You Can't Be Serious

By John Mauldin | March 27, 2013

You Can't Be Serious
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I admit to being surprised by Cyprus. Oh, not the banking crisis or the sovereign debt crisis or the fact that its banks were eight times larger than the country itself or even the fact that the banks were bloated with Greek debt that had been written down. I wrote about all that a long time ago. What surprised me was that all the above was apparently a surprise to European leaders.

While there is much to not like about what European leaders have done since the onset of their crisis some five years ago, they have demonstrated a prodigious ability to kick, poke, and massage the can down the road, to defuse crisis after crisis, and to indefinitely postpone the inevitable. They have demonstrated a remarkable ability to spend taxpayers' and others' money in order to keep Europe and the euro more or less in one piece. At every step they have been keenly intent on maintaining trust in the system. That they have been successful in keeping a majority of citizens in favor of the Eurozone and the euro, even in countries forced to endure serious austerity, must be recognized.

However, the shock in Cyprus reveals an absolute lack of preparedness in dealing with a problem that had festered for several years. By now it should be no surprise to anyone that sovereign nations can default, that banks can go bankrupt under the weight of defaulted sovereign debt, and that banks can be too large for some countries to bail out. That a clear and consistent response to Cyprus should have been worked out in the halls of Brussels and the ECB seems so, well, reasonable. Clearly, the large depositors in Cypriot banks, the majority of whom were Russian (according to *Financial Times* reports) thought the Eurozone had a plan. In fact, the apparent assumption, bordering on religious faith, that Eurozone leaders would not allow depositors in Cypriot banks to lose one euro, is almost touching. This snafu is going to have repercussions that spread far beyond this tiny island nation. Let's look at a few of the implications.

You Can't Be Serious

When we woke up to the Eurozone pronouncement that all depositors in Cypriot banks, no matter the size of their deposits, would take a loss, my reaction was somewhat akin to John McEnroe shouting, "You can't be serious!" to a line judge whose call he infamously questioned.

While there was no official deposit guarantee in place in Europe, the implicit guarantee was €100,000, a number that had become all but sacred during the recent banking crisis. To wake up and find that European leaders not only did not consider this protection to be implicit but also planned to demand losses from all depositors, was quite the shock. I think this may have been the single worst "call" by European leaders since the beginning of the crisis in 2008.

Let's look first at what actually transpired. Cypriot banks held deposits of roughly €68 billion, four times the size of the total national GDP, while the total size of the banks was roughly eight times GDP. The "Troika" seemed to feel that Cyprus needed €17 billion in bailout money to be able to handle the crisis. But after finding hundreds of billions for Greece and Spain, they were only able to offer tiny Cyprus €10 billion (€10 billion is the equivalent of offering the US $8 trillion, give or take a few euros, just to keep it in perspective), and demanded that depositors in Cypriot banks be levied for most of the remaining €7 billion. They offered a formula by which small depositors would lose somewhat less than 10% and large depositors somewhat more (the actual number varied day by day).

The Cypriot parliament totally rejected the Eurozone proposal. Not one vote was cast for the deal. And when you look at the numbers, as any politician does, you can see why. This is an island of 1.1 million men, women, and children. There are (were) 370,000 bank accounts, with 360,000 of those containing fewer than 100,000 euros (per Dennis Gartman). In the recent presidential elections in Cyprus, there were 445,009 voters and a voter turn-out rate of 81%. Thus, a huge majority of voters had accounts with less than €100,000 in them. Call me cynical, but I think any politician could figure out which side of this fence to land on.

It now appears that "only" €5.8 billion is needed for the bailout, so the 10,000 or so accounts holding more than €100,000 will be docked an average of €580,000. "The tottering banks hold 68 billion euros ($88 billion) in deposits, including 38 billion ($49 billion) in accounts of more than 100,000 euros – enormous sums for an island of 1.1 million people, which could never sustain such a big financial system on its own." (NBC World News).

On the surface it looks like large depositors will lose about 15%. And if the *Financial Times* is right (and the betting line is heavily on their side), a significant majority of that money is Russian. Much of the remainder is tax-haven money (more on that later). "Not so bad," you might think; "things could be worse."

