Realm Cyprus Review

26th March 2013

There has been plenty said about the bail in of depositors and whether it does or doesn't set a precedent, ultimately the market will vote with its feet through the European Target 2 mechanism. However, the decisions relating to Cyprus are more far reaching.

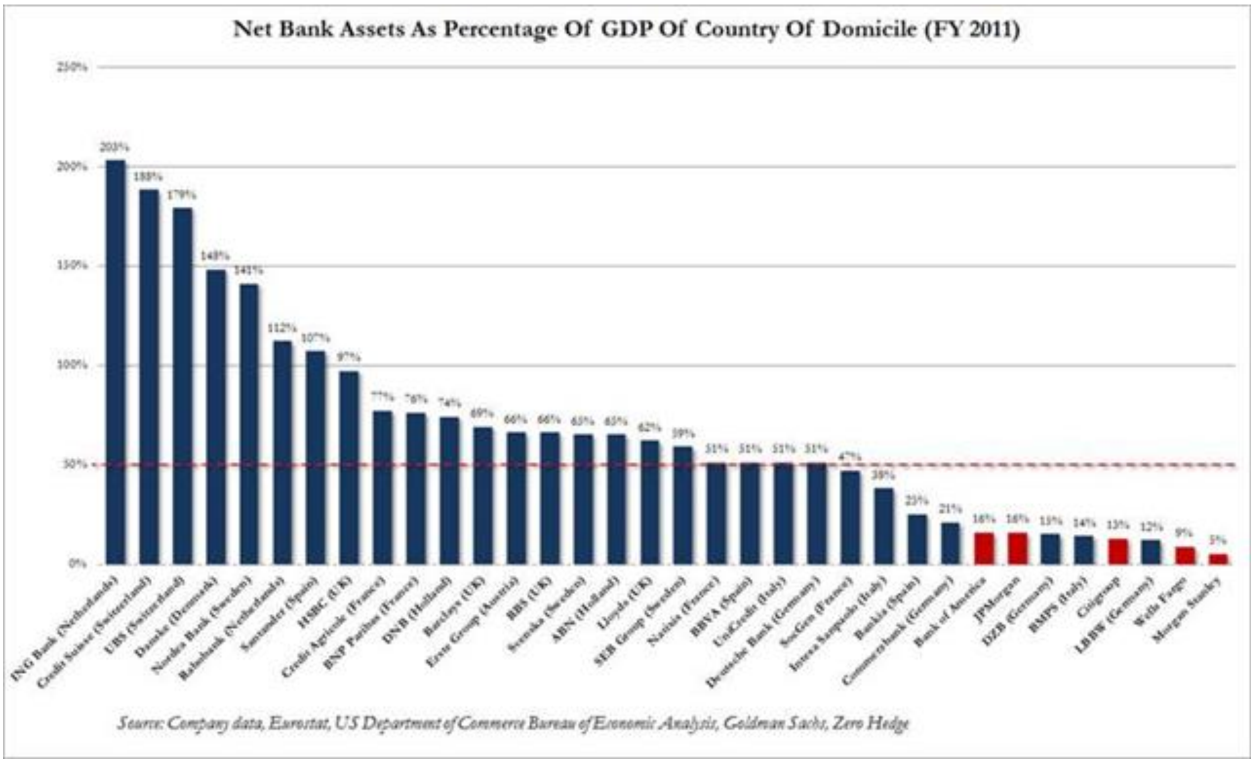
Given the Euro group's fumbling on their own deposit guarantee (initially haircut was to be applied to balances under 100K euro), one can only assume that the majority of these second order effects are yet to be considered.

For example, the decision to make Bank Of Cyprus wear LAIKI's ELA (Eurozone Emergency Liquidity Assistance facility) liabilities, essentially means that the other less talked about effect of this decision is burden sharing among banks. In simple terms, LAIKI's ELA liability became the Cypriot banking sector and Cyprus's problems the second they couldn't make good.

What might this all mean?

- There will be no such thing as an unconditional direct bank bailout from the Eurozone under the current structure (in the absence of a formal banking union), not at an individual or a systemic level (Spain the key concern here).
- The Germans will accelerate crisis to force restructuring on the periphery, with a view to minimising contingent liabilities on the German people (because ultimately their decision shows a real aversion to crystalise any loss).
- All banks within troubled jurisdictions might be considered as cross collateralised, arguable that there is no such thing as a good bank in a bad jurisdiction (ELA liability transfer shows us this, ratings ramifications to follow).
- Democracy is little like the Monty Python Cheese sketch in Europe, you can have whatever you like as long as it's what we give you. Might be particularly flammable fodder for Beppe and might cause further divisions across Europe in the shorter to medium term.
- Large global banks are benefitting both ways, in that they have implied parental support if required and are bankruptcy remote if the parent falls over. This is particularly interesting given that the Cypriot "burden sharing" did not extend to these foreign banks and their liabilities.

The chart below illustrates that Uber financial services sectors are anything but anomalous or a Cypriot condition, however where the Cypriots went wrong was collecting all of the assets within Cyprus rather than spreading the burden across regulatory jurisdictions (there is a question here for bank regulators everywhere).



The question is what percentage of Big banks assets are domiciled in greater Europe (outside of home country). Applying the debt to GDP measure on a Euro wide basis (including the UK) may make the Cypriot story a lot less anomalous than the Euro group wants us to believe. We are in a European credit crisis after all, so presumably it isn't a long bow to suggest that Europe suffers from the Cypriot condition.

Ultimately it comes down to growth.

If 2013 sees recessions deepening and a transmission from periphery to core continue (France and Italy), the Cypriot plan or a similar version of it (liability targeting) might well be used again.

Over the last 12 months Spanish and Italian banks (and the odd Dutch one) have been busy turning subordinated debt to equity, through a cross section of conversions and discounted redemptions, this unfortunately might not be the end game, but rather a sign that the active remediation of these banks has begun. The problem is that delivering growth and austerity simultaneously is impossible which in effect means that more and more of the capital structures in the banking sectors of these countries will need to be used up to compensate for losses and write downs.

Ultimately the ECB seems reticent to wear losses through Target 2 which would turn contingent liabilities into expenses, this has hollowed out Draghi's whatever it takes assertion which initially underpinned the 2012 second half recovery.

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