A SYMPOSIUM OF VIEWS

In light of "Cyprus," are eurozone uninsured bank deposits vulnerable?

If told today that you have a forgotten account in a Greek, Portuguese, Spanish, Irish, or Italian bank with $130,000 in insured deposits, would you move those deposits to avoid the repeat of a potential Cyprus-type situation? Or was the Cyprus banking crisis, and taxation of those deposits as part of the financial rescue, an aberration in a largely irrelevant country roughly half the size of Brooklyn, New York (and complicated by its involvement in international money laundering)? What are the takeaway implications of the Cyprus crisis and would you move your newly discovered bank deposits elsewhere?

Seventeen Noted Thinkers Weigh In

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Cyprus has the potential to undermine confidence in deposit insurance throughout the eurozone.

ROBERT JOHNSON
Executive Director, Institute for New Economic Thinking, and Former Managing Director, Soros Funds Management

Sink or swim? That has long been the Darwinian choice facing each country in the eurozone. And in many ways Cyprus, a small country in the scheme of things, can be seen as just the latest test of Europe's collective resolve.

Yet the Cyprus fiasco also could prove to be a turning point in the ongoing euro crisis. Once again, just enough has been done to keep a member of the monetary union afloat—but not enough to bring the entire European Union to dry land. And in this case, by pretending they were dealing with an isolated country, the nations of the European Union have damaged the faith in deposit insurance throughout the eurozone. This may become a crippling blow.

The rescue of Cyprus was a microcosm of how the nations of Europe have failed to work together to adequately address their ongoing financial crises. In this case, with Germany unwilling to foot the bill for a loan that it had good reason to suspect would never be paid back, the eurozone's finance ministers opted to make the numbers work by going after depositors.

The scheme that taxed even small deposits was eventually abandoned in favor of taxing only those that were uninsured. But the implications to the public were clear. Bank deposits could be at risk in future debt crises. This message was especially significant in Europe, where markets and credit allocation are much more dependent on banking than in the United States.

The so-called "bail in" of depositors (what was called a tax, but was really a haircut in all but name) made the numbers work in the short term. But it has had the long-term effect of undermining confidence in the deposit insurance system across the eurozone, insurance that was one of the only barriers to a full-on banking panic during the early stages of the crisis.

When the next wave of the crisis hits—and eventually it will, as long as Europe continues to rely on half measures to address its problems—depositors across Europe now understand that their leaders have identified a new way to fund the periphery's debt troubles: their savings.

The anxiety this implicit threat creates may already be contributing to a deflationary shock to Europe's credit allocation system at a time when the region can least afford it. At a minimum, the Cyprus fiasco has created long-term instability that mere words—the promise that Cyprus will not be a precedent—cannot settle.

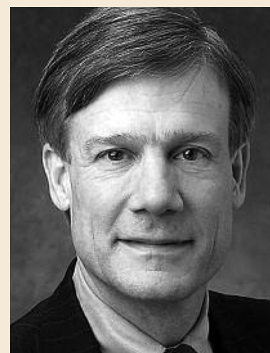
Unfortunately, this means that Cyprus is yet another illustration of the collective action deficit at the heart of the eurozone's struggles. Europe's countries have not yet learned the lesson that they cannot survive alone.

After Cyprus, the eurozone still faces the same question: sink or swim? And each country in the eurozone is still struggling to stay above water.

Even Germany faces potentially catastrophic economic consequences if the crisis is not resolved. The lessons learned in Cyprus have only made the downward pull of financial gravity a little bit stronger. But the monetary union can't survive over the long term without collective action.

A true banking union could have helped prevent the fiasco in Cyprus. And it could be the life raft that keeps Europe afloat.

Perhaps it's time to build that raft. If nothing else, the eurozone countries must find the political will for collective action—or they will each sink alone.



The money is safe.

JIM GLASSMAN
Managing Director and Senior Economist, JPMorgan Chase

Europe's deposit markets are calm in the wake of the (potentially bank-run provoking) first proposal by Brussels that required Cyprus to raise bailout funding from its own banks, possibly seizing money from bank deposits, including a levy on deposit accounts under €100,000. Most of the burden would have been borne by deposits above a threshold at both Laiki Bank and the Bank of Cyprus, the two largest lenders. The surprising calm across Europe's deposit markets may provide the best and simplest answer to the question of what you would do with your newly discovered account found in a bank of Europe's struggling members. That's probably the right answer too—that the money is safe—but the answer needs to be

right for the right reason in order to be sure your newfound money is safe where it sits.