Well, actually they are worse. Some EZ officials suggest that the losses of large depositors could range up to 40%, and the Cypriots themselves suggest 30%. That is because if you are a Greek bank with a Cyprus branch your deposits are exempt from the levy. The logic behind that decision is just too arcane to explain in a brief letter that prides itself on rational explanations. Which is another way of saying that I actually couldn't understand it myself. But then, I'm just a country boy from West Texas, not a European financial wizard.

Things keep spiraling down in the Eurozone. One of the founding principles of the Eurozone was that a euro anywhere within the zone would be as good as one anywhere else. Euros would flow freely. All for one and one for all.

Except that now euros in Cypriot banks are no longer equal. Not only are they going to be "taxed" (or whatever euphemism they end up choosing – they're still debating that one – but if it were your account you might call it theft), but deposits will be subject to capital controls. Reports coming out of Europe this morning suggest that banks in Cyprus will stay closed until at least Thursday. It is not clear when you will actually be able to take your money and leave the sunny shores of Cyprus.

> Cypriot banks will remain closed until Thursday, the government announced on Monday night, as President Nicos Anastasiades acknowledged that the country had come "a breath away from economic collapse" before its last-minute bailout. Speaking after he agreed a €10bn international rescue that includes the restructuring of the island's two biggest lenders with losses for bigger depositors, Mr Anastasiades also said capital controls would be imposed but as a "very temporary measure that will be gradually relaxed". *(The Financial Times)*

We will eventually learn what time frame a Cypriot politician has in mind when he says "temporary." And Mr. Anastasiades may have been speaking optimistically to the press. Other Cypriot politicians were rather less sanguine. From Dennis Gartman this morning:

> They (bank depositors) knew for certain, however, that they were going to face massive losses when Mr. Averof Neofytou, the deputy president of the ruling Disy Party, said that those large depositors "Will [have to] wait for many years before they see what percentage they will get back from their savings – 30 percent, 40 percent, 50 percent, 60 percent, it will be seen…."

The Serious Unintended Consequences

Basel III standards require European banks to increase their deposit ratios. This European response to Cyprus is going to make that harder for banks in smaller European countries to accomplish. Very tiny Luxembourg has banking assets 13 times the country's GDP. Yes, I know that Luxembourg's banks are the very epitome of solid banking and that the majority of those assets are loans to central banks and other credit institutions, but there is no way on God's green earth that Luxembourg as a country could even begin to think about backing its banks. Of course, everyone knew that before this crisis, but if you are the treasurer of a large corporation, how soundly do you sleep at night after Cyprus? And God forbid you have an account in one of the peripheral countries. In the case of Ireland, the lesson was that the money would be found to back the banks, even if taxpayers suffered. But now? New rules for new times. And then you open *The Financial Times* this weekend and read (emphasis mine):

> The chairman of the group of eurozone finance ministers warned that the bailout marked a watershed in how the eurozone dealt with failing banks, with European leaders now committed **to "pushing back the risks" of paying for bank bailouts from taxpayers to private investors**.
>
> Jeroen Dijsselbloem, president of the eurogroup, was speaking after Cyprus reached its 11th-hour bailout deal with international lenders that avoids a controversial levy on bank accounts but will **force large losses on big deposits** in the island's top two lenders.

Evidently, Jeroen interprets the term *private investors* to mean depositors with over €100,000 in a bank. That has to be unsettling to anybody who has diligently saved for decades and is now retired and depending on those funds for sustenance. And for corporations that run a payroll account through a bank? The thought that you could see a lifetime of work building a business go down in an unelected bureaucrat's blink of an eye would keep me up at night. I do not think most corporate financial types see their deposits as an "investment" in the bank.

