

NOT SO LUCKY LAIKI: THE TRANSFER OF DEBT AND LIQUIDITY OBLIGATIONS BETWEEN GREECE AND CYPRUS AND THE BAILOUT CONSEQUENCES

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1. INTRODUCTION AND BACKGROUND

This paper concludes that the bungled euro zone bailout of the Cypriot banking sector, the treatment of its different depositors and the distribution of bailout aid and bail-in losses is highly inconsistent.

In getting to this conclusion it charts the rise and downfall of Laiki Bank and in particular the events leading up to and following the fateful day in March 2011 when Marfin Popular Bank (as it was then known) merged its Cypriot and Greek operations.

From there it looks at the reasons behind the merger decision and the position of the Central Bank of Cyprus in the merger. It then briefly charts the downfall of Laiki bank and attempts to stave off the inevitable in the dying days of the discredited Christofias presidency.

The paper then looks at the disposal of the Greek operations of Cyprus's banking system that were a condition and consequence of the euro zone bailout. It then analyses shifts that took place in the Central Bank obligations of Marfin/Popular Bank/Laiki that were consequent to the merger decision.

In its conclusions it examines the inconsistencies of the euro zone bailout in Cyprus with particular regard to the fate of Laiki uninsured deposits in Cyprus and Greece and the different treatment of different parts of the Cypriot banking system with regard to recapitalisation aid (European Financial Stability Facility –EFSF - and European Stability Mechanism - ESM) that has gone to some parts of the system (via sell offs to Greece or in Cyprus itself) and not to others (the Cypriot operations of Laiki and Bank of Cyprus). I suggest that this differential treatment is more to with considerations of political expediency than any principled approach to the bailout.

The paper is based as far on possible on trusted media and other sources. I have tried to stick to the facts and keep my predilection for rhetoric and speculation contained (not always successfully). Tracking the story of Laiki's downfall without access to Greek-language sources or participants on the ground clearly leaves much to be desired. I know there are huge gaps in the narrative set out here and there will be mistakes. There is lots of further information on the [Cyprus bailout](#) and [Cyprus](#) itself on my [website](#).

I am not great fan of the Cypriot banking system of the first decade of the 21st century but it is important to remember at all times that the fall of Laiki Bank

was preceded by the fall of much bigger banks in much longer-established parts of the EU. Indeed, the folly has been almost universal.

Background

On the 31st March 2011 Laiki (then known as Marfin Popular Bank) merged **Marfin Egnatia Bank (MEB)**, a 95% owned subsidiary based and regulated in Greece into the parent company. As a consequence MEB became branch based in and regulated in Cyprus.

Almost two years to the day on March 26th 2013 **Marfin Egnatia Bank** was sold at a knock down price to Piraeus Bank (along with the Greek operations of the Bank of Cyprus and Hellenic Bank) as part of the post-bailout resolution of Laiki Bank.

Loss forecasts for Laiki's operations in Greece and Cyprus

Figures from the PIMCO March 2013 report (*Independent Due Diligence of the Banking System of Cyprus*) that show potential losses between Laiki's Cyprus and Greece operations are presented in Table 1.

Table 1 PIMCO forecast Laiki losses on new and existing loans at June 2012 (€bn and percentage new total)				
	Cyprus	Greece	Laiki: New summed losses total	Laiki: PIMCO Total
Base Scenario	1.640 (30.5%)	3.756 (69.6%)	5.396 (100%)	5.698 ⁽¹⁾
Adverse Scenario	2.469 (35.3%)	4.524 (64.7%)	6.993 (100%)	7.313

(1) The difference between the summed and PIMCO totals are different because the PIMCO totals include forecast losses on international loans.

Source: PIMCO March 2013 p. 91.

The figures in Table 1 show that proportion of loan losses attributable to Laiki's Greek operations 2012 -2015 was forecast at between 65 and 70 per cent of the bank's total losses.

A [Moody's](#) March 2011 downgrade of Marfin Popular bank stated that Greek loans accounted for 45 per cent of Laiki Group's loans.

Half Year results for Laiki Group for Quarters 1-2/2012

The Half Year results give a vivid picture of the bank's deteriorating situation and the contribution to this of bad loans and deposit losses in Greece.

- Group operating revenues decreased by 22%
- Cyprus operating revenues increased of 14%.
- Revenue decrease largely attributable to Greek operations
- Cypriot net loans €10.6bn (3% increase)
- Greek net loans €10.2bn (21% decrease)
- Deposits down by 22 per cent, 'mainly due to the reduction of deposits in the Greek market.'
- Q2 2012 Non-Performing Loan ratio in Cyprus 13.6% (increase 4.15%)
- Q2 2012 Non-Performing Loan ratio in Greece 32.6% (13.6% increase).

([Laiki press release First Half Year Results 2012](#)).

These figures show that:

- 1) Laiki's net loan books in Cyprus and Greece were broadly similar in size
- 2) The size of the Greek loan book was rapidly declining.
- 3) Loss rates on Greek loans were more than twice those in Cyprus
- 4) Deposits in Greece were falling rapidly.
- 5) Compared to the PIMCO loss forecasts in Table 1 we can say that the losses on Laiki's Greek loans were disproportionate to their size.

2. THE CREATION OF MARFIN POPULAR BANK

Laiki was born as the **Popular Savings Bank of Limassol** in 1901 and grew steadily to become one of Cyprus's biggest banks.

It undertook limited overseas expansion in the 1990s in Greece and Australia but it was essentially a Cypriot bank based and operating in Cyprus.

In 2006 the renamed **Laiki Group** was taken over by the Greek Marfin Bank, part of the Marfin Investment Group. This was a strange takeover. In effect Laiki Bank made an all-paper (no cash) reverse takeover for 100 per cent of Marfin.

(Previously Marfin had bought out HSBC's 21.8 per cent stake in Laiki.)

Dubai Investment acquired a 15 per cent stake in the new bank and the deal was put together by Marfin and the Cypriot Lanitis family, Laiki's other major shareholder.

Laiki Bank was chosen as the vehicle for the new group due to less onerous Cypriot bank takeover legislation compared to that of Greece (which required bidders to make an 100% cash offer for a target company's shares). The differential between corporation tax of 10% in Cyprus and 25% in Greece was also important.

The bank was renamed **Marfin Popular Bank (MPB)**.

New Management

After the takeover Marfin replaced the Laiki Bank Chair, Kikis Lazarides, and several board members on the grounds that they had been linked with the illegal transfer of billions of dollars to Laiki Bank from Serbia by governments headed by Slobodan Milosevic.

(The **Cyprus Popular Bank** had been renamed **Laiki Bank** in 1990 in an attempt to distant it from its past deeds).

And while the new bank had its legal and regulatory base in Cyprus its new management team was based in Greece. It was subsequently 'held responsible for the bank's large exposure to Greek government debt and for a sharp rise in non-performing loans held by its Greek branches' ([FT Hope and Spiegel 17 May 2012](#)).

Marfin Popular Bank got a new Chief Executive – Andreas Vgenopoulos – who was also the Chair of the Marfin Investment Group.

[Mr Vgenopoulos](#) served as the Chief Executive Officer of Marfin Popular Bank Public Co Ltd. since June 15, 2006 and as its Managing Director since November 6, 2006'

He also served as Non Executive Chairman of Marfin Popular Bank Public Co Ltd. from February 2010 to November 2011 and as a Director of Marfin Popular Bank Public Co Ltd. from November 6, 2006 to November 2011.

[Efthimios Bouloutas](#) joined Marfin Popular Bank as Chief Executive on February 14, 2008 and left on December 6, 2011. He had also served as Managing Director of Marfin Egnatia Bank.

In 2012 after his departure from MPB became the [chief executive of the Marfin Investment Group](#).