What are the wrong reasons to be sanguine about the Cypriot situation? The money is safe, because Cyprus is a special situation and unlike anything else in Europe? In contrast to the banking system in nearly all other EU members, Cypriot banks rely on deposits for funding—their capital structure is relatively unique. Many depositors are not Cypriot nationals but rather foreigners. So, could the confiscation have been unique because it was targeted against outside money? That's not very reassuring. Ordinary Cypriots had their money in the same banks and so did many Cypriot and foreign companies, who were conducting business in Cyprus. If the proposal looked like it was an effort to seize funding from possibly illegal activities, it would squeeze all Cypriots' bank accounts and legitimate business accounts. The Cypriot parliament rejected the proposal, because it would have devastated Cypriots and companies probably would have ceased operations in Cyprus and moved elsewhere. This logic probably is not the reason why depositors elsewhere in Europe are not panicking. Perhaps the money is safe because the Cyprus government flat out rejected the first proposal to "haircut" deposits under €100,000? Yes, but the political response wasn't surprising. And most depositors probably aren't likely to take comfort in the support of the political system. Perhaps the money is safe because Cyprus is not a useful guide to potential banking crisis response elsewhere? Cyprus is a tiny member of the European community, but it has the precedent set in Brussels and the willingness to violate the sanctity of deposits that could undermine confidence in banks elsewhere.

What are right reasons to be sanguine? Most know that confidence in the safety and soundness of a country's banking system—a stable deposit base—is key to a healthy economy, because banking provides profoundly positive benefits for modern economies. The invention of the deposit insurance idea broke the cycle of periodic bank runs and credit crunches in the nineteenth century. Europe's existential crisis has triggered capital flight out of the periphery economies to the safety of German banks, because fears that a member might be forced to leave the monetary union and possibly default could mean trouble for the national deposit insurance safety net. If global investors had been pulling money out of Europe, the euro likely would have weakened significantly. That's why European leaders have been desperately searching for a way to create a European-wide deposit insurance mechanism (a banking union). A levy on small deposits would have undercut that effort.

Maybe bank retail customers across Europe haven't panicked in the wake of the Cyprus debacle because they know better. Maybe the bank crisis and the bizarre suggestion to put retail depositors on the hook along with the large players was a refresher course on the importance of stable banking systems to modern economies and the fundamental importance of the sanctity of deposits. You're safe.

This opinion is the author's own and not necessarily that of JPMorgan Chase.

I would move my deposit.

JARED BERNSTEIN
Senior Fellow, Center on Budget and Policy Priorities, and former Chief Economic Adviser to Vice President Biden

I would move my deposit. While I sympathize with the challenge facing European policymakers—a veritable 3-D chess problem in political economy—they have time and again shown too little consideration for the rights and preferences of the people affected by their decisions.

Think about the psychology of a group of policymakers who, in the midst of a debt crisis on top of a shaky-balance-sheet banking system, would suggest springing a tax on bank deposits on Cypriot savers. Didn't anyone around that table in Brussels raise their hand and say, "Wait a second…do we really want to levy this tax on everyday savers in a banking system that's already teetering?" After all, history is very clear on this point: Put almost any restriction on savings deposits and people will want them back. And such responses are amplified in a time of financial crisis.

We've seen this same kind of disregard for the impact of their actions—where "they" are more often than not unelected officials—on both public sentiment and people's livelihoods throughout the crisis, whether it's budget cuts, mass layoffs, or reneging on pension contracts. And when the high priests ignore the will of the people, even if they think they've got the economics right, nothing good can result.

That said, I understand that it's easy for outsiders to criticize the Cyprus debacle. Those who do so should consider that dealing with debt or solvency crises is a lot harder when you're stuck in a currency union that's neither a fiscal nor a regulatory union. The inability to devalue your currency (because it's not yours alone) means a key exit ramp from recession highway—tapping external demand—is shut down.

So I want to be on record noting that Europe faces steep challenges to which there are no easy answers and many American critics can come off too glib in that regard. We should also recognize and give kudos to the European Central Bank for aggressively backstopping loans to troubled eurozone countries, while the International Monetary Fund has, at least on paper, now recognized that austerity under current conditions is contractionary.

Still, I'd move my deposit until I had a sign that the leaders of Europe were once again thinking clearly about the people of Europe.

Color me and my money gone.

W. BOWMAN CUTTER
Senior Fellow and Director, Economic Policy Initiative, Roosevelt Institute

You don't answer this question with normal policymaker/business/finance rationality. You have to "grock" it *à la* Heinlein in *Stranger in a Strange Land.* And you have to assume I care about this money.

