International Institute of Certified Public Accountants

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Ostersonntag, 31 March 2013

The Cyprus Bail-in of March 2013
Dilettantish and Misconceived "haircuts" on Cypriot Bank Deposits

OPEN LETTER TO:

Wolfgang Schäuble
Bundesfinanzminister of Germany

AND TO:

Maria Fekter
Finance Minister of Austria

Koen Geens
Belgian Ministry of Finance

Michalis Sarris
Minister of Finance – Cyprus

Jürgen Ligi
Minister of Finance - Estonia

Jutta Urpilainen
Minister of Finance – Finland

Pierre Moscovici
Minister of Finance – France

Wolfgang Schäuble (addressed above)
Bundesfinanzminister of Germany

Giannis Stouraras
Minister of Finance – Greece

Michael Noonan
Minister of Finance – Ireland

Vittorio Grilli
Minister of Finance – Italy

Luc Frieden
Minister of Finance – Luxembourg

Edward Scicluna
Minister of Finance – Malta

Frans Weekers
Minister of Finance – Netherlands

Vítor Gaspar
Minister of Finance – Portugal

Peter Kazimir
Minister of Finance – Slovakia

Urus Cufer
Minister of Finance – Slovenia

Luis de Guindos Jurado
Minister of Finance – Spain

AND COPY TO:

Olli Rehn
Commissioner, Econ. Affairs & the Euro

Jeroen Dijsselbloem
President, Eurogroup

Angela Merkel (mentioned)
Bundeskanzleramt, Berlin

Box 9, Pakthongchai 30150
Thailand

31 March 2013

Dear Doctor Schäuble
and Ministers of Finance of the Euro Area:

1. The haircuts imposed on Cypriot bank deposits is not a remedy, is misconceived and therefore punishment on the people of Cyprus, and unwittingly also upon yourself and your reputation as Germany's Minister of Finance — Germany again, of all nations.

2. You have stated on national TV[1] on 19 March 2013, that Cyprus cannot support a banking sector with some EUR 70 billion deposits because its GDP is only EUR 18 billion, that Cyprus's *Geschäftsmodell muss rekonstruiert werden* — economic model must be reorganized — that Cyprus's financial sector must shrink itself back to health, but your design meted out in punishment is nothing but a misconceived exercise for the specialist in mental disease.

3. Private banking has nothing to do with the productive capacity of the nation in which the private banks are domiciled, because the banks's assets initially recorded as cash deposits from abroad remain abroad; can be located anywhere in the large Euro Area. If Cypriot deposits are made by investors from Russia, the Russian currency is most likely converted into Euros on the foreign currency markets among the Euro Area's money center banks, primarily Deutsche Bank in Frankfurt, who then credits the Cypriot banks who transfer the money according to instructions, including the purchase of Greek national debt securities. In other words, the funds recorded by the Cypriot banks have never reached the country where the record keeping took place. That's all.

4. In your televised interview on 19th March 2013, you say that creditors must contribute in a resolution for insolvency (you say, *Gläubiger sind bei einer Insolvenz zu beteiligen*). The deal is, if the Cypriot banks's depositors are converting EUR 5.8 billion into the insolvent banks's capital equity, then the ELA will bail-out Cyprus with EUR 10 billion in fresh money, but only the government of Cyprus, not the Cypriot banks. In other words why impose anything on banks?

5. Before I explain your misconception, I understand that legal action has been taken in Cyprus, and an injunction has been granted, to prevent your requirement of forced deposit conversion into capital equity of the banks.[2] I hope that the legal action will be successful, exposing the fallacy of your bail-in requirement.

6. Allow me to explain this accounting-finance side:[3]

7. The value of a Euro of bank liabilities, say deposits, depends on the solvency of the bank itself. (Martin Wolf, "Cyprus Adds to Europe's confusion," Financial Times, London 26th March 2013.)

8. Depositors cannot contribute to an insolvent bank's resolution, as you require, because they are the bank's victims. As a German saying goes, *Einem nackten Mann kann man nicht in die Tasche greifen*. One cannot reach into the pockets of a man who is naked.

