

Derivatives in the context of Cyprus

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When Cyprus and the Eurogroup (consisting of finance ministers of the EU member states having the Euro as their currency) decided on the terms of a memorandum of understanding with Troika (consisting of the European Commission, the European Central Bank and the International Monetary Fund) the whole world was taken by surprise. Not because Cyprus needed to reorganise its credit and financial institutions, but rather because of the measures decided upon for implementing such reorganisation.

Cyprus resolution measures

The initial decision between Cyprus and the Eurogroup was viewed as completely unjustified and would have required all depositors in financial institutions licensed to carry out banking activities in Cyprus to contribute by way of bail-in anything from 6.75 per cent to 10 per cent of their deposits with such institutions. The Cypriot parliament, being the legislative body, did not accept the passing of a law which would have facilitated the above. A new agreement between the Eurogroup and Cyprus as to the terms of the Troika Memorandum of Understanding was finally sanctioned by the Cypriot parliament and to facilitate its implementation the following main pieces of legislation were passed:

- Law No. 17(I) of 2013 on the Resolution and Other Institutions Law (the “Resolution Law”); and
- Law No. 12(I) of 2013 on the Imposition of Restrictive Measures in Transactions in Situations of Emergency (the “Restrictive Measures Law”).

Pursuant to the Resolution Law and the decrees issued under it, Laiki Bank and Bank of Cyprus were made subject to the Resolution Law and a bail-in was applied to deposits with them. One should bear in mind that the Eurogroup made its decision on the basis that the two endemic banks of Cyprus, namely Laiki Bank and Bank of Cyprus, were insolvent and unless the Resolution Law had been passed the banks would have been forced into liquidation.

Effect on derivatives

Notwithstanding their necessity the Restrictive Measures Law and the Resolution Law have raised a number of questions in relation to transactions with international counterparties, mainly because restrictions on capital transfer meant that certain trades could not be effected and, whilst derivatives would usually be subject to agreements governed by foreign laws (typically English), the Resolution Law and Restrictive Measures Law contained provisions which expressly provided that such measures would not activate any contractual clause or statutory provision that would be triggered by bankruptcy or insolvency or on the occurrence of any other event which could qualify as a credit event or an event equivalent to insolvency.

Such statutory provisions have raised complex conflicts of law issues where contractual clauses triggering defaults and terminations are ordinarily enforceable under the governing law of the agreement but where Cypriot laws applicable to the counterparty restrict such terminations from triggering. While it is fairly clear that these statutory provisions are intended to prevent the closing out of derivatives contracts based on the insolvency of Laiki Bank or Bank of Cyprus, it is not clear to what extent a court would also consider them to frustrate termination provisions based on a failure to pay as a result of the imposition of the Restrictive Measures Law, or even based on indirect consequences such as a ratings downgrade. It also raises the possibility that in applying the Resolution Law and the Restrictive Measures Law, the Cypriot courts may come to a different conclusion from the English courts which will presumably be inclined to construe contractual provisions strictly under English law as their governing law. It is also not clear, where for example Laiki Bank or Bank of Cyprus is a reference entity under a derivatives contract and neither party to that contract is based in Cyprus, the extent to which the provisions of the Resolution Law and the Restrictive Measures Law would be taken into account, especially given that the forum for any dispute will generally be driven by the governing law or the location of collateral.

What the Resolution Law and Restrictive Measures Law have not affected are (i) the ability of a counterparty to set off obligations or to calculate net termination amounts following a valid termination or (ii) the enforceability of collateral provisions, at least where they do not require the transfer of funds from a Cypriot counterparty. In this context some questions still exist as to the extent to which Laiki Bank and Bank of Cyprus can use a foreign branch or foreign accounts not subject to the Resolution Law and Restrictive Measures Law to service derivative contracts.

While there undoubtedly remain open questions relating to the termination of derivatives arrangements which will be considered over the coming weeks in the context of specific transactions, substantive law relating to financial markets transactions has not and is not expected to change in Cyprus. While the Resolution Law and Restrictive Measures Law have thrown up transitional uncertainties, the legal foundations of Cyprus as a jurisdiction which upholds the effect of derivative arrangements against counterparties based there remain solid.

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