We know all the obvious comforting points. Cyprus is small. It is/was badly over-banked. Governance was terrible. But now all this has changed. The bailout was conditioned on fiscal and banking reform. Certainly, the task isn't entirely finished, and Cyprus still has work to do. But Europe has made clear its determination to keep the community intact, to defend the euro, and to find a way in every case to make a deal. So rest easy, your money is fine.

But I'm a Great Depression baby. The normal peasant instincts of my family—that someone is after your money—were raised to the *n*th degree by the Depression. And much of the last sixty years has taught me that governments, banks, and wide swaths of the political spectrum consider me fair game. Because Cyprus is small, because it is a special case, and because it can be firewalled, there is a low ceiling to how much political capital the outside world will invest in Cyprus. Also, I've come to see the assurances of governments and banks that I'll be protected as the best available leading indicators that I'm about to be screwed.

Color me and my money gone.

Take the money out immediately.

DINO KOS
Director of Regulatory Affairs, CLS

Take the money out immediately. Peripheral Europe is in a long-term recession. Nonperforming loans will continue to rise as deflationary headwinds make debt servicing ever harder. With no ability to independently ease monetary policy and a single currency preventing unilateral depreciation, a compression of the economy is the primary short-term adjustment factor. Banks' asset quality will remain under pressure.

So what are the prospects for a true "banking union" that could deal with failing banks by injecting capital and/or winding down failing banks while supporting depositors? The likelihood of a banking union (single supervisor, deposit insurance, and a common resolution authority) is smaller now than it was in mid-2012. Yes, there is a plan for a single supervisor, but this is the easy part. The other two parts is where the money needs to be allocated, and decisions on both aspects have been put off into the distant future. The northern countries are clear: they will not use the banking union as a backdoor bailout of the south. We know the peripheral countries have limited resources and cannot support multiple failures of their financial institutions. Indeed Spain had to turn to the European Union last year when Bankia failed.

With that background—weak economies, impaired banking systems, rising nonperforming loans, and no policy response to achieve a banking union—the risks for depositors are very high. One set of risks is that policymakers follow the initial Cyprus model and haircut depositors, including insured depositors. Apparently deposit insurance does not have the sanctity it does in other countries. Having proposed a haircut of insured depositors once, why would anyone stick around and assume they will not do it again?

Even if there are no depositor haircuts, if economic performance stays weak—which seems likely—then potential exits will again be surfaced. In such a scenario, the country leaving would convert euro deposits into the new local currency and immediately and substantially devalue that currency. Note that in an exit scenario, deposit insur-

ance is irrelevant. Both insured and uninsured deposits face substantial losses.

Either way, the risks to remaining depositors are too high. With deposit rates so low, what is the benefit of staying and risking principal? The prudent action is to shift those funds into a stronger banking system immediately.

The larger implications of Cyprus are anything but an aberration.

EDWARD N. LUTTWAK
Senior Fellow, Center for Strategic and International Studies

It might still be convenient to keep $130,000 in a Greek, Portuguese, Spanish, Irish, or Italian bank ready for a pending transaction, but that says nothing at all about the implications of the Cyprus confiscation of banking deposits. They are very grave indeed, and anything but an aberration.

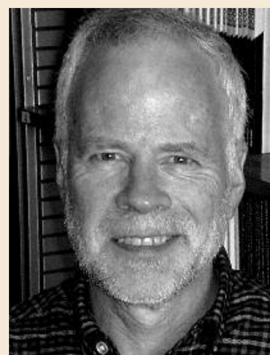
That Cyprus is a very small country is entirely irrelevant. Who would argue that it is a lesser crime to rob a child rather than an adult?

Nor was there anything small about the event: the slighting of the fundamental difference between profit-seeking shareholders, interest-seeking bondholders, and depositors, who are not required to be experts in financial matters when leaving their money with duly authorized and presumptively supervised banks.

Paradoxically, it was a further excuse that finally condemns the European Commission, the European Central Bank, and the International Monetary Fund, the trio of perpetrators who compelled the Cyprus government to confiscate deposits. It was their press guidance that peddled the message that the money to be confiscated would come from the deposits of tax-evading, money-laundering, and generally criminal "Russian oligarchs." It duly dominated European and world headlines, as journalists failed to consider the utter implausibility of the stories they were writing. Who was more likely to have his money in a Cyprus bank when the boom fell, after many months of bad news and increasingly sharp warnings—canny "Russian oligarchs" or Cypriot pensioners, busy expatriates, and small savers?

