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On the true meaning of Cyprus

In the first quarter, European peripheral states issued more debt than in any three months since the first period of 2010. In America, BB-minus-rated H.J. Heinz raised $3.1 billion through a sale of seven-year notes at the lowest interest cost ever attached to any public LBO-related debt in America (4¼%, no less than 2⅛ percentage points below the previous record). The message of the market is that Cyprus is a blip, or news particle. We write to contend that it is no such thing.

Likely, we judge, the scourging of the third-smallest member of the euro zone is the end of something and the beginning of something. It will prove to be the end of depositor complacency and the beginning of depositor anxiety. This is not the market's first thought, admittedly. But on second thought—recalling the suffering of the Cypriots and the indiscreet admission of the head of the Eurogroup, Jeroen Dijsselbloem, that the Cyprus approach will be the preferred approach in the next financial panic involving a single currency—the market may reconsider.

Depositors, we think, will certainly reconsider. They will be a lot faster off the starting blocks in the next run than they were in the one in Nicosia. "Some Savers in Cyprus May Lose 60%," hung the headline over a bulletin in Saturday's *New York Times*. One here recalls the governor of the Bank of England saying it is irrational to start a bank run but rational to join one. Post-Cyprus, it will be less than rational not to anticipate one. We will attempt to do just that.

Current events underscore three essential facts about the nature of 21st-century banking:

1. The depositor is a creditor.
2. The bank to which he or she has lent is a leveraged speculator in debt, much of which is illiquid or of low quality or both.
3. Many bankers, trained in the past era of bailouts, as opposed to the coming era of "bail-ins," aren't very good at their jobs.

It's a dull moneybags who hasn't figured out by now that something is wrong with modern banking. When all demand liquidity, the banks don't seem to have it. Enter, at the moment of crisis, a central bank, printing the money the banks (or the broker-deal-

Bank assets to GDP
(in local FX billions)

	bank assets	GDP	bank assets as percent of GDP
Luxembourg	961.5	44.2	2,174%
Malta	53.5	6.8	792
Hong Kong	14,858.7	2,001.1	743
Cyprus	128.1	17.9	716
Ireland	1,170.0	163.6	715
Switzerland	2,857.7	592.9	482
U.K.	6,994.0	1,547.9	452
Netherlands	2,493.1	601.1	415
France	8,068.1	2,029.9	397
Spain	3,572.5	1,048.5	341
Denmark	6,139.1	1,820.0	337
Portugal	557.2	165.4	337
Sweden	11,702.7	3,631.4	322
Germany	8,225.5	2,643.9	311
Italy	4,219.0	1,565.9	269
China	132,500.0	51,900.0	255
Greece	442.0	193.7	228
Slovenia	50.8	35.5	143
Norway	3,950.7	2,956.9	134
Estonia	19.7	17.0	116
U.S.	13,264.7	15,681.5	85

ers) can't quickly realize from their dubious assets. The crisis abates—unless, as in the case of Cyprus, the sovereign decides that the depositors should chip in to rescue themselves. That depositors should bear some of the cost of their own failing bank may or may not be a meritorious idea. But, in Europe, it is likely to be a destabilizing one.

Some historical perspective may help to illuminate the problem. In June 1920, a senior American bank regulator declared without a smile: "I am optimist enough to hope that men now here will live to see the time when a bank failure anywhere in the United States will be a thing unthought of." It happens that this optimist, Comptroller of the Currency John Skelton Williams, was speaking in the teeth of the second-most severe depression of the 20th century. Nor was his faith misplaced. No nationally chartered bank of any consequence failed during the slump of January 1920 to July 1921—and this was a dozen years before the coming of federal deposit insurance.

The world has progressed in countless ways over the past 90 or 100 years, but it has not advanced far in banking. Yes, you can deposit a check with the click of a smartphone. But the institution into which that check will digitally fly is almost certainly less liquid and less substantially capitalized than the ones whose praises Williams sang 93 years ago. (For chapter and verse on capital adequacy, see the new book by Anat Admati and Martin Hellwig, "The Bankers' New Clothes.")

Deposit insurance, "too-big-to-fail" and the methods of central banking under the pure paper standard have obscured the risks inherent in fractional-reserve banking. They have not erased that risk, but they have pushed it out into the future. Before the government got into the financial-risk attenuation business, banks were responsible for their own solvency. In America in Williams's day, shareholders got a capital call if the bank in which they owned a fractional interest became impaired or insolvent. In 2008-09, in this country and many others, it was the taxpayers who chiefly got stuck. Now comes the precedent of Cyprus, in which depositors—i.e., the senior-most creditors—as well as the stockholders and, to be sure, the European taxpayers, got the call.