The Greek Subsidiary

At the same time Marfin also acquired an 100 per cent stake of Laiki Bank Greece, the Cypriot bank's unlisted Greek subsidiary with a network of almost 80 branches and assets of €3bn. It also took control of Egnatia Bank, a private bank with assets of €3.3bn that had a strong branch network in northern Greece (FT Hope 19 June 2006).

Later that year Marfin Group consolidated its Egnatia and Laiki Greece acquisitions to form the **Marfin Egnatia Bank (MEB)**, a 95%-owned Greek subsidiary of Marfin Popular Bank based in Thessalonica (FT Hope 1 November 2006 and 19 December 2006).

Marfin Investment Group

The major shareholders in MPB are Marfin Investment Group (10%), Dubai Holdings, an investment arm of the Gulf state (17-18%) and the Cypriot Lanitis family (believed to 4-5%) ([FT Hope and Spiegel 17 May 2012](#)).

MIG was the creation of self-made businessman, Andreas Vgenopoulos, who made MIG one of Greece's corporate stars. But the rise of MIG has been controversial – for example a Greek parliamentary inquiry alleged serious "[conflicts of interest](#)" in the issue of bank loans to fund MIG's broader activities. Mr Vgenopoulos has consistently denied any wrongdoing.

In 2010 the group made a loss of €1.8bn - the biggest ever for a Greek company. A joke in Athens at the time suggested a new meaning for MIG: 'Money Is Gone'.

The links between MIG, MPB and the fate of Laiki have yet to be fully untangled.

The 15% holding in the bank by Dubai Investment was apparently part of an ambitious plan for the bank 'to become the European investment vehicle of Dubai's sovereign wealth fund' ([FT Hope 22 March 2013](#)).

MPB goes global

The takeover by the Marfin Investment Group marked a sea change in the fortunes of Laiki bank – now known as **Marfin Popular Bank (MPB)**.

The bank grew rapidly through a series of acquisitions in Eastern Europe and the culture of the bank underwent a profound transformation.

Andreas Chrysafis, a senior IT manager at MPB recalled,

'They transformed the Bank from a conservative bank to a bank that was ambitious and expanding all over the place. The first thing they managed to do - they gave everybody a €2,000 bonus because we 'did a good job'. And we wondered: 'What did we do?'"

"If you complained then you [were] considered to be a loser or to be a conservative or not to be part of them - so, all in all, nobody talked about it."

(Quoted in [Laiki Bank: The Cyprus bank staff hit worst of all](#) BBC News Magazine 5 April 2013.)

Expansion and Haircut

These were heady days for the banks. In January 2007 Marfin Popular Bank made a hostile bid for **Piraeus Bank** (remember the name) to which Piraeus Bank made a counter-offer.

In June 2007 Marfin Investment Group announced plans to raise €5.2bn of new capital to fund an ambitious acquisition strategy.

Chief Executive of Marfin Popular Bank, Andreas Vgenopoulos, was thought to be investing €50m of his own money in the share issue. (FT Arnold and Hope 18 June 2007).

Things were not all plain sailing with growing concerns about loans for share buyback schemes to Greek monks and parts of MIG that have been detailed elsewhere (see [Reuters 12 June 2012](#)).

In October 2011 the bank ran into huge trouble when Greek government bonds suffered the Private Sector Initiative (PSI) haircut resulting in losses of €2.3bn.

As the FT commented later in 2012 the bank was in,

‘An especially awkward position as it is not eligible for recapitalisation under a €48bn rescue package for Greek banks included in the country’s second bailout, even though its insolvency was caused by exposure to Greece’ ([FT Hope and Spiegel 17 May 2012](#)).

Downgrade and Greek loans

[Moody’s](#) had downgraded Marfin Popular Bank a notch in March 2011. It warned that, ‘the outlook on the ratings is negative,’ and said,

‘erosion of market confidence, over the last years, has curtailed access to the wholesale/bond markets for its Greek subsidiary Marfin Egnatia Bank.’

‘Among the top three Cypriot banks, Marfin Popular Bank’s exposure to Greece (45% of group loans) presents significant downside risks to the bank’s asset quality.’

3. THE FATEFUL DECISION TO MERGE MARFIN POPULAR BANK AND MARFIN EGNATIA BANK

But before the PSI haircut Marfin Popular Bank had made the fateful decision to merge its Greek and Cypriot operations and to make Marfin Egnatia Bank a branch of the Cyprus-based bank.

The bank announced,

‘The Cross Border Merger of the Bank and its subsidiary Marfin Egnatia Bank S.A. through the absorption of Marfin Egnatia Bank S.A. by the Bank as decided by the Boards of Directors and approved by the Extraordinary General Meetings of the shareholders of the two Banks was completed on 31 March, 2011 (12:00 p.m.). ‘

Laiki Bank Group Annual Financial Report Year ended 31 December 2011, p.4.

This decision was recommended and approved by the Board of Marfin Popular Bank under the leadership of Andreas Vgenopoulos, Chair and Efthimios Bouloutas, Chief Executive.

In effect, the merger shifted all the liabilities, contingent liabilities and regulatory responsibility for Marfin Egnatia Bank from Greece to Cyprus.

The decision to restructure

Given the paramount importance of the decision to merge Marfin Popular Bank and Egnatia Marfin Bank such that the latter’s obligation were transferred to Cyprus from Greece we need to look into the decision and why it was made.

The decision has clearly become a very hot political potato. As a consequence interpretations of the decision are mired in the visceral post-bailout politics of Cyprus.

In the domestic political arena ex-President Demetris Christofias has publicly blamed Athanasios Orphanides, ex-Governor of the Central Bank of Cyprus, for the fiasco. [Reuters](#) (Grey, Kambas and Leontopoulos June 13 2012) reported that whilst making few remarks about his term in office at the CBC Orphanides,

‘has accused Cyprus’s ruling communist government of siding with Vgenopoulos [ex-CEO and Chair of Marfin Popular Bank] and opposing more stringent banking regulations.

[Orphanides said,] "it saddened me to be the recipient of political interventions which in all cases were to relax the supervisory framework or meet certain interests," he told parliament.

Marfin Popular Bank’s rationale: Plan B after Greek merger defeated

What were Marfin Popular Bank’s reasons for undertaking the merger?

Was it pushed reluctantly into the merger by Greek and Cypriot regulator’s following negative reports of it Greek operations?

Or did MPB have particular motives for making the merger? Were there corporate tax advantages to be gained by switching the Greek operations to Cyprus (corporation tax Cyprus 10%, Greece 25%)? Or were their regulatory differences that MPB was hoping to exploit?

Or given the gap between deposits and loans in the Marfin Egnatia was it a way of allowing the use of non-resident deposits in the Cypriot bank to cover the deposit-loan gap in the Greek bank by merging them into one entity?

Added May 19 2013

[Reuters](#) reported on May 19 2009 that,

Marfin Popular's decision to move its base to Greece comes after media reports that Cyprus' Central Bank informally blocked a Marfin affiliate, Marfin Investment Group (MIG) from raising its stake in the bank.

[Cyprus Mail](#) 19 May 2009 reported a statement issued by the bank that said,

the proposed merger was aimed "at improving the Group's strategic flexibility in terms of potential expansion in the Greek market and south-eastern Europe and strengthening the Group's capitalisation by 10 per cent."

Later in September the [Cyprus Mail](#) 16 September 2009 reported MPB Executive Vice President Andreas Vgenopoulos' explanation of why the Board had reversed its initial decision,

"The unfavourable developments for the Cypriot economy imposed the need to put the best interests of the country and its society first. **Our decision was significantly influenced by the pleas of the ordinary people of Cyprus** and of the vast majority of the Cypriot business community and political establishment."

