From Deauville *to* Cyprus

BY KLAUS C. ENGELEN

The seeds of another eurozone crisis have been planted.

When the history of the euro area sovereign and bank debt crisis is written, the way the troika of Eurogroup finance ministers, the European Central Bank, and the International Monetary Fund managed the rescue of the outsized Cyprus offshore banking center will be useful as a case study to document the extremely fragile state of European monetary union at that point in time. The handling of the crisis puts big question marks around the June 2012 EU summit council resolution to transfer banking supervision to the European Central Bank—to a European institution acting as the euro area's financier of first resort for banks that lack access to market funding. This huge conflict of interest between supervising and funding large and small eurozone zombie banks and pursuing monetary policies oriented toward price stability is ignored by Europe's democratically elected leaders. When they talk about "Chinese walls," it is sheer nonsense—look at Cyprus.

On April 18, 2013, Germany's parliament passed the aid package for troubled Cyprus with a large majority—486 in favor and 104 against. Under a decision by the German Constitutional Court, the German legislature retains the right to vote on any new

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support program by the €700 billion European Stability Mechanism. Behind the impressive support of German legislators for the €10 billion ($13.05 billion) rescue loan provision was the fact that Eurogroup finance ministers in the case of Cyprus not only insisted on far-reaching reforms, but also put the reigning bank bail-out doctrine aside and required bank bail-ins by creditors and large depositors. Leaving a guarantee in the Cyprus bank resolution exercise to insure deposits of up to €100,000 made it easier for Germany's left and green opposition parties to back the terms of the revised rescue agreement under which Cyprus also must raise €5.8 billion of its own money.

For the German government, the Cyprus rescue turned politically explosive in an election year after an intelligence report was leaked alleging that the island is a haven for Russian organized crime. And Sigmar Gabriel, the SPD floor leader, attacked Cyprus in a speech in the Bundestag as having "a business model based on Russian oligarchs, Serbian mafias, and tax evaders." Along with other German politicians, Gabriel dismissed claims that the Cypriot banking system could set off broader contagion if allowed to fail since it is "systemically undesirable."

Before discussing the complex new burden-sharing and rescue approach and its wide implications in detail, two developments in the run-up to the Cyprus banking disaster have to be explored.

THE PRESIDENT'S LETTER BOMB TO DRAGHI

The fallout from the bitter struggle between the new conservative president of Cyprus, Nicos Anastasiades, and ECB President Mario Draghi over removing Central Bank of Cyprus Governor Panicos Demetriades from office is bringing into the open the "smoking gun" of how Cyprus has been misusing the Eurosystem.

When the new conservative government's move to get rid of the Central Bank of Cyprus head reached the European Central Bank, Draghi was quick to come to the defense of Demetriades, who also has a seat on the ECB Governing Council, the main decision-making body of the Eurosystem.

In a letter to the Cypriot president, Draghi warned that the governor could only be dismissed on grounds specified by EU law and even then the action would have to reviewed by the European Union's Court of Justice.

The problem, however, is that the role of both the Central Bank of Cyprus and the ECB Governing Council—which can block the use of emergency liquidity assistance funds to a financial institution with a two-thirds majority—reveals a breakdown of governance and the rule of law in the Eurosystem. Emergency liquidity assistance liabilities were issued by the Central Bank of Cyprus to keep an insolvent Laiki Bank, the country's second-largest bank, afloat after the former Cypriot government presented its application to the euro area rescue funds in June of 2012.

Nicos Anastasiades

Panicos Demetriades

Leadership Failure

In his letter to ECB President Mario Draghi, Anastasiades cites the March 28, 2013, confession of Demetriades in a press conference: "I was constantly informing the government about the risk for the banking system to collapse and that is why I proposed that the former government reach an agreement for a bail-out deal in June 2012, as the situation was evident since then. Emergency Liquidity Assistance for Laiki reached 60 percent of the GDP of Cyprus. This was not pleasant, but we had to sustain Laiki in order for the elections to take place, a new government to come to power and take its decision, and to reach agreement with our European partners so as to avoid not only the bankruptcy of Laiki, but also the bankruptcy of the country."

