

Cyprus ... A Test Case for Future European Banking Policy

John Bruton

21 March 2013

All resolutions of banking crises involve imposing and sharing sacrifices. As far as possible, however, people should know in advance how the sacrifices are to be shared.

No way of saving is completely risk-free, but the greater the risk, the greater should be the reward and vice versa. A high-yield bond should be riskier than a low-interest deposit.

It is on this basis that the terms of the proposed bailout of the Cypriot banking system should be scrutinised, because it illustrates how eurozone policy-makers are thinking.

The initially proposed bailout of Cypriot banks involved imposing haircuts on the depositors in Cypriot banks who have been covered by the deposit guarantee scheme, namely, depositors with amounts less than €100,000. Whose idea was this?

Setting aside the terms of a deposit guarantee in this way would be a very serious step for eurozone policy-makers to have taken. It calls into question the integrity of deposit guarantees generally, which is hardly a good idea at a time when we are trying to restore confidence in banks and rebuild their capital bases.

Senior bondholders to be preferred to depositors?

According to Gabriele Steinhauser on the Wall Street Journal's blog (18 March 2013), an alternative to burning the guaranteed depositors was proposed by the IMF. This involved "radically shrinking the two largest banks, including bailing in senior bondholders, and letting deposit insurance kick in. In that case, depositors in Laiki Bank and Bank of Cyprus would have faced losses of 30 to 40% above the insured €100,000".

It would appear therefore that an explicit legal guarantee of deposits is to be set aside so that senior bondholders and unguaranteed deposits are to benefit from reduced, or in the case of senior bondholders, no haircuts.

The net effect of this approach would make a deposit-guaranteed euro in a Cypriot bank not worth the same as a euro in a bank somewhere else in the eurozone. This is a clear violation of the underlying principle of having a single currency.

John Bruton is Chairman of IFSC Ireland, former Prime Minister of Ireland and member of the CEPS Board of Directors.

CEPS Commentaries offer concise, policy-oriented insights into topical issues in European affairs. The views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

Available for free downloading from the CEPS website (www.ceps.eu) • © CEPS 2013

The philosophy behind the decision to afford protection to the position of the, admittedly small number of, senior bondholders of Cypriot banks, at the expense of guaranteed depositors, has yet to be explained.

Senior bondholders are commercially well-informed investors; depositors are not. Senior bondholders also earn a better interest rate than do small depositors.

Should bondholders of banks be preferred to bondholders of states?

It is also hard to understand why it was EU policy to impose a haircut on the senior bondholders of the sovereign Greek state a few months ago, but not now to impose a haircut on the senior bondholders of private Cypriot banks, when that was suggested by the IMF.

Indeed, part of the problem of Cypriot banks is that they were themselves senior bondholders of the Greek state, which suffered a haircut on those bonds as part of the terms of the Greek bailout.

Who are the senior bondholders of Cypriot banks who are so deserving of 100% protection? And who are the big depositors whose haircuts were to be reduced by attacking the sub-€100,000 guaranteed depositors?

A credible and consistent banking system is essential to a modern economy.

The EU is committed to establishing a banking union, including a single system for winding up banks and guaranteeing deposits.

The precedents being set in the Cypriot case are important, and, in my personal view, troubling. They do not indicate clarity or consistency of thought by either the eurozone Finance Ministers or the European Commission. The rejection of the deal by the Cypriot Parliament now gives eurozone policy-makers a chance to think again about the underlying philosophy of their approach to the financial crisis.