Nobody knows of course, but what we do know is that the confiscation was an extreme act, the latest in a series compelled by the fanatical defense of the euro, and attended by the deliberate fanning of prejudice. Other examples of extremism abound, including such desperate fiscal expedients as the ambushing of luxury automobiles in expensive resorts in order to determine whether their owners had paid income taxes in congruent amounts. While the European Central Bank with its gigantic new headquarters and lavishly paid staff continued be an exercise in exceedingly expensive nullity, decorated by Mario Draghi's perpetually self-satisfied smirk (on the occasion of his Cyprus press conference, it visibly incensed the attending reporters), it is the sayings of Jeroen Dijsselbloem, the Dutch finance minister and head of the Eurogroup, that exemplify the combination of irresponsibility and desperation induced by the fanatical defense of the euro. Early on, he proclaimed the Cyprus confiscation as a "model" to be emulated, duly triggering a wave of withdrawals from the banks of other vulnerable countries. His recent statement (May 7, 2013) before the European Parliament's Economic and Monetary Affairs Committee again condemned the Bank of Cyprus and the Laiki bank for their 2009–2011 purchases of Greek public debt, as if anyone needed that reminder.

It has now become quite clear that for the more indebted countries, severe fiscal austerity will last just as long as the euro persists, while polls and recent election results demonstrate its political impossibility and anti-euro populism keeps mounting. Hence, there is no point in prolonging the agony. The countries that will not be able to pay down the required 2 percent of their public debt each year as is now required should be allowed and indeed encouraged to leave the euro now, instead of doing so after more years of socially catastrophic impoverishment and unprecedented unemployment. The particularities of the Cyprus confiscation are less important than this context, which ensure its futility at great cost.



When I see bank regulators cracking down, I'll feel more comfortable.

BARRY EICHENGREEN
Professor of Economics and Political Science, University of California, Berkeley

One must hope that Cyprus is an aberration. Deposit insurance exists for a reason. Depositors have incomplete information about bank balance sheets (another

lesson driven home by the Cyprus incident), creating scope for banking panics and runs. Anything which impugns the integrity of existing deposit insurance guarantees is bad policy and should be avoided.

Of course, any regulatory regime that allows the national banking system to grow to eight times the size of the economy, as in Cyprus, is itself corrosive of the integrity of the deposit insurance guarantee, since the authorities then lack the resources to meet it. The real aberration was letting the country's banking system grow so large. When I see other regulators of national banking systems with similar problems cracking down, I will feel more comfortable with my "forgotten account."

It would be very naïve for depositors to belive they were totally safe.

BERNARD CONNOLLY
CEO, Connolly Insight

Cyprus was exceptional in that its banking system was not systemically important. The euro area authorities thought they could get away with something in Cyprus that they could not get away with in larger countries. And German public opinion had been led to believe that a bailout would benefit Russian mafia billionaires; and, for sure, the ratio of deposits—many of them non-resident deposits—to GDP in Cyprus was exceptionally high.

But Cyprus is not exceptional in its underlying problem: monetary union. The country developed an enormous current account deficit in anticipation of entry into the euro. Former ECB President Jean-Claude Trichet had said in 1994 that monetary union would permit the elimination of risk premiums (and as late as 2010 he was, astonishingly, praising the euro for the "*ex ante* assistance" it had provided to heavily indebted euro area countries by "facilitating easy external financing conditions"—in other words, by encouraging unsustainable current account deficits). Yet it should have been very obvious that countries which developed large current account deficits within monetary union would subsequently face a cycle of depression, deflation, and—in the absence of perpetual transfers from some hegemonic benefactor-*cum*-overlord—default.

In the case of Cyprus, the country skipped straight to default, to all intents and purposes, in its financial system because its major banks had, however unwisely, taken Trichet at his 1994 word and placed huge amounts of funds in Greek government bonds. When massive haircuts on those bonds were imposed by the troika, the Cypriot banking system was toast. Now the whole economy is toast: the country faces depression, deflation, and default as long as it stays in the euro area.

Other euro area countries that have had massive current account deficits (and still have massive full-employment current account deficits) face problems which, although not quite as severe as those of Cyprus, are qualitatively similar to them. In the absence of massive transfers via a banking union—from which the German bloc would be wise to step back—banking systems in several euro area countries are insolvent as long as those countries stay in monetary union. The social and political upheaval which could result would be so severe that nothing can be ruled out, whether expropriation of even insured deposits within the monetary union, capital controls, euro exit (and associated uncertainty about the value of deposits, insured or not), or whatever. Depositors in such countries may have more time available to them than Cypriot depositors thought they had. But they would be very naïve if they believed they were totally safe from expropriation.

Don't sleep too easy!