The Cypriot president continued: "I believe that the decision of Governor Demetriades not to annul the ongoing liquidity assistance provided to Laiki Bank by ELA with the aim of holding elections in February 2013, despite the fact that the "situation was evident" since June 2012, demonstrates his failure of effective prudential regulation and supervision of the banking system." At the same time, "It raises questions related to the independency that the Governor enjoyed with the former Government."

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Jeroen Dijsselbloem

First Test Case

Jeroen Dijsselbloem, the Dutch finance minister heading the Eurogroup, seemed determined to use the somewhat disreputable and bloated Cyprus offshore banking center as a first test case to end the prevailing bank debt bail-out doctrine in eurozone crisis management.

—K. Engelen

Under the Eurosystem rules, emergency liquidity assistance loans should only be provided to solvent financial institutions. But in the case of Cyprus, emergency liquidity assistance funds were used—under pressure from the government and in collusion with its central bank governor—to delay the bankruptcy of Laiki Bank for almost a year.

In a six-page letter, Anastasiades responded to Draghi by denying any action aimed at sacking the central bank governor, but listing dubious policies and decisions that Demetriades was responsible for since taking office in May 2012 under the previous left-wing government of Demetris Christofias. "A systemically important financial institution of Cyprus, Laiki Bank, which according to the European Central Bank and the troika partners was already bankrupt, received €9.5 billion in Emergency Liquidity Assistance, an amount that accounts for 60 percent of GDP," wrote the Cypriot president. Together with €1.8 billion in bailout funds from the State of Cyprus, Laiki received €11.3 billion, or 70 percent of GDP.

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The questions all this raises for the European Central Bank, its Governing Council, and for the troika must be answered if the whole euro area rescue approach is to remain credible and restore market confidence. In the case of Cyprus emergency liquidity assistance loans—which are extended under the sovereign guarantee of a European monetary union member country but constitute an increase in Eurosystem liability—the Cyprus central bank-issued liabilities were used to bridge a change in government and make elections possible.

As Willem Buiter and Juergen Michels of Citi Research note, such liabilities issued by national central banks carry a guarantee from the national central bank's sovereign but are Eurosystem liabilities. "In the case of an insolvent euro area sovereign, such guarantees would be irrelevant without external support for the sovereign, and the credit risk *de facto* would remain with the Eurosystem. As a conse-

The huge conflict of interest between supervising and funding large and small euro area zombie banks on questionable collateral is ignored by the power-hungry Eurosystem central bank kingpins.

The European Central Bank and the Eurosystem are losing their independence.

quence, the ELA is a dilution of the collateral and counterparty requirements of the Eurosystem."

This holds at least to the extent that emergency liquidity assistance does not replace earlier repo collateral that was cancelled from the European Central Bank's direct refinancing operations as a result of downgrades, as Achim Dübel, a Berlin-based capital markets specialist, points out. He estimates that about half of the €9.4 billion emergency liquidity assistance accumulating within Laiki through mid-March 2013 was used to pay depositors and bondholders in this way. Dübel emphasizes that emergency liquidity assistance funds were also used to buy back subordinated bonds at highly favorable pricing for investors who would have faced total loss in the subsequent restructuring.

This shows the extent to which the European Central Bank and the Eurosystem are losing their independence, operating under regulatory capture in member countries, and becoming politicized. It shows how much the European Central Bank is becoming a "side government" for eurozone sovereign states.

GREECE'S RESCUE BANKRUPTED CYPRUS BANKS

Another conclusion from the run-up to the Cyprus crisis is that the European Central Bank and the other troika partners neglected to deal in a timely manner with the fallout from the Greek government bond haircuts on the closely connected Cyprus banks located both in Greece and Cyprus.