Leaked documents (see the [Alvarez and Marsal report](#) below) have revealed that at least on the face of it Marfin Popular Bank's rationale for the merger was due to the rebuff of its initial decision to fold the Cypriot arm of the bank into the Greek arm. This move was defeated by political pressures from Cypriot stakeholders within and outside of the bank.

To start at the beginning and to follow the Alvarez & Marsal account the MPB took a decision on 19 May 2009 to undertake a cross-border merger between MPB and MEB to move the headquarters of the bank **from Cyprus to Greece**.

The reasons for this decision seem, at least on the face of it, to have been largely negative.

The bank was in part motivated by the time and cost of dealing with two regulators – vis the Bank of Greece and the Central Bank of Cyprus. And there were concerns over the regulatory environment in Cyprus and MPB's alleged 'unfavourable treatment' by the Cypriot regulator in comparison with its competitors.

Andreas Vgenopoulos, Vice Chair of MPB, attended a session of the Cyprus parliament on 13 July 2009 where he alleged unfavourable treatment of MPB and capital requirements that were too strict compared to European counterpart requirements (see [Reuters 15 September 2009](#) where the Central Bank of Cyprus denied Marfin's claims).

He also referred to the recent employment 'with immediate effect' by a competitor of MPB of a former CBC official who had investigated MPB. Vgenopoulos implied that commercial confidentiality had been broken.

On 19 September 2009 the MPB Board agreed under political 'and other' pressures from Cypriot stakeholders to a revised cross border merger under which the **Greek operation would be absorbed into the Cyprus operation** with the HQ in Cyprus under the CBC's supervision.

Cypriot stakeholders were particularly concerned about reputational damage and the economic loss to Cyprus of a Greek merger.

The delay in acting on the decision was caused by the need for the Cyprus parliament to pass a law on covered bonds (which it did on 23 December 2010).

The merger gained court approval in Cyprus on 15 December 2010 and was finalised on 31 March 2011.

Other accounts of the MPB merger decision

There is very little English-language media coverage or comment on the MPB/MEB merger and possible MPB motives.

One exception is come from [Greek Reporter 24 January 2012](#).

It suggests there were three possible reasons for MPB's initial decision to merge its Cyprus operations into its Greek ones. These were,

- that the bank believed that the 'banking system of Cyprus was hampering [MPB] from fully developing investment opportunities'.
- that the bank was seeking take advantage of 'the Greek system of bank recapitalization at that time,' as it had previously benefited from the favourable legal framework in Cyprus in 2006 for the reverse all-paper takeover between Marfin Bank and Laiki (see above).
- that the request to transfer the bank headquarters from Cyprus to Greece was a bluff in order to obtain greater scope for action in Cyprus.

The report claims that CBC governor, Athanasios Orphanides, was not willing for Cyprus to be "seduced and abandoned" by the Marfin when it suited it.

Presumably the 'seduction' referred to the 2006 reverse takeover based on Cyprus's more relaxed takeover legislation and lower rate of corporation tax. While the 'abandonment' referred to the MPB Board decision of 2009 to merge the Cyprus-based MPB into the Greek-based MEB.

The report also suggests that Vgenopoulos had not only met with the Cypriot Parliament in 2009 in his lobbying against what he saw as the unfair and overly-restrictive regulation of his bank. He also met with the President and members of the Council of Ministers.

It further reports that some Marfin shareholders, 'like [the] Lanitis family, ... had suspicions that not everything in the [MEB] was under control.'

4. THE CENTRAL BANK OF CYPRUS AND THE TRANSFORMATION OF MARFIN EGNATIA FROM GREEK SUBSIDIARY TO CYPRIOT BRANCH BANK

The Alvarez & Marsal Report

The Cypriot central bank commissioned Alvarez & Marsal, a financial restructuring firm, to investigate the Bank of Cyprus's high-risk investment strategy of buying billions of euros of Greek government bonds between December 2009 and June 2010 which resulted in a loss of €1.9bn.

Part of the report also examined the Marfin Popular Bank/Marfin Egnatia Bank merger.

This was leaked to the Cyprus Mail in April 2013, which ran a long article on it ([Psyllides 5 April 2013](#)).

The Financial Times' FT Alphaville Blog posted the section of the report on the MPB merger (see [Alvarez and Marsal report](#)) on the FT website in April 2013. Although strangely it has never reported on the detail of the report (see Joseph Cotterill's passing reference ([FT Alphaville 5 April 2013](#))).

Supervision of Marfin Egnatia Bank

As a subsidiary with its own banking licence in Greece MEB was supervised by the Bank of Greece (BOG). The Central Bank of Cyprus has supervisory responsibilities for MPB in Cyprus and has very limited oversight of MEB through the consolidated accounts of MPB.

In 2008 the CBC attempted a lone on-site inspection visit to MEB in Thessalonica but it 'was not afforded access on the basis that the bank's regulator was the BOG.'

In March 2009 the CBC and the BOG carried out a joint on-site inspection of MEB.

This revealed that MEB had,

€800 million in loans to various entities for the purpose of investing in Marfin Investment Group (MIG), loans granted to the MIG group on favourable terms – e.g. low interest, long term repayment – and a deterioration of profits by 68 per cent due to low margin and an increase in provisions for non-performing loans. (Cyprus Mail 5 April 2013 [Psyllides 5 April 2013](#)).

The inspection also threw up concerns over conflicts of interest on the Board and posted an overall assessment of MEB as a 'high risk entity' (Point 4.1.4 in the A&M report).

On 27 January 2011 letter prior to the MPB/MEB merger the CBC wrote to the BOG in asking it if it had supervisory concerns regarding MEB.

The BOG letter in response stated that it had rated MEB at 3.25 under the Bank Risk Assessment System, which was 'lower than the average of the Greek banking system.' It set out the improvements it considered necessary at MEB.

These concerned internal control and conflict of interest systems, the sustainability of funding, the 'concentration' [co-ordination?] of risk management policies and credit risk provisioning policy and a need to hold additional capital against the MEB's credit risks.

There were no further on-site visits or assessments of MEB until the CBC's comprehensive on-site visit after the merger. The upshot of this was a demand to MEB to hold additional capital of €2.1bn against its loan portfolio and later, after quarterly visits, to increase Greek sovereign bond cover by €1.5bn.

The Legislation covering the merger

Cyprus's Law 66(1)/1997 on Banking Activities (the 'Banking Law') gave CBC considerable powers with regard to the conversion of a subsidiary into a branch operating from Cyprus in another EU member-state.

Firstly, the bank had to furnish the CBC with details of the proposed branch – its management, the business to be pursued, its structure, capital base and adequacy ratios.

Once in possession of this information the CBC had three months to convey it to the regulatory authority in the host country (i.e. Greece), which it did.

Secondly, the CBC retained the right at any time to impose new conditions on a foreign branch including revoking the original permission. Under Section 30 of the Banking Law the CBC could also set conditions on the scope of the branch and its network.

However, whilst having considerable powers, including that of revoking a branch's permission to operate these were constrained by other factors.

“Mr Costas Poullis, former head of supervision at CBC, stated in his interview that revoking the approval for Marfin Popular Bank to operate a branch in Greece, and therefore essentially terminating the bank's operations in Greece, was not an option as it would have had a significant impact on the confidence of the banking sector,” (Quote of report from Cyprus Mail 5 April 2013 [Psyllides 5 April 2013](#)).

The effect of the merger was to give the CBC greater regulatory control of MEB.

This came at a price in that the change from subsidiary to branch shifted responsibility for MEB's liabilities and recapitalisation needs to MPB. It also shifted Depositor Guarantee obligations and possible contingent liabilities associated with MEB to the Cypriot regulator and the Cypriot state.

The report seems to argue that as MEB's parent company MPB would have been on the hook for its liabilities in as much as there would have been political pressure to recapitalise whatever the legal liability so that, says the report, 'in real terms the liability to recapitalise the bank may not have changed.'

