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Bitter lessons of Cyprus

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Summary

The attempt to make Cyprus' international bailout contingent on an enforced bail-in of Cypriot bank depositors is a serious political gamble for the EU and a gamble on market sentiment on Eurozone banks. The attempt to make Cyprus a test case is motivated by a desire to keep Russian money in Cyprus firmly on the hook for any bailout – a fact that explains the contortions in the plan. But the Eurozone states behind the plan are also behind a wider push to put creditors back in the line of fire for bank failures, which is a reaction to the acceleration in plans for a European banking union.

Cypriot bank depositors woke this morning to find that they are the unwilling participants in the EU's first major experiment imposing losses on bank creditors. As part of the €10bn bailout package agreed for Cyprus on Saturday, Nicosia has been cornered into agreeing a plan that will extract a planned €5.8bn directly from Cypriot bank deposits. The bitter debate over how this should be done is still raging – with the suggestion that it should include deposits under €100000 technically protected by the Cypriot deposit protection guarantee scheme subject to particular criticism. To sweeten the pill, depositors will be given equity in the institutions proportionate to the sums levied.

Pressure to cut the size of the Cypriot bailout by over a third from €17bn by enforcing a virtual bail-in of Cypriot bank deposits has come chiefly from Berlin and from the IMF, which made creditor participation and renewed privatisation commitments conditions of any bailout programme. The European Commission had resisted hitting senior bank creditors and depositors out of fear of the risk that such a move could provoke a run on banks across the Eurozone and a wider crisis of market confidence.

As with last year's negotiated haircut for private sector holders of Greek sovereign debt, European officials are at pains to insist that the Cypriot situation is unique. That is certainly true. In the case of previous Troika bailouts and bank recapitalisations, the question of exposing senior debt holders - let alone uninsured depositors - has been explicitly excluded. The ECB explicitly required that Dublin agree to leave senior debt holders in failed Irish banks untouched in 2011, although its position on senior creditor write-downs became a lot more ambiguous in 2012. In that respect, Cyprus is a gamble that, with the terms of the Spanish bank recapitalisation agreed and funded and Italy's banks shaky but probably not critical, the bail-in agreement is not – and will not be seen to be - setting a serious precedent.

But this is surely wrong, and the contortions in the bailout design are striking. Hitting insured depositors is politically toxic and will be viewed as a terrible breach of trust, even if technically the government is not breaking the pledge to make deposits whole in the event of bank insolvency. Leaving senior bondholders intact at the same time is also hard to justify. Both choices only make sense when you see them as the tradeoff. On one hand, Berlin demanding that large foreign depositors – read, Russians (Fig 1) – bear the bulk of the costs of a bank recapitalisation and Nicosia desperately trying to preserve some semblance of its attractiveness to offshore 'savers'.

The German SDP opposition has pushed back on Merkel today, arguing that she was wrong to allow protected deposits to be levied. But it has taken the same implicitly anti-Russian line as the German government, pushing for consolidation of the Cypriot banking system and an external money laundering audit of Cypriot banks – neither of which Nicosia has given much ground on.

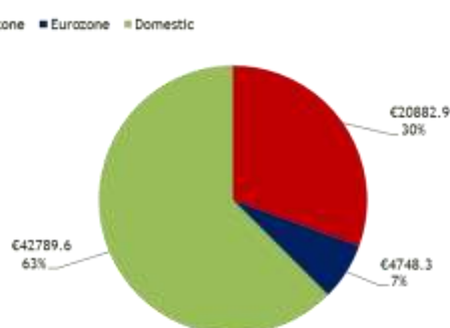

Fig 1: Source of deposits, Cypriot banking system, January 2013. The bulk of non-Eurozone deposits are Russian in origin. Many 'domestic' deposits are, in fact, made by foreign-owned Cypriot companies.

Source: Bank of Cyprus 2013.

Lead me from moral hazard, just not yet.

