From: John Mauldin <3jmauldin@gmail.com>
Subject:
Date: March 28, 2013 12:00:58 PM PDT

Has the EU Solved the Bank Capital Adequacy Problem?

March 28, 2013

Bob Eisenbeis is Cumberland's Vice Chairman & Chief Monetary Economist. Prior to joining Cumberland Advisors he was the Executive Vice President and Director of Research at the Federal Reserve Bank of Atlanta. Bob is presently a member of the U.S. Shadow Financial Regulatory Committee and the Financial Economist Roundtable. His bio is found at www.cumber.com. He may be reached at Bob.Eisenbeis@cumber.com.

Among all the negative consequences of the Cyprus banking crisis and the disastrous way that policy was framed, there is a silver lining to the problem. That is: the Europeans may have inadvertently solved the bank capital adequacy problem, and European banks have now gone from being some of the weakest to some of the strongest in the world, at least as far as capital adequacy is concerned. How could that be?

The Cyprus problems and their resolution by confiscating the funds of large depositors now show that there are definitively only two types of liabilities now remaining in European banks - insured deposits and capital. While capital usually represents the claims of owners, regulatory supervisors have proved willing to include other kinds of liabilities as capital when computing capital asset ratios, including not only equity but also preferred stock, subordinated debt, and other liabilities, on the grounds that they are available to offset losses in times of financial distress. By imposing losses on all creditors including debt holders, equity holders, and uninsured depositors, the EU has essentially declared that all liabilities that aren't government-guaranteed will bear losses and hence, have the critical attribute of capital. The priorities of those claims are not yet clear and will likely depend upon individual EU country law. Nonetheless, any questions about whether uninsured deposits are going

to experience losses in times of financial distress have now been answered, in a total reversal from the essentially 100% guarantees that were originally extended during the financial crisis.

By imposing losses on large depositors in Cyprus, the EU has effectively redefined all liabilities that aren't insured as capital, which means that the capital ratios of European banks, for purposes of assessing capital adequacy, have exploded - not through competent management but with the stroke of a pen. While virtually unlimited loss absorption should now be a comfort to European banking supervisors, the policy decision should be sobering for all uninsured depositors who don't want to risk being treated like equity holders when it comes to losses. This is especially true for depositors in Greek, Spanish, Portuguese, and Italian banks. We would expect a flight of depositors from European banks and not only from those in Cyprus.

The other lesson from the Cyprus debacle, upon which we have opined in another commentary, is that pretending that sovereign debt is riskless is illusionary and dangerous. Cypriot banks loaded up on Greek debt, which was both non-diversified and risky. Cypriot supervisors should have been well-warned, but chose to turn a blind eye. During the US financial crisis, problems with state and local debt did not infect the balance sheets of US banks, mainly because they didn't hold such debt. So when the Meredith Whitney-manufactured municipal debt crisis occurred, it was a non-event for US banks. The reason, however, was not enlightened bank supervisory policy. Rather, it was a quirk of US tax law that made it uneconomic for banks to hold state and local debt. Sometimes it pays to be lucky rather than smart.

Finally, the European decision on Cyprus also has interesting implications should a large European institution fail or need to be restructured. The losses will be huge and their incidence uncertain, unless the policy is clarified and simply declaring Cyprus a one-off event won't do. Since most of the major European banks have been rescued

rather than being reorganized or having their losses imposed upon creditors, the assumption had been that all deposits would be protected. How will European regulators respond to the next Cyprus-like crisis in a much larger economy? Taxpayers are already on the hook because they are the major bank shareholders due to the financial crisis. But also all depositors are de facto, if not de jure, stock holders as well. The poor taxpayers can't run, but surely uninsured depositors will no longer hesitate to be out the door, thereby reducing loss-absorption capacity and also creating a short-term liquidity problem that will only exacerbate any other problems the institution may be experiencing. The end result of Eurozone handling of the Cypriot crisis is to create incentives on the part of depositors to look for safe havens, and we now know that Europe is not one of those.