The one point where the report raises more explicit concern with the merger is the way in which it reduced post-merger restructuring options in the event of insolvency. The report says,

Post the merger restructuring options in the case of insolvency were reduced; while this would not necessarily be a primary consideration for a business when deciding on whether to operate a branch or subsidiary, a regulator should always consider the full implications of any actions taken by the institutions it regulates.

In terms of the CBC's knowledge of MEB's potential liabilities the report refers to the joint CBC/BOG inspection of 2009 and the BOG letter in response to the CBC's request for an opinion of MEB weaknesses in 2011 (see above for details).

The report states that other than these enquiries,

The CBC did not undertake any additional joint or independent review of the MEB's data until after the merger was finalised despite the

findings from the onsite review ... [a]nd the concerns raised by BOG in March 2011.

With regard to the legal powers of the regulator the report concludes that under Merger law the CBC did not have a say in the merger. Whilst under Banking Law it could basically either approve or prohibit the setting up of a foreign branch operation (although it does seem to have had more discretionary powers than is perhaps alluded to in the conclusion).

The report says that the CBC approved the branch establishment in part 'given the desire to maintain the bank's headquarters in Cyprus and the perceived regulatory benefits.'

In the final paragraph the report concludes,

"Based on the findings of the investigation, it would appear that the current regulation and legislation does not provide sufficient support to the CBC where a Cypriot bank wishes to convert an existing foreign subsidiary into a branch." (Quoted in Cyprus Mail 5 April 2013 [Psyllides 5 April 2013](#)).

Gabriel Sterne's Exotix Analysis of the MPB merger

In his detailed analysis of the Cypriot banking sector in July 2012 Sterne gives four possible reasons for the Central Bank of Cyprus's apparent acquiescence in the merger of MPB and MEB and the change in status of MEB from Greek subsidiary to Cypriot branch (see Sterne 2012, [EU Olive Branches? Cyprus, its banks, and their Greek operations](#)).

'First, we think the Cypriot regulators may have sought an increase in their legal authority to act on considerable dissatisfaction with the performance of the management.' This is borne out by the Alvarez & Marsal report above.

'Second, it appears to us the Cypriot authorities may have underestimated Greek vulnerabilities and Cypriot banks' exposure to them.' This needs to be examined further but there is clear evidence that MEB had major vulnerabilities as revealed in the joint inspection by CBC and BOG in 2009 and the letter from BOG to CBC prior to the merger (see above).

Third, he argues that the Cypriot authorities may have calculated that Laiki Bank was not completely protected from Marfin Egnatia Bank's liabilities by the bank's subsidiary status.

As such the CBC may have considered it better to grasp the nettle of future recapitalisation needs once and for all rather than have Laiki Group (and the CBC as back-stop) exposed to a growing drip-drip recapitalisation bill.

The Olivarez & Marshal report tends to support this position.

Lastly Sterne speculates that, ‘the Cypriot authorities may have correctly anticipated that Europe would not allow Cyprus to carry [alone] the burden of losses on Greek operations.’ Although as he adds,

‘It is hard to envisage how such assurances could have been given in advance given the legal quagmire that would have needed to have been negotiated absent a euro-wide agreement, but perhaps some comfort was provided.’

The CBC in an invidious position

By the time of the MPB/MEB merger the CBC had been placed in a pretty invidious position.

The initial MPB decision to merge the Cyprus operations into the Greek one would have reduced the CBC’s regulatory power to that of an onlooker.

The outcry amongst MPB’s Cypriot stakeholders to block the initial Cyprus-into-Greece merger decision was a considerable victory. Political ‘and other’ pressures were brought to bear and concerns were raised about reputational damage to Marfin Popular Bank and economic loss to the Cypriot economy.

As a consequence the MPB changed its mind and now sought a merger in the opposite Greece-into-Cyprus direction.

Having achieved their ‘victory’ I suspect the Cypriot stakeholders within and outside the bank would have been outraged if the CBC had blocked the creation of Greek branch.

The CBC certainly had access to enough information to know the outlines if not the exact detail of the regulatory challenge and liability burden it was taking on. But it would have been under immense pressure to approve the creation of the branch bank in Greece. And there was good legal precedent to support an interpretation that such a move with regard to liability formalised the parent bank implicit liabilities.

Of course, Central Banks within the euro zone are supposed to answer to the European Central Bank and be immune to domestic political pressures but this is rarely the case in reality.

Nevertheless it was a momentous decision.

Conspiracy Theories?

A conspiracy theorist at this point might suggest that in retrospect the MPB Board’s initial merger decision was a bluff designed to create the momentum for a merger in the opposite direction.

But it is hard to see what advantage this gave to MPB. Vgenopoulos had alleged unfavourable treatment of MPB and had argued that CBC capital requirements were too strict compared to European counterpart requirements. And now both parts of the bank – MPB and MEB – were to be regulated by the CBC.

Perhaps there were tax advantages but it is hard to see them outweighing the loss of prestige suffered by Boardroom defeat. And in any case the bank was making spectacular losses.

5. LAIKI BANK: COUNTDOWN TO DISASTER

Averting disaster? The meeting between Mario Draghi, the CBC and the Cypriot Finance Minister

Sterne (above) notes a meeting took place between the Governor of the Cyprus Central Bank, Athanasios Orphanides, Cyprus Finance Minister, Vassos Shiarly, and Mario Draghi, President of the European Central Bank on 17 April 2012.

[Bloomberg Orphanides 23 April 2012](#) reported on the meeting and subsequent developments:

The newspaper Politis reported on April 18 that Shiarly and Orphanides had met with European Central Bank President Mario Draghi to discuss [a] plan, under which the Cypriot and Greek operations of Cyprus Popular Bank, formerly known as Marfin Popular Bank, would be separated, making its Greek-based unit eligible for Greek bank recapitalization aid.

Finance Minister Shiarly is reported as saying that a plan that would allow Cypriot lenders access bailout funds earmarked for the recapitalization of Greek banks was “one of the measures being examined.” He added that obtaining approval would be difficult and that this option was not one that could not be “quickly implemented.”

The Bloomberg article also reported Shiarly saying that the Cypriot government was also considering guaranteeing loans and issuing bonds for bank recapitalisation as complimentary or alternative strategies.

Shiarly is quoted as saying,

“It wouldn’t be proper to discuss the method of the recapitalization or the order of preference as this is a subject of negotiations,” he said, adding that any rescue would be done in a way “that won’t affect markets.”

His comment of the method of recapitalisation and 'the order of preferences' is interesting. This draws our attention to alternatives and political factors that were coming to bear on the recapitalisation alternatives in April 2012 (see).

Sterne (above) summarises the plan put forward at the meeting,

basically [it] entailed setting up a 'bad bank' in which to transfer some assets of Greek operations. ... [T]his bank would then receive support from the Greek government, which would assume its control. This would probably mean the [Marfin] Popular Bank leaving Greece although it would still incur the losses from its exposure to Greek sovereign debt.

Added 15 May 2013 [Reuters](#) quoted a senior Laiki source on 18 April who said,

"We think there is good reason to treat Popular like a Greek bank and to partake in the liquidity and capital support available to Greek banks in so far as its activities in Greece are concerned, since it was a subsidiary of a Greek bank until March 2011,"

Ironically when the Greek bank rescue plan was first mooted in 2008 the first three banks to officially respond to it were Marfin Popular Bank, Marfin Egnatia Bank and the Investment Bank of Greece.

In a statement the three banks, all part of Marfin Investment Group said, "Marfin Popular Bank, Marfin Egnatia Bank and Investment Bank of Greece do not need and do not intend to use any state aid of any nature whatsoever."

The Politics of Recapitalisation

At this point Laiki had two options.

