



From the desk of Komal S. Sri-Kumar, Ph.D.

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Cyprus Depositors Take a Haircut

The \$25 billion GDP of the tiny island nation of Cyprus constitutes just 0.19% of the Eurozone figure. Yet, developments in the country's banking sector during the early hours of Saturday could have significant implications for how the rest of the region handles its debt crisis.

In exchange for a €10 billion bailout of the debt-strapped nation by the European Union, the European Central Bank and the International Monetary Fund (the "troika"), the Cypriot government agreed to impose a tax of 9.9% on deposits in excess of €100,000, and a tax of 6.75% on smaller deposits. In this manner, low-income Cypriot residents have also been co-opted as involuntary participants in their country's debt restructuring. The depositors' collective losses will provide an estimated €5.8 billion to the government in addition to the funds from foreign creditors. And in a reversal from the way Greece's debt restructuring was handled, bondholders appear not to have suffered a loss in the weekend developments.

"Haircuts" on Deposits Sets a Eurozone Precedent

Losses imposed on depositors in Cypriot banks is a first in the four-year old Eurozone debt crisis. Even in the case of Ireland, where excessive bank investments in US subprime securities led to the banks being rescued by the Irish government (and eventually by the troika), depositors did not lose money. In every bailout since that of Greece in May 2010, the ECB has stood by to ensure that depositors were protected. In the case of Cyprus, the ECB is a participant in imposing losses on all deposit holders.

Bank depositors are generally provided preferential treatment relative to other creditors because a loss of

confidence by depositors could result in a run on banks, worsening the debt crisis. A potential bailout will not only have to make up for the prior funding gap but also deal with the additional loss of cash as depositors flee the banking system. A second reason for protecting depositors is that they are seen as "innocent" victims of an economic crisis. Unlike more sophisticated creditors who lend to banks accepting the risk in order to earn a spread, depositors leave their money with banks at a lower interest rate than other creditors, essentially for safe-keeping.

European authorities also run the risk that by exchanging a haircut on deposits for aid they are setting a precedent for other countries, especially Spain and Ireland, where the crises began in the banking sector. Some European officials have tried to calm concerns elsewhere in Europe by emphasizing that the Cypriot solution was a one-off deal - - no haircuts will be imposed on deposits elsewhere in the Eurozone. Is that because they are bigger countries and cannot be pushed around like tiny Cyprus? No doubt, the ECB will stand ready during coming days to provide assurances to deposit holders in Greece, Ireland, Portugal and Spain.

How much are the assurances of the top European leaders worth? After all, Cypriot authorities assured their depositors until a few days ago that no tax on deposits was contemplated. And wasn't the Greek bailout of May 2010 also a one-time deal never to be repeated - - until it was followed by emergency measures to save Ireland, Portugal and Spain? And European banking regulators assumed in stress tests that sovereign debt will never lose value until Greece's debt had to be restructured. . . You get the point.

Cyprus: A Special Case?

To be fair, the haircut on deposits announced Saturday should not have come as a total surprise. Banks in Cyprus are major recipients of funds from Russian depositors, and have long been suspected by other European countries to be laundering centers for funds of questionable origin. There has been reluctance, especially in the German government, to extend taxpayer funds to, in effect, bail out Russian oligarchs. This being an election year in Germany, bailing Cyprus out has been an especially sensitive political issue.

It is unlikely, in my opinion, that European authorities can convince savers elsewhere that the deposit losses in Cyprus will not be repeated. It would be easy to find excuses why depositors in Spanish or Italian banks should also suffer loss of principal in order to provide a part of the bailout funds. Perhaps the depositors were in search of troubled banks paying higher interest rates and, therefore, deserved to incur a loss? Or, maybe a specific bank's lending activities were not totally above board and, therefore, both the bank and its depositors should suffer losses? In any case, if you were a depositor in Madrid, Milan, Athens or Dublin, are you being paid to take the risk that you are running by leaving money in domestic banks rather than moving them to Frankfurt?

The importance of the Cypriot precedent cannot be overstated. As in other countries that received bailouts, residents will be forced to experience job losses and reductions in government subsidies. Even though Cypriot leaders are telling residents that tax hikes and spending cuts will not be necessary because of the €5.8 billion raised from the deposit tax, austerity is the standard EU prescription in the ongoing debt crisis.

Deposit outflows from Cypriot banks are certain to follow after the banks reopen this week. They were set to open tomorrow, but could remain shut until later in the week unless the Cypriot government can get its parliament to approve the moves. Parliamentary discussion set for yesterday (Sunday) was postponed, as it seemed that the government might not get the approval.

In a new development for debt-ridden Eurozone countries, Cypriot residents will begin the debt restructuring process with a portion of their net worth confiscated by their government. If it works, it would be hard to avoid the temptation that it could be tried elsewhere as a hitherto untapped source of government revenue.

Concluding comments

Despite Cyprus's small size, the haircuts on deposits add another element of sovereign risk for investors in countries undergoing bailouts monitored by the troika. Unless European officials can impress depositors that the Cyprus case is a unique one - - and I don't believe that they will succeed - - the developments will raise debt yields in the peripheral countries even as capital inflows lower yields in Germany. This is the opposite of the result that European officials should be trying to achieve.

And by adding deposit loss as an additional risk to be considered by Eurozone residents and depositors, the weekend developments threaten to deepen and lengthen the ongoing recession in the region.

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