What must be taken into account is that the "Europeans planted the seeds of crisis in Cyprus." Under this headline, Andrew Higgins and Liz Alderman, in a report from Nicosia for the *New York Times* on March 28, 2013, document how the European leaders, the International Monetary Fund, and the European Central Bank, at the Brussels EU summit in October 2011, decided to force the private sector to share some of the burden of securing Greece's external debt sustainability through haircuts on Greek government bonds of up to 50 percent and later up to 75 percent of the bonds' face value. At the time, German Chancellor Angela Merkel praised the "Private Sector Involvement" program that was negotiated with the leading finance industry association, the Institute of International Finance. "We Europeans showed tonight that we reached the right conclusions." What at the time neither the Eurogroup, nor the European Central Bank, nor the International Monetary Fund admitted was that the troika had

Continued on page 73

Draghi Blunder

In his first press conference after the Cyprus deal, ECB President Mario Draghi—who so far has been using the Lehman systemic risk scare to justify the bank debt bail-out doctrine—also seemed to adjust to the new bail-in world. "A bail-in by itself is not a problem, it's the lack of rules, *ex ante* rules, known to all parties, which can make a bail-in a disorderly event. And it's the lack of buffers, capital buffers or other bail-in-able asset buffers."

But Draghi has ignored the most important finding that an objective analysis of the European Central Bank's role in the run up to the Cyprus banking disaster would bring to light. What happened in the case of Cyprus puts big questions marks behind the June 2012 EU summit Council resolution to transfer banking supervision to the European Central Bank—in spite of acting as the eurozone financier of first resort for banks that lack access to market funding. The huge conflict of interest between supervising and funding large and small euro area zombie banks on questionable collateral is ignored by the power-hungry Eurosystem central bank kingpins and—even worse—so far by eurozone's policymakers to their peril. As was demonstrated in the Cyprus case, the European Central Bank and the national central banks in times of crisis are not only supervisor but also the only funding source for those banks without market access.

—K. Engelen

Mario Draghi

Continued from page 53

ripped a big hole in the closely connected Cyprus banking system that was heavily invested in Greek sovereign debt paper. Laiki, also known as Cyprus Popular Bank, alone took a hit of €2.3 billion according to its 2011 annual report.

While financing a generous bank bailout in Greece, the troika opted for "kicking the can down the road" regarding the huge Greek government bond losses that the closely connected and highly over-expanded Cyprus banks experienced on their balance sheets. As Achim Dübel notes, the Hellenic Financial Stability Fund fully compensated the haircut losses of the four systemic Greek banks—Alpha Bank, National Bank of Greece, Eurobank, and Pireus Bank.

As the European Commission Directorate General for Economic and Financial Affairs noted in its Cyprus assessment paper of April 12, 2013: "The Cypriot banks suffered about €4 billion in losses from the Greek PSI, i.e., more than 22 percent of GDP. The steep contraction of the Greek economy has caused a significant deterioration in the quality of the Greek loan book. … Based on stress-tests, including by PIMCO, the capital shortfall of the Cypriot banks is estimated at around €10 billion, after bailing in junior debt holders, or almost 60 percent of GDP."

With a GDP of less than €18 billion, Cyprus has a banking sector reaching about 750 percent of GDP when foreign banks operating in Cyprus are included. The assessment went on to point out that a disorderly Cyprus default with very steep deposit losses could negatively impact deposit stability elsewhere. Eurozone banks could see their ability to raise unsecured funding deteriorate. There could be a negative impact on the funding outlook for vulnerable sovereigns. The imposition of capital controls in one part of the euro area could impact the private capital flows to other vulnerable countries. An uncontrolled collapse of Cyprus could create renewed doubts about the integrity of the eurozone, damaging financial stability and economic growth in the euro area.

The troika-mandated advisor PIMCO stated in its due diligence report on the Cyprus banking system that the three largest commercial banks active domestically and internationally, Bank of Cyprus, Laiki Bank, and Hellenic Bank, accounted for 75 percent of total loans and deposits and 83 percent domestically of all twenty-two participating institutions representing domestic banks (including their branch operations in Greece, Russia, and elsewhere) as of March 31, 2012. "As an aggregator of international bank liabilities, including the deposits of the Cyprus-domiciled subsidiaries of international corporations, Cyprus banks have expanded their balance sheets dramatically," says the PIMCO report. "Total assets of the Cyprus banking sector stood at €143 billion as of 31 March 2012."

For the German government, the Cyprus rescue turned politically explosive.

