries like Germany and the Netherlands, the Cypriot bailout is an entirely different story — one that happens to involve Russian gangsters. Here's what you need to know.

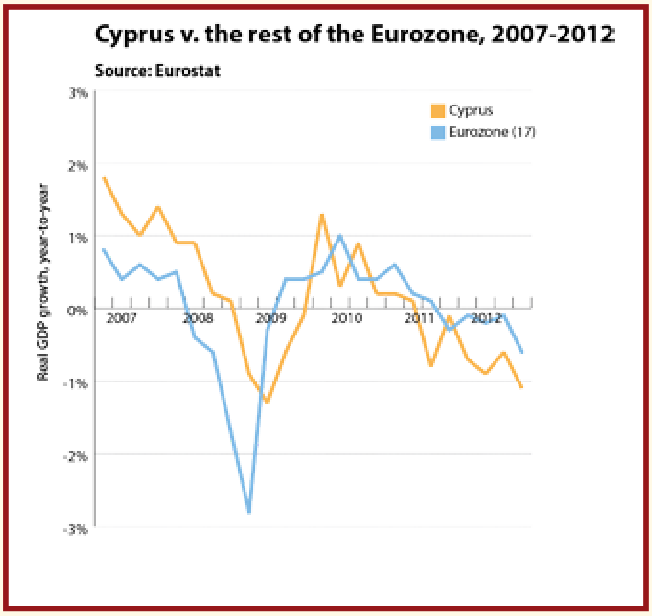
An Animal called "Cyprus"

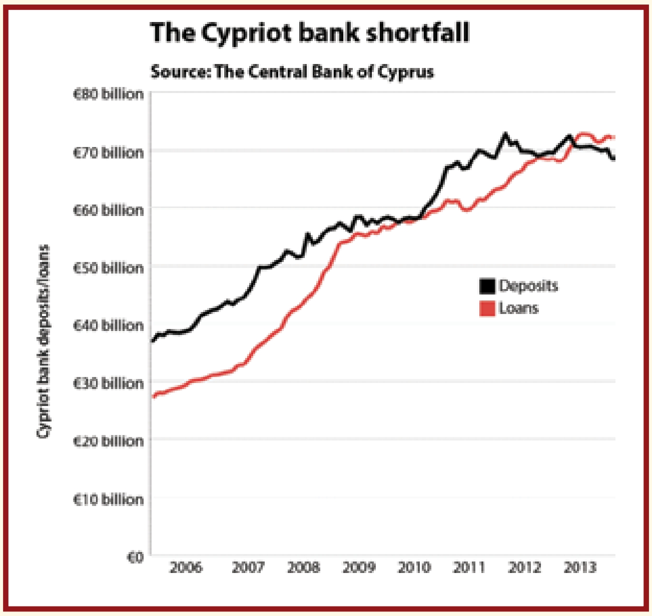
Cyprus is an island in the eastern portion of the Mediterranean Sea. The northern half of the island is primarily populated by Cypriots of Turkish origin, while the south is dominated by Greek Cypriots. After nearly a century as a British colony, the island became independent in 1960, with a fragile power-sharing arrangement in place between Greek and Turkish residents. That broke down in 1963, and a U.N. peacekeeping force was sent to maintain order.

That situation persists to this day, with the U.N. peacekeeping operation set to mark its 50th anniversary next year. The Turkish Republic of Northern Cyprus, a puppet state recognized by no country other than Turkey, rules the north, while the Republic of Cyprus governs the south, joined the European Union in 2004, and — in a spectacular display of poor timing — joined the euro zone in January 2008, just before the crisis hit. The E.U. has stated that the northern part of the island rightfully belongs to the Republic of Cyprus, and said that it considers Turkey an illegal occupier.

The Cyprus Crisis

Cypriot banks were heavily exposed to the Greek debt crisis, by virtue of having large bonds holdings of Greek debt, both public and private. The value of that debt took a nosedive, destroying the balance sheets of Cypriot banks. Cyprus Popular Bank had €3.4 billion





in Greek government debt, and the Bank of Cyprus €2.4 billion; they ended up losing €2.5 billion and €1 billion, respectively.

When Greek government debt was written down as part of a deal in 2011,that wiped out a lot of the remaining value of Greek debt. Popular Bank lost 76% of the value of their Greek bond holdings in the deal.

Cyprus needs €17 billion.

