Cyprus has long confused Europeans given the intersection of Greek and Turkish interests, plus competing Western and Russian interests in the Eastern Mediterranean. Over the years Cyprus has become a tax haven for hot money that led to a massively levered banking system whereby the bankers had no compulsion about accepting the deposit inflow. Like Ireland, Iceland et al, the banking system is now teetering. I do not know all of the politics involved beyond the EU's desire to haircut Russian oligarch funds, but amid all of the hand-wringing, officials are right to require the haircuts. Small and large Cyprus depositors and bank bondholders are being forced to take a haircut as a cost to secure European support of their banking system. In return, they will receive equity in what presumably are worthless banks, but not as worthless as prior to their involuntary investment.

Cyprus may be an asterisk in the ongoing European banking and sovereign debt saga, or maybe it will be something bigger. The concern is that Cyprus (or Greece, Spain, etc.) might become a Creditanstalt moment when the failure of an Austrian bank in 1931 triggered a run on banks throughout Europe. Creditanstalt did not instill confidence in the U.S. banking system during 1931-1932 either.

A few thoughts:

* The system has to be disciplined, which includes writing off of bad assets promptly. Unfortunately, discipline may only apply to banks in small, expendable countries such as Cyprus.

* Depositors as creditors have less incentive to be discerning with deposit insurance. It may prevent bank runs, but it allows weak banks to carry on.

* Excluding the FDICIA mandate to start the resolution clock when a U.S. bank's leverage ratio falls below 2%, banks and non-banks fail because of a lack of liquidity, not because of a lack of capital or accounting profits; however, capital and liquidity are joined at the hip. Without depositors' and creditors' confidence in a bank's capital position, liquidity is hard to come by unless a bank has acceptable assets that can be pledged for financing. Had the ECB not expanded collateral eligibility in late 2011, many European banks would have had their Cyprus moment already.

* Converting the Cypriots' deposits to equity does nothing to improve liquidity of the banks other than reducing the amount of deposits that can be withdrawn. Citigroup obtained $2.3 billion of TARP preferred in late 2008; however, enhanced capital did not prevent a pre-packaged bankruptcy filing in September 2009 when the FDIC declined to allow the parent to transfer assets to CIT Bank where they could be funded with FDIC-backed brokered deposits. Corporate debt that cannot be rolled is the usual precursor to a bankruptcy filing. Despite hand-wringing in the press at the time about Treasury's complete loss, CIT survived and is now prospering since the reorganization.

* Commercial banks used to invest deposits primarily in high-quality, short-term instruments and loans to commercial customers who secured the loans with collateral that converted to cash within a year (e.g., inventory or accounts receivable). Real estate, the most illiquid of collateral, was for land banks and life insurance companies to lend against. Second-lien home mortgages (i.e., home equity) were relegated to pawn shops.

* Earnings are easy to manufacture in a bank. If assets are never properly marked, spread revenues are close to the theoretically impossible concept of perpetual motion provided the deposits (funding) stick. It is just a thought, but one might wonder how much confidence has been instilled in the Western banking system as a result of central banks manipulating their bond markets and thereby forcing interest rates lower and asset values higher.

* Because liquid assets yield so little, lenders are being forced to stretch on credit quality and pricing to obtain yield. As over-levered as the Cypriot banks are, had the excess deposits been invested in safe assets — bonds, gilts, bunds and short-term investment-grade corporate debt — the system probably would not be teetering. Of course, the banks would not make anything either given zero-rate policies employed by all of the world's major central banks. A case in point is the unique banking model as reflected in money market mutual funds. The business is a money loser for most plan sponsors today; hence, widespread fee waivers and a move by some (e.g., Fifth Third Bancorp) to sell their funds.

* While forcing small Cypriot depositors with less than €100,000 to incur a haircut may go against an implicit social contract, it is consistent with any corporate reorganization. Creditors, subject to priority in the capital structure, have claims on assets and residual equity in reorganization. Depositors are lenders to a bank; they are not customers of a bank's trust department. Even FDR was not initially in favor of deposit insurance because depositor caution always had been a key governor on bank management's investment decisions.

* Families that accumulated great wealth in Europe through the centuries usually had a common asset allocation: one-third of assets were allocated each to gold (and jewels), real estate and fine art. These families were distrustful of paper money and banks. Both had a tendency to blow-up at the same time. Even among Europe's great banking families such as the Rothschilds, I suspect there was some hedging. The development of corporations with limited liability equity interests in the 17th century led to an additional allocation to equities, especially those in key industries such as agriculture, beverages, chemicals and transportation.
Financial types in Wall Street and London are decrying the forced Cypriot deposit (i.e., senior creditor) for equity swap as robbery. Maybe a better descriptor is a corporate reorganization. As for a possible Creditanstalt moment, it is hard for me to imagine that European banking authorities have not thought out all the possible permutations. It is ironic that it is unfolding right after the Federal Reserve wrapped up the Dodd-Frank mandated stress tests and Comprehensive Capital Analysis and Review. For all of the flaws of the stress and capital tests, it is hard to argue with a proposition that banks should hold excess capital even if the one doing the measuring has proven no more adept than the banks and now deploys Lehman-like leverage.

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