The report continues: "As a result of this growth in total assets—along with lending standards that generally focused much more on the collateral of a loan than on the borrower's debt service capacity—Cyprus private-sector credit as a share of GDP has risen to one of the highest levels of any economy on record according to World Bank data. Access to external funding also helped to fuel an external expansion on the part of the Cyprus banks, primarily in Greece, but to a lesser extent in the UK, Russia, and other Eastern European countries." As of June 2012, Greek loans represented about 40 percent of defaulted balances. PIMCO estimated that the aggregate capital shortfall for the participating Cyprus financial institutions would be €5.98 billion under a base scenario and €8.87 billion under an adverse scenario. No wonder getting rid of the loss-producing Cyprus bank operations in Greece—in a fire sale to Pireus Bank—was the first important step towards containing the Cyprus banking meltdown.

ENTER JEROEN DIJSSELBLOEM

In the lead-up to the March 2013 failed Cyprus rescue deal, a former top banking supervisor with decades of crisis management expressed the widely prevailing frustration over yet another eurozone bank bailout. "To European taxpayers, the bloated Cyprus offshore banking center offers a 'gift from heaven' that Eurogroup finance ministers cannot refuse. When if not now can they call the systemic Lehman scare a bluff? It has been used by banks and the European Central Bank to muzzle politicians and bureaucrats and let taxpayers pay. Now the Eurogroup can insist on bailing in bank creditors and large bank depositors, and force Cyprus to pass the necessary emergency laws, including a moratorium to stop capital flight, so

that it can recapitalize its banks." In his view, "bailing out Russian oligarchs with European Stability Mechanism taxpayer money would not be possible in a German election year."

Our veteran bank supervisor was right on the money. As it turned out, Jeroen Dijsselbloem, the Dutch finance minister heading the Eurogroup, also seemed determined to use the somewhat disreputable and bloated Cyprus offshore banking center as a first test case to end the prevailing bank debt bail-out doctrine in eurozone crisis management. His recent experience at home rescuing the large Dutch banking and insurance group SNS Reaal NV at a cost of €2.2 billion was helpful. In nationalizing the group, losses were imposed on shareholders and junior bondholders. The latter were bailed in to the tune of €1 billion.

Confronted with a possible disorderly Cyprus banking meltdown, the Dutch newcomer had to overcome some hurdles. The first deal negotiated with the new government March 15 and 16—€10 billion aid against reforms, a €5.8 billion contribution raised through a "Financial Stability Levy" (6.7 percent for deposits up to €100,000 and 9.9 percent for higher deposits, with savers compensated with shares in their banks)—was rejected by the Cypriot parliament. But the final deal negotiated March 24–25, with the same troika loans of €10 billion and a Cyprus contribution of €5.8 billion, came with a major bail-in of large depositors (those above €100,000).

Mario Draghi seemed to adjust to the new bail-in world.

According to the background paper provided by the European Commission to Germany's legislators:

- Laiki will be resolved immediately, with full contribution of equity shareholders, bond holders, and uninsured depositors, based on a decision by the Central Bank of Cyprus using the newly adopted Bank Resolution Framework;
- Laiki will be split into a good bank and a bad bank;
- The good bank will be folded into the Bank of Cyprus using the bank resolution framework. It will take €9 billion of emergency liquidity assistance with it. Only uninsured deposits in the Bank of Cyprus will remain frozen until recapitalization has been effected, and may subsequently be subject to appropriate conditions;
- The Governing Council of the European Central Bank will provide liquidity to the Bank of Cyprus in line with applicable rules;
- The Bank of Cyprus will be recapitalized through a deposit/equity conversion of uninsured deposits with full contribution of equity shareholders and bond holders;
- The conversion will be such that a capital ratio of 9 percent will be attained by the end of the program;
- All insured depositors in all banks will be fully protected in accordance with the relevant EU legislation;
- The program money (up to €10 billion) will not be used to recapitalize Laiki and Bank of Cyprus.

THE GERMAN-FRENCH DEAUVILLE PACT

While walking along the beach in Deauville, France, during the EU Summit in October 2010, German Chancellor Angela Merkel and then-French President Nicolas Sarkozy came to what some have called the "Deauville pact," an agreement to force private-sector investors to share some of the burden in order to reach the IMF-required debt sustainability for Greece.

