BANKING

With Cyprus Bail-In, Europe Bids Adieu to 'Too Big to Fail'

By Peter Gumbel | March 28, 2013 | 2 Comments

In June 2012, the European Commission outlined a set of proposals for dealing with failing banks in the E.U. Known as the "E.U. framework for bank recovery and resolution," the proposals didn't receive much public attention at the time, but in hindsight they should have, because at their core is a startling premise: the hitherto guiding principle of "too big to fail" should no longer apply to troubled banks and other financial institutions. Instead, they should be allowed to go under, in as orderly a fashion as possible, and the financial burden shared by creditors and depositors, rather than automatically shouldered by taxpayers.

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A man sits in front of empty ATMs outside the National Bank of Cyprus, which has been closed for two weeks, in Nicosia, Cyprus, on March 26, 2013

The Commission has some executive powers but its proposals aren't always accepted by the E.U.'s 27 member states. However, nine months after the publication of that document, it is increasingly clear that this premise has become a central plank in Europe's strategy to combat continuing financial problems and create a fully fledged banking union.

The Cyprus rescue agreed to over the weekend is the most obvious sign: European taxpayers will be paying $13 billion for the latest E.U. bailout. But Cyprus' two biggest banks have been folded together, and their depositors and creditors are on the hook for the $7.5 billion "bail-in" that Cyprus itself must deliver as its contribution to the rescue package.

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Cyprus is the first country to have received this treatment, but it isn't the first case of an imposed bail-in. A precedent was set by Denmark, when it imposed losses on senior creditors at tiny Amagerbanken and Fjordbank Mors in 2011. Earlier this year the Dutch government took a much bigger step when it rescued SNS Reaal, a troubled real estate lender, and in doing so, expropriated its subordinated bondholders to recoup about $1.3 billion. At the time, the Dutch Finance Minister Jeroen Dijsselbloem suggested that the government even considered confiscating SNS's senior bonds, but decided against doing so because of fears of the effect this might have on stock and bondholders of other big Dutch lenders in better health.

Dijsselbloem recently took over as head of the Eurogroup, which brings together top finance officials from the 17 nations that make up the euro zone, and his ambiguous remarks this week about whether the Cyprus bail-in was exceptional or would be the new European norm spooked markets and sent European bank stocks tumbling just hours after that accord was finalized.

"What we've done last night is what I call pushing back the risks," Dijsselbloem told Reuters. Asked what the new approach meant for euro-zone countries with highly leveraged banking sectors, such as Luxembourg and Malta, and for other countries with banking problems like Slovenia, Dijsselbloem said they would have to shrink banks down. "It means deal with it before you get in trouble. Strengthen your banks, fix your balance sheets and realize that if a bank gets in trouble, the response will no longer automatically be that we'll come and take away your problem."

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In fact, under the Commission's plans, bail-ins will apply to subordinated debt from 2015 and senior debt from 2018.

It's easy to understand why the "too big to fail" policy is no longer acceptable to European authorities. The Commission has calculated that between October 2008 and October 2011, it approved a staggering $5.75 trillion, the equivalent of 37% of the E.U.'s GDP, in state aid measures to financial institutions. Of that, about $2.05 trillion was actually used between 2008 and 2010, as banks in countries from Ireland to Greece teetered on the brink of collapse and had to be rescued. The crisis plunged the E.U. economy into a severe recession, with the E.U.'s overall economy contracting by more than 4% in 2009 alone, and saddled governments with a massive additional debt burden. The European economy as a whole remains stagnant as a result of the tough austerity policies governments have put in place, including social-spending cutbacks and tax increases, in an effort to reduce that debt burden.

What's not yet clear is the extent to which bail-ins can actually replace bailouts. A pan-European system of deposit insurance akin to the FDIC program in the U.S. is a critical missing pillar of the banking union that would protect about $130,000 for bank-account holders. So far, it's an idea that is being discussed but has not yet been finalized or put into draft legislation. Indeed, the very first plan to rescue Cyprus would have taxed all bank-account holders there, including small depositors with less than $130,000. That plan was vetoed by the Cypriot parliament and caused days of high drama and tension on financial markets. Largely for that reason, some well-known economic commentators including Nicolas Véron believe the E.U. made a critical blunder with the initial deal.

Yet others say Europe has gotten the policy right, at least on principle. Zsolt Darvas at the Bruegel think tank in Brussels describes the Cyprus deal as "a victory of common sense. Taxpayers should not foot the bill for private-sector losses. Depositors have taken the risk of investing in Cypriot banks and thereby benefited enormously from years of low Cypriot taxes and high deposit rates. They could have taken their money to Germany, facing much higher tax rates and much lower deposit rates — but in exchange for more safety."

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As the revamped European policy takes shape, lawyers, bankers and other analysts are trying to evaluate the consequences. Clearly, the movement to penalize subordinated bondholders, and perhaps all bondholders, is a negative for investors. "Bondholders in heavy weather," is how one Dutch law professor viewed the SNS Reaal situation. A thoughtful paper issued by AXA Investment Managers this week predicts that banks will increase subordinated issuance as they seek to build cost-effective bail-in buffers. As for investors, AXA notes that they'll need to become far more discerning about the risks of distress and the yields that at-risk paper could offer. "Going forward, any financial name investment must be justified by sound issuer fundamentals," AXA writes. "With government support no longer expected or reliable, differentiation between issuers, particularly within the banking sector, is set to increase materially."

For Europe's banks, in other words, all bets are off in a brave new world in which nobody is too big to fail.

Peter Gumbel @petergumbel

Peter Gumbel writes about European business and finance from Paris, where he has lived since 2002. He was worked as a staff writer for The Wall Street Journal, TIME and Fortune. The London-based Work Foundation named him "Journalist of the Year" in 2005.

Gumbel's latest book is *They Shoot School Kids, Don't They?*, a critique of the French education system that was a best-seller in France. A digital version is available in English.