Levy Economics Institute of Bard College

Policy Note

2013 / 4

LESSONS FROM THE CYPRIOT DEPOSIT HAIRCUT FOR EU DEPOSIT INSURANCE SCHEMES

JAN KREGEL

What Is Wrong with Taxing Bank Deposits?

In March of this year, the government of Cyprus, in response to a banking crisis and as part of a negotiation to secure emergency financial support for its financial system from the European Union (EU) and International Monetary Fund (IMF), proposed the assessment of a tax on bank deposits, including a levy (later dropped from the final plan) on insured demand deposits below the 100,000 euro insurance threshold. An understanding of banks' dual operations and of the relationship between two types of deposits—deposits of customers' currency and coin, and deposit accounts created by bank loans—helps clarify some of the problems with the Cypriot deposit tax, while illuminating both the purposes and limitations of deposit insurance. Notably, the operational impossibility of distinguishing between types of deposits for the purposes of creating an equitable deposit insurance scheme reveals something of the unavoidable moral hazard that accompanies these schemes. In addition, a deposit insurance system requires the backing of a strong central bank in order to meet its commitments. These are relevant lessons in the context of current plans to establish a system of EU-wide deposit insurance.

From the legal point of view, a bank deposit is an unsecured loan to the bank. It is a call loan, legally no different from a call loan that a bank extends to a stock exchange specialist. It is a liability

---

Senior Scholar JAN KREGEL is director of the Levy Institute's Monetary Policy and Financial Structure program. He is a professor at Tallinn University of Technology and holds the title of Distinguished Research Professor at the University of Missouri–Kansas City.

for the bank; an asset for the depositor. Many countries assess taxes on real property or wealth taxes that cover financial assets such as debt and equity securities. From this point of view, there is no reason why bank deposits, just as any other asset, should not be included in wealth taxes.

By analogy, the holder of government-issued currency and coin is an unsecured creditor of the government. Currency and coin is a liability of the government and an asset of the holder, and could equally be subject to a wealth tax applied by the government.

Governments applying wealth taxes have generally excluded coin and currency.[1] A probable reason for this differential treatment of private liabilities held as assets—deposits, equity, and bonds—and public debt is that taxation of government liabilities could be considered as default or expropriation, which is usually precluded by social contract or constitution.[2] This is not the case for private liabilities, which means that there is no reason why deposits should not be subject to taxation, and governments have assessed private bank accounts for fiscal purposes (Italy did so in 1992 when the lira was under speculative attack, for example).

If this is the case, why did the assessment of a tax on bank deposits create such criticism when it was recently applied in Cyprus? From the fiscal point of view, the most obvious reason is that it was a tax that was unforeseen, applied to particular creditors of specific financial institutions, and of uncertain amount, which would create great difficulty amongst taxpayers. It thus violated two of the basic principles of sound taxation that have been accepted since the time of Adam Smith,[3] although it was described in some circles as an implicit tax on presumed money laundering of illicit funds from Russia.

While wealth taxes, or capital levies, are not common, Keynes notes in the *Tract on Monetary Reform* (1924, 67) that opposition to such taxes was more general and based on "the ground that they infringe the untouchable sacredness of contract." In response to this view, Keynes argued that "nothing can preserve the integrity of contract between individuals, except a discretionary authority in the State to revise what has become intolerable."

The deposit levy was not a means of generating government revenue or alleviating the burden of debt service on the government or in individuals' finances. Rather, it served to write off the liabilities of specific financial institutions in order to generate an external infusion of funds from the IMF and the EU to make the institutions financially viable. The assessment did not diminish government liabilities, but only the liabilities of the financial institutions. It was thus a tax levied by the government on the wealth of specific individuals to the benefit of specific financial institutions.[4]

What Is Deposit Insurance Supposed to Insure?

The violation of good fiscal principles was not the major objection to the application of the tax. Rather, it was criticized because it was presented as violating the intentions of pending EU legislation on deposit insurance and the proposals for a uniform EU-wide deposit insurance scheme. Since 2000, Cyprus has had a 100,000 euro deposit guarantee scheme in compliance with current EU directives. From the legal point of view, deposit insurance provides secured creditor status to 100,000 euros of a bank's liability to its deposit lenders in the case of bank failure.