So it's back to the future, but with a difference. Though the nature of the human animal isn't quick to change, the incentives have changed. Consider, over the course of the Great Depression in the United States, 73% of the nationally chartered banks extant at year-end 1929 *didn't* fail, despite a 45.6% decline, 1929 peak to 1933 trough, in nominal GNP. What percentage of 21st-century banks would be left standing after such an ordeal? A smaller percentage, it seems safe to say. Today's bankers operate under different rules, therefore under different management methods. They skimp on equity capital and load up on sovereign debt not because they are shortsighted or weak willed, but because the rules allow it. Some take flyers in the derivatives market. The incentive structure allows that, too.

Which brings us back to the Republic of Cyprus and the meaning thereof. What all can see now is that Cyprus was grotesquely overextended. Compared to a €17.9 billion GDP, the tiny island nation was home to €128.1 billion of banking assets. In 2011, Greek-related assets of the two biggest Cypriot banks, Cyprus Popular Bank PLC and Bank of Cyprus PLC, amounted to €28.7 billion, or more than one-and-a-half times Cyprus's GDP. As a financial center, Cyprus was Switzerland but without the gnomes.

Writing in *The Wall Street Journal* on March 27, the columnist Holman Jenkins denied that a high ratio of banking assets to GDP necessarily puts a country at risk of financial implosion. We would say that it all depends on the assets and the era. Under the doctrine that a suitable banking asset was one secured by salable goods, a high concentration of banking activity might have presented no grave risk. But a distended banking industry is a different story under the incentives and operating protocols in place today. A particular source of danger is the newish doctrine, handed down by the regulators in Basel II, that suitable banking assets encompass the sovereign debt of the euro zone's wastrel governments. The regulatory politburo has decreed that the sovereign debt of Germany, Netherlands, Luxembourg, Austria, Belgium and Estonia are essentially risk-free. France, too, makes the list, despite that country's 90% ratio of public debt to GDP and its 10.6% unemployment rate, the highest in 13 years.

"All the same," observes colleague Evan Lorenz, "there is no Rubicon of bank assets to GDP beyond which a financial crisis is guaranteed. For instance, at 143% of output, banking assets in Slovenia would seem to be manageable in relation to those in Cyprus, where the pre-crisis ratio of banking assets to GDP was 716%. But slow loans in Slovenia total one-fifth of GDP. The Slovenian government, led by new-

What they own
balance sheets as of Dec. 31, 2012

	Danske		Nordea	
	DKK billions	total assets	billions of euros	total assets
Retail Denmark	953.5 kr.	27%	€ 43.2	6%
Retail Finland	152.2	4	35.0	5
Retail Sweden	184.0	5	45.9	7
Retail Norway	141.5	4	30.0	4
Other lending	243.3	7	210.6	31
Total loans	1,674.4	48	364.8	54
Cash	97.3	3	36.1	5
Interest-bearing securities	706.0	20	102.9	15
Derivatives	409.0	12	118.1	17
Fixed assets	6.5	0	0.5	0
Other	592.0	17	55.1	8
Total assets	3,485.2		677.4	
Risk-weighted assets	819.4	24	215.0	32
Equity	138.2	4	28.2	4

source: company reports

comer Alenka Bratusek, is desperately trying to cobble together an austerity program to 'avoid becoming the euro region's sixth member to require a bailout,' as Bloomberg recently put it. Or maybe not a bailout if Cyprus precedent holds, but a bail-in.

"A financial system that is outsized in relation to its domestic economy introduces several risks," Lorenz continues. "To fund assets several multiples of GDP, you need foreign deposits, overseas wholesale funding, or both. Such dependence makes the domestic financial market susceptible to contagion from the global credit markets even if the home banks stick to domestic assets. Then, too, banks of such immense proportions as the late, unlamented Anglo-Irish—at the end of 2008, its €101.3 billion in assets were 57% of the size of Irish GDP—can virtually hold their own government hostage."