The first was to push for a de-merger of Laiki Bank's Greek operations or some other type of carve out (see below) such that the contingent liabilities in its operations would be pushed back to the Greek regulator and government and towards the euro zone recapitalisation funding that available to Greek banks.

This de-merger option was dependent on agreement from the European Central Bank that the European Financial Stability Facility funds bound for Greece could be used to recapitalise the de-merged Greek operations of Laiki Bank.

The downside of this was that Laiki would lose its large but debt-ridden Greek operation via their acquisition by a Greek bank.

Given the uncertainties regarding the possibility of direct recapitalisation of banks under the European Stability Mechanism that Sterne discusses the de-

merger option might only have been possible via a rapid knock-down-price sale of Laiki's Greek operations to a Greek bank prior to recapitalisation.

The other option was to attempt a recapitalisation of the whole Laiki group through, in effect, a takeover by the Cypriot state.

This had the advantage that it maintained the prestige of Laiki Bank and would have protected it from a fire sale of its Greek operations.

Added to this was the complicated mix swirling about in Cypriot politics at the time with the carousel-like blur of personnel entering and leaving key positions in the Central Bank and Finance Ministry.

Firstly Athanasios Orphanides term at the Central Bank of Cyprus was renewed. He was replaced on 3 May 2012 by the relatively inexperienced Panicos Demetriades, a former Professor of Financial Economics at the University of Leicester who but for a five-year stint (1985-90) in the Economic Research Department of the Central Bank of Cyprus had pursued his career in UK academia.

At the Finance Ministry there was no leadership continuity at all. The Finance Ministers and their terms were:

29 February 2008 -5 August 2011: Charilaos Stavarakis. Dismissed by the president on 5 August 2011. President Christofias publicly vetoed spending cuts supported by Mr Stavarakis in 2009 (Wikipedia: Charilaos Stavarakis).

5 August 2011- March 2012: Kikkis Kazamias, an AKEL career politician. Resigned for health reasons.

23 March 2012 - 28 February 2013: Vassos Shiarly - with a long career in the Bank of Cyprus.

Recap wins over de-merger and sale option

For whatever reasons it appears that the state-backed recapitalisation option won or simply became the default programme.

On 30 June 2012, five days after Cyprus had finally requested a bailout from the European Commission just a few days after all three major rating agencies had reduced Cypriot government bonds to junk status and with the deadline to meet EU bank capital rules looming the Cypriot state bailed-out Laiki with a €1.8bn share purchase that gave it an 84 per cent holding in the bank.

The bailout was approved by a Decree issued by the Minister of Finance on May 18 2012 and under its conditions Laiki announced that with consultants, KPMG UK, it had completed and submitted to the Central Bank of Cyprus a comprehensive five-year Restructuring Plan of the Group's operations. ([Laiki press release](#) First Half Year Results 2012).

Seven new directors were appointed and Michalis Sarris became the new non-executive chair.

Whether the state-sponsored recap route was an active and thought-through decision or the only option left on the table under rapidly reducing wiggle room is a moot point.

I personally favour the later interpretation particularly as Cyprus's assumption of the six-monthly EU presidency was to begin on July 1st 2012 and created further distraction and pressure on the machinery of government.

The new Laiki directors were horrified by what they found ([Reuters Noonan 2 April 2013](#)),

The board were taken aback by size of the problem at Laiki. "I found what I did not expect to find," said one board source, describing how the bank was already relying on the Cyprus central bank for more than 9 billion euros of emergency funding that had to be renewed fortnightly.

In April 2013 an un-named 'very senior executive' at Laiki Bank claimed that the Cyprus 'side' of the bank did not have information about the bank's total exposure to Greek corporate loans until 2011,

'This only came to the surface in 2011 when all the credit committees were merged. So we looked into the loans and realised what was going on and said, 'What is this?' We had lots of arguments about it.'

(The credit committees presumably only came together as a result of the March 2011 cross-border merger).

In the same programme Efthimios Bouloutas , Laiki Chief Executive at the time of the merger denied that this was the case (see BBC World Service, [The Bank that Brought Down Cyprus](#)).

The consultancy group, KPMG, were brought in to devise a radical restructuring of the bank. At first it was proposed to sell-off assets and put bad loans into an asset management company. This was rejected by the troika that had concerns that Cyprus could foot the bill for the bad bank.

In late 2012 the chief executive of Laiki, Christos Stylianides, who had appointed in December 2011 as Bouloutas' replacement went on sick leave. An acting CEO was appointed, Takis Phidias, who was the head of Laiki's life insurance arm.

620 staff, mainly in Greece, were laid off, branches were closed, costs were trimmed and assets were prepared for sale.

Stylianides came back from sick leave in early 2013 and clashed with the board who 'wanted him to quit so the bank could make a fresh start.'

KPMG put forward a plan B that involved creating a 'carve-out' by pushing the healthy parts of Laiki,

'into a new subsidiary that could be sold once it was freed from the long shadow cast by Greece, which was to remain in the bank's main holding company' ([Reuters Noonan 2 April 2013](#)).

Catastrophe

From this point on the fate of Laiki bank was sealed. Christofias had been holding out for a euro zone recapitalisation that focussed only on Cyprus's banks but the Commission was having none of it. With state finances in tatters the only bailout on the table offered limited bank recapitalisation and an onerous restructuring and reform of public finances from EU officials long weary with the procrastination and halting reforms of the Cypriot president and government.

With a massive Emergency Liquidity Assistance (ELA loan of €9.2bn that was being rolled over against an €20bn pile of Laiki collateral on a fortnightly basis it was questionable as to whether the bank met going concern regulations (see the Auditors' note on this in the 2011 Annual Financial Statement).

The last straw came with the rating agency downgrades of Cypriot debt. The knock-on effect of which was to render Cypriot government bonds unacceptable as bank collateral against refinancing loans by the ECB (see FT Wilson, Dombey and Spiegel [25 June 2012](#)).

Thus, Laiki bank could not use its €1.8bn of government backing as collateral with the ECB.

President Christofias in belligerent, not to say delusional, mood threw down so many un-crossable 'red lines' that it was impossible to reach a bailout agreement until he had been democratically shunted from his position in March 2013. By then, and without a counter-party with whom to plan the bailout, the die was cast.

The growing impatience of EU officials, the internal divisions in the troika, the influence of the German electoral cycle, the rise of new-kid-on-the-block, Jeroen Dijsselbloem, as Chair of the Eurogroup of finance ministers, the re-emergence of a more rigorous approach at the IMF under Christine Lagarde and the lack of preparation, divisions and continued dalliance with Russian help in the Cypriot negotiating team led to a bungled and botched bailout.

6. THE FIRE SALE OF THE GREEK BRANCHES

With amazing rapidity following the finalisation of the bailout on March 25th 2013 the entire Greek operations (312 branches and 5,268 staff) of Laiki,

Bank of Cyprus and Hellenic Bank were sold. [Reuters](#) estimated that this represented a tenth of the Greek banking market.

The Greek Central Bank sought bids for the Greek operations of the Cypriot banks and Piraeus emerged the winner.

A press release from [Piraeus Bank](#) of 26 March 2013 said,

Piraeus Bank signed an agreement today to acquire all of the Greek deposits, loans and branches of Bank of Cyprus, Cyprus Popular Bank and Hellenic Bank including loans and deposits of their Greek subsidiaries (leasing, factoring and the Investment Bank of Greece) for a total cash consideration of €524m.

The press release produced the table below, which shows the assets, gross, and net loans and deposits Piraeus Bank took on in the sale.

This suggests that Piraeus bank took the entire Greek loan book of the Marfin Egnatia/Cyprus Popular Bank. A note below the table says that the net loans of €16.2bn includes expected losses 'determined by the review of international specialized firm.'