Yet, deposit insurance is not motivated by the idea of protecting the unsecured legal status of creditors in bankruptcy, but rather by the belief in the importance of a safe and secure means of payment for the operation of the economic system. It is thus based on a completely different conception of a bank deposit: it is the idea that deposits are not loans, but a safe, secure store of wealth. Providing a safe means of storing wealth thus supports saving and provides security that supports demand. It also supports the intertemporal transfer of income that the financial system provides via intermediation between borrowers and lenders. The fundamental basis for deposit insurance is thus based on the idea that a deposit is the transfer of purchasing power to the financial institution. This purchasing power is represented as the deposit of specific government liabilities, coin and currency, which in the banking system are represented as bank reserves. This is the basis of the idea that the operation of banks is to receive currency and coin and to lend currency and coin. The difficulty to be resolved then is the fact that banks in general lend more than they receive as deposits. That is, that they are leveraged by the application of fractional reserve banking. This is the vision of banking that has dominated economics, and has been the basis of monetarism and the policy proposal of 100 percent reserve banking to provide financial stability.[5] It is only because banks lend more than the funds they hold on deposit that creates the problem that insurance is meant to resolve.

However, once it is admitted that banks can lend more than they hold in the form of reserves, an alternative interpretation of the operation of banks is possible. And this is the idea that banks can "create" money. This occurs when a bank makes a loan and the loan is not in the form of coin and currency but rather the creation of a bank deposit to the credit of the borrower. Traditional banking theory does not call this the creation of "money"; it is called the creation of "credit." Thus, banks do not lend more "money" than they hold on deposit, banks can create credit because they accept deposits that can be used as general means of payment in substitute for coin and currency. Banks thus have a dual function. One function is to accept deposits of government liabilities, coin and currency, that are held as reserves with the central bank or as till money. The second function of credit creation involves the purchase of the liabilities of the private sector in exchange for the creation of a deposit account, which is the liability of the bank. This is the bank loan, and it is a completely separate operation of banks.

Thus, at any point in time bank liabilities are composed of two different types of deposits: one is backed by the liability of the government as coin and currency provided by the depositor/lender to the bank and forms bank reserves; the other is backed by the liability of the private borrower that has been accepted by the bank and does not initially create bank reserves. Deposit insurance meant to secure the purchasing power of depositors is directed to the first type of deposit, while the second is secured by the acceptance guarantee of the bank. If a bank makes bad loans, secured by its own credit, it is argued that the first type of deposit holders should not be responsible and that they should be protected. Deposit insurance is meant to provide this protection. The losses of the bank should be met by the bank, or its equity owners and unsecured lenders other than depositors. This is the basis of the arguments against public "bailouts" of banks and the insistence that the costs of bankruptcy due to bad bankers should be met by the shareholders of the bank, not by depositors. This principle is often extended to the non-deposit-holding unsecured creditors of the bank. However, it is not clear that these lenders to the bank have a different standing than the reserve-bearing depositors, as they may also have provided the bank with coin or currency. The only difference is that they have received a fixed-term liability from the bank. But it is clear that they have no more responsibility for the operation of the bank than other unsecured, insured depositors.

The problem with this theoretical separation of who should bear the costs of bank failure and how to prevent the errors of a single institution from having systemic effects on other banks, and thus on the financing of the economic system, is the conflation of the two types of deposit origination noted above. It is clear that the cause of bank runs, which deposit insurance is designed to prevent, is the result of a failure to distinguish between the ability of different institutions to redeem their deposits. It is for this reason that insurance has to apply uniformly to all banks' deposits. The failure and introduction of full support for Irish bank depositors in the recent crisis has made this clear, and the result has been the decision by the EU to introduce a uniform European deposit insurance scheme.

But even more important is the extension of insurance to all of a bank's deposits, whether they were created by a deposit of coin or currency or by the acceptance of the depositor's liability. The distinction is important because it is the failure of the holder of the second type of deposit to redeem its liability that is the major cause of bank failure. Yet, the application of insurance to this deposit simply eliminates any sanction for losses resulting from the failure to redeem the liability.

If I borrow from a bank against my promise to pay and receive a deposit and then default on my note, causing the bank to fail, I will still have the value of the material acquired by the deposit that now sits on the balance sheet of the sellers and is insured. This suggests that if the system is to reduce the moral hazard incentives to sanction bad practice, insurance should not apply to deposits created by loans that default but should be applied to deposits created by loans that have remained current.