Luxembourg is the undisputed champion in the banking assets-to-GDP department with a reading of 2,174%. "Some countries," Luxembourg's foreign minister, Jean Asselborn, told newsmen on March 22, "such as my country and Cyprus also, have legally built something up over the past decades." Yes, and so have Malta, Hong Kong and Ireland, as the table points up.

The question before the house is how to hedge against the risk that Cyprus is both the end of something and the beginning of something. Luxembourg would seem an obvious candidate in which to make a bearish investment, but its GDP is small and its stock market illiquid. Malta is even less accessible than Luxembourg. Hong Kong, with its HK$2 trillion ($258 billion) GDP and hugely liquid stock market, is more inviting. Because the former British Crown colony pegs its dollar to the American greenback, it necessarily imports America's interest rates, such as they are. And because it imports America's interest rates, Hong Kong inevitably imports the consequences of those rates, including a flyaway residential real estate market that the city fathers are valiantly trying to bring down to earth. Higher taxes and fatter required down payments have contributed to plunging transaction volumes and softening prices. March is poised to record the fewest monthly sales since 2003, which year marked the dwindling close to a six-year property slump.

So in the editorial tickler file we leave a note of reminder concerning Hong Kong's banks. But for now we focus on a pair of Nordic short-sale candidates. They are Danske Bank A/S (DANSKE on the Copenhagen exchange) and Nordea Bank AB (NDA in Stockholm). As a stock, each is big and liquid. And as a bank, each overshadows its respective economy—Danske's assets totaling 191% of Danish GDP and Nordea's assets amounting to 155% of Swedish GDP. Besides, each is highly leveraged to equity capital, assets-to-equity ratios amounting to 25.2:1 for Danske and 17.7:1 for Nordea.

Danske, with DKK 3.5 trillion ($600 billion) of assets, is Denmark's largest bank. Regulatory capital would seem more than adequate, with core Tier 1 capital equivalent to 14.5% of assets. But there is a catch: Danske's risk models deem that "risk-weighted" assets constitute just 24% of total assets, the balance being—by common agreement of the bank and its regulators—largely riskless. It would be a good thing if Danske's creditors concurred with the risk modelers and the regulators. Customer deposits and equity fund just 31% of the balance sheet. The sometimes flighty capital markets provide the rest.

Nordea, with €677.4 billion in assets, is the Danske of Sweden. Like Danske, it shows a seemingly invincible core Tier 1 capital position: 13.1% of assets. But again like its counterpart in Denmark, just 32% of Nordea's assets are risk-weighted, the balance being presumably as good as gold. Then, too, like Danske, Nordea needs the capital markets: customer deposits and equity fund only 34% of its assets.

The Nordic countries enjoy a reputation as financial sanctuaries. But they, like certain residents of the 50 states, have tended to overborrow and to turn a blind eye to the risks of inflated house prices. So far, we Americans take the cake in terms of residential real estate-generated financial drama, but Denmark is a worthy contender. Thus, in the 10 years to the 2007 peak of its market, Danish house prices notched annual compound gains of 8.5%. Tumbling from those heights, they have fallen by 19.6%. American prices appreciated at a 10-year average compound rate of 11.4% before plunging by 33.8%. Sweden presents a different narrative. House prices there compounded at an annual rate of 8.5% till the 2008 top. But that snow-capped peak has itself been bested, with prices today 10% higher than they were in 2008.

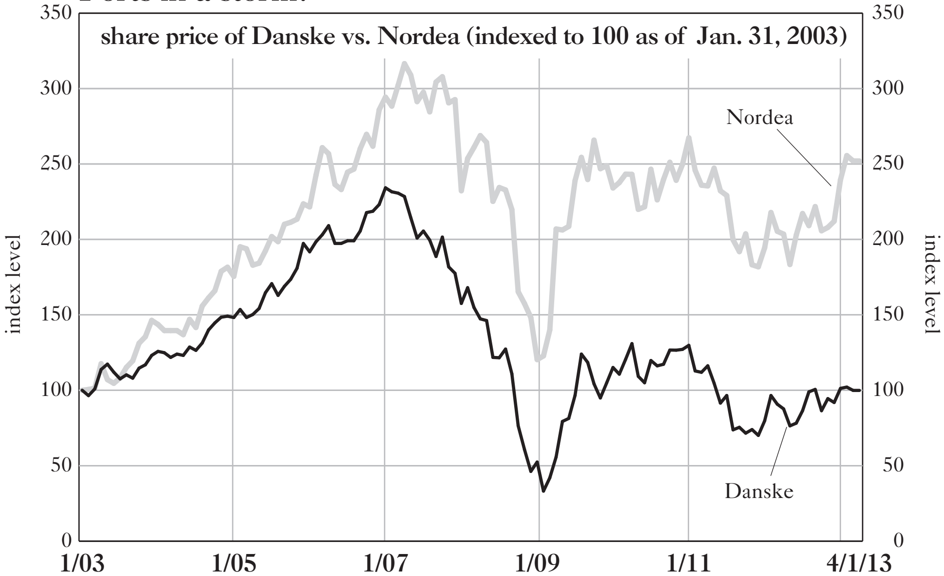
As to debt, we Americans are actually the virtuous ones. Ratios of total debt to household income stand at 267% in Denmark, 173% in Sweden—and a (relatively) trifling 105.5% here in prudent America.

