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Eurozone Signals Deposit Grab In Future Bank Bailouts

By JASON MA - March 25, 2013

The Cyprus rescue and a top European official's comments signal rich eurozone governments are ending their support for troubled banking sectors, which now face greater bank-run risks as additional deposit seizures loom.
The island tax haven averted an immediate meltdown with a last-minute deal to impose steep losses on bondholders and deposits above 100,000 euros at the top two Cypriot banks. That will secure a 10 billion-euro international bailout.

Cyprus was billed as a unique situation, but the head of eurozone finance ministers, Jeroen Dijsselbloem, said responses to future financial crises will resemble Cyprus' rescue with bank shareholders, bondholders and uninsured depositors subject to losses.

U.S. stock indexes reversed earlier gains and closed moderately down. European markets retreated as well, with benchmark Italian and Spanish indexes each off more than 2%.

Dijsselbloem later called Cyprus "a specific case with exceptional challenges" that doesn't represent a template for future action. But his original interview with Reuters and the Financial Times indicated countries like Luxembourg and Malta with outsized financial sectors must learn from Cyprus if their own problems arise.

"It means deal with it before you get in trouble," he said. "Strengthen your banks, fix your balance sheets and realize that if a bank gets in trouble, the response will no longer automatically be that we'll come and take away your problem. We're going to push them back."

He acknowledged eurozone leaders have changed their minds about bank support, moving away from using public rescue funds in the European Stability Mechanism and toward "bail-ins" where creditors see their bank bonds converted to equity stakes.

In fact, policymakers should work toward never using the ESM as a way to directly recapitalize banks, he said. This comes less than a year after eurozone leaders agreed to use the ESM to save Spanish banks.

"Banks should basically be able to save themselves, or at least restructure or recapitalize themselves as far as possible," Dijsselbloem said.

Financial institutions and investors will have to "think about the risks they are taking on because they will now have to realize that it may also hurt them," he added.

Depositors elsewhere may be more nervous, but indebted eurozone members such as Spain and Italy are unlikely to see bank runs unless conditions worsen significantly there, said **Bernard Baumohl, chief global economist at the Economic Outlook Group.**

While Dijsselbloem tried to walk back his earlier statements, they could still end up doing more harm than good by igniting additional uncertainty, he added. "You're just pouring more gas on the fire," **Baumohl** said.

Meanwhile, Cyprus may need another bailout in the future as its economy suffers what's expected to be a severe contraction and undergoes painful reforms.

The island's next crisis may not be on the same scale as this last one, and **Baumohl** believes the eurozone is still committed to keeping all 17 members in the currency union.

Cyprus' financial sector is too large and has too many foreign deposits to act as a template for Spain and Italy, said Josh Feinman, global chief economist at Deutsche Bank's DB Advisors.

But the eurozone is playing a dangerous game of potentially stirring contagion fears of bank runs, he said. "The policymakers so far in Europe have gotten away with it."

Questions about the latest bailout remain. For example, how much creditors and depositors at the country's two biggest banks will lose is uncertain.
The plan is to shift deposits under 100,000 euros from the Popular Bank of Cyprus to the healthier Bank of Cyprus to form a "good bank," with the remaining entity serving as a "bad bank." Deposits above 100,000 euros in both will be used to pay off the bad bank's debts and recapitalize the Bank of Cyprus.

Deposits below 100,000 euros will be protected. The initial plan sought a levy on small holdings.

New capital controls meant to prevent a total exodus of money out of banks and Cyprus will be a "very temporary measure that will gradually be relaxed," President Nicos Anastasiades said in a TV address.

Cyprus late Monday said banks won't reopen until Thursday, a further delay of two more days.

While Russian firms and investors will suffer some of the worst losses in Cyprus, Moscow said it will negotiate to restructure a 2.5 billion-euro loan it made in 2011.

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