QUICK MARKET UPDATE

Bail Out or Bail In: Implications of the Cyprus Rescue

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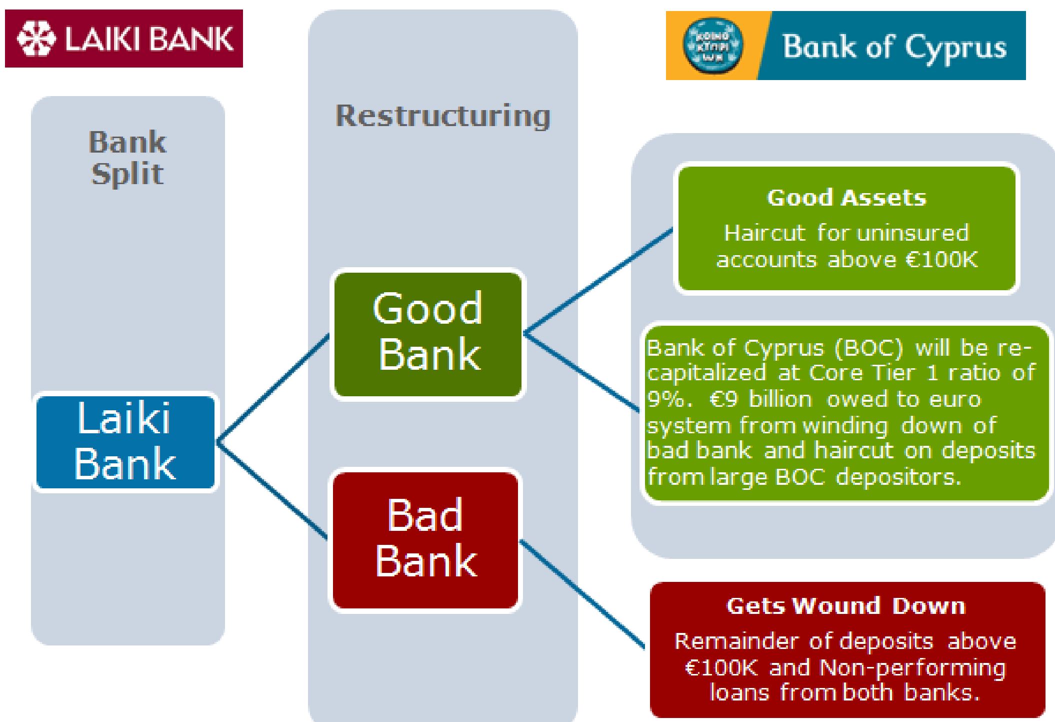
After two false starts, and amidst much criticism from press, the Cyprus rescue was finalized in the early hours of March 25. For the sovereign island-nation, it could indeed be described as a "bail-out," with up to €10 billion of program funds available. But for the remainder of the rescue—the resolution of the Cypriot banking crisis—it was more akin to a "bail-in," one that is more aggressive than any we've seen so far.[1] Cypriot lawmakers agreed to split their country's second-largest bank, Laiki Bank, into a good bank and a bad bank, with the bad bank to be wound down and its good assets and insured deposits to be rolled into the nation's largest bank, the Bank of Cyprus. This means that equity shareholders and bondholders alike in both banks face total losses in the restructuring. Uninsured deposits exceeding €100,000 at Laiki bank will also suffer deep losses, while uninsured deposits at Bank of Cyprus will suffer a haircut (reportedly between 30 percent and 50 percent but still undecided), sufficient to bring the capital ratio of the newly merged bank to nine percent.[2]



**One half of bank deposits in Cyprus are housed in Laiki Bank or Bank of Cyprus, Financial Times, March 2013*

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[1] Bail in refers to bondholders and stakeholders who must share the burden of loss before taxpayers are called to bail out an insolvent bank.
[2] The capital ratio is a measure of a bank's financial strength from a regulator's point of view. Basel III rules mandate Eurozone banks to maintain a Tier 1 Capital Ratio of nine percent by the start of 2013.

At first glance, this agreement has considerable advantages over the original accord from last week that proposed a 6.75 percent levy on insured deposits and a 9.99 percent levy on uninsured deposits. The proposition of taxing insured deposits provoked widespread anger in Cyprus and was ultimately rejected by the Cypriot Parliament. The final agreement is effectively a bank restructuring, so the investor contributions are viewed as "haircuts" rather than taxes, and is implementable without further recourse to the Cypriot legislators. Most importantly, the agreement leaves insured deposits up to €100,000 untouched, and the principle of E.U.-wide deposit insurance intact, albeit precariously so. The Eurogroup's official statement on the restructuring plan stressed that it safeguards deposits below €100,000 in accordance with E.U. principles. This assertion, in our view, is somewhat disingenuous since there was implicit acquiescence in the proposed small-depositor tax of the original accord. Also the final agreement bails in investors at only two banks rather than spreading losses across the whole economy. Ultimately, such a deal is likely the least unsatisfactory that could be struck given the very real constraints—political and economic.

Market response: special case or template?