"Yet," Lorenz observes, "international investors insist on treating the Nordic countries as safe havens. Since the end of 2008, the Swedish krona has appreciated by 32% against the euro and by 21% against the U.S. dollar. Denmark, which pegs its krona to the euro, was on the receiving end of such a gush of hot money last year that the Danksmarks Nationalbank slapped a 20 basis-point fee on excess bank reserves on July 5 (in January, the penalty was reduced to 10 basis points).

"You wonder," Lorenz continues, "what kind of haven moneyed foreigners expect to find in charming Copenhagen. In the 2003-07 boom era, when house prices showed year-over-year gains of as much as 25.6%, Danes availed themselves of interest-only mortgages that pushed off amortization for a decade. 'The first households will have to start repaying loans this year,' a knowledgeable Danish economist tells me. 'It shouldn't be a problem for them because they bought their houses back in 2003 when prices were still pretty low, but when we look ahead for a couple of years—2015, 2016, 2017—when people who took interest-only loans in 2005, 2006, 2007 have to start repaying them, it might become an issue for the housing market and the economy. As it is, a lot of these people are technically insolvent because house prices have come down a lot. These households have to start considering a way to repay their loans.'"

This wasn't supposed to happen in Denmark (*Grant's*, Aug. 10). You will remember the ingenious theory: With each first-lien mortgage comes a matched mortgage bond. To discharge his debt, the homeowner may mail a check to the bank or buy the appropriate face amount of bonds. The thinking had it that the price of the bonds would rise and fall with the level of house prices. But Mr. Market, groping for yield in Denmark even as he does in America and Japan and Cyprus, pushed up bond prices in the face of falling house prices. The unhappy result is that consumers are stuck. Then, too—another worry-

Ports in a storm?



source: The Bloomberg

ing element in the situation—banks were all too happy to lend 20% in a second lien over and above the 80% on a first lien. Last week, the Danish government turned thumbs-down on a bankers' plan to postpone the looming amortization crush. If you were wondering if Denmark has its own Fannie Mae or Freddie Mac, the answer is no. Investors in Danish mortgage securities (of which there are boodles outstanding) own the risks of those securities themselves.

Mortgage amortization is a timely topic in Sweden, too. The governor of the Swedish central bank, Stefan Ingves, called the other day for the restoration of "an amortization culture." As well he might have: At the current repayment rate, finds Sweden's Financial Supervisory Authority, Swedish households would own their houses free and clear in 140 years. A little more tangibly, the Swedish authorities are considering the imposition of a 15% risk weighting on residential mortgages, three times the value Nordea assigns to them.

"To say there is a bubble in Sweden is to exaggerate," the CEO of Danske's Swedish subsidiary, Ann Krumlinde, tactfully remarked last week, "but we believe we could see a slow puncture of the housing market. If we get an increase in unemployment, there is a risk that will trigger a correction." In February, Sweden's jobless rate hit 8.2%, up from 8% in January and 7.8% in February 2012—and 5.6% in the distant day of April 2008. As for Denmark, the January unemployment reading stood at 7.4%, flat from the prior month and down from 7.5% in January 2012, but way, way up from 3.2% in April 2008.