	Piraeus Group	Greek operations of the 3 Cypriot banks	Piraeus Bank Group Post Transaction
Balance Sheet (€bn)			
Assets	78.6	16.4	95.0
Gross loans	50.0	23.9	73.8
Net loans	44.0	16.2*	60.2
Deposits	35.1	15.0	50.1
Financial Ratios (%)			
Net loans / deposits	125%	109%	120%
>90dpd / gross loans	21%	38%	26%
>90dpd coverage ratio	58%	85%	70%
Loan loss reserves / gross loans	12%	32%	18%
Footprint / FTEs (#)			
Number of branches	1,348	312	1,660
Employees	18,801	5,268	24,069
Market Share in Greece (%)			
Gross loans market share	18%	9%	28%
Deposits market share	19%	8%	27%

The forced sale of the Cypriot banks' Greek operations happened so quickly that it has been hard to gather any detail about it.

What we know is that:

1) The forced sales of the Greek operations of Laiki, Bank of Cyprus and Hellenic Bank were carried out through the decrees issued on 25 March 2013 and 29 March 2013 by the [Central Bank of Cyprus](#) in its capacity as the Resolution Authority, through the powers vested under the *Resolution of Credit and Other Institutions Law, 2013*.

2) Piraeus Bank's purchase of the Greek operations was directly funded by Greece's bank bailout fund - the Hellenic Financial Stability Fund ([Reuters 26 March 2013](#)).

The €524m for the Cypriot acquisitions will be supplied by the HFSF in exchange for shares, an official at the fund told Reuters.

3) The Greek finance ministry also pledged to inject €1.5bn of new capital into the combined Greek operations of the Laiki and Bank of Cyprus before they were taken over by Piraeus Bank ([FT Hope 22 March 2013](#)).

4) Piraeus Bank was a direct beneficiary of the EU recapitalisation of Greek banks in May 2012 and received €4.7bn bonds from the European Financial Stability Fund via the Hellenic Financial Stability Fund in May 2012.

These bonds were designed to act as collateral which would allow the banks involved to regain access to the ECB's liquidity operations at cheaper rates than under the emergency liquidity assistance. This mechanism was denied banks in the Cyprus bailout ([FT Hope 28 May 2012](#)).

5) Piraeus Bank was expected to benefit from a further recapitalisation from the Hellenic Financial Stability Fund (HFSF).

Greek banks including Piraeus will themselves be recapitalised to shore up their solvency ratios. Most of the cash injection will be provided by a state bank bailout fund - the Hellenic Financial Stability Fund (HFSF).

Piraeus's capital needs have been estimated by Greece's central bank at 7.3 billion euros.

([Reuters 26 March 2013](#) Georgiopoulos, Papadimas and Noonan)

6) Piraeus expected to close half of its expanded network of 1,600 branches ([FT Chaffin 26 March 2013](#)).

Added 15 May 2013

7. MARFIN EGNATIA BANK AND PIRAEUS BANK: LOANS FOR SHARES

In a Reuters report of [16 July 2012](#) reporters in Greece claimed that they had seen audit documents that showed that Marfin Egnatia Bank (MEB), the Greek subsidiary of Marfin Popular Bank (Laiki) had agreed in May 2009 a loan facility of €150m to Michalis Sallas, the one-time chair of Piraeus Bank (he was non-executive chairman at the time of the article in 2012).

It appears from the report that Sallas and family members utilized most of the €113m of this facility that was drawn down to buy shares in Piraeus Bank.

The shares were purchased by the Sallas family through three separate Cyprus-based companies. Ownership was then switched to two Greek companies linked to the family.

MEB 2012 audit documents seen by Reuters record the two companies, Benidver and KAEO as being owned respectively by Sallas' daughter, Myrto and son George. The article states,

'Internal Marfin auditors said [in 2012] that executives at MEB had "failed to act in the best interests of the bank" by granting successive loans to Sallas to buy his own bank shares. By 2011 his investment in those shares, the auditors found, had "dire prospects" and had been made through special purpose vehicles and with no personal guarantees'.

The article suggests that the purchases through the MEB loans may have brought the Sallas holding of Piraeus shares to above 5% of the bank's ordinary stock, which would normally trigger a public declaration. However, there was uncertainty as to the status of family member holdings of shares with regard to a consolidated share holding.

Again according to the article, nearly one-fifth of a Piraeus €800m-rights issue in January 2011 was raised with 'financing from other Greek banks – including another 20 million euros or so loaned by MEB bank to investors.'

These figures would suggest that around €130m of MEB loans were used in January 2011 to buy shares in Piraeus Bank. The loans to the Sallas family were apparently 'ranked amongst its [MEB] riskiest exposures' according to MEB audit reports.

Apparently the MEB loan facility to Sallas was 'signed off by the Marfin group's Andreas Vgenopoulos, then executive vice-chairman' in May 2009.

Previous to publication of the Reuters' article Sallas issued a statement to the Greek media attacking Reuters and accusing the news agency of "slandering" and "undermining" the bank.

Andreas Vgenopoulos, former chairman of Marfin Popular Bank, has denied conflicts of interest alleged by a Greek parliamentary inquiry and Cypriot lawmakers.

The report quotes Louka Katseli, professor of economics at the University of Athens and former Greek minister of economy,

"This (the Greek financial system) is a closed circuit, operating as a system of power with no transparency and effective supervision. Through triangle deals between banks, businessmen and other banks, capitalization requirements were fulfilled without new money injected."

It is interesting to note that two months after the Piraeus rights issue in January 2011 MEB, though the cross-border merger detailed above had been rendered from a Greek subsidiary into a Cyprus branch of Marfin Popular Bank. This cross-border merger was a compromise after the Board of Marfin Popular Bank had initially attempted to merge MPB into MEB, thus making the whole bank a Greek-based and regulated bank. Spirited opposition from share- and stakeholders within MPB managed to reverse this decision.

It is also interesting to note that on March 2013 Piraeus Bank purchased the combined Cypriot bank networks in Greece for €524m. This included the former Marfin Egnatia Bank which represented about 50% of Laiki's loan operations. The purchase was funded by the Hellenic Financial Stability Fund, which itself was funded by the [European Financial Stability Facility](#).

8. LAIKI'S OBLIGATIONS TO THE CENTRAL BANKS OF GREECE AND CYPRUS 2010-11

Update Note 29 April 2013: I have added 2009 figures to Tables 2 and 3 below to check that the 2010/11 figures were not an aberration. They were not.

This section of the paper looks at changes in Marfin Popular Bank/Laiki's obligations to other banks between 2010 and 2011 – that is, pre and post- the MPB/MEB merger.

Table 2 below the distribution of MPB/Laiki money due-to-other-banks between interbank borrowing, obligations to Central Banks and repurchase agreements for 2010 and 2011.

It can be see that while total due-to-other-banks falls slightly the percentage of that total accounted for by obligations-to-Central-Banks rises dramatically from 65 to 90 per cent from €6.9bn to €9.3bn.

Table 2: Laiki Bank: Money due to other banks by loan type 2010-11				
	Interbank borrowing	Obligations to Central Banks	Repurchase agreements	Total
2009 €bn	2.178	5.990	2.302	10.470
2009 % Total	20.8	57.2	22	100
2010 €bn	1.978	6.945	1.727	10.65
2010 % Total	19	65	16	100
2011 €bn	0.345	9.293	0.663	10.301
2011 % Total	3	90	6	100

Source: Laiki Annual Financial Statement 2011 Note 31 p.68 and 2010

Table 3 presents figures for the geographical spread of money due-to-other-all-banks 2010-11. Greece and Cyprus are the predominate location of these obligations.

The figures show a massive shift in the location of money due-to-other-banks from Greece to Cyprus between 2010 and 2011.

In 2010 the Greek operations of MPB/Laiki account for 71 per cent of the bank's money due-to-other-banks.