One of my favorite reads is Kiron Sarkar (who variously lives and writes daily in London, Ireland, and India). I talk and correspond frequently with Kiron. He is a retired but *very* senior investment banker with deep European political and business connections in many countries. As we say in Texas, he is "wired." (You can subscribe to his letter at http://sarkargm.com.) He shot out a special note on the rather incendiary comments of Mr. Dijsselbloem. I have seen other comments similar to these (but less well-said), expressing various levels of disbelief about the timing of Dijsselbloem's remarks, but here's what Kiron had to say:

> Reuters quotes the Chairman of the EZ Finance Ministers, Mr Dijsselbloem, as having said:
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> "If there is a risk in a bank, our first question should be OK, what are you in the bank going to do about that? What can you do to recapitalise yourself? If you can't do it, then we will talk to the shareholders and the bondholders, we'll ask them to contribute in recapitalising the bank and, if necessary, the uninsured deposit holders."
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> He is also reported as having said, "It will force all financial institutions, as well as investors, to think about the risks they are taking on because they will now have to realise that it may also hurt them. The risks might come towards them". These are very likely to be personal remarks, rather than an EZ finance minister's policy statement, but these comments suggest:
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> - Uninsured depositors in EZ countries may well be bailed in in the future, ie Cyprus is a precedent;
> - EZ countries with large banking sectors will have to reduce their size and restructure;
> - EZ countries are seeking to shift risks away from the public sector and onto the banks; and
> - Bail-ins will reduce the need to use the ESM funds to recap banks, a policy which was proposed just under 1 year ago.
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> **These are INCENDIARY remarks,** especially given the timing and debacle over Cyprus. What happens to Malta? Slovenia is in trouble. Luxembourg has a massive banking sector, though it is an AAA-rated country. All 3 are in the EZ. I realize that Mr. Dijsselbloem is new to the job and has little to no experience of the financial services sector (why was he appointed, you may well ask), but to make such comments, especially at this time, is the height of irresponsibility. The comments Reuters reports seem accurate, as the FT carries similar quotes.
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> **At the end of the day, Mr Dijsselbloem is, of course, right; but to say something like this, especially at this time, well …**

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[Now this is the key paragraph and takeaway. Read twice. – John]

> Essentially, why will anyone keep more than E100k in any EZ bank – indeed, why deposit any amount in certain EZ banks, as the value of the EZ bank-deposit guarantee is worthless in a number of cases, as a number of the peripheral EZ countries can't afford to pay up. I repeat, the EZ bank deposit "guarantee" is not a joint and several responsibility across the EZ; it is the responsibility of individual EZ countries.
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> If these comments are not withdrawn/clarified, the weaker EZ banks in the troubled countries, in particular, are going to come under severe pressure. Even if withdrawn/clarified, this is yet another self-inflicted wound. The euro has declined materially since these statements by Mr Dijsselbloem were published by Reuters and the FT.
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> The euro has declined to US$1.2873 at present and continues to weaken. The European banking sector is being hit – no surprise. The peripheral countries (Spain and Italy) are also being hit, in particular. Bond yields of the safer countries are declining, unsurprisingly, whilst the yields in the EZ peripherals are rising. Italy and Spain look to be under pressure. **A number of you may now understand why I am so negative on the EZ.**

As I noted, Basel III makes it more necessary than ever for Eurozone banks to retain depositors, but this action on Cyprus will make getting large deposits more difficult for many banks. Note that less than 4% of depositors account for almost 60% of the deposits in Cypriot banks. Banks need those large depositors if they are going to grow their capital base to the required standards.

This unfortunate business underscores one of the most significant problems in the Eurozone, which is the lack of a collective deposit-insurance scheme. I wrote pessimistically about that topic over a year ago when European leaders promised they would create a Eurozone-wide deposit-insurance mechanism. That initiative has gone nowhere, primarily because the Germans have opposed it. (Ironically, so did Cyprus.)

Let me state this very clearly: if something as seemingly straightforward and necessary as deposit insurance cannot be achieved, then how can there be any hope for deeper fiscal union? And fiscal union will be necessary before all is said and done if the Eurozone is to survive.

It is not just tiny Cyprus or even Spanish banks that will be looked at with growing worry by large depositors. Let's examine this note from David Stockman on European banking, and in particular French banks:

> BNP-Paribas is the classic example: $2.5 trillion of asset footings vs. $80 billion of tangible common equity (TCE) or 31X leverage; it has only $730 billion of deposits or just 29% of its asset footings compared to about 50% at big U.S. banks like JPM; is teetering on $500 billion of mostly unsecured long-term debt that will have to be rolled at higher and higher rates; and all the rest of its funding is from the wholesale money market , which is fast drying up, and from repo where it is obviously running out of collateral.

