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Central Bank Gets Blame for Cypriot Crash

By Yu Tanebe, J.D. Candidate 2017 | November 24, 2014

The release of a Cyprus government report this past week reveals the enduring difficulties faced by central banks of small European nations, in their efforts to stabilize fragile economies while promoting the monetary interests of the wider Eurozone.

The 40-page report, commissioned by Cyprus President Nicos Anastasiades, examined the 2013 collapse of the country's second-largest bank, the Cyprus Popular Bank, and the devastating effect it had on the Cypriot economy.

Drawing on undisclosed official documents, the report blamed the Central Bank of Cyprus (CBC) for masking the failing bank's problems. It alleges that the CBC ignored evidence that the bank was insolvent, in order to secure €10 billion of emergency loans from the European Central Bank (ECB).

Under ECB rules, a troubled bank that can no longer raise funds on the open markets is allowed to receive emergency liquidity assistance (ELA) from their national central bank. The ECB relies on the central bank to assess the solvency of the requestor. The central bank must disclose its methodology for valuing the requestor's collateral used to secure the credit, and can disburse ELA only to those deemed solvent.

Cyprus Popular Bank, having been heavily exposed to the despairing Greek economy, first applied for ELA in the fall of 2011. At the time, its depositors were increasingly withdrawing money, and the liquidity ratio of the bank had fallen well below the minimum required threshold.

Fearing the wider chain effects from the bank's failure, the ECB's governing council, consisting of the Eurozone's 18 central bank governors and six executive board members, approved the emergency loan request.

Still, Cyprus Popular Bank reported a €3.3 billion loss for 2011 that wiped out its equity, which forced its auditor, PricewaterhouseCoopers, to refuse signing off on the financial results unless it received a letter of guarantee from the government. By the bank's own analysis, "the core Tier 1 regulatory capital ratio was negative."

And while there were plenty more ominous signs, the CBC insisted on keeping the failing bank on a lifeline. There are allegations that the CBC employed alternative valuation techniques that overstated the bank's collateral by €1.3 billion in assets. In effect, inflating the value of Cyprus Popular Bank's collateral would allow the failing bank to secure more emergency loans.

But the CBC was not alone in doing a poor job. In fact, there are indications that this very approach was suggested from within the ECB. Confidential communications from the ECB now suggest that a member of its executive board advised against Cyprus Popular Bank using government bonds to secure more loans, and instead suggested, "The Central Bank of Cyprus has

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in principle the possibility to apply less stringent valuations and haircuts compared to the approach followed by the Eurosystem in credit operations."

Panicos Demetriades, the CBC governor who resigned in March 2014, contends "[The bank] was dynamically solvent since there was a credible plan to recapitalize it." His predecessor, Athanasios Orphanides, also said in his own statement, "[T]he bank was solvent and posted adequate collateral, the rules were properly followed."

The ECB released a statement in October 2014 claiming, "The ECB fully relied on the assessment of the Central Bank of Cyprus" that Cyprus Popular Bank was solvent. It further claims that the CBC confirmed the proper valuation of the bank's collateral.

In the end, the ECB had approved nearly €10 billion in short term loans to Cyprus Popular Bank, an amount equivalent to two-thirds the size of the Cypriot economy. In March 2013, the bank was finally wound down as part of an ECB bailout that was financed largely by a haircut imposed on Cypriot deposit holders.

That the ECB would be willing to ignore its own bylaws and dictate policy to sovereign governments to prevent wider financial contagion is troubling. The ECB's core principles are that central banks are independent, and that it won't become involved in the rescue of a failing or bankrupt bank or government.

The Cypriot case sets a worrying precedent in the Eurozone, and reveals the realities of divisional power – perhaps most importantly, that a nation's central bank is only notionally independent. The ECB's governing council, in determining monetary policy in the interests of the wider Eurozone, has the capacity to dictate a country's monetary decisions, while disclaiming any responsibility for potential failures.

The CBC has proved to be an easy scapegoat for domestic politics as well as the ECB. Such positions are untenable, and undermine the central bank's dual-capacity to act in the interests of the nation's struggling economy, and the wider Eurozone as a whole.