A year later the Greek operations of the bank account for just 37 per cent of total money due-to-other-banks while the Cyprus operations account for 63 per cent it.

Table 3: Laiki Bank: Money due to other banks by geographical region 2010-11				
	Cyprus	Greece	Other Countries	Total
2009 €bn	3.006	7.145	0.319	10.470
2009 % Total	28.7	68.2	3	100
2010 €bn	2.915	7.509	0.225	10.649
2010 % Total	27	71	2	100
2011 €bn	6.476	3.784	0.041	10.301
2011 % Total	63	37	2	102

Source: Laiki Annual Financial Statement 2011 Note 31 p.68 and 2010

Combining data from the two tables above we can see in Table Two that in 2010 MPB/Laiki owed €6.9bn to central banks and that the total of money due-to-other-banks in its Cyprus operations in 2010 was €2.9bn. This suggests that in 2010, other things being equal, the Cyprus operations of MPB/Laiki owed a maximum to the Central Bank of Cyprus of €2.9bn.

Again other things being equal this shows that an amount equal to or above that of the remainder of the bank's obligations to Central banks must have been accounted for by its Greek operations and have been due to the Bank of Greece. That 'remainder' due to the Bank of Greece in 2010 was at least €4.03bn

After the merger of Marfin Popular and Egnatia Banks that took place on 31 March 2011 the maximum amount that the Greek operations of the combined bank could owe to Greek Central Bank had been reduced to from €4.03bn to €3.783bn. Even though the total obligation to Central banks had risen from 65 to 90% of all money due-to-other-banks.

At the same time the Cypriot operations of the combined bank now had obligations to the Central Bank of Cyprus of at least €5.5bn – up from a maximum of €2.9bn the previous year.

It is my contention that these figures suggest a massive shift of obligations to central banks within MPB/Laiki from its Greek operations and the Bank of Greece to its Cyprus operations and the Central Bank of Cyprus between 2010 and 2011.

This would after all make sense in that with the transformation of the Greek-based MPB/Laiki subsidiary Marfin Egnatia Bank to a branch it lost its banking licence and hence its ability to borrow from a Central Bank (for MEB's loss of bank licence see [Alvarez and Marsal report](#)).

It is strange that this shift in the Central Bank obligations of MPB/Laiki that appears to be a consequence of the MPB/MEB merger is not picked up in the Alvarez and Marsal report.

I have tried to trace it in the [monthly balance sheet](#) reports of the Bank of Greece but the figures for Lending to/liabilities to euro area credit institutions are presented at aggregate levels and vary considerably month-to-month.

Subsequently it was revealed that Laiki Group had Emergency Liquidity Allocations of €9.2bn that were transferred from Laiki Group through the resolution process to the Bank of Cyprus.

It is reasonable to believe that most of the 'obligations-to-central-banks' shown in Table 2 above were in large part made up of Emergency Liquidity Allocations made by both the BOG and CBC that eventually totalled €9.8bn when Laiki was 'resolved'. By then, of course, all of this allocation had been extended by the CBC while none of it came from the BoG.

9. CONCLUSIONS

Conclusions (1) – the inconsistency of EU-funded bank recapitalisation

In July 2012 Gabriel Sterne presciently wrote in conclusion to his account of the bewildering decision of Marfin Popular Bank to merge its Greek subsidiary into its Cypriot parent,

Whatever the legal obligation, it seems to us wrong and unfeasible for one country's taxpayers to be expected to pay such a large proportion of their national income to bail out a bank for its operations in another country.

To do so would involve the preposterous situation in which Cyprus bears the highest fiscal burden of a bank rescue in the history of banking crisis even before a euro is spent bailing out lending to its own citizens

One thing we need to try and assess here is the extent to which (within the terms of the Cyprus bailout) Cypriot taxpayers and/or depositors in the Cypriot operations of Laiki and Bank of Cyprus are being expected bail out Laiki's operations Greece.

[Hugo Dixon](#) argues that euro zone officials insisted that the Cyprus bailout insulate the Greek banking system from contagion. He suggests that this imperative 'left the Cypriot banks little option but to agree a fire-sale of their Greek operations.'

However, in and of itself the transfer of Cypriot Greek operations with their large bad debt burden was unlikely to insulate the Greek banking system. Remember that the PIMCO report above forecasts that the losses on Laiki's former Greek new and existing loans could be €4.5bn under its now optimistic-looking Adverse Scenario.

This figure represents 65 per cent of Laiki's forecast Greek and Cypriot loan losses. Using a proportional conversion this would give a forecast recapitalisation for Laiki's former Greek operations of €2.5bn.

It is not surprising then that the Greek state pledged €1.5bn for the recapitalisation of the Greek operations of the Cypriot banks bought by Piraeus Bank. But this pledge looks like it falls €1bn short of the recap needs of the Piraeus purchase.

If we take the Laiki directors' estimate of recap needs for their Greek operations of €2.8bn (reported by [Hugo Dixon](#)) the gap increases to €1.3bn.

Presumably Piraeus Bank analysts were aware of the size of expected losses in their purchase from the Cypriot banks and also aware of the subsequent

capital shortfall and reflected this in the very discounted price bid for the Cypriot banks' Greek operations (Dixon above calculates that the sale price was about 19% of Net Asset Value).

Did this in effect transfer liability for €1-1.3bn of bad Greek debt to Cypriot tax payers/Cyprus Laiki/Bank of Cyprus uninsured depositors?

Or has all the bad debt in Greek operations been transferred to Piraeus Bank to perhaps be covered by further injections from the Hellenic Financial Stability Fund (which in turn is funded with EU EFSF funds)?

Dixon (above) argues that, 'exempting Greek deposits [in the former branch networks of the Cypriot banks] from the bail-in meant that the Cypriot [deposits] had to shoulder the whole burden [of the bailout] instead of only 63 per cent of it.'

But if all the Greek bad loans were transferred to Piraeus Bank is this the case? Isn't it more likely that this portion of Laiki Group's debts will in fact be written off and recapitalised using EU EFSF funds through the Hellenic Financial Stability Fund?

If this is the case this it is not such a bad thing is it? Whilst on the surface EC officials are saying a big fat 'No' to the use of euro zone funds for bailing out the 'despicable' Cypriot banks they are under the surface facilitating exactly that. But only in their 'less despicable' Greek operations (and other bits as well as we shall see later).

The only trouble with this wheeze (which nicely ducks beneath the radar of the populist press in Germany) benefits Greek depositors (who face no haircut on their Laiki uninsured deposits) much more than it does Cypriots depositors (who do).

There is more than a little of inconsistency here. After all, if Laiki depositors are being punished in Cyprus for the recklessness of Laiki's executive team, (who for much of the reckless period were led by a Greek management team) why shouldn't Greek depositors also be 'whacked', as Hugo Dixon puts it?

On this note, and as an aside, it is one of the great and inglorious ironies of the Cyprus bailout that the Marfin Popular Bank Chief Executive, Efthimios Bouloutas, who presided over the cross-border merger should have been awarded the sum of €941,000 on his departure from Laiki in December 2011 (in a package totalling €1,543,000) that was paid in accordance with 'the provisions of Greek Labour Law?' (Laiki Annual Financial Statement 2011 p. 122)

I think that what we see developing here is one aspect of the political fix that lies at the heart of the Cyprus bailout.

Contagion in Greece embodied in the threat of depositor haircuts, runs on banks, and the controls on capital movement had to be avoided at all costs.

The fix used to avoid that contagion was a nifty workaround that by-passed (or made a mockery of) the prohibition on using EFSF funds for the recapitalisation of Cyprus's bad banks and their bad (aka 'Russian') depositors. Instead of loaning the money to Cyprus the Greek operations of Cypriot banks were summarily chopped-off (or 'carved-out'ⁱ in the Cyprus [Memorandum of Understanding](#)) and sold at a knockdown price to a Greek bank, and refinanced with euro zone funds in Greece.