> Looked at another way, the three big French banks have combined footings of about $6 trillion compared to France's GDP of $2.2 trillion. So the Big Three French banks are 3X their dirigisme-ridden GDP… By contrast, the top three U.S. banks which are no paragon of financial virtue – JPM, BAC, and C – have combined footings of $6 trillion or 40% of GDP. The French equivalent of that number would be $45 trillion for the U.S. banks. Can you say train wreck!
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> It is only a matter of time before these French and other European banks, which are stuffed with sovereign debt backed by no capital due to the zero risk weighting of the Basel lunacy, topple into the abyss of the shadow banking system where they have funded their elephantine balance sheets. And that includes Germany, too. The German banks are as bad or worse than the French. Did you know that Deutsche Bank is levered 60:1 on a TCE/assets basis, and that its Basel "risk-weighted" assets are only $450 billion, but actual balance sheet assets are $3 trillion? In other words, due to the Basel standards, which count sovereign and other AAA assets as risk free, DB has $2.5 trillion of assets with zero capital backing!
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> This is all a product of the deformation of central banking and monetary policy over the last four decades and the destruction of honest capital markets by the monetary central planners who run the printing presses. Furthermore, this has fostered monumental fiscal profligacy among politicians who have been told for years now that the carry cost of public debt is negligible and that there would always be a central bank bid for government paper. Perhaps we are now hearing the sound of some chickens coming home to roost.

Yes, yes, I know: "John, how can you even think that French debt could be at risk?" But if you look at France's income and balance-sheet statements, as if France were a stock rather than a country, you might not be so sure. Might I suggest that a good trade would be to be long German government debt, short French debt? Essentially, this is a bet that France will be worse off than Germany in the coming years, which seems like a good wager right now. And in a French debt crisis (well within the realm of possibility) that trade could work both ways! Just saying …

We will wrap up with this note that just hit my inbox from Louis Gave. (I am up late, as usual, and Louis writes from Hong Kong, where it is early). Remember that Louis is French as you read this.

> So we now know that, in Europe, big depositors are the first in the line of fire to ensure that small depositors do not suffer losses. Needless to say, this raises the question of who wants to be a big depositor in a weak bank in a country undergoing a secondary depression?...
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> EU policymakers are probably not evil henchmen set on destroying the financial industry (even if it often looks that way from the City of London). The more likely explanation is that EU policymakers are simply ignorant of how financial markets work. For example, the fact that the two largest Cypriot banks' London branches have remained opened through the past week, allowing large depositors to take out millions of euros, hints that Europe's policymakers are simply clueless when it comes to how financial markets work. This also means that whatever pound of flesh the EU thinks it will be getting by wiping out the large

depositors could turn out to be on the light side.

Or, for a second example of cluelessness, what could rival yesterday's declarations by the Dutch finance minister that the Cyprus bailout set a new “template” on how to deal with bust banks, namely make the rich depositors pay for the little depositors? What large depositor in a troubled bank in a country going through a secondary depression will want to stick around for that deal? We would venture that the next time that "solution" is applied, the eurocrats will find that the large depositors will not have waited around to get fleeced. In fact, as mentioned above, it might not even work this time (i.e., Cyprus), let alone the next one.

Going one step beyond the ignorance of how financial markets work, what seems profoundly shocking is the lack of recognition of this ignorance. Place yourself back in the fall of 2008. As the financial crisis was unfolding, the likes of John Mack, Jamie Dimon, John Thane and other banking heads were asked to meet at the New York Fed, the US Treasury or even the US Congress on a regular basis to explain what was unfolding (and what they planned to do about it). Meanwhile, how many times have the heads of Santander, Intesa, SocGen, Deutsche Bank, etc., been called in to explain what was going on, or for them to give their views on what should be done? If asked, perhaps these CEOs would have said that:

a) European banks are much more dependent on deposits than their US counterparts.