What transpired from the two-stage chaotic negotiations on the Cyprus bailout deal was "the absence of an established legal framework, or at least explicit policy statements by the Eurogroup, about the criteria and procedure to decide on how burden sharing is done," notes the Institute of International Finance, the global association of major financial institutions, in its April 2013 *Capital Markets Monitor*. "Market participants could be left to assume that the process might have been driven opportunistically: go where the money is."

Putting the Cyprus rescue in a larger perspective, the IIF capital market experts conclude, "While the EU summit in Deauville in October 2010 launched the concept of 'Private Sector Involvement' (PSI) in sovereign debt restructuring as part of an adjustment program to crisis countries in the euro area, the Cyprus package included the bailing in of bank creditors and depositors as part of a rescue effort. This marked the first time in the context of euro sovereign/bank debt crisis resolution that bank senior creditors and depositors have been haircut, in an *ad hoc* manner—and well ahead of the finalization of the EU Directive on the Recovery and Resolution of Financial Institutions."

Therefore, going forward "it looks like burden-sharing from the private sector in rescue efforts could materialize in the context of either sovereign debt restructuring or bank resolution, or both."

The Eurogroup rescue mission for the oversized, highly deregulated, and poorly supervised Cyprus offshore banking center, says Dübel, "opens a new chapter in eurozone efforts to save monetary union, namely by progressing from a whatever-it-takes mode to bail out bank debt investors to bail in bank debt investors and—at least—large bank depositors."

Dübel has been campaigning against the troika's dominating euro area rescue strategy of comprehensive bank bondholder and bank debt bail-outs. Says Dübel: "Despite rhetoric to the contrary, the eurozone's banking crisis management choices taken in recent years have confirmed the status of bank bond investors as privileged. For senior unsecured bank bond investors, the banking union is not a distant project, but a reality today. Even subordinated bank bond and hybrid equity investors have been bailed out in many cases of near-insolvent banks. While comprehensive bank bondholder protection was implemented, national and European insolvency legislation that could have rationalized these policies was delayed. The corresponding bail-out costs have almost exclusively been funded by sovereign bond investors. Through the unfolding events, they have become *de facto* subordinated to senior unsecured bank bond investors."

Dübel continues: "In the case of Ireland, the sovereign was able (by swift new legislation) to recover €5.5 billion through haircutting the original junior bond investors. This means that roughly 10 percent of the roughly €50 billion capital gap of Irish banks has been covered through the bail-in of bondholders. Ireland could have achieved a greater ratio of burden sharing if the eurozone had not resisted haircutting Irish senior unsecured bank bondholders." With respect to Spain, Dübel notes, "Spain, in contrast, had permitted banks for several years to keep financing new house purchases at inflated prices in order to sell off defaulted developer stock, with the help of rock-bottom interest rates. The consequence was that in 2010 and 2011, only partial restructuring of bank balance sheets was undertaken. The low loss recognition at that point permitted some original investors to fully recover their investments and misled new investors into investing in seemingly sound balance sheets. Much of risk position in banks that could have been used for bail-in in Spain was *de facto* transferred from professionals to real estate investors, or was lifted in insolvency rank. Shares sold to retail investors implicitly protected bank bonds sold earlier. Only 2012 saw finally both the inflated prices collapse and a full bank restructuring and creation of a bad bank along the lines of the Irish model."

HOW CENTRAL BANKERS AVOID LOSSES

But the Cyprus bail-in also demonstrates how much it was eventually structured and put into practice so as to avoid losses to the Cypriot public sector, the European Central Bank, and the Eurosystem creditors.

First, about one-quarter of the remaining "good assets" of the merged and liquidated Laiki Bank and the ongoing Bank of Cyprus are being used to secure the repayment of outstanding emergency liquidity assistance loans of about €9 billion provided by the Central Bank of Cyprus. This way the Cyprus central bank, the Eurosystem, and the European Central Bank

The Importance of Cyprus

Jörg Asmussen

ECB Executive Board member Jörg Asmussen made the case for a full bank bailout: "If one simply looks at the size of the economy—it is something like 0.5 percent of euro area GDP—one may conclude that Cyprus is not systemically important," the former deputy German finance minister told the Greek newspaper *Kathimerini.* "In normal times, one may be tempted to agree. But I think we are still not in normal times, and therefore I think that disorderly developments in Cyprus can harm the progress we made in Europe in 2012."