And while hostile German politicians (from the at-least-consistent, Wolfgang Schäuble, to the horribly inconsistent SPD and Greens) were thrown the red meat of a massive bail-in for Laiki depositors in Cyprus, Greek depositors got off scot-free. And Mr Bouloutas, the ex-CEO of Marfin Popular, got his €941,000 pay-off because he was covered by 'Greek Labour Law'.

In addition to the avoidance of contagion the forced sale of the Greek operations of Cypriot banks was also designed to contribute to the rapid downsizing of the Cypriot banking industry. It did this by reducing 'the size of the Cypriot banking sector by 120 per cent of GDP' [Debt Sustainability Analysis](#) p.9.

Conclusions (2) – the final resting place of those Obligations to Central Banks

So if the Piraeus buy-out did at least take on the debt burden of the Greek loans of the Cypriot commercial banks what about the apparent transfer of all that money-due-to-central banks explored above?

While we do not have direct evidence to conclusively show that central bank borrowing, and in particular ELA borrowing by Marfin Egnatia bank from the Greek Central Bank, was transferred to the Marfin Popular Bank and the Cypriot Central Bank as a consequence of the MPB/MEB merger the figures in Laiki's Annual Financial Statement of 2011 in Tables 2 and 3 above point in this direction.

Since then the massive €9.2 of ELA racked up by Laiki bank in its Greek and Cypriot operations has been transferred to the remnant Bank of Cyprus as a life-threatening burden that will be met from uninsured deposits in Cyprus (but not Greece).

Hopefully light will be shed on all this through the [continuing work](#) of Alvarez & Marsal and the enquiry ordered by President Anastasiades to examine the collapse of Cypriot banking. ⁱⁱ

Conclusion (3) The contours of the Cyprus bailout/in map

When we take a closer look at the Cyprus bailout we find it is full of inconsistencies.

So, for example, and despite protestations to the contrary, EFSF and ESM funding are being used to bail out Cypriot banks. In the first instance this is being done through the workaround that stands behind the Piraeus Bank's takeover of Cypriot commercial bank Greek operations.

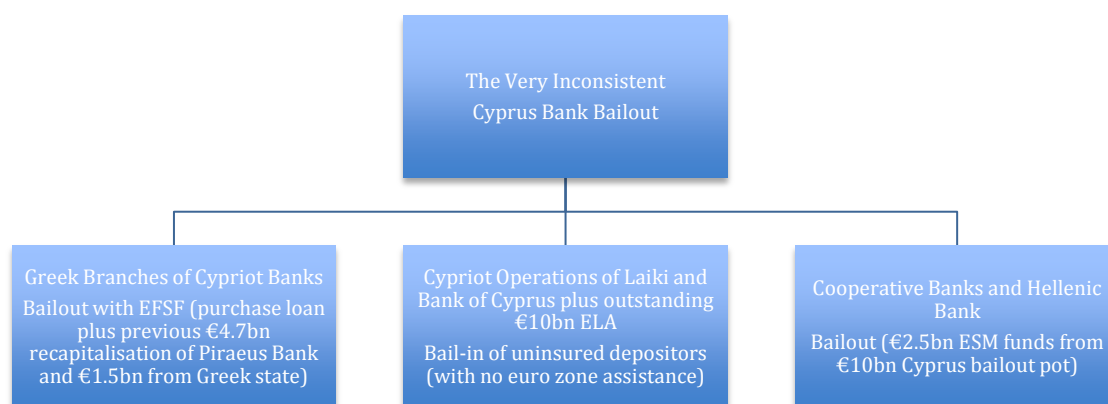
In the second place it is being done through the €2.5bn of ESM funding detailed in the '[Assessment of the actual or potential financing needs of Cyprus](#)' from DG Economic Affairs Provisional Draft 9 April 2013.

This 25 per cent chunk of the €9bnESM/€1bnIMF bailout funding will be available for the recapitalisation needs, under stringent conditions, of the island's cooperative banks and Hellenic Bank if restructuring and private capital-raising efforts cannot meet their targets.

But when we come to the domestic operations of Laiki Bank and the Bank of Cyprus these are not to receive any ESM or EFSF funding. Instead the resolution of the Laiki 'bad bank' and the recapitalisation of the rolled-into-one Laiki good bank/Bank of Cyprus are to be achieved solely through the bail-in of uninsured depositors with debt-for-equity deals (of dubious value) thrown in.

This seems wilfully inconsistent. First you bailout Greek deposits in Cypriot banks with EFSF funding and no haircut. Then you help out Cypriot cooperative banks and one commercial bank with ESM funding. But then you bail-in Cypriot and other-depositors-in-Cyprus in the Cypriot parts of the banks you have bailed out in Greece with absolutely no help from Europe. And then, to piss everyone off, you chuck all the Emergency Liquidity Allocation used to keep Cypriot banks in Greece afloat into the rapidly dwindling bail-in pot of the rolled into-one-Bank of Cyprus.

I've tried to represent that inconsistency in the diagram below.



Such inconsistency must have an explanation.

In the case of Greece it seems to have been inspired by the naked fear of the systemic risk posed for the euro zone inherent in the collapse of the Greek banking system and economy.

In the case of Cyprus's cooperative banks and Hellenic bank it seems to have been inspired by a genuine concern to break the doom-spiral between bank debt and sovereign debt.

And in the case of Laiki Bank and Bank of Cyprus it has been sold by saying that both banks were insolvent and needed resolution and that levels of Cypriot state debt prohibited further EU loans for recapitalisation.

Which is all well and good but why is it that it is only Cypriot and other-depositors-in-Cyprus in Laiki and Bank of Cyprus get to see up to 60 per cent of their deposits disappear forever?

On one level imposing a bail-in on those depositors was an expedient and opportunistic solution to a difficult problem (particularly as the euro zone is still years away from putting in place a banking union and common bank resolution procedures). And it was believed that it could be done without generating systemic risk for the euro zone.

But there was also a different objective and that was to avoid the accusation (particularly in Germany) of being soft on the vast amounts of Russian money deposited in Cypriot banks.

In the end, if you are a Cypriot uninsured depositor in Laiki or the Bank of Cyprus and your money is going up in smoke is that because of the ('Russian') company your deposits kept?

Or because you were in the right bank but in the wrong branch (i.e. the Cypriot branch and not Greek one) at the wrong time?

And if on top of that your deposits are being sequestered to pay off Emergency Liquidity Assistance funding that was used to keep afloat bad-loan-laden Greek operations suffering a deposit drain afloat is that consistent or fair with the treatment of Greek deposits in the self-same banks?

ⁱ The sale of the Greek operations of Cypriot banks is referred to in the [Memorandum of Understanding on Specific Economic Policy Conditionality \(provisional draft 9 April 2013\)](#) between Cyprus and the euro zone as the 'carve-out:'

'The carve-out has substantially reduced the cross exposures between Greece and Cyprus.'

A strange term. Wikipedia refers to an Equity Carve-out as ‘a sort of corporate reorganization, in which a company creates a new subsidiary and IPOs it [floats it on the stock exchange] later, while retaining control.’

There is nothing remotely similar about this definition of ‘carve-out’ and the forced amputation of the Cypriot banks’ Greek operations – a subsidiary was not created, it was not floated on the stock exchange through an Initial Public Offering and the parent company did not retain control.

ii Unfortunately two of the judges have already resigned, one to ill health, the other to a conflict of interest and AKEL Party leader, Andros Kyprianou, has hinted that the committee of inquiry is but a thinly-disguised political witch-hunt. [Cyprus Mail 23 April 2013](#) and [Cyprus Mail 24 April 2013](#).