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MACROCOSM

Dubious Timing, Obvious Truth

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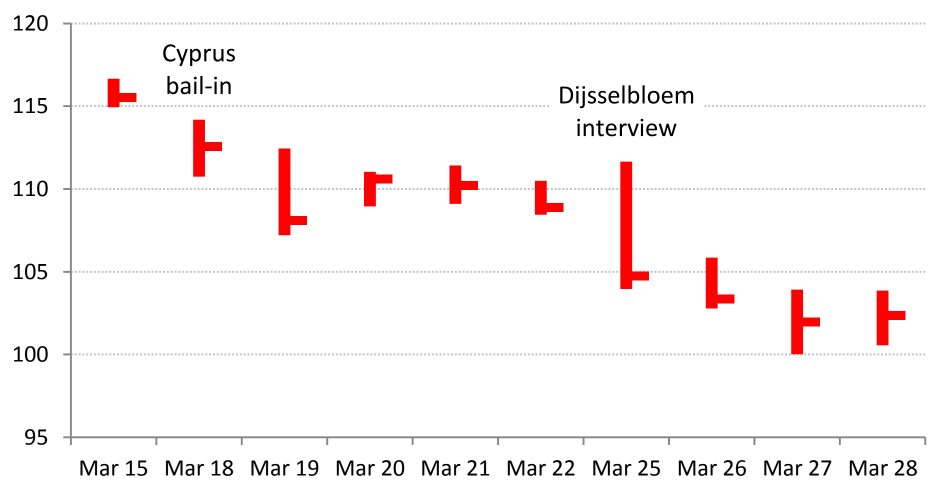
Lorcan Roche Kelly

No more euro area bank bail-outs allowed -- but most banks have been bailed out already.

Eurogroup President Jeroen Dijsselbloem is probably still wondering what all the fuss is about. In his interview with Reuters and the *Financial Times*, Dijsselbloem was just repeating the same tougher bank bail-out policies that had already been put forth by both the ECB and the European Commission -- and put into action already in Cyprus.

- The European Commission document said that in the event of a bank resolution, "some liabilities … would be excluded ex-ante (such as secured liabilities, covered deposits and liabilities with a residual maturity of less than one month)." This list does *not* include junior or senior bank creditors nor uninsured depositors.
- Similarly, the ECB document said, "the Eurosystem is supportive of the introduction of bail-in as it will be critical to ensure that taxpayers' exposure to losses if a bank fails is minimized."
- While the EC and ECB documents referred only to proposals, these proposals did reflect future policy towards bank failures in the euro area. Dijsselbloem's comments did no more than affirm these policies -- which, by the time he spoke, had been applied in Cyprus

STOXX euro area bank stock index



Source: Bloomberg, TrendMacro calculations

Update to strategic view

EUROPE FINANCIAL STOCKS, EUROPE MACRO : Jeroen Dijsselbloem upset markets on Monday with his comments on future bank bail-ins. His comments only reflected stated European Commission and ECB policy on this issue, as self-evidently already put into action in Cyprus. With policy now so clear, markets are correct to reprice bank stocks, as some banks will now face higher funding costs. But the wholesale dumping we saw this week strikes us as very much overdone, and to present a buyable dip. Banks able to fund themselves long-term should see the least deposit flight or cost-push -- the strong will get stronger.

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(see "On the ECB's Move Against Cyprus" March 21, 2013).

Clearly, while Dijsselbloem's comments were badly timed -- what is gained by rubbing the market's nose in it while the Cypriot catastrophe was still so fresh? -- they were not incorrect. So now that the cat is out of the bag, markets have to price in the new reality (see "Regime Change Comes to Euro Policy" March 28, 2013).

- First, perhaps we should be relieved that -- at last! -- we have a euro area official who speaks frankly and honestly. Dijsselbloem's predecessor as Eurogroup president was Luxembourg Prime Minister Jean-Claude Juncker, who famously said, "I am for secret, dark debates" and admitted that he often "had to lie."
- And even if Dijsselbloem's comments had been new information rather than a reiteration of known policy, there is a strong element here of much ado about nothing. Bail-out policy going forward would, necessarily, only apply to the few banking markets in the euro area that haven't *already* been bailed out under the *old* policy. New tougher terms will hardly help Irish or Spanish taxpayers who footed the bill for massive bailouts -- nor harm their depositors or bondholders who already benefited.
- But while euro area bank stocks -- correctly -- acted with relative calm to the Cypriot bail-in itself, even in its clumsy original form as introduced last week (see the chart on the previous page, and "On the Cypriot Depositor Bail-in" March 17, 2013), the comments from Dijsselbloem this Monday shocked investors, as they seemed to be blithely risking a run on any euro area banks still perceived to be weak.
- It is certainly a rational fear for bank shareholders that a run might happen -- although there certainly is no sign of stress in any of the liquidity demand indicators we watch, such as EUR LIBOR/OIS spreads (please see the chart below).

EUR LIBOR/OIS spread

Source: Bloomberg, TrendMacro calculations

- However, any such run would not happen in a vacuum. The ECB would be able to maintain any solvent bank's funding through its

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liquidity operations -- and through national central bank Emergency Liquidity Assistance (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011) -- as it has done several times throughout the crisis. ECB board member Jörg Asmussen went to great lengths to confirm the robustness of this critical safety valve at the March 17 Cyprus press conference.

- So for bank investors, it still is not the funding side that will cause a resolution and result in losses -- it is the assets side. *Nothing Dijsselbloem has said will make assets of a bad bank any better, or those of a good bank any worse.*
- For equity holders -- who were always first in line for any bail-in -- the new risk is to future profits, which they are right to discount to some extent. In a world where deposits may be harder to find, it will be more difficult to grow balance sheets -- and also more difficult to maintain interest margins when rates paid on deposits are no longer artificially suppressed by an implicit government guarantee.

So Dijsselbloem's comments will cause euro area bank investors to re-assess their positions, not so much due to increased risk of bank failure, but rather to reduced future profitability. The big unknown in all this is what the large depositors in peripheral banks will do.

- In the short term, there is a reasonable expectation that there will a reversal of recent increases in deposits at peripheral euro area banks.
- However, in looking for a new home for their funds, depositors may have some perverse incentives. Instead of trying to find a conservative bank with a safe loan book, they may be better off seeking a bank with a very high loan/deposit ratio.
- If a bank has a loan/deposit ratio close to 100%, then there is very little cushion -- in the form of junior and senior bank debt -- that can be hit before depositors get bailed in. However, if the loan/deposit ratio is over, say, 200% -- as is the case in some euro area banks -- then depositors would have to see a very large collapse in asset values at the bank before they would suffer losses.
- In a nutshell, depositors and equity markets should prefer banks that are capable of funding themselves long-term -- unlike the Cypriot banks that funded themselves dominantly with deposits.
- Since sounder banks can more easily fund themselves long-term, they will in virtue of that be able to fund themselves short-term, too. The strong will get stronger. As we have already said, we will continue to watch for signs of significant deposit movement, but for now, the reaction from depositors -- like the reaction from Cypriot bank customers today -- has been very muted.

Bottom line

Jeroen Dijsselbloem upset markets on Monday with his comments on future bank bail-ins. His comments only reflected stated European Commission and ECB policy on this issue, as self-evidently already put into action in Cyprus. With policy now so clear, markets are correct to reprice bank stocks, as some banks will now face higher funding costs. But the wholesale dumping we saw this week strikes us as very much overdone, and to present a buyable dip. Banks able to fund themselves long-term should see the least deposit flight or cost-push -- the strong will get stronger.