Asmussen continued, noting that a "bad development" in Cyprus could result in two kinds of developments. "One is possible contagion of Greece via banking channels, since a number of Cypriot banks are active in Greece. Secondly, it can send the wrong signals to the rest of the euro area," with countries such as Portugal and Ireland preparing to re-enter capital markets.

—K. Engelen

will avoid losses despite also sharing responsibility for letting the crisis escalate.

Second, with respect to the bail-in of bank depositors, the Cypriot public sector has been trying to protect itself through a long list of exemptions.

Third, special interests were able to escape the full impact of the large bank depositor bail-in by getting money out of the banks or—with the help from legislators—by cutting off parliamentary investigations into where millions in bank funds went shortly before the introduction of capital controls.

Fourth, by concentrating the bail-in of depositors on the two largest banks—liquidating Laiki and strengthening the ongoing Bank of Cyprus—most of the member banks and branches of the Cypriot Deposit Protection Scheme won't be required to be part of burden-sharing exercise.

Fifth, the Cypriot public sector has been limiting its bail-in costs by *ad hoc* upgrades in the capital structure, disregarding the principles that the Financial Stability Board required in its 2011 recommendations, "Effective Resolution Regimes for Financial Institutions."

MARIO DRAGHI DIDN'T GET WHAT HE WANTED

As in the previous troika rescue operations in Greece, Ireland, Portugal, and Spain, and in the run-up to the Cyprus rescue negotiations, the European Central Bank sounded the systemic risk alarm. In interviews, Executive Board member Jörg Asmussen made the case for a full bank bailout: "If one simply looks at the size of the economy—it is something like 0.5 percent of euro area GDP—one may conclude that Cyprus is not systemically important," the former deputy German finance minister told the Greek newspaper *Kathimerini.* "In normal times, one may be tempted to agree. But I think we are still not in normal times, and therefore I think that disorderly developments in Cyprus can harm the progress we made in Europe in 2012." Asmussen continued, noting that a "bad development" in Cyprus could result in two sorts of outcomes. "One is possible contagion of Greece via banking channels, since a number of Cypriot banks are active in Greece. Secondly, it can send the wrong signals to the rest of the euro area," with countries such as Portugal and Ireland preparing to re-enter capital markets.

The troika had ripped a big hole in the closely connected Cyprus banking system that was heavily invested in Greek sovereign debt paper.

In one important respect, the European Central Bank put pressure on the Cypriot government to negotiate a rescue and banking restructuring deal. It had the ECB Governing Council set the date of March 25, 2013, and declare that "thereafter, emergency liquidity assistance could only be considered if an EU/IMF program is in place that would ensure the solvency of the concerned banks."

In his first press conference after the Cyprus deal, ECB President Mario Draghi—who so far has been using the Lehman systemic risk scare to justify the bank debt bail-out doctrine—also seemed to adjust to the new bail-in world. "A bail-in by itself is not a problem, it's the lack of rules, *ex ante* rules, known to all parties, which can make a bail-in a disorderly event. And it's the lack of buffers, capital buffers or other bail-in-able asset buffers." As the *Wall Street Journal* observed, "Mr. Draghi's remarks suggest a change of heart is underway. Echoing the German, Dutch, and Finnish governments, he recommended that the new bail-in regime come into effect in 2015, not 2018. He also highlighted the importance of proposed requirements that banks fund themselves with sufficient 'bail-in-able' debt."

But Draghi has ignored the most important finding that an objective analysis of the European Central Bank's role in the run up to the Cyprus banking disaster would bring to light. What happened in the case of Cyprus puts big questions marks behind the June 2012 EU summit Council resolution to transfer banking supervision to the European Central Bank—in spite of acting as the eurozone financier of first resort for banks that lack access to market funding. The huge conflict of interest between supervising and funding large and small euro area zombie banks on questionable collateral is ignored by the power-hungry Eurosystem central bank kingpins and—even worse—so far by eurozone's policymakers to their peril. As was demonstrated in the Cyprus case, the European Central Bank and the national central banks in times of crisis are not only supervisor but also the only funding source for those banks without market access. In the world of eurozone zombie banks, European leaders are planting again the seeds of another crisis. ◆