Unfortunately, it is impossible in practice to make these distinctions between reserve deposits, defaulted-loan-created deposits, and deposits created by loans that are current. It is for this reason that there are limits on the size of insured deposits based on the presumption that the first type of deposits will be relatively small household deposits created by the transfer of reserves and used as means of payment or store of value. It thus limits coverage of the other types of deposits. However, this is clearly inequitable for the deposits held by borrowers who are still current on their loans.[6]

It is the means of payment function of deposits that creates the difficulty in distinguishing among the different types of collateral behind deposits. As Hyman Minsky noted, this difficulty is inherent in the explanation of why deposits are held by the public and why banks are able to use their deposit business to create credit:

> In our system payments banks make for customers become deposits, usually at some other bank. If the payments for a customer were made because of a loan agreement, the customer now owes the bank money; he now has to operate in the economy or in financial markets so that he is able to fulfill his obligations to the bank at the due dates. Demand deposits have exchange value because a multitude of debtors to banks have outstanding debts that call for the payment of demand deposits to banks. These debtors will work and sell goods or financial instruments to get demand deposits. The exchange value of deposits is determined by the demands of debtors for deposits needed to fulfill their commitments. Bank loans, while ostensibly money-today for money-later contracts, are really an exchange of debits from a bank's books today for credits to a bank's books later. (Minsky 2008 [1986], 258)

The key to the acceptability of deposits in the system is that borrowers must repay the lending bank by acquiring and transferring a deposit. Thus, the deposit the borrower receives from the bank as a loan is only useful if it can be used to acquire the inputs required in production. Used as a means of payment, the ownership of deposits is transferred to households who are free to transfer ownership to any other bank in the system. This is what is called "deposit drain" for the lending bank and generates the need for bank reserves that are used to effectuate the transfer of ownership of the deposit to the bank of the new owner, achieved via a transfer of reserves in the interbank market. The deposit originally created by a loan appears at the acquirer's bank as a transfer of reserves. For the receiving bank, there is thus no way to distinguish this deposit from one that was originally created by the deposit of notes and coin. It is also the case that there is no way to distinguish between an original deposit of reserves and a deposit created with a bad loan or a current loan.

The use of reserves to effectuate transfer between banks highlights the importance of deposits of coin and currency for the creation of credit, for in the absence of reserves acquired in this way, the deposit created by a loan could not be transferred to another bank and thus could not be used as a means of payment. And, as Minsky pointed out, an equally important part of the ability of banks to create credit is that after the borrower has used the deposit as a means of payment, it has to acquire deposits created by other banks (or its own) in order to extinguish the loan. Thus, there is a demand for deposits from the banks both to acquire reserves and to repay loans, while the household demand for deposits is independent of their origin.

As a result, it is impossible to distinguish between deposits backed by currency and coin, and deposits backed by currently serviced loans or bad loans. The current system of deposit insurance thus provides a minimal guarantee of the first type of loans, usually believed to be household transactions accounts, but it provides favorable treatment for borrowers who default on their loans, relative to borrowers who are current on their loans[7] as well as unsecured nondeposit lenders to the bank who may have no role in the fraudulent operation of the bank or its borrowers.

Does Deposit Insurance Create Instability?

This simply reflects Minsky's point about the perversity of general schemes of lender-of-last-resort support for financial institutions in the interests of financial stability, for such support generally tends to "validate the new ways" of lending and thus "sets the stage for a broader acceptance and use of the new financial instruments" and confirms the dubious practices of lenders (2008 [1986], 281).

But in the case of deposit insurance, Minsky noted that it eliminates traditional constraints to banks' risk exposure in the form of "customer and collegiate surveillance. In a regime in which banks can and do fail and in which bank failure imposes losses upon depositors, stock owners, and borrowing customers, sophisticated users of bank services reacted to the portfolio and leverage properties of their banks." The result is a system in which "a depositor need not be concerned about the viability of a bank with which he deals" (267).

Who Should Be "Liable" for Deposit Insurance?

Minsky also pointed out the intimate relation between the central bank and deposit insurance that provides insight into the current discussions of deposit insurance in the EU. Deposit insurance schemes are in general funded by assessments on their member banks. As such, the insurance agencies are considered as legal entities independent of both the government and central banks. But, as Minsky observed, the ability of the scheme to meet its commitments implicitly requires the central bank to validate the insured deposits of any failed bank. It is a contingent liability represented in the United States by the existence of a line of credit with the US Treasury should the fund fall short of needs. The central bank must then provide the reserves necessary to meet the needs of the scheme, which is a contingent liability of the central bank. In general, insurance schemes attempt to keep the fund large enough to meet potential needs. A representation of this was the use of open bank resolution by the Federal Deposit Insurance Corporation during the recent crisis because it minimized the use of the fund in validating deposits, since the insured deposits become the responsibility of the acquiring bank upon resolution.