b) Owners of large deposits are likely to be more risk averse and much more active in moving their money than small retail savers (for whom moving money from one country to the next presents high costs and almost insurmountable hurdles). And this for obvious reasons: a 40% haircut on $1,000 is unpleasant but it's not going to change anyone's life. But a 40% haircut on a pensioner's life savings of $500,000 will have a huge impact—and a 40% haircut on any middle-sized company's $10mn payroll will be enough to bankrupt the business. In fact, this simple reality brings us back to Mark Twain's advice that it is always better to tax poor people as there are so much more of them—unfortunately, Europe keeps going the other way, with devastating consequences.

c) For these reasons, regulators and governments have never in living memory allowed big banks to default on their depositors, regardless of the wording of formal deposit insurance contracts. If this implicit guarantee is now removed in Europe (and it sure looks like it has been), then we should expect a big shift of large deposits out of the banks and into government bonds or credit market instruments.

d) This will prove very problematic, especially given the new Basel III regulations which encouraged a funding model whereby banks should rely more on deposits and less on bonds.

e) As savings shift out of banks and into credit markets, the "German bank" model based on bank-financing of industrial companies and long-term creditor-debtor relationships will inevitably erode, to be replaced by the Anglo-Saxon model credit-market financing along with the short-termism which it implies.

In other words, the law of unintended consequences is at work: the eurocrats will end up with exactly the opposite of the financial system they wanted. Either that, or the European banks will end up having to be nationalized in great numbers. These two possible outcomes seem to be the logical consequence of the EU's very unfriendly financial sector policies.

Louis is right. If you are a large depositor, you HAVE to be thinking about what country your deposits are in and how safe the actual bank is. Even if a bank is seemingly safe, is that any comfort? Is there any evidence that the depositors in Cyprus are better off being in one bank than another when the entire country's banking system has seemingly failed? Was *every* bank in Cyprus bankrupt at the same percentage rate? Who's to say, if BNP Paribas has problems, that a few finance ministers in Brussels would not demand that Societe Generale and Credit Agricole should be penalized, since they are in the same country? What is the logic here? Or is Cyprus a one-off because most of the losses are Russian and who really cares about those commies anyway? Except that the next time, comrade, it might be your bank account that is deemed expendable.

If you run a family office, large corporation, or just your own small pension account, you are not exercising reasonable prudence if you are not asking yourself, what are the risks as of today? You're calling European friends and trying to figure out what the new rules are. Who made these decisions and why?

After spending hundreds of billions and not flinching from potentially printing perhaps trillions of euros to shore up the periphery, the Eurozone leaders now balk at a mere €5.8 billion and raise questions about their whole enterprise? Over German politics? You can't be serious.

This may one day rank up there with "Let them eat cake" in the politically tone-deaf department. Merkel may have risked the entire euro experiment over local politics, after writing such large checks in prior situations. The Eurozone response to Cyprus indicates serious ignorance of how financial systems operate. Trust is an ephemeral thing. It is hard to build and maintain and can be so easily squandered. I suggest you go back and read (if you have not) the recent posting in *Outside the Box* of Dylan Grice's masterful essay on trust.

Last-second insert, which I haven't done in years, but this seems important:

As my editors and tech staff are literally ready to send this letter out, reports are starting to come across my desk that Russian depositors are finding ways to get money out of Cyprus, through branch banks in other countries. The ECB has supposedly told Latvia not to take Russian-flight money if they expect to join the Eurozone. Haircut estimates are ranging to 50%. If a lot of Russian money actually goes, it could be closer to 100%. I offer a few links, one from Reuters and one from ZeroHedge. I see some other reports and can't completely separate rumor from fact, but Reuters is usually reliable and has a policy of multiple sources.

No one knows exactly how much money has left Cyprus' banks, or where it has gone. The two banks at the centre of the crisis – Cyprus Popular Bank, also known as Laiki, and Bank

> of Cyprus – have units in London which remained open throughout the week and placed no limits on withdrawals. Bank of Cyprus also owns 80 percent of Russia's Uniastrum Bank, which put no restrictions on withdrawals in Russia. Russians were among Cypriot banks' largest depositors. (Reuters)
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> So, while one could not withdraw from Bank of Cyprus or Laiki, one could withdraw without limitation from subsidiary and OpCo banks, and other affiliates? Just brilliant. (Zero Hedge, citing the above Reuters quote)

If this is true (and Reuters makes it sound real), so much for sticking it to the Russians. This could escalate into something ugly. I rather think this weekend's *Outside the Box* will be on this still-brewing crisis. The Europeans are looking more and more like the Keystone Cops, in addition to being merely clueless. (And watching Jeroen Dijsselbloem trying to take back his words at this late moment is amusing. The Dutch are normally so disciplined. It just gets stranger, and if it was not so sad and scary it would be funny.)

