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Financial & Fiscal Features Newsletter

IREF — Fiscal Competition & Economic Freedom

INSTITUTE FOR RESEARCH IN ECONOMIC AND FISCAL ISSUES

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Secondary market volumes in US Bonds reducing sharply; parallels with 2006-8 subprime. What does this imply for Europe?

CENTRAL BANKS

by Gordon Kerr and John Butler, with Enrico Colombatto

Most media optimism, both in the US and Europe, continues to focus on the dizzy levels of stock and bond markets, but in our view these index levels have been driven up by professionals front-running QE in the US and Europe.

Critics of US central banking policies are increasingly pointing to the perverse reaction of markets to data. Whereas traditionally markets would fall when poor data are announced, US data has been particularly disappointing of late and yet the markets have boomed this year. We can now dispel the excuse that the unexpectedly poor winter GDP performance was weather related. Furthermore, the continuing slump gives credence to our then observations that prior, better data had not

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Bulgaria's 2014-15 Unique Banking Crisis: Liquidation of its probably solvent Corporate Commercial Bank (CCB).

FINANCIAL MARKETS

by Gordon Kerr and John Butler, with Enrico Colombatto

In the past month, a Bulgarian court appointed two experts to liquidate the assets of CCB (known also by its Bulgarian initials KTB). This marked the end of a rather remarkable story that began in June 2014, when the rest of the Eurozone banking system was enjoying a period of relative calm.

Initial trigger

Public concern about CCB was obvious by last June, when there was a run on deposits, with 20% of its entire deposit liabilities withdrawn in a week. Mainstream media attributed these events to public disquiet at the reports of allegedly shady dealings by the bank's largest shareholder, Tsvetan Vassilev, and public pronouncements by the Bulgarian Central Bank (BNB) that it was worried about CCB and concerned that undocumented loans had been made. The public prosecutor quickly became involved and issued statements further undermining confidence in the owners/ senior management.

On June 20th the bank was shut down by the authorities and quaestors (individuals selected by regulators to act as

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CENTRAL BANKS

(cont'd) Secondary market in US Bonds...

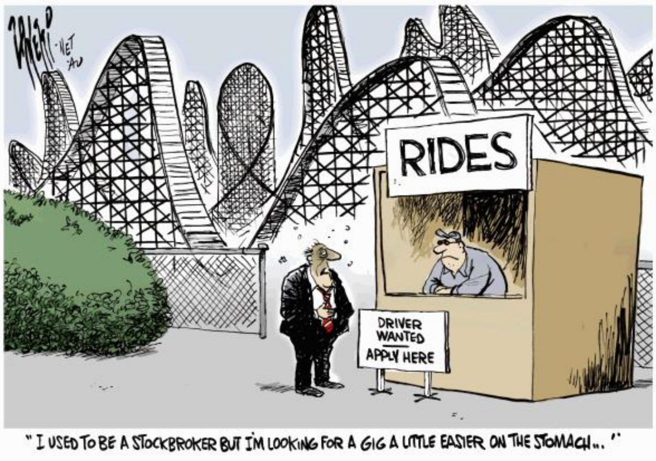
been adjusted by supporters of QE for inventory increases. We remain of the view that QE has merely created a huge bubble that will deflate before long. Perhaps this will occur in the US before it does in Europe: after all, they started 6 years earlier.

Strong evidence of the scale of the problem can be seen from the slump in volumes in US secondary bond markets. The parallels with 2007 –8 are stark. The significance is this: Whilst it is obvious that central banks can and do engineer healthy looking price levels in financial markets, they are far less able to suppress the obvious reduction in investor confidence revealed by the drying up of secondary bond markets. The organisational structure of global capital markets ensures that the last market to freeze up will be the new issue bond market, but in 2008 the primary market for US subprime mortgages eventually did freeze. Astute watchers had predicted this by observing the effective closure of the secondary markets a few months earlier.

European authorities and the IMF are worried. There is now probably insufficient secondary market liquidity to provide for asset managers in the event there is a general desire to sell. Banks used to provide a buffer as they would be able to raise inventory but they are now insufficiently capitalised so to do.

> *We remain of the view that QE has merely created a huge bubble that will deflate before long. Perhaps this will occur in the US before it does in Europe: after all, they started 6 years earlier*

Further evidence is provided by the recent surge in bond volatility generally. In German bunds, the substantial rise in bond yields over the past couple of weeks has resulted in losses wholly disproportionate to the implied returns; bonds are supposed to be a store of value but are now exceptionally risky with secondary market volatility at these levels.



> *Regulators increasingly recognise the 'unintended consequence' of their supposedly 'macroprudential' policies, which really*

Now that banks are insufficiently capitalised to perform their market-making functions, the secondary bond markets are in disarray. Regulators increasingly recognise that this is an 'unintended consequence' of their supposedly 'macroprudential' policies, which really just amount to a game. They move the excessive debt/leverage from one place to another with each new policy. So they are beginning to realise they have created another monster but don't know what to do about it. ■

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(cont'd) Bulgaria's Unique Bank Crisis...