There is something rotten in Cyprus Banks

There are four things you need to know about Cypriot banks. First, they have assets equal to roughly eight times the country's GDP. Second, they get a huge percentage of their deposits from tax-dodging Russians. Third, they invested a ton of money in Greece. And fourth, they are highly dependent on central bank financing to stay afloat. In other words, Cypriot banks are too big for Cyprus to save. But somebody needs to save them.

How did all this money get into Cyprus Banks?

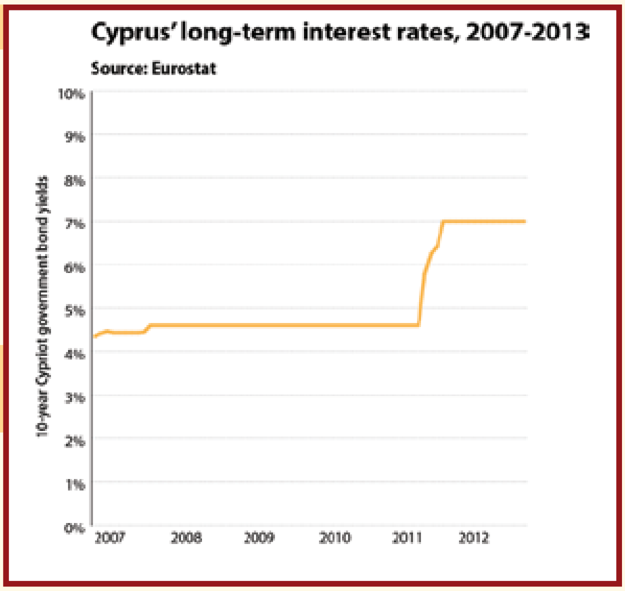
Like many other small islands, Cyprus has found that turning itself into a tax haven (and money-laundering centre) is a pretty lucrative business. Money has poured in from Russian oligarchs and mobsters looking to avoid taxes back home, and that Russian money has bloated Cypriot banks to a size far beyond the government's ability to bail out. Indeed, roughly 37 percent of the island's €68 billion of deposits come from abroad. This foreign money makes up €25.5 billion of the €37.6 billion of deposits over €100,000. In other words, almost all of the foreign money is in uninsured accounts, and 68 percent of all uninsured accounts come from abroad.

What did Cyprus banks do with all this money?

Well, they invested it where they thought they had a competitive advantage: Greece. After all, southern Cyprus is ethnically Greek (the northern half is occupied by Turkey), and the Greek economy, which is 12 times larger than the Cypriot one, looked like an ideal place to expand. It wasn't. Cypriot loans to the Greek government and businesses have opened black holes on bank balance sheets. In 2012 alone, two of the biggest Cypriot banks, Cyprus Popular and the Bank of Cyprus, lost a combined €3.5 billion on Greek bonds. That's over 10 percent of GDP in a €31.8 billion Cypriot economy. It'd be like if Citigroup and JP Morgan lost $1.5 trillion in a single year (or approximately 250 times the "London Whale" losses).

How could government afford that?

It couldn't; interest rates have spiked to 7 percent on long-term debt, which means that paying for all these bailouts is getting difficult for the Cypriot government. That's why the Bank of Cyprus's request, and the continued struggles of the nationalized Popular Bank, forced Cyprus to go to the Troika (that is, the European Commission, ECB, and IMF) in pursuit of a bailout covering both the government's financial needs, and the shortfalls faced by its largest banks.



Proposed Rescue Package by EU – Levy a Tax rate

The proposed package incorporates privatisation of state assets, increase in corporate taxes (from 10% to 12.5%) and withholding taxes on capital income (to 28%) and restructuring of existing bank or sovereign debt.

Most controversial was to spare small savers up to €20,000 from the proposed bank levy and to impose a one-time levy of 6.75% on deposits between €20,000 and €100,000. Deposits above that level are to be charged 9.9%. in return, depositors will receive shares of relevant banks.

This did not distinguish between the Russian and Ukrainian millionaires who have slashed their ill-gotten wealth, and the local widow who have squirreled away their savings. This bank levy plan is intended to raise revenue of €5.8 billion.

The logic of this Levy

- The IMF participation requires the debt level to be sustainable. The write-off of depositors reduces debt and also the size of the required bailout package to Cyprus to 10 bn.
- Cypriot banks have limited amounts of subordinated or senior unsecured debt (that are cleared only after other lenders are repaid). This means a write down of bondholders would only raise between 1 and 2 billion, below the required amount.
- As in the case of the Greek debt restructuring, the European Central Bank (ECB) and others are unwilling to take losses on their exposure.
- Restructuring Cyprus's sovereign debt is risky because many bonds are governed by English law where the right of the creditors are more protected. Any attempt to restructure these while insulating official creditors from losses would invite litigation.
- Germany, Finland and Holland are increasingly concerned about losses on bailout loans. German Chancellor Angela Merkel does not want concern about actual cash losses to German taxpayers to affect her prospects in the September 2013 elections.
- Germany wants to prevent any bailout fund flowing to Russian depositors, such as oligarchs or organised criminals who have used Cypriot banks to launder money.