It Is Time to Break Up the Banks

The problem we have been discussing is not just a problem in Europe. In a general sense, it is the problem of banks that are too big to be allowed to fail. It is time to rein in the size of large banks before the next crisis. BAC and C are not just too big to fail, they are too big to effectively manage. If banks want to get larger, they should pay more deposit insurance to offset the implicit guarantees they get from taxpayers to cover losses beyond the ability of an FDIC to underwrite. I would go so far as to increase the capital requirements of banks as they increase in size, giving an incentive for management to break them up into smaller (and more manageable) pieces. The number of top experts, economists, and bankers who agree with me is rising, as this recent post from my friend Barry Ritholtz over at The Big Picture demonstrates.

New York, Singapore, and the Strategic Investment Conference in California

In two weeks I will be in New York for a few nights. The following week I fly to Singapore (one of my favorite cities), where I will be featured at a conference sponsored by *The Business Times* and Saxo Capital Markets. I just now looked at the conference webpage and found I am in deep kimchee, as they have labeled me a guru. I have often noted that you get called a guru just before you make a major-league bad call. Full risk disclosure would suggest I tell you to ignore any of my upcoming prognostications until I really screw up bad. Then you can just ignore me at your usual discretion. You can register to attend the BT Investment Dialogue at http://pbp.sph.com.sg/btinv2013/.

My Strategic Investment Conference, May 1-3 in Carlsbad, California, co-sponsored by my partners at Altegris (whose staff does the heavy lifting to make this one of the best-run conferences in the country) has almost sold out. Louis Gave (mentioned above) will be there. There will be a lot of discussion about Europe, and with Kyle Bass on hand you know we'll be talking about Japan. This is one you do not want to miss. In addition to the line-up I have mentioned past weeks, which I think is the best at any economic conference anywhere this year, Paul McCulley is going to come to kick off the conference on Wednesday evening. Paul has spoken at our conference nearly every year since we started, and I am grateful that he will come again. You can learn more and register at http://www.altegris.com/sic. Check out the speaker line-up. Even McEnroe would agree that this is a seriously world-class line-up.

As long-time readers know, I have written this letter from planes, trains, taxis, limos, and hotels all over the world, and from every continent except Antarctica (which is on my bucket list) and scores of countries. But this is the first time I have written to you from a hospital waiting room, as I wait to see my new granddaughter, Addison, who has arrived fashionably late. The old caricature, when I grew up, was of the useless father waiting nervously outside the delivery room. Times have changed, and it is now *de rigueur* for fathers to be at their wives' side. (It was something of a novelty when I was in there some 36 years ago.) Now the most useless thing in the waiting room is the grandfather, and I must confess to not being nervous (at least not that I will admit to). The clan gathered as the time wore on. I brought my computer to do a little work on this letter, assuming we were going late into the night; but after 14 hours of induced labor and not much going on, they elected to do a C-section, so it all happened rather quickly after I got here. I had an all-too-brief moment with mother and daughter and was then ushered out so the time could be shared with siblings and such. Amanda and Addison (6 pounds, 1 ounce, for those who might ask – I am just happy to see the requisite number of fingers and toes) are doing just fine. Son-in-law Allen has a huge Oklahoma grin on his face. It is one of those great nights to be alive.

And finally, for those who are nostalgic for a time when old warriors worked together when necessary for the good of the country, I offer this YouTube clip I ran across of President Ronald Reagan at a tribute dinner for his long-time political adversary and personal friend Speaker Tip O'Neill:http://www.youtube.com/Reagan&O'Neill. We need a little of that Irish magic now. Have a great week.

Your rather be a grandfather than a guru any day analyst,

John Mauldin

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