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trustees on behalf of the Bulgarian taxpayer and other stakeholders). The quaestors' job was to scrutinise the books and determine whether the bank was a going concern or whether officials had inflated values of good assets and suppressed expected losses. Rather than searching for further liquidity for CCB, the quaestors

Sofia, 20 June 2014

turned to new auditors (Ernst and Young, Deloittes and local firm AFA) and commissioned a solvency report.

Whilst the report was being prepared, nothing happened to allay the disruptive effect of the quaestorship on the bank's depositor and overdraft customers. Those depositors who had not been lucky enough to get out before June 20th lobbied for the central depositor fund to pay out. But their request was turned down on the grounds of the quaestorship. Frustration among small and medium sized business customers rose as overdraft promises were not honoured. Moreover, deposit accounts remained frozen, resulting in domino defaults among trading partners, and businesses being unable to pay employees.

Interim government vs. Quaestors

These problems only worsened when the government of Prime Minister Plamen Oresharski resigned on July 23, and October 5th was set as the date for new elections. The caretaker officials ap-

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(cont'd) Bulgaria's Unique Bank Crisis...

pointed by the President saw their remit as so narrow that they were never going to get involved, leaving the quaestorship to run under the broad supervision of the central bank - BNB. Even the European Commission was worried about the destabilisation effect on the Bulgarian economy, and wrote a letter urging that the depositor fund pay out guaranteed deposits – up to the local currency equivalent of euros 100,000, stating that if this was not done the Commission itself might take legal action against Bulgaria and noting that depositors could sue the Bulgarian government. The Bulgarian authorities just ignored this.

The stasis continued until October, when the auditors finally wrote to the quaestors. The quaestors cited this document in their recommendation to the BNB to wind up the bank, and the BNB applied for such a court order in November. This provoked a slew of legal actions from bondholders and shareholders – Mr Vassilev (54%), Oman's sovereign wealth fund (30%), VTB bank of Russia (9%), and also from large depositors. Why? Because none of the litigants believed the bank was insolvent at all. The BNB then became worried that this litigation would succeed and expose their actions to public and ECB/ EBA (European Banking Authority) scrutiny, so they delayed the process of appointing liquidators. By April they realised they had little option but to complete that process.

None of the litigants believed the bank was insolvent at all. The BNB then became worried that this litigation would succeed and expose their actions to public and ECB/ EBA scrutiny, so they delayed the process of appointing liquidators.

Indicators of actual good health

In asserting that the bank was always solvent, litigating stakeholders have alleged the following:

- That the original auditors, KPMG, gave the bank a clean bill of health on June 10th in documents that had to be filed when CCB acquired a local affiliate of France's Credit Agricole;
- That until mid-June the BNB had issued comforting (if lukewarm) statements about CCB's health, but was pressed to change its stance by the Office of the Public Prosecutor;
- That the October auditors' document upon which the quaestors and central bank relied in ordering liquidation was procured from the 3 firms involved by improper suasion; the auditors' discomfort being evidenced by their insistence on couching it as consultancy work, rather than an audit report;
- The fact that the third largest bank of the country successfully withstood a run of 20% of its deposits proved that it was demonstrably sound.

These arguments will soon be tested in international courts. If the plaintiffs win, it means that the Bulgarian authorities, the BNB and public prosecutor conspired to wind up a perfectly solvent bank, disrupt the national economy and payments system and undermine confidence in other banks.

The smell of corruption is in the air. It is sadly plausible that Mr Vassilev fell out with top officials in these institutions, individuals to whom he had previously granted soft loans to ensure a smooth regulatory ride. According to some rumours, when he called in the loans the borrowers countered by conspiring to put him out of business.

What this suggests about our bank accounting rules

Is this just another story of governmental mismanagement motivated by corrupt ambition? At one level, yes it is. At another, the story has greater significance. Our Newsletters have consistently demonstrated that IFRS accounting standards render the assessment of bank solvency impossible. We have thus maintained that, even if governments believe in bailouts, bailouts should only be undertaken when the quantum of capital shortfall is clearly understood.

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By contrast, this story demonstrates how this dystopian system of bank accounting rules can facilitate the wholly improper closure and asset stripping of a healthy bank by those meant to be supervising it. We will follow the legal proceedings with interest. ■

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БЪЛГАРСКА НАРОДНА БАНКА

PRESS RELEASE

22 October 2014

On 21.10.2014 the BNB Governing Council examined a report on the analysis and assessment of Corporate Commercial Bank AD (KTB) assets, conducted by the audit firms Ernst & Young Audit OOD, Deloitte Bulgaria OOD, and AFA OOD.

In the period 05.08.2014 – 20.10.2014 the above audit firms analysed and assessed major balance sheet items and bank guarantees issued by the bank. The analysis and assessment were based on the principles of recognition and assessment in compliance with the applicable International Financial Reporting Standards (IFRS). The assessment was based on the assets and bank guarantees entered in the bank's records as at 30.06.2014, reflecting all significant events by 30.09.2014 that affect the analysis.

As at 30.09.2014 the total assets of the bank amounted to BGN 6 662 million. The audit firms concluded that assets of the bank needed to be impaired by BGN 4 222 million in total. Detailed

BNB uses the word "audit" only as "audit firms" to feign credibility