Initial market reaction to the 11th-hour deal was benign, with the euro vs. U.S. dollar exchange rate rising back above 1.30, and 10-year Italian Government debt yields reaching post-election lows of 4.45 percent. Even banks responded positively to the news. By mid-morning Monday, the EuroStoxx Banks Index was some 1.6 percent higher in London trade and the iTraxx subordinated financials Credit Default Swap (CDS) Index was more than 10 basis points tighter from Friday's close, signs of easing uncertainty. It's easy to rationalize why this should be so. With a deal secured, the market finally had some closure. While many investors will take losses, any alternative outcome would surely have been far more precarious. At best, it could have involved the end of the deposit insurance guarantee, or at worse, the disorderly exit of Cyprus from the Eurozone, with unpredictable consequences. Given the muted capital-market response, many investors appeared to convince themselves that Cyprus was indeed a "one-off" or "special case" (albeit, cynics claimed, the latest in a series of unique events), given the sheer size of its swollen financial sector (eight times GDP) and the predominance of foreign (Russian) money within large-scale deposits.

Eurozone finance minister speaks out

The Eurogroup of Eurozone Finance Ministers head Jeroen Dijsselbloem's press interview was made public mid-afternoon Monday and put an end to such complacency.[3] Not only was the Cyprus bank resolution not considered a special case, it was in fact, to be seen as a model for future bank resolutions within the Eurozone. Using uncompromising language, the Dutch policymaker spoke of "pushing back the risks," from the Eurozone taxpayers—via the European Stability Mechanism (ESM) and other bailout vehicles—to the banks and investors where the risk originates. Such a stance implicitly retracts both the June 2012 agreement on the use of the ESM for directly recapitalizing banks, and represents an acceleration of the timetable in the EU's 2012 Recovery and Resolution Directive, that envisaged employment of senior bond writedowns (the "bail-in tool") only from 2018. And in case investors did not get the hint, Dijsselbloem made it explicit by proclaiming: *"We should aim at a situation where we will never need to even consider direct recapitalization. If*

[3] The Eurogroup is the grouping of Eurozone Finance Ministers

we have even more instruments in terms of bail-in and how far we can go on bail-in, the need for direct recap will become smaller and smaller."

Market reaction to Dijsselbloem's comment was immediate, fierce, but not catastrophic: the EuroStoxx Banks Index and the iTraxx reversed their gains from earlier in the day, and eventually closed the session in negative territory. After rallying on the news of a deal, U.S. markets closed down for the day as well. This reaction was reasonable given the thrust of the Eurogroup head's remarks, coupled with his track record as Dutch Finance Minister of restructuring SNS bank, in which subordinated bondholders were effectively expropriated. After the nationalization of the bank on February 1, Dijsselbloem noted that he would like to see "all bond holders" (i.e. including senior debt holders) contribute to bank restructurings in the future.

The negative market reaction resulted in a two-line statement from Dijsselbloem: *"Cyprus is a specific case with exceptional challenges which required the bail-in measures we have agreed upon yesterday. Macro-economic adjustment programs are tailor-made to the situation of the country concerned and no models or templates are used."* Optimists see this remark as a retraction of the views stated earlier, and evidence that Dijsselbloem simply "misspoke", conflating his own views with Eurogroup policy. This is arguably too optimistic a reading. It is inconceivable that the Eurogroup leader should give such a high-profile interview without being acutely aware of the impact of his words.

Broader Eurozone implications

If the original interpretation of Dijsselbloem's comments is the correct one, we anticipate a number of implications for Eurozone policy-making and for the capital markets in general. In the very big picture, the lasting legacy of the Cyprus rescue may be a decidedly negative one—the exacerbation of already poor relations between the northern Eurozone including its taxpayers and the peripheral south. Ultimately, it may be the political flaws in the Eurozone project (insufficient solidarity between nations) rather than its economic failings that could lead to its downfall. In the medium term it seems that the 2012 agreement on moving toward a pan-Eurozone banking union, already being called into question, is now in jeopardy. The Dijsselbloem philosophy implies that each nation should resolve its own banking crises, with its own resources.

For the markets, the overall impact may be summed up by the words of London School of Economics Professor Paul de Grauwe: *"We have solved the Cypriot case at the cost of increase of systemic risk in the Eurozone"*.[4] Specifically, a number of asset classes should be perceived as more risky than before, if investors, rather than Eurozone taxpayers, are the ultimate backstop. Eurozone bank stocks and subordinated—especially senior bank debt—should trade weaker than they otherwise would have. Arguably the euro itself should be weaker, as Eurozone policy-making becomes less consistent and private investor assets less certain. But this call ultimately depends upon whether the model outlined by Dijsselbloem is seen as preferable to the 2012 version—whether investor bail-ins on a national basis are better than a centrally-sponsored resolution vehicle. Our view is that while the latter might be preferable in an ideal world, it was never truly

[4] Bloomberg, March 25, 2013

practical given the complexity of Eurozone politics. But the Dijsselbloem approach, while providing welcome clarity, is also high risk and may yet have unintended consequences. The euro is unlikely to rally strongly in these circumstances.

For peripheral government debt (Portugal, Ireland etc.), the implications are not necessarily negative ones. If the Cyprus model means that the ESM's €500 billion resources will now be dedicated solely towards sovereign bailouts, then these limited resources will stretch further than they would before. Put another way: the Dijsselbloem view that private sector banks and investors should resolve themselves is perhaps a more practical and more viable way of achieving the Eurogroup's stated aim of breaking the vicious spiral of declining creditworthiness between banks and sovereigns, precisely because it responds to the political realities of "bailout fatigue" in northern Eurozone electorates.

Data for this QMU was sourced from Bloomberg Finance, LLP, unless otherwise noted.

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