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Administrative Office  
c/o Professor George Kaufman  
Loyola University Chicago  
820 North Michigan Avenue  
Chicago, Illinois 60611  
Tel: (312) 915-7075  
Fax: (312) 915-8508  
E-mail: gkaufma@luc.edu

Statement No. 338

Dr. Robert A. Eisenbeis  
(941) 254-4628

Statement of the Shadow Financial Regulatory Committee on

**Lessons from Cyprus**

May 13, 2013

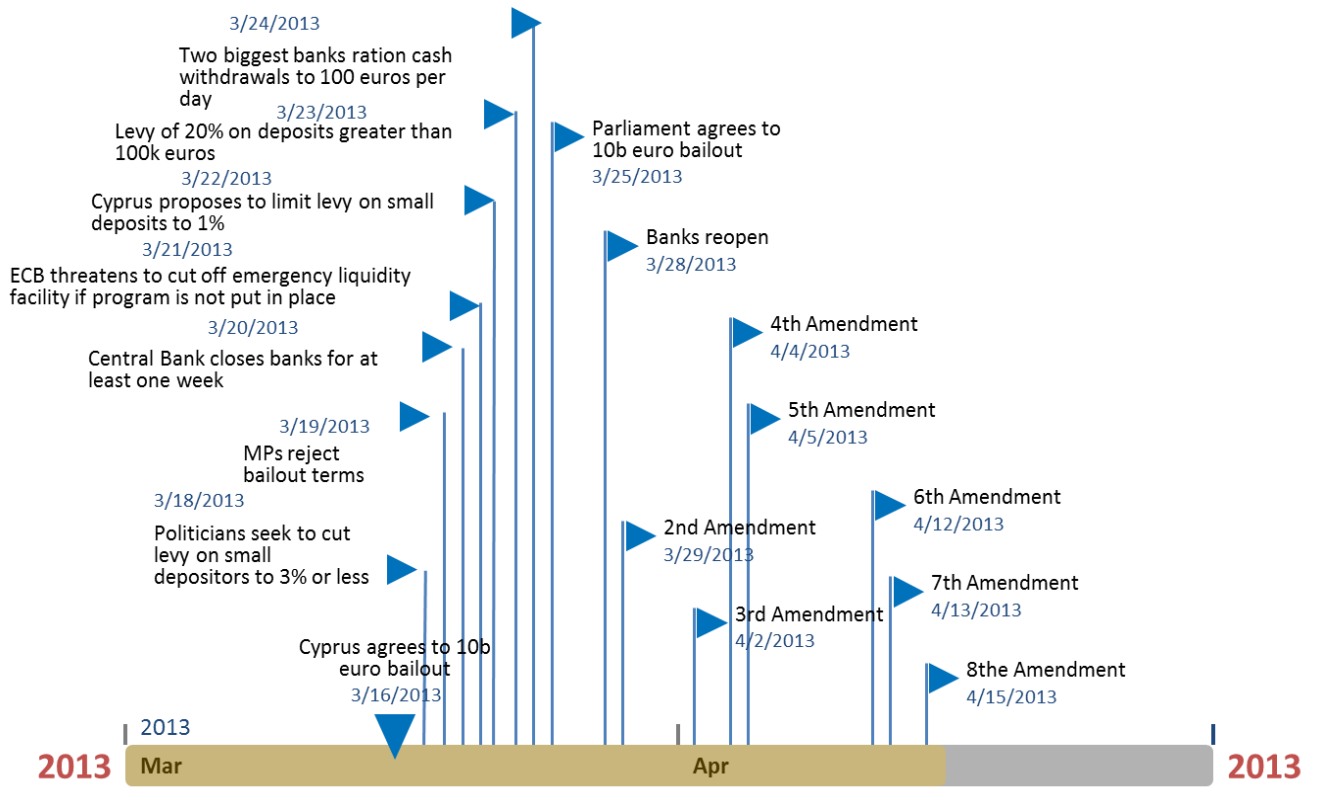
On Saturday, March 16<sup>th</sup> Cyprus agreed to a €10 bn bailout from the eurozone to deal with its debt and financial crisis. The chilling aspect of the agreement was that it included, for the first time since the formation of the eurozone, a levy of 9.9% on deposits over €100,000 and a 6.7% levy on insured deposits less than €100,000 to compensate for bank losses. What ensued over subsequent days was a series of populist riots in the streets and attempts by Cypriot politicians to reduce the levy on insured deposits, but the changes were rejected in the Cypriot parliament. The crisis dragged on, and banks were closed until a rescue could be worked out. Finally, on Monday, March 25 a last-ditch agreement was reached that protected insured depositors but imposed heavy losses on accounts over €100k that hit large depositors especially hard. The final deal included closure of Popular Bank of Cyprus, the nation's second largest bank. The Bank of Cyprus, the island's largest bank, survived but investors and large depositors were forced to absorb losses that could amount to as much as 40% by the time everything is resolved. And for now, at least, Cyprus remains within the EMU.

