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Untangling the Mess of Austrian Bank Hypo

Tracing the Losses Behind a Lending Debacle That Has Cost Taxpayers Billions of Euros So Far

By Gabriele Steinhauser Follow

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Wolfgang Kulterer, former CEO of Austria's troubled Hypo Alpe-Adria-Bank, pushed a rapid lending expansion. ILLUSTRATION: REUTERS

KLAGENFURT, Austria—A paper sign reading "Forensics" is all that suggests a drab suite of offices at the foot of the Alps may hold the key to one of Europe's biggest financial scandals.

Here, in the headquarters of Hypo Alpe-Adria-Bank International Group AG, former detective Christian Böhler and his team are untangling a web of suspected collusion among bankers, politicians and Balkan power brokers that has tarnished the reputations of two of Europe's richest nations.

The small bank's downfall has cost the governments of Austria and Germany €9.05 billion ($11.93 billion). Investigations by Austrian prosecutors and Hypo's forensics unit have resulted in criminal convictions of six of the bank's former bosses. Now, Austria's plan to wind down the nationalized bank has set Vienna up for a new struggle involving former investors—among which are a Bavarian bank that bought it in 2007 and one of the hedge funds that recently pushed Argentina to default.

Mr. Böhler's team has tracked down sports cars that were leased but never delivered, and yachts that vanished from Mediterranean harbors. One boat, mysteriously, turned up with some North Korean currency aboard. The team has also looked into how Hypo came to finance the purchase from Serbia of some land that actually belonged to Croatia.

Late politician Jörg Haider ILLUSTRATION: AGENCE FRANCE-PRESSE/GETTY IMAGES

"I'm not aware of a criminal case bigger than this one," said Mr. Böhler, who spent 15 years chasing white-collar criminals, including stints undercover, before he began working for Hypo in 2011 under a new government-installed management.

The story of Hypo Alpe-Adria goes beyond Austria to Europe at large: Despite an overhaul of banking rules that includes a path to wind down fatally troubled lenders, dealing with bank failures remains a messy and costly situation. It stands as a warning of the struggles still ahead for other bailed-out European banks where governments are trying to recover some of their losses.

Hypo ran into trouble in 2006 and was nationalized by Austria in 2009. Five years later, Vienna is still struggling to close it down and sell off its remaining €25.2 billion in assets. Austrian officials warn that a "bad bank" for its most troubled holdings could cost taxpayers an extra €3 billion, while dozens of lawsuits still fester.

Until the early 1990s, Hypo was a small lender owned by its home province of Carinthia, in Austria's south bordering Slovenia and Italy. It took deposits and lent to local businesses.

That changed when a local banker named Wolfgang Kulterer became chief executive in 1992. Meanwhile, rising through local politics was Jörg Haider, a far-right populist who paid visits to Iraq's Saddam Hussein and Libya's Moammar Gadhafi. Mr. Haider served two stints as the province's governor.

Together, the two pushed Hypo into southeastern Europe, racing to stake out a frontier market. While the bank opened branches and wrote loans far from home, government guarantees for Hypo's liabilities, authorized by Mr. Haider, gave Hypo access to cheap money. In turn, the province-owned bank's profits allowed Mr. Haider to finance handouts for his constituents.

"There were two kingdoms—one had the money, the other the power," said Rolf Holub, Carinthia's energy minister, who spent years in the political opposition exploring Mr. Haider's and Hypo's dealings.

In its expansion, Hypo was drawn to the powerful, the rich and the famous, often paying little heed to the risks.

In Croatia, a deputy foreign minister took €545,000 in kickbacks from Hypo in the 1990s when Croatia faced a trade embargo because of the Balkan war, according to a 2012 conviction. Lawyers for the jailed former official, Ivo Sanader, who was Croatia's prime minister from 2003 to 2009, didn't respond to requests for comment. In the past, he has said the charges were politically motivated.

Hypo's Balkan ties reached down to local celebrities and power brokers