It is, however, cold comfort to the Nordic states that unemployment in the 17 member nations of the monetary union stands at 12%, the highest since data were first recorded in 1995 and two percentage points higher than the U.S. jobless rate at the depth of America's Great Recession. More than half of the exports of Denmark and Sweden are destined for the EU (or were when those figures were last tallied in 2011). So there's likely no chortling in Copenhagen or Stockholm at news that—for instance—industrial production in the euro zone fell by 1.3% in January from the year before or that car registrations in the 27-member European Union in February showed a year-over-year decline of 10.5%. Nor is trouble solely concentrated in the monetary zone's sunny periphery. February retail sales fell by 2.9% and 2.2% from February 2012 in the zero-risk-weighted nations of France and Germany.

"In early 2008," Lorenz points out, "investors hopefully sank capital into commodity-related plays believing that emerging markets had 'decoupled' from the United States and Europe. Yes, the bulls would admit, the American housing market was crashing and Lehman Brothers was teetering, but China, indomitable, would sustain commodity prices and exploration-related investment. Between May and December 2008, the Commodity Research Bureau Raw Industrials index fell by 40%. It turned out that the world remained 'coupled' after all."

Investors today are betting on a different kind of decoupling. The Euro Stoxx Banks Index, a capitalization-weighted index of euro zone financials, trades at 55% of book and has fallen by 6.9% in the year to date. Société Générale SA and UniCredit SpA, two of the euro zone banks acknowledged least likely to succeed, trade at 45% of book and 31% of book, respectively. The market has seemingly not twigged on to the fact that Danske and Nordea, which trade, respectively, at 75% and 130% of book value, are also exposed to Europe's vicissitudes. In fact, as managers have sold off euro zone banks, they've purchased shares in Danske and Nordea, sending the share price of Danske up by 9% and that of Nordea up by 22% so far in 2013.

Nor, it seems to us, have investors fully priced in the Nordic titans' exposure to their own over-encumbered local economies. Over the euro zone as a whole, the ratio of debt to disposable income stands at 99.4%. Compare and contrast the readings in Denmark (267%) and Sweden (173%). The managements of Danske and Nordea must be praying for prosperity.

At Danske, non-performing loans last year amounted to 6.8% of the total loan book, up from 6.5% in 2011 and 0.8% in 2007. The ratio of loan-loss reserves to slow loans fell to 36.7% in 2012 from 39.7% in 2011. At Nordea in 2012, non-performers edged up to 1.9% of total loans, compared to 1.7% in 2011 and 0.5% in 2007. The ratio of loan-loss reserves to slow loans fell to 41.2% in 2012 from 45.4% in 2011.

"It would be no small thing," Lorenz points out, "if investors chose to take an appropriately dimmer view of the Nordics. At Danske and Nordea, loans amount to 212% and 173% of deposits, respectively. And since floating-rate mortgages are the standard in each country, rising interest rates would exact an additional toll on Danish and Swedish house prices. Sweden has another point of vulnerability: Its banks draw heavily on the world's money-market mutual funds, including America's. Governor Ingves, in his previously quoted remarks, mentioned the money-market connection. 'Although this indicates a high level of confidence in the Swedish banks,' he said, 'it also entails risks. During the crisis, we saw that money-market funds were among the more volatile investors. A high degree of funding from the money market funds also makes the banks dependent on the U.S. regulatory frameworks and legislative processes.'"

So, too, are the banks dependent on the risk tolerances of the money-fund managers. One such manager, an American, mused to Lorenz: "There continues to be uncertainty. Our mandate is to continue to be conservative in that kind of environment." Especially is conservatism warranted when money-market funds are returning zero percent to their investors. Why seek exposure as a creditor to banks whose problems are not yet fully reflected in their equity valuations? And one might ask a more existential question: For the work of picking and choosing among assets that offer a return of zero, why should the credit department of a money fund even get out of bed in the morning?

In Denmark and Sweden, banks don't fail without consequence to the people who own them or lend to them. As a kind of souvenir of the crisis of 1992, the Swedish government still owns a 13.5% stake in Nordea, which it bailed out. Since 2008, the Danish authorities have taken over 12 failed regional banks, while handing off another dozen to stronger competitors. However, it would surely tax the regulators' resources if Danske itself, with assets representing 191% of Danish GDP, required a governmental helping hand. Michael Moeller, chairman of Denmark's committee on systemically important financial institutions, was quoted as saying last week: "To have a principle that we would never, under any circumstances, save a bank—that's like saying that you would never trade [i.e., negotiate] with terrorists. But what if they had an atomic bomb that could blow up half the United States?"

To continue with Moeller's colorful imagery, financial terror comes not from without but from within. It is encoded in the easygoing ways of socialized risk taking.

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