EDWIN M. TRUMAN
Senior Fellow, Peterson Institute for International Economics

If, as a non-resident, I discovered a forgotten insured deposit for $130,000 in a bank in Greece, Ireland, Italy, Portugal, or Spain, I would repatriate that deposit unless I had good use for it in the country in question. The Cyprus debacle reminded us that non-residents are at risk and that all deposits in banks, even if insured, are at some risk. There is an implicit and explicit pecking order, and the drama in Europe over the Cypriot deposits helped to clarify this, somewhat in Europe and somewhat, one hopes, elsewhere. In the United States, deposit insurance is guaranteed by law, but laws can be changed, *ex post.* Insurance,

like many things in life, except death, is not absolute anywhere. Don't sleep too easy!

It now seems likely that there will be a greater focus on private sector bail-ins.

ANDREW BALLS
Managing Director and Head of European Portfolio Management, PIMCO

Cyprus represents an evolution, rather than an aberration. The fact that eurozone finance ministers, the European Central Bank, the International Monetary Fund, and the European Commission were prepared to endorse haircuts for insured deposits suggests that all options are on the table for all eurozone countries in need of a troika program. The creditor governments, the troika, and the Cypriot government may have subsequently changed their minds, but their words and actions demonstrated that this option was acceptable and endorsed by policymakers.

Cyprus is a very small country, but that does not mean the precedent is unimportant. Indeed, the message is that some combination of the troika members and the German government wanted to send a clear signal. European policymakers will say that Cyprus is a unique situation—but it is just the latest unique case. This precedent has implications across the eurozone capital structure, including government bonds, private sector assets, and bank deposits. If the troika was prepared to endorse haircuts for small deposit holders in Cyprus, then what would really be off the table in terms of private sector burden sharing? At PIMCO, we would see the implications as most significant for small countries that are regarded by the troika as having little systemic importance, and also for smaller financial institutions in both large and small countries that would be regarded as non-systemic.

The eurozone crisis, and the corresponding responses, will continue to evolve, and it now seems likely that there will be a greater focus on private sector bail-ins. This has implications for investors and for bank deposit holders alike. We see large, systemically important countries, such as Italy and Spain, as offering reasonable sources of credit risk. We are cautious on the government bond markets of small countries in the eurozone, especially those countries that require ongoing troika support. And we are cautious on eurozone banks across the board, where the balance of risk and reward looks unfavorable. Developments in Cyprus suggest that this caution should be shared on the part of deposit holders as well.

This article contains the current opinions of the author but not necessarily those of PIMCO.

Politicians have discovered bank deposits as an easy target.

SEBASTIAN DULLIEN
Senior Policy Fellow, European Council on Foreign Relations, and Professor for International Economics, HTW Berlin—University of Applied Sciences

Even though small-scale depositors in Cyprus have been spared in the end, the EU crisis management in the island state's bail-out has changed the way investors will judge the safety of bank deposits all over Europe. While this does not necessarily have to lead to immediate large capital flows from periphery countries into Germany, it will make the European banking system more vulnerable and might lead to medium-term flows into the already heating-up German real estate market.

The central point is that politicians now have discovered bank deposits as an easy target for taxation should the need for funds arise. The package which was on the table in Cyprus and which was voted down by the national parliament only in the eleventh hour did not legally include a haircut for depositors, but rather a "tax" on bank deposits. By calling this surcharge a tax, EU authorities and the national government tried to have it both ways: Keeping the promise of full deposit insurance for deposits below €100,000 and still getting money from the depositors. While the Cyprus bail-out does not necessarily need to be a blueprint for the future, one can almost be sure that politicians will resort to taxation of bank deposits in future stages of this or other financial crises.

At the moment, there does not seem to be immediate need for small-scale depositors to move their funds from an account in Rome or Madrid to one in Frankfurt. While problems in the Spanish and Italian banking systems persist and might get worse when the recession continues, the banking systems in these countries do not seem fragile

enough that after wiping out bank shareholders, banks still will not be able to repay depositors. However, if there is further negative news on these countries' banks, we might see a renewed wave of deposit outflows, then exacerbating the problems of the periphery's banks.

On the other hand, a potential tax on bank deposits might also make it less attractive to move money into a German bank account. Should at some point the euro break apart and the Bundesbank or the German government be confronted with large costs either because claims against other European central banks or governments cannot be recovered or German banks need to be recapitalized, a tax on bank deposits (potentially differentiated by the country of residence of the depositor or by the age of the deposits) will be on the table. Thus, after the Cyprus bail-out, even German bank deposits are not safe anymore.