There has been much fallout from the Cyprus affair. First, there has been a clear shift in Europe away from indiscriminant government (i.e. taxpayer funded bailouts) and protection of all creditors of failed and failing banks. While the Shadow Financial Regulatory Committee favors policies that would impose losses on uninsured creditors of a failed institution, the process by which the eurozone got to that policy also had the consequence of calling into question the reliability of deposit insurance guarantees throughout Europe. It was a mistake the European Finance Ministers to support the proposed levy on insured deposits.

Second, the disproportionately large size of the banking system in Cyprus, which was over seven times the size of the country's GDP combined with the developing losses quickly overtook the assets in its deposit guarantee fund so that the country could not honor its deposit guarantees without outside help from the rest of eurozone. The US learned long ago that small, individual state-sponsored deposit insurance guarantee systems are fragile and not viable because of the inability of the local state governments to live up to their guarantees or issue currency. It now looks like this may be the case in some countries in Europe as well. In the US during the Great Depression the FDIC was established to provide credible federal deposit insurance nationwide. In contrast, the eurozone stepped up in an ad hoc fashion to provide loans and establish loss sharing arrangements for creditors and depositors in Cyprus. While Cyprus was supposedly a one-off event, should conditions in other countries like Spain, Portugal and Greece deteriorate further, only a pan-European deposit guarantee system backed up with EU-wide taxing and money creation authority could effectively help ensure financial stability.

Third, there has been widespread interest not only within Europe, but also in the US, Canada and New Zealand, to establish a Cyprus-style bail-in scheme in which uninsured depositors funds in insolvent institutions are converted to equity as a way to recapitalize systemically important institutions should they fail. In effect, such proposals create a type of contingent capital but with all the drawbacks that poorly designed contingent capital schemes contain. Loss sharing arrangements must be carefully designed to avoid uncertainty as to how much, what or when the commitments might be required and uncertainty due to the reliance upon an ad hoc conversion triggers with market-based signals. Indeed, as the attached appendix shows, numerous exemptions were made absolving certain large depositors from the levies that had initially been proposed. Should the proposed bail-in proposals be implemented, the Committee fears that the structure will only contribute to accelerated runs from troubled institutions in weak countries by uninsured creditors. The lesson here is that without an ex ante loss sharing system in place, uninsured creditors will have even greater incentives to withdraw their funds from institutions in times of general financial stress.

Finally, the bail-in concept assumes failure of the supervisory process in place because a troubled institution had been permitted to fall into an insolvent state. Hence, the ensuing problem is one of loss allocation. The approach fails to recognize that the primary focus should be on the creation of a credible supervisory process focused on prompt corrective action and early resolution so that potentially insolvent institutions are identified and closed before their net worth drops to zero. Losses would then be imposed only upon shareholders and all the uncertainties associated with various bail-in proposals would be avoided. Also, an effective prompt corrective action and early intervention process would reduce, and perhaps eliminate, the threat to state and federally sponsored deposit insurance schemes and eliminate the need for taxpayer injections of funds. The Committee urges that all nations considering bail-in schemes concentrate instead on establishing effective prompt corrective action and early intervention processes, and only after that is done focus on structuring loss-sharing arrangements when resolving a failed institution.



## **Description of 2013 Amendments**

- Friday March 29- 2<sup>nd</sup> Amendment
  - CB amends restrictions to permit credit and debit card transactions within Cyprus and transfers of € 300 from notice accounts
- Tuesday April 2-3<sup>rd</sup> Amendment
  - Payments through checks to accounts held in other credit institutions are allowed for up to €9.000 per month per natural person in each credit institution.
  - The amount for payments to other credit institutions for transactions that fall within the normal business activity of the customer that are not subject to any restrictive measures has increased from €5.000 to €25.000 per day per account.
  - There is no restriction for the payment of tuition fees of a person studying in educational institutions in Cyprus.
  - Fixed term deposits can be terminated in order to create one or more fixed term deposits for the total amount which is equal to the initial deposit and for a term at least equal to the initial term of the terminated deposit.
- Thursday April 4-4<sup>th</sup> Amendment
  - Maximum amount of foreign cash withdrawal limited to €300 daily
- Friday April 12 – Sixth Amendment
  - Legal entities and individuals are allowed only to make payments of up to €300,000 to other financial institutions, but transfers are not allowed.
  - Individuals and legal entities are allowed to transfer €2.000 and €10.000, respectively, to other financial institutions, once a month.
  - Only existing customers of a credit institution are allowed to open a new account.
- Saturday April 13 – Seventh Amendment
  - Only payments of up to €300,000 are allowed, and that bank transfers of that size are prohibited.
- Monday April 15 –Eighth Amendment
  - Per person permissible transfers increased from € 2b to €3
  - Other transfer restrictions lifted.
  - Limits on withdrawals from demand deposits are on consolidated accounts
  - Cashing of checks is prohibited
  - Cashless transfers to accounts held abroad are prohibited
  - Payments of up to € 25K not restricted, payments from € 25K to € 200K must be approved, prior approval is required for payments over €200K
  - Plus 13 other changes