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[1] Wolfgang Schäuble: "Zypern ist selbst schuld." http://www.youtube.com/watch?v=PvY8STg9ar4
[2] " Decision on BoC shares hits a snag."Cyprus Mail, 29 March 2013.
[3] Also refer to my publication, Michael Schemmann. 2012. "Liquid Money — The Final Thing. Federal Reserve and Central Bank Accounts for Everyone." IICPA Publications, ISBN 978-1478312239.

9. Moreover, bank deposits are on the liability side of the balance sheet, and by moving them to a lower, less liquid position such as equity capital, yes, the deposits are eliminated and no longer a current liability of the bank, but they do not provide the much needed liquidity which is on the asset side of the balance sheet of banks, namely claims against solvent banks (interbank) or, better yet, claims against the central bank which are in the nature of legal tender.

10. Your remedy is further misconceived in that the conversion of deposits into capital equity destroys the much need money supply, and its destruction leads to deflation of prices in Cyprus and, of course, bankruptcies in the local economy (and abroad, eg, Greek and Russian companies banking in Cyprus).

11. Allow me to refer you to the resolution of the Asian Financial Crisis of 1997. I have been a university professor of accounting and finance in Bangkok shortly after the time, and know the situation fist hand. ALL of the Thai commercial banks had incurred non-performing loans completely eroding their capital equity, which was still negative in 2004 while the Thai economy was well on its way to recovery. Today, the Thai baht has recovered from 45 to 29 THB to the US dollar, and the banks are doing their business happy-go-lucky as ever.

12. If you ever studied and read the American Colm-Dodge-Goldsmith Plan of 1946 (CDG)[4], by which the German Monetary Reform of 1948 was enforced by the Allied Military Governments, ushering in the German Economic Miracle under your party's Minister of Economics, Professor Ludwig Erhard, you would learn that the CDG restructured the banks from their liabilities-side where most of the their activities are transacted. The banks were allowed to record large amounts on their assets-side known as "consoles" to balance their books. CDG is proof, as are the commercial banks of Thailand in the post-Asian Financial Crisis, that capital equity is not the banks's Achilles heel as presumed by the Basel Committee on Banking Supervision which has not prevented ANY of the bank-failures in the 1990s, let alone during the ongoing Global Financial Crisis.[5]

13. If you accept the above explanations, you may ask what is the solution to Cyprus's Money Debacle, or what should have been the deal in March 2013?

14. The deal started with the failure of Greece, another member of the Euro Area, who did not use her sovereign money power but was allowed to borrow in the money markets bank-book quasi money that eventually ended up on the books of Laiki Bank of Cyprus subject to a 70% haircut, causing several billions of losses on Laiki Bank's financial statements. Your depositors' haircut is designed to compensate for these losses. But on what basis? What have depositors in common with creditors of investments vehicles? They were depositors in good faith, not villains investing in expectation of high yields.

15. It is this quasi money in the deposit accounts of private commercial banks that is not liquid, but transfer only by offset in the daily clearing of payments among banks. Only federal or central bank money is liquid, and that is not being provided in any other Euro Area country, presenting a time-bomb ticking. Instead commercial banks are continuing to create it out of nothing — *quasi money*.

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[4] **"**A Plan for the Liquidation of War Finance and the Financial Rehabilitation of Germany (1946)" by Gerhard Colm, Joseph M. Dodge and Raymond W. Goldsmith. Republished by IICPA 2010. ISBN 978-1450521901.

[5] See also Michael Schemmann. 2011. "European Banking Authority's *Stress Teasing*. The fallacy of capital adequacy requirements for commercial banks." IICPA Publication. ISBN 978-1463729905.

16. Now that this so called money has been created, though wrongly, it is not an investment by the public at large, but a *common highway of business*. You cannot punish people to recover losses of money in the banks by closing their roads, demolishing their bridges, and such infrastructure. You might as well take their land and chase them off the island… how dare you, Doctor Schäuble?

17. Money is what people get, before they can do anything. Your requirements curtail this ability in a most brutal way calling it "a creditor's contribution to insolvency," except that YOU are creating the insolvency which did not exist before your dictate; or at least not to such an extent.