Consequently, we will see a flow of funds into markets which still can be perceived as safe—such as the German real estate market. A property tax on houses would certainly be much more difficult politically in Germany than a tax on foreign-owned bank deposits, as can be seen from past attempts to increase the property tax. German real estate will therefore be an investment of choice for foreigners. Get ready for a further pick-up in German real estate prices.

When small economies with large banking systems suffer systemic crises, no assets are fully insured.

THOMAS OATLEY

Associate Professor of Political Science, University of North Carolina at Chapel Hill

Cyprus is not an anomaly. In fact, Cyprus is not even the first of the current wave of European banking crises in which depositors who believed their assets were insured discovered after the fact that perhaps they were not. Iceland refused to insure British and Dutch residents' deposits when Icesave failed in October of 2008. Moreover, Iceland's refusal to guarantee foreign deposits in an Icelandic bank received legal sanction by the Court of the European Free Trade Area in a ruling handed down earlier this year. In exonerating Iceland, the Court specifically noted that European banking directives did not require governments to assume the liabilities of deposit insurance schemes whose resources had been exhausted by a systemic banking crisis. Although Cyprus and Iceland differ in many ways, in both instances governments facing a systemic banking crisis sought to force some depositors who thought they bore no risk to accept losses. While Cyprus ultimately insured all small depositors, Iceland refused to insure foreign depositors, regardless of the amount.

Although I might not keep my windfall in a bank in Ireland, Italy, Portugal, or Spain, I wouldn't remove it because I feared it was at risk. The broader message of the Icelandic and Cypriot crisis is that when small economies with large banking systems suffer systemic crises, no assets are fully insured. After all, what put deposits in Icelandic and Cypriot banks at risk was total banking system liabilities way out of proportion to GDP. According to EU figures, Cypriot banks' liabilities were 750 percent of Cypriot GDP at the end of 2012—more than twice the EU average. In Iceland, bank liabilities in 2008 were close to 1000 percent of GDP. Economies this small cannot credibly insure depositors in the face of liabilities that large. Bank liabilities in Ireland, Italy, Portugal, and Spain are much smaller relative to GDP, lying quite close to the EU average of 300 percent of GDP. Governments can thus assume these liabilities if (when?) deposit insurance schemes cannot, as the Irish government did in the fall of 2008. Although I might anticipate some illiquidity if I left my cash in Madrid, I don't believe I would risk a loss of capital.

In short, there are many good reasons why I might not keep my windfall in a bank in Ireland, Italy, Portugal, or Spain. Fear that governments would renege on deposit insurance is not one of them.

Move the money.

MILTON EZRATI

Partner, Senior Economist, and Market Strategist, Lord Abbett

I would move the money, but not especially because of Cyprus. I would move it because the nations of the eurozone have shown neither consistent nor cogent policies. They handled Cyprus differently from Greece, which they handled differently from Spain, which was handled differently from Ireland or any of these other touch points of cri-

sis. Each had a unique response. The pattern says that there is no telling how the zone will handle the next incident.

That uncertainty makes Europe a bad place to leave assets, however well or poorly protected they were in the last incident. The authorities, no doubt, would argue that every aspect of this ongoing crisis has its particular character and so requires special handling. While conceding that point, an investor still might want to see some consistency in the basic principles applied to each event. Without such guidance, there is no knowing which way the authorities will leap next time and consequently who will bear the burdens. Until the authorities can offer such guidelines, the money is better kept elsewhere, outside their power.

Cyprus was a unique case.

GEORGE HOGUET

Global Investment Strategist, State Street Global Advisors

Cyprus was a unique case and insured depositors should leave their deposits in banks in the GIIPS. They might wish to focus, however, on the most liquid, best-capitalized, and largest financial institutions in each country.

One of oldest maxims in the investment industry is "investigate before you invest." In January 2013, Cypriot banks were paying roughly 4.5 percent on term deposits at a time when German banks were paying roughly 1 percent. This phenomenon alone should have provoked questions. The presence of deposit insurance should not alleviate depositors from evaluating the five "Cs" of credit—precepts that are taught in every entry-level bank training program: character, capacity, capital, collateral, and conditions.

When Cyprus joined the eurozone in 2008, its economy had grown at roughly 3.6 percent per year over the past eight years and its government debt-to-GDP ratio was 49 percent. Since then it has been hit by three shocks: the global financial crisis; electricity supply disruption from a plant explosion in 2011; and the write-down of Greek bonds resulting from the private sector involvement initiation. Of these, the Greek PSI was the most significant.

Cyprus' adjustment program is severe, with output contracting by at least 15 percent. And Cyprus' debt-to-GDP ratio is expected to peak at roughly 120 percent in 2015.

