Paying the Price of Procrastination

Hans-Joachim Duebel, founder of the Berlin-based financial and real estate sector specialist Finpolconsult, recently produced a study for the Centre for Financial Studies of the University of Frankfurt entitled *The Capital Structure of Banks and Practice of Bank Restructuring: Eight Case Studies on Current Bank Restructurings in Europe*. One of case studies was Laiki (Cyprus Popular) Bank. Duebel, who is one of the speakers at the forthcoming Cyprus Banking Forum, presented by **Gold**, at the Hilton Park Hotel, Nicosia on 5 December, talks about the Europgroup's handling of the Cyprus banking crisis. **By JohnVickers**

Gold: You have written that what happened in Cyprus with Laiki Bank and Bank of Cyprus was "a classic US strategy". Why do you think it was implemented in Europe?
Hans-Joachim Duebel: Because the fatigue of policy makers and their advisors with taxpayer-funded bank rescues had reached a peak by 2012-13. Even junior bond creditors had been left untouched in the first wave of bank rescues in Northern Europe (2008-2010). There is a parallel with the US S&L crisis of the 1980s, when it also took a couple of years to change policies from bail-out to bail-in. The turning point for Europe was, in fact, not Cyprus in November 2012, but Spain in June 2012. At that time, Germany was asked at the European summit to back up direct recapitalizations of banks while some Spanish Cajas were still offering junior bond holders an exit at par (no losses). This prompted Germany to ask Spain for a sovereign guarantee for the eurozone funds and pass a bail-in law. The ECB turned around on this after Germany had given green light in late July on the OMT. You may see it as a *quid pro quo.*

Gold: You have described as "misguided" the Emergency Liquidity Assistance (ELA) from the European Central Bank. What do you mean?
H-J. D.: Let us consider Laiki. Some of the ELA that built up from September 2011 until the ECB pulled the plug in February 2013 had been used to fund collateral – covered bonds and sovereign bonds – that had fallen out of ordinary ECB repo. So far, so good. However, during that period Laiki also was constantly losing large amounts of deposits, mostly from its International Business Unit and from other foreign depositors. Back on the envelope, perhaps half of the ELA turned around and left Cyprus again. Without the ECB providing ELA *de facto* without limitations, Laiki would have been unable to cater for this capital flight. The ECB understood that supporting capital flight from a bank with solvency problems dramatically undermines the credibility of its overall liquidity policy framework. In September 2013, the ECB tightened its ELA policies. Not enough in my view, but it's a start.

Gold: When the Eurogroup took its decision to impose a haircut on uninsured deposits, it was loudly stated that Cyprus was a 'unique case' and not a model for the future. How true do you think that is?
H-J. D.: Let us first understand why Cyprus got into this situation. Next to the flight of depositors there was a flight of subordinated bond investors from the banks. Bank of Cyprus bought back subordinated debt years after Deutsche Bank had stopped the practice, in May 2011 when the Greek haircut debate was in full swing. Laiki then did a frankly disingenuous deal in June 2012, paying out a lot both in cash and senior unsecured bonds to investors while asking the Cypriot government – i.e. civil servants, teachers and welfare recipients – to foot the bill with fresh equity. Of course, Greek banks had done the same earlier. When you lose your subordinated bond positions in this way, the next step is to call for senior unsecured creditor bail-in. The ECB perhaps just hadn't done the maths when they proposed a subordinated bond bail-in for Cyprus only by autumn 2012. The Laiki deal also showed that not all senior bond positions were truly legitimate. This made it easy to call for senior bond bail-in. Unique? Well, the question going forward is how much subordinated bonds banks in Europe will be able to issue and retain, in order to truly protect senior bond holders and depositors. The number that we tend to agree on currently is 8% of risk-weighted assets. Two thirds of the large European banks have issued currently below that level, but if they make it I would see the bail-in risk of senior unsecured and depositors going forward as limited. This, by the way, is only formalising what Switzerland and Denmark are already asking from their banks.

Gold: The banking system in Cyprus currently faces a dilemma: to maintain capital controls and therefore render the question of trust even more difficult, or to remove controls and watch as billions of euros is withdrawn. What would your solution be to this?
H-J. D.: The ECB's main point of contention has been bank capital. With that issue being addressed I would not see lots of obstacles to lifting the controls. Cyprus is not Iceland, which has no backup when foreign investors pull their accounts and must fear exchange rate destabilisation. I have always seen the Cyprus capital controls more as a means to buy the government time to technically implement the bail-in. After all, there was a real IT mess within the banks and too many people were able to escape the bail-in in March.

Gold: The first Eurogroup decision (rejected by the Cyprus parliament) was for a haircut of all deposits (insured and uninsured) in all banks. Why did the Eurogroup accept something that went against EU principles?
H-J. D.: The key reason probably was the high deposit rates paid by all the Cypriot banks. When a German depositor gets 1% and a Cypriot depositor gets 4%, it is hard to persuade the German depositor to pay higher taxes in order to bail out the Cypriot. Another reason was that on February 1, the Netherlands had restructured SNS Reaal Group with a levy imposed on all banks in the country. So the EU thought that they could transfer the model. My advice to Cyprus was always to focus on the problem banks and restructure them rather than do a brush taxation approach. Fortunately, my Cypriot counterparts developed 'Plan B' on that basis.

Gold: If Cyprus had accepted the original decision, do you think things would have been better today?
H-J. D.: You can tax homogenous groups of companies and depositors easily, and the Netherlands is an example. But Cyprus being what it is – an investment hub for the very heterogeneous Christian Orthodox world – I would think that the long-term implications for the banking market would have been more serious. The Russians can to go Serbia or Latvia, where they pay the same low corporate tax rates. Perhaps your Middle Eastern clients would have stayed. It is always better to focus on the problem banks than affect the entire system. A Russian investor in VTB on Cyprus has not lost anything; most investors are able to differentiate.

Gold: You mention in your report on eight banks that "many international corporations and individuals… selected Cyprus banks for tax evasion and other illicit purposes" and this was alleged in the international media prior to March 2013. Yet, subsequent investigations have indicated that such allegations were untrue. Has your view changed?
H-J. D.: I remember that the Deloitte report that was commissioned by the eurozone in April to double-check on Moneyval's earlier finding has come to a very different conclusion. If you run a low-tax system, you always have a lot of tax evasion with account names being hidden. This is true for all small countries that are in this business. It was unfair to single Cyprus out.

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Gold: You have described President Anastasiades' attacks on the ECB's policy of continuing to provide emergency liquidity to Laiki Bank when it was clearly insolvent and therefore not eligible for such assistance. Why did you find his stance "a highly unusual turn of events"?
H-J. D.: It is unusual indeed for countries that depend on financial services to be that outspoken, compare e.g. to Luxemburg's Jean Claude Juncker's legendary manoeuvring. I can only congratulate the President on his courage. He has really put pressure on the ECB to change its ELA policy. Remember that this policy has damaged Cyprus – like Ireland, the country now owes odious debt, i.e. debt caused by foreigners who were paid back their investment. He had every right to be clear about this.

Gold: Do you believe that the crisis in the Cyprus banking sector could have been dealt with in a different way in March?
H-J. D.: It could have been dealt with in a different way in June 2012, when Laiki was restructured. Cyprus would have bailed in subordinated bond investors and perhaps a small proportion of seniors and the government would have taken a far more comfortable position. After that the train was on a collision course. The Europeans should have acted at the latest by November 2012. The four months of agony until March 2013 was a criminal act against investor confidence – both in Cyprus and in Europe – for which we Europeans may have to pay for a long time. G