18. In this regard, your British colleagues are years ahead of the Euro Area by introducing legislation to ring-fence the banks, protecting deposits of the public against other commercial activities by splitting banks into deposit-taking institutions, and into lending and investment businesses. The German postal chequing system of the past was such a safe government-owned deposit-taking system. Privatizing public entities, which your Christian-Democratic Party advocates, all too often results in the socializing of private losses. And now this!

19. The further answer would have been to provide liquidity assistance to the government of Cyprus alone and leave to the country's banking sector to its own devices, negative equity capital or positive equity. Now there is nothing but blocked accounts and capital controls. Your medicine, Herr Doktor Schäuble, killed the patient.

20. The further answer could have been by simply allowing the Central Bank of Cyprus (CBC) to extend its services to the island nation as a whole by opening accounts for its businesses, pursuant to Art. 39(1) of the Bank of Cyprus Laws 2002-2007 (similar to the *Bundesbankgesetz* Art. 22),[6] namely:

> 39(1) In order to conduct its operations, the Bank may open accounts for credit institutions, public entities and other market participants, and accept assets, including book entry securities, as collateral.

21. In the further alternative, nothing prevents the CBC to become the substitute depositor of Cypriot depositors at the Bank of Cyprus, and at Laiki Bank, effectively transferring the deposits to the central bank, and increasing reserve requirements for re-deposits of central bank money at the private commercial banks, without increasing the nation's money supply by one iota. Such a model could prove to be the template for the future.

22. I support the monetary reform movement, MONETATIVE e.V. in Berlin, who advocate Irving Fisher's (1935) "100% Money" now effectively underway by the US Federal Reserve's "monetary easing," and the ECB's equivalent known as "Outright Monetary Transactions" (OMTs)[7]

23. Cyprus is deserving not any less of the ECB's correctives only because it is a small nation, rather than punitive measures leading to nothing but devastation and ruin based on misconceptions, including

[6] Art. 22. "The Deutsche Bundesbank is entitled to conduct the transactions specified in section 19 (1) 4 to 9 above with natural persons and corporations at home and abroad." http://www.iuscomp.org/gla/statutes/BBankG.htm#19 Retrieved 2013-03-31.

[7] Speech by Mario Draghi, President of the ECB, Discussion on ECB policies with Members of Parliament, Berlin, 24 October 2012. http://www.ecb.int/press/key/date/2012/html/sp121024.en.html

(a) your initially imposed haircut on bank deposits up to EUR 100,000 which are in fact protected under EZ rules, and the creation of a second Euro, the Cyprus Euro, based on subsequent capital controls which are already in effect (for this your grave oversight you earned the righteous anger and scorn of your Bundeskanzler Angela Merkel), and

(b) the violation of the Euros single currency concept by allowing capital controls, effectively creating a diminished *Cyprus Euro*.

24. To correct your misconceptions and to remedy your requirements, I recommend that you and the so called *Troika* (EU, ECB, IMF) who are limping along only to please you and your country being the largest player in the EU, proceed as follows:

25. Do not appear in the legal proceedings currently underway in Cyprus internally concerning the conversion of bank deposits into capital equity of the banks, but acquiesce to the court's rulings.

26. Inform the CBC of your permission to accept Cypriot bank deposits to transfer into CBC accounts, which will not increase the Cypriot or any other Euro Area money supply, but turns quasi bank money into legal tender. Eventually the Cypriot banks will retire the deposits now held by the CBC in central bank money, and nothing else needs to be done in the way of a so called rescue. (Refer to my publication mention above, "Liquid Money — The Final Thing.")

27. Do not intervene with regard to the Cypriot bank's so called recapitalization under the rules of the Basel capital accords which I consider entirely misconceived, have never worked, and never will, even if the Cypriot banks's so called regulatory capital may fall below Basel's minimum requirements.

28. You are a principled man, valuing principle over outcome. I respectfully submit that your principles are misconceived, and therefore the outcome is accordingly, as we all see.

Sincerely,

Michael Schemmann, PhD, CPA
Professor of Accounting and Finance
Bankkaufmann
Director of the IICPA

DIE DEUTSCHE ÜBERSETZUNG

FOLGT DEMNÄCHST