At the end of 2012, bank assets in Cyprus represented roughly 700 percent of GDP. Russian entities held roughly 20 percent of Cypriot deposits, and Cyprus served as a major conduit for investment in Russia. Russia's reluctance to increase its financial assistance to Cyprus may imply reservations in the Kremlin as to the origin of the deposits.

That the Eurogroup initially considered making insured depositors bear part of the adjustment burden is deeply troubling, and the imposition of "temporary" capital controls (the legal basis of which is anticipated in Article 66 of the Treaty on the Functioning of the European Union) undermines one of the main pillars of monetary union. However, the Cyprus case is unique because of the small size of the economy (0.3 percent of eurozone GDP), the country's "business model," and the deposit base.

The decisions by European leaders at the June 2012 summit and the ECB announcement in August 2012 of prospective Outright Monetary Transactions have bought time and reduced financial fragmentation. But until the Single Supervisory Mechanism becomes fully operational and the three pillars of banking union are put in place, weak banks in weak countries will continue to face funding pressures.

European policymakers should use the current period of relative market calm to accelerate financial and labor market reform and to implement a strong pro-growth agenda. The Cyprus situation highlights several factors, including how capital market conditions can change rapidly and small countries can be vulnerable; how depositors should carefully analyze banks in tax havens; how weak banking regulation is self-defeating; how large banking systems relative to output are particularly problematic; how even if one engages in stimulus (as Cyprus did in 2009), structural soundness is key to long-term growth; and finally, that private sector involvement programs need to be carefully crafted.

I would avoid holding $130,000 in any single bank.

HANS-JOACHIM DÜBEL

Founder, Finpolconsult.de

Over the past hundred years, every time Europe got into particularly serious trouble, a solution was brought to the continent by the United States. It has

not been different this spring in Cyprus, even though very few noticed.

During the restructuring of the Cypriot banks, not only did U.S. consulting firms PIMCO and Alvarez & Marsal do most of the due diligence and forensic examination. The situation in Cyprus presented two textbook applications of the FDIC bank resolution handbook: Laiki Bank underwent a classic purchase and assumption transaction of good assets and high-ranking liabilities, with the remainder being unwound; and Bank of Cyprus performed a comprehensive debt equity swap. To support these deals, for the first time in Europe full seniority of government-insured deposits was implemented, the economic foundation of the FDIC's iron grip over U.S. banking.

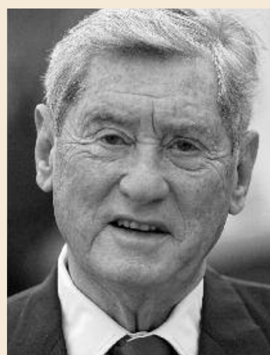
This all came as a surprise to the Europeans, and certainly Germany, which never did anything like these deals during her own, deeply subsidized bank restructurings, but nevertheless conveniently and as usual agreed to take the blame.

So are standard FDIC banking policies an aberration, or will they be the model for Europe? The answer is probably both yes and no.

Yes, Europe needs to terminate the epic capture of its governments and fiscal budgets by politically well-connected large depositors and bond investors, many of which are subordinated and thus first in line to take bank losses. It's time for Europe to finally implement a serious version of both deposit insurance and bank resolution. U.S. President Franklin Roosevelt acted within months of the 1933 banking crisis to implement the Glass-Steagall banking reform establishing the Federal Deposit Insurance Corporation. Europe has wasted the better part of a decade watching investors pull money from its banks, enabled by the misguided liquidity "assistance" of the European Central Bank, and leaving taxpayers and potentially small depositors to hold the bag. The difference between the FDIC's fast and decisive bank closures and the months of public slaughtering of the Cyprus banks by the Europeans, allowing the insiders to terminate their accounts, can only be described as the mother of all operational deficits.

Yet the FDIC deposit protection concept is a relic of the 1930s, before the computer was invented, and a historic emergency solution that has outlived its time. Today every American knows that the true protection limit is a couple of million dollars, not U.S. $250,000. Dozens of firms stand ready to distribute your money to a sufficient number of bank accounts. In an interconnected financial world with hundreds of products distributed to retail investors, a public safety net also should go beyond deposits. Finally, the weakness of the U.S. bank bond market, the emergence of shadow banking, and the considerable powers of the FDIC over banks are closely connected with each other. The model needs a rethink for the twenty-first century.