Cyprus could still go badly wrong if depositors there or elsewhere take serious fright. Banks' stocks have fallen sharply across the Eurozone today. Even if the Troika and Nicosia back down on the question of including small savers in a deposit raid, Cyprus will still be an object lesson in what makes bail-in so tricky as a regulatory and political tool. Despite the constant demand from politicians and regulators that taxpayers should never again be required to take losses in the place of senior bank creditors, it has proven hard to shift taxpayers from the head of the queue.

The European Commission has spent the last three years drafting European legislation that would establish pan-European practice and powers for national supervisors in these sorts of situations. The Commission wants states to have the power to force debt to equity conversions and to have the power to write down senior creditors and derivatives counterparties. But capitals have been reluctant to engage in a public discussion about bondholder exposure that might undermine already volatile sentiment on the Eurozone's fragile banks, or raise their borrowing costs. Until recently, the legislation languished.

There have been exceptions. Denmark experimented with writing down senior bondholders and depositors in 2011 when the relatively small Amagerbanken and Fjordbank were resolved through write-downs for senior creditors and depositors above the deposit protection limit of €100000. The ratings agencies responded by downgrading Danske Bank and four other large Danish lenders. The Dutch Government wrote similar provisions into its intervention Act in 2012, but chose to protect senior bondholders in the €3.7bn nationalisation of SNS Reaal in February 2013 when it wrote down junior debt holders. It stayed its hand on senior bondholders after the ratings agencies speculated publically that a Dutch repeat of the Danish exercise would be likely to prompt downgrades and rises in borrowing costs.

Other examples are now starting to appear. The part-nationalised Spanish bank, Bankia, will write off a very large part of its junior subordinated debt this year, large parts of which were sold as preference shares to its own retail depositors. This may be practically different from writing down actual deposits, but its political effect will be close to the same. In each case, politicians and regulators have had to weigh the risk that exposing investors to the costs of their own bad judgements will simply provoke a wider crisis of confidence in the European banking sector.

Bail-in trumps bail outs

So why make Cyprus a test case? In very large part, as noted above, the desire to go after Russian deposits. But there is also a bigger political shift in the Triple-A European states towards a more aggressive approach to creditor losses. The Finns, the Germans and the Dutch now all want the kinds of bail-in powers proposed by the Commission accelerated to 2015 rather than the planned later date of 2018. This renewed enthusiasm among the Triple-A sovereigns

Global Counsel

for bail-in powers is driven by a calculation as political as the desire to avoid Russian money in Cyprus escaping a bailout unscathed. This relates to banking union in the Eurozone.

The December 2012 agreement on banking union established the basis for a pan-Eurozone banking supervisor based on the ECB. The next phase of banking union is widely accepted to require the agreement of resolution and restructuring protocols for Eurozone banks, including the mechanisms for recapitalisation through European conduits like the European Stability Mechanism. The logic in Berlin, The Hague and Helsinki is very simple: their taxpayers are implicitly on the hook for these bailouts in inverse proportion to the degree that bank creditors are not. Granting the principle of senior creditor write-downs or bail-ins, even in their own jurisdictions, is the price for limiting the prospect of cross border transfers to bailout other countries' banks.

Politicians and regulators in Europe have restarted the bail-in debate in part because they judge the systemic risk to have mitigated enough for the debate not to spook the market or bank customers. But the political need to limit the implicit exposure of Triple-A state taxpayers in a future banking union is also steeling their nerves. They have judged that the political cost of a pain-free bailout for Cyprus' depositors was higher than the potential risks. Both may yet prove misjudgements.

If they don't, for senior bank creditors Cyprus is another reminder that regulatory willingness in bank restructurings to shield senior bondholders from losses cannot be taken for granted from here on out. SNS Reaal and the Dutch experience suggest regulators and politicians in Europe know what they want from bank creditors, but are still easily spooked by the tools they are arming themselves with, even if they appear to have sanctioned a reckless test firing in Cyprus. European banks can expect to pay more for senior debt and anecdotal evidence from the debt markets suggests that buyers are getting more picky on a bank by bank basis. This is what politicians and regulators have long said they wanted. Cyprus suggests getting there will not be easy.

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