Cypriot Parliament Rejected a Bank Levy Plan

The European Union was plunged into a new crisis on Tuesday night after the Cypriot Parliament overwhelmingly rejected a bank levy plan agreed by the Eurozone finance ministers at the weekend as part of a €10 billion ($13 billion) bailout package for the cash-strapped nation.

Faced with public outrage over the controversial plan to impose a one-off levy on all bank accounts on the island and opposition within the government, the President presented a compromise shortly before the Parliamentary debate in Nicosia, but it failed to win support even from a single Member of Parliament.

After a heated debate in parliament, 36 MPs out of a total of 56 Parliamentarians voted against legislation on the bailout package and the President's compromise plan while 19 MPs abstained and one deputy failed to attend.

The rejection of the bailout deal by Parliament raised new fears that it could reignite the Eurozone debt crisis after a few months of relative stability.

The Eurozone governments have also taken “adequate precautionary measures to ensure that Tuesday’s decision will not have any negative consequences for the rest of the Eurozone.w

The Euro group called upon the Cyprus government to present an alternative proposal as soon as possible.

Impact on other Nations

The move is significant as it has the potential to create instability in Europe. The worry is that depositors in other financially weak, or bailed out, nations might fear similar bailout provisions in the future from the EU. Depositors and investors elsewhere could easily see this as another in a string of ‘one-offs’ and react badly. The bailout, while small compared to the emergency loans supporting other troubled European nations like Greece, represents more than half the size of the €22 billion Cyprus economy. Cyprus is the EU’s smallest state, accounting for just 0.2% of output.

This precedent could cause a capital flight of money from the euro-zone. The euro started the week by falling to low support before moving back to the 1.29-1.30 mark.

There could be serious repercussions for other financially over-stretched economies, such as those of Spain and Italy. It is possible that Spanish banks, in particular, could be hit by an outflow of deposits. That would reinforce their dependence on emergency funding from the ECB which would act as further brake on the ability of Spanish banks to provide vital credit - and would represent a serious setback in the stabilization of the currency union. The lesson is in the form of a warning to banks that they should take care where they place their funds, and avoid banks that overstretch themselves.

Impact on India

With Cyprus not being really significant for India, two issues would stand out -

It will affect the Indian firms that set up investment entities there to take advantage of the country’s loose banking regulations.

Several Indian companies in the infrastructure and real estate sectors set up subsidiaries in Cyprus as it is by far the most beneficial location in terms of Double Tax Treaty Comparison, as there is no dividend withholding on payments from Cyprus to India and from India to Cyprus, according to Cyprus and India laws. An Indian company has to pay a dividend distribution tax but a company based in Cyprus receiving dividends is tax-free. Also, there is no interest withholding tax on payments made from Cyprus to India.

Eg: Network 18 has four subsidiaries based in Cyprus. The four subsidiaries include: Indian Films Company Cyprus, TV18 HSN Holdings Limited (Cyprus), E18 Limited (Cyprus) and Namono Investments. Together, these companies hold $260,000 in Cyprus and if the Cypriot parliament decides to impose a tax on deposits, the group will have to pay tax on this amount.

The second is the impact on the exchange rate. The euro-dollar relation would tend to get a bit volatile more on account of the uncertainty on the perceptions of the repercussions on other nations rather than Cyprus, which is a very small part of the story. At the margin, the dollar could be expected to strengthen vis-à-vis the euro that can put downward pressure on rupee.

SARTHI
Bridging the Gap

CONTACT US

Please write to us with your feedback, suggestion or query at **smelisting@sarthiwm.in**
www. sarthiwm.in

Sarthi Capital Advisors Private Limited
SEBI Registered Category I Merchant Banker
SEBI Registration No : INM000012011

Mumbai
159/11, Amar Brass Compound,
Vidya Nagari Marg,
Kalina, Santacruz (E),
Mumbai – 400098
Landline: 022-26528671-72
Fax: 022-26528673

New Delhi
Anthem House,
E-360, 1st Floor,
Nirman Vihar, Delhi - 110092
Landline: 011-22449817, 011-22449815
Fax: 011-22439816