DOI: 10.1007/s10272-013-0455-x

The Cypriot Precedent

The Cyprus case has been considered as a barometer of the willingness of member states to liquidate insolvent banks and limit taxpayer-funded direct bailouts of banks. Notwithstanding the validity of such an objective, dangerous market processes have already been set in motion. Cyprus epitomises the toxic intertwining of banks and governments, which are reflected in the weaknesses of the current economic governance of the area. Under euro area enhanced cooperation, a prohibition on member states providing any sort of liquidity support to national banks would be a precondition to introducing an effective common resolution regime run by an independent authority. A banking union will not thrive on shaky foundations.

Cypriot banks landed in the middle of the storm when the national government declared its inability to recapitalise two of the biggest banks in the country. The government's intervention possibilities were strongly limited because the financial sector in Cyprus was eight times the size of the country's GDP. The prologue to this story is that Cyprus and the Eurogroup chose not to liquidate Laiki Bank and to restructure the Bank of Cyprus on the basis of a voluntary solvency test applied to the Cypriot banking system. For instance, the German government has so far avoided the disorderly liquidation of German banks by providing over €400 billion in liquidity and guarantees to them, which its significant fiscal capacity has allowed it do to. France and Italy have undertaken similar interventions to provide liquidity for national banks, though for smaller amounts.

As a consequence, a strong national bias emerges when a bank encounters liquidity issues and is unable to raise money in the interbank market. The nationality of the bank can affect its fate, and this factor is undoubtedly priced into the market for interbank credit. The strong link between the fiscal capacity of the country of legal incorporation and the solvency status of the country's major banks is further strengthened by the banks' massive purchases of national debt, especially by those banks facing high downside risks. As a result, a euro in a country with a lower fiscal capacity may have a lower value than a euro in a country with a strong fiscal base, even if the economy of the country with lower fiscal capacity is performing relatively well. Cyprus is the precedent where the use of capital controls has implicitly introduced a parallel currency. However, due to the limited size of the country within a much larger monetary union, these measures might not destabilise the euro as a global currency.

Cyprus is also the first case during this crisis of a haircut on deposits above €100,000 in the liquidation/restructuring of a bank. Additionally, this will be the first precedent of capital controls within a common monetary area. Imposing losses on deposits is not only an act which conveys a strong message that markets will need to take into account when the next crisis looms. It also raises the question of whether deposits should be considered "taxpayers' money" rather than "bank credits" from which contributions to the restructuring/liquidation of a bank would come only in very specific emergency situations. Using such a tough approach towards a banking system with just €68 billion in deposits, though, may be a different story than applying the same method to the banking system in Italy – with roughly €500 billion in current accounts and €400 billion in other deposits – if the Italian government were to ask for assistance to unwind some of its biggest banks. In addition, most of the deposit guarantee schemes in the euro area are unfunded government-backed programmes. Markets are going to reflect this by putting additional pressures on government funding, thus inevitably involving taxpayers' money.

Although calling in deposits may be a potential way to support the restructuring of the banking system in the euro area, what is really striking is the discretional use of such an important tool. It has not been applied uniformly across the euro area, nor have any promises been made to do so in the future. Rather, it has been discretionally utilised for reasons that have perhaps nothing to do with the current financial crisis. The decision to punish Cyprus for the lax implementation of money laundering directives and for its bilateral agreements with third countries on corporate taxation and transparency is a case in point. This approach obviously creates uncertainty and does not clarify if and how the fiscal governance of the eurozone (through the ESM) will deal with issues in the financial system, especially when other member states ask for liquidity to assist national banks. This points at the lack of stable economic governance in the area. In addition, the imposition of capital controls to stop deposits outflows, which would be illegal under Articles 63 and 65 of the TFEU, points at the frequent à la carte interpretation of the rules that purport to represent the common level playing field within a monetary area.

Insolvent euro area banks should be resolved or at least restructured. Prolonged monetary policy interventions to provide long-term liquidity with limited conditions, such as the ECB's long-term refinancing operations, have so far only postponed problems and increased the potential costs for the liquidation or restructuring of several zombie banks, which have used this liquidity to purchase massive amounts of their home countries' sovereign debt. The absence of a formal euro area prohibition on member states providing liquidity support to national banks has further fragmented the financial system supporting the common currency. In effect, government interventions to bail out or provide support to national banks are exempted under Article 107.3(b) of the TFEU, which finds aids compatible with the single market when they are intended "to remedy a serious disturbance in the economy of a Member State". This assessment was also confirmed by two Communications of the European Commission (2009/C 195/04 and 2009/C 10/03). The exemption, which makes sense in a common market with diverse financial systems based on different currencies (like the European Union), may not only distort competition among banks, but may also affect the stability of the common currency area. In effect, on top of a "natural" rebalancing of the financial system within the euro area towards regions with higher income creation, government interventions are forcing the common financial system to concentrate in areas with higher fiscal capacities, independent of the fundamentals of the areas' economies.

In addition to a *tout court* prohibition of government support to troubled banks, the dangerous path laid down with the Cyprus decision also calls for the establishment of a resolution authority to support the "bailout prohibition", even though this would require a Treaty change. This authority would include a resolution fund (financed by banks) and access to an ECB credit line if the fund were insufficient to protect deposits below €100,000 (as well as those above this threshold in specific cases that the authority would independently define). The resolution authority would become an important stability factor for the financial system of the eurozone, which would no longer rely on the nationality of a bank's assets. This role can hardly be played by the ESM, due to the direct control exercised by member states and their fiscal powers, nor by the ECB, due to the conflict with its monetary policy function. More likely, this role may fall under the remit of the Directorate General of the European Commission that deals with state aid rules and competition policy (DG COMP). DG COMP would be transformed into an independent authority, whose decisions would be scrutinised by the General Court and the European Court of Justice, and which would periodically report its activities to the European Parliament. State aid rules, modified within the framework of the directive on crisis management proposed by the European Commission (including the prohibition), would become the common set of resolution procedures that would guide the decisions on whether to resolve or restructure banks and to call in deposits to cover losses. Regardless of whether deposits are again called upon to contribute to the liquidation of a bank, the Cyprus case is the precedent that has demonstrated the instability of the foundations of the banking union and the weakness of an institutional set-up that will be required to make ever more important decisions as the economic crisis lingers and the banking system suffers further blows.

Diego Valiante, European Capital Markets Institute (ECMI) and Centre for European Policy Studies (CEPS), Brussels, Belgium.