EU Deposit Insurance Proposals May Not Improve Financial Stability

In the current European schemes, there is no implicit contingent guarantee by the European Central Bank (ECB), and there is no implicit guarantee by the national governments. Indeed, the difficulties that have been seen in the recent crisis were due to the fact that national governments could not provide the required guarantees when their deposit schemes failed, given the high ratios of deposits to GDP. The response has been to propose a uniform EU-wide insurance scheme independent of national governments. This scheme has been criticized by some governments on the grounds that it makes them responsible for validating debts created under conditions in the financial systems of other countries over which they have no direct control. However, surveillance is not the major drawback of this proposal. Rather, it is the absence of any contingent credit line from the ECB or an implicit recognition that the ECB would provide the support required to support the scheme.

It would thus seem impossible to design a truly fair deposit insurance scheme that eliminates the inherent moral hazard and the necessity of a contingent guarantee of the central bank. It is now possible to see more clearly the problems created by the "fiscal" measure of taxing deposits taken to support the banking system in Cyprus. The problems of the Cypriot banks appear to have been caused not by an increase in bad loans to residents, or even to nonresidents who represented the majority of the banks' assets. Some have suggested that the banks' problems were caused by foreign deposits serving as the backing for loans to the depositors. However, as noted, these deposits would not have been subject to insurance in any case, since the Cypriot scheme only covers exposure to individual depositors net of loans. More likely the problems were caused by the investments of the banks' excess deposits from nonresidents in Greek sovereign bonds that were purchased at a discount to par from EU banks seeking to reduce their exposure after the outbreak of the Greek crisis. The difficulties commenced when the troika imposed a private sector bail-in of creditors to the Greek government, which meant that the Cypriot banks were also bailed in, producing substantial losses that led to insolvency. This interlinkage of the Greek haircut and the Cypriot insolvencies recalls the failure to notice linkages between Lehman Brothers' commercial paper holdings and money market mutual funds in the United States.

The fact that many of the larger deposit holders included legitimate businesses (as well as the national pension fund, beneficial charities, and nongovernmental organizations) makes the use of the fiscal measure of a wealth tax on depositors in the banks even more inequitable. It is little wonder that such measures generate resentment, given that hedge fund holdouts with over six billion euros of Greek debt purchased at substantial discounts were paid in full after the first haircut, and those who bought subsequently exited with substantial profits before the second haircut—while the losses were effectively borne by Cypriot bank depositors.

Notes

1. Silvio Gesell proposed this as a measure to support demand (Gesell 1958 [1929]).
2. This is why conservatives highlight the so-called inflation "tax," but as Keynes pointed out, this tax is ubiquitous and applies to all financial assets.
3. "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. . . . Every tax ought to be levied

at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it" (Smith 1976 [1904], 350–51).

4. To the extent that the government had a liability to guarantee the depositors of these banks, it could have been conceived as generating government revenues that were then used to guarantee remaining deposits, but this was clearly not the case. The Cyprus fund is a separate legal entity funded by the assessment of banks licensed by the central bank.
5. The Wikipedia entry on deposit insurance explains, under the heading "Why it exists," that "banks are allowed (and usually encouraged) to lend or invest most of the money deposited with them instead of safe-keeping the full amounts (see fractional-reserve banking). . . . If many of a bank's borrowers fail to repay their loans when due, the bank's creditors, including its depositors, risk loss. Because they rely on customer deposits that can be withdrawn on little or no notice, banks in financial trouble are prone to bank runs, where depositors seek to withdraw funds quickly ahead of a possible bank insolvency. Because banking institution failures have the potential to trigger a broad spectrum of harmful events, including economic recessions, policy makers maintain deposit insurance schemes to protect depositors and to give them comfort that their funds are not at risk" (see http://en.wikipedia.org/wiki/Deposit_insurance).
6. For example, during the 1980s savings-and-loan crisis depositor/borrowers who were current on their mortgages were asked to redeem their notes when the institution failed, creating defaults when they could not find alternative funding.
7. Most schemes, including the Cypriot one, only provide for coverage of deposits less any loans granted to the depositor. Unfortunately, this only resolves the problem if deposits and loans always remain within the same bank.

References

Gesell, S. 1958 (1929). *The Natural Economic Order*. Trans. Philip Pye. London: Peter Owen.

Keynes, J. M. 1924. *A Tract on Monetary Reform*. London: Macmillan and Co.

Minsky, H. P. 2008 (1986). *Stabilizing an Unstable Economy*. New York: McGraw-Hill.

Smith, A. 1976 (1904). *An Inquiry into the Nature and Causes of the Wealth of Nations*. Chicago: University of Chicago Press.