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TRENDMACRO LIVE!

On the Cypriot Depositor Bail-in

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Lorcan Roche Kelly

Making depositors take a hair-cut is a risky precedent for the world's most fiat currency.

It must be spring. Because just as in each of the last three years, there's a threat from Europe. This time it's Cyprus, with the Europe's bailout "troika" -- the EU, the ECB and the IMF -- taking the risky gambit of requiring a bail-in by bank depositors in the form of a haircut on deposits. It's the first time that European depositors haven't gotten 100 cents on the euro.

The problems for the troika -- when it came to agreeing the bank bailout that Cyprus so desperately needs were two-fold. First, if the entire burden were to be put on the Cypriot taxpayer through a bailout loan agreement, then Cypriot debt would rise to a level as a proportion of GDP that the IMF would deem to be unsustainable, thereby preventing the IMF from getting involved at all. Second, solving at least the optics of this problem by repeating the Greek solution and reducing Cypriot sovereign debt through so-called "private sector involvement" (PSI) -- a selective default -- would have only have made matters worse, as Cypriot banks are the biggest holders of that debt.

The banks themselves have surprisingly little debt outstanding that could be reduced by some form of default. Of the two biggest banks, most recent reports show Laiki with €376 million and Bank of Cyprus with €40 million of senior debt outstanding. The only thing that this leaves is the banks' deposits, with Laiki having €20.1 billion and Bank of Cyprus having €27.8 billion according to their most recent reports.

The only other major liability that exists on the Cypriot banks' balance sheet is Emergency Liquidity Assistance (ELA) from the Central Bank of Cyprus (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011). Latest data shows that the Cypriot central bank has extended ELA loans of €9.1bn to Cypriot banks. The problem with taking these loans off the banks' books is, again, that the liability would fall back on the Cypriot government, ruining the IMF's debt sustainability analysis.

That's the context. So what's the likely reaction? What's the risk of contagion?

- Though on the face of it this is a shocking development, bailing in Cypriot depositors has actually been openly discussed as a possibility for some time.

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, EUROPE FINANCIAL STOCKS, EUROPE BONDS, ECB, FX: In the Cyprus bank rescue, for the first time ordinary euro area depositors are going to suffer losses. While Cyprus' unique circumstances forced the troika's hand on this, we think the risk of contagion is low. The ECB has backstops in place to counter depositor nervousness in the rest of the periphery. Any sell-off in markets should be viewed as a short-term correction, and not a return to the existential crisis that had become an annual event for this time of year.

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- The precedent aside, there is little risk of a bank run in other peripheral euro area nations. Cyprus is viewed as being sufficiently unique by other peripheral depositors -- the Russian mobster money-laundry service story is well known in Europe -- to allow this to pass without too much immediate contagion risk.
- Even if there is such a risk, Jörg Asmussen -- a German representative on the ECB's Governing Council, who had a leading role in negotiations of the deal -- said that the ECB stands ready to provide support to any euro area banks through normal monetary operations and national central bank ELA.
- We can easily monitor if either of these promises by Asmussen are called upon by European banks. There is a normal liquidity operation due to be allocated on Tuesday, with all operations so far this year in a tight range from €124 billion to €132. The overnight liquidity Marginal Lending Facility operations will also be an early indicator of stress.
- If ELA is called on in any major way, we will see it in the weekly ECB financial statement. Unfortunately, any moves this week will not be reflected until the following Tuesday.
- All that said, we have yet to get approval of any of this from the Cypriot parliament. There was supposed to be a vote today (Sunday), but it has been postponed to tomorrow (Monday) afternoon. While it is likely that a vote will pass, the exact terms of the depositor haircuts still seem to be up for negotiation.

To be sure, the euro area has crossed the Rubicon here. This is the first time in the crisis that ordinary depositors in a bank will find their euro deposits haircut. This risks the most critical thing for the continued functioning of the euro area: trust in the currency.

- It's not really about Cyprus itself. Cyprus is too small to matter, with a GDP only 7% of tiny Greece.
- But as the world has seen repeatedly, even tiny countries like Greece matter.
- That's because, as we have told clients many times, the euro is unique among global currencies because it lacks a single treasury backing it. As such, it can be described as the most fiat of currencies.
- While we stress that this move will not turn into a major bout of what ECB President Mario Draghi euphemistically calls "convertibility risk," the fact that the troika was willing to put it in play at all here shows how few options they felt they had.

For the coming days, it is likely that there will be a correction in global markets, particularly for peripheral European financial stocks and sovereign debt. It's already begun as of this writing, in overnight trading. But as the ECB's backstops are proven to be sufficient to counter any case of nerves by depositors, we think this won't shape up as another existential crisis for the euro area such as we have seen at this time in each of the last three years.

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Bottom line

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