My best guess is that for the time being Europe will highlight the negative aspects of the U.S. model. Until the last depositors have pulled their money out, banking politics here will remain dominated by the insider bondholders, which will portray Cyprus conditions as peculiar and keep pushing for government bailouts and supra-nationalization of its costs. The investment banks, who make tons of money arranging fiscally suicidal bank debt buyback deals, will be on their side. No Roosevelt is in sight in Europe to end this policy at the expense of the poorest relying on government services, and the younger generation that will have to foot the bill. So we will keep coming back to America for advice as the full restructuring is delayed another day. And I will keep my money diversified enough to avoid holding over €100,000 in a single bank, wherever it is located.



The $130,000 deposit is not really the problem.

HANNES ANDROSCH

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As every first-year finance student knows, bank safety is an illusion. Yet faith and trust in this illusion is the foundation of our economic and financial systems and, ultimately, of our well-being. The systemic risk of the financial system is buried in the balance sheets of our financial intermediaries, mostly banks, where maturity and interest-rate gaps can be managed, but not eliminated. Systemic risk is the source of bank profit.

A succession of euro-area banking crises have taught us that the corollary of "too big to fail" is that no one is so small as to be ignored with impunity. Too many banking crises have turned into solvency crises for the countries in which the banks are located. The old model of underpinning the illusion of bank safety with the entire financial capability of the taxpayer, whether through the medium of "lender of last resort," public-sector bailouts, deposit guarantee schemes, and so forth, while simultaneously permitting special interest groups such as senior management to cream off economic rent, has passed its sell-by date.

Our trust in bank regulation to restrain the risk-taking behavior of banks was also misplaced. Powerful bank lobbies managed to water down prudential regulation, such as

capital adequacy requirements, or simply innovated past them. The creation of bank profit became the goal of our banking system, and the stability of the financial system, a public good, was largely neglected. But there is no profit without risk and our experience in the past six years has reinforced the established economic principle that the free-enterprise economy produces less than the optimal quantity of a public good.

A new approach and one certainly worth pursuing is that announced by Jeroen Dijsselbloem, the Dutch finance minister and president of the Eurogroup, following agreement on the Cypriot rescue package at the end of March. In essence, the new approach shifts the burden of bank rescues away from taxpayers, the so-called bailout, and leaves it with bank creditors including depositors and senior bond holders, the so-called bail-in. This will put bank risk back in the banks, where it belongs, and remove it from taxpayers.

While this will certainly change the behavior of bank management, it need not lead to greater bank stability. It could cause bank distress at the slightest whiff of danger. As such, it remains to be seen if it is more crisis resistant than the old approach. Although not the intention of the plans' architects, it is likely to create a greater need for a banking union and the sharing of risk. Peer pressure might then become a workable model of bank regulation.

So, the $130,000 deposit is not really the problem, either for the depositor or the bank. Much more important are the large corporate accounts, the CD and inter-bank markets, and, possibly, the senior bond holders. Funding will become much more sensitive to risk-taking behavior and more volatile. This should put prudence back at the top of the professional profile of bank management.

Delineation of a clear line between insured and uninsured deposits is key.

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The Cyprus banking crisis was mutualized into a eurozone rescue by communication and implementation missteps. First, deposit insurance. Deposits are either insured, or they are not. Taxing insured deposits violates that contract. Taxing deposits that are in excess of the insurance avoids moral hazard. The authorities' whipsaw of "Tax all deposits" but then following the outcry "All deposits are insured" ratified the strategy of regulatory arbitrage engaged by large depositors, and magnified the uncertainty and fear of small depositors, which collectively generated the self-fulfilling deposit run and banking crisis. Clearer communication at the outset on which deposits would be part of the bailout and which were protected, according to contractual obligations and commitment, might require precision in terms of implementation, but would help to avoid spillovers of Cyprus to other countries in the region.

Second, capital controls. Capital controls must be imposed immediately to have any hope of being effective. Yet, as the deposit tax uncertainty unfolded, controls were in open discussion, which ensured that all large deposits (insured or not) were gone by the time controls were implemented. The small depositors were forced to stay, but were too small to support the banks. The exit of large uninsured deposits from a highly leveraged banking system forces the policy dilemma of whether to allow the banks to collapse or to rescue the system using eurozone and other funds. In the previous versions of this scenario, as played out over the past five years or so, the banks have been bailed out by one or another savior. It is not surprising that the Cyprus players (large depositors, banks, policy authorities) thought the same would be true for their episode.

For the future, delineation of a clear line between insured and uninsured deposits is key. But this is an unstable equilibrium. In times of banking crisis, the immediate threat of costs of collapse always trumps the future costs of moral hazard. Given that this trade-off could be seen in advance, was Cyprus a set of missteps or a bluff that was called, but did not go down as expected? ◆