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Cyprus Depositor Tax: Could It Happen Here?

By: Joe Adler – March 19, 2013

The small island nation of Cyprus' proposal to tax its insured depositors is likely to stoke fears of bank runs in Europe and elsewhere, even if it is an extremely unlikely scenario in the United States.

Over the weekend, several media outlets fronted photos of anxious customers lining up at automatic teller machines to withdraw money in Cyprus, and Huffington Post published a piece on its home page with the alarming headline "Fear the Bank Run." That has renewed concerns of international bank runs, particularly in nations close to Cyprus.

"If Spanish and Italian bank depositors wake up tomorrow morning and say, 'They could tax my deposits too,' the potential for triggering an international run on the banks in these countries is a potentially high risk," said V. Gerard Comizio, a partner at Paul Hastings.

Yet such fears are unlikely to materialize within the U.S., observers said, in part because the Federal Deposit Insurance Corp. has an unbroken track record of repaying all insured deposits. While customers bear the indirect costs of banks' deposit insurance premiums and other obligations, many said that a direct levy on bank deposits would be unimaginable.

"If it's a scenario of going after insured depositors and taking wealth away from them that was promised, I don't think that would happen," said Ed Kane, a finance professor at Boston College. "If anything, our authorities jump in during difficult times and offer more guarantees than are formally on the books."

The Cyprus levy was floated as part of a proposed bailout agreement between the reeling nation - less than half the size of New Jersey - and other members of the European Union. The deal would impose a 6.75% tax on depositors with less than \xE2,\xAC100,000 - which is the maximum level of funds insured in Cyprus, as well as other European nations - which would rise to a 9.9% level on higher deposit amounts.

The idea has led to instant backlash, with news outlets reporting a longer bank holiday than previously planned to stem withdrawals, a delayed vote by lawmakers on the plan and calls for the final agreement to include smaller losses for insured depositors.

But observers said the FDIC's history makes it unlikely that panic will spread here.

"Europe has deposit insurance schemes just like we do, so I don't think it's something that could ever be ruled out. But the probability is very, very low," said Bert Ely, an independent bank consultant based in Virginia.

William Isaac, a former chairman of the FDIC, said the idea of haircutting insured depositors "would be unthinkable" in the United States.

"I can't believe the Europeans were that insensitive to the psychology of depositors throughout the world. They have a government pledge to cover these people, and they've reneged on it," Isaac said. "With the uninsured depositors, you certainly have the right to haircut them. But I would question in light of the worldwide financial instability over the past five years whether this is the right time to make that move, particularly without any notice."

Indeed, U.S. policymakers in a crisis tend to give greater guarantees, not pullback in coverage.

"We go the opposite direction. We have a long history of making whole uninsured depositors," said Mark Calabria, a former senior staffer on the Senate Banking Committee who now directs financial regulation studies at the Cato Institute.

While U.S. policy might ultimately raise prices on bank products, "we would never do it as transparently," he said.

"Could we potentially raise insurance premiums "\xA6 that are ultimately passed on to consumers in one way or another? Sure. We'll do indirect taxes. But I don't see us ever doing something like Cyprus where we tax depositors," Calabria said.

Ely said even though "the taxpayer rode to the rescue" to help honor obligations of U.S. government insurance programs in past crises, such as the former Federal Savings and Loan Insurance Corp. and the national flood insurance program, taxpayer losses are a much different animal than imposing depositor losses.

"People do not hold deposits in the same proportion of what they have in tax liabilities," he said. "A tax on bank deposits is a tax on wealth, whereas most of the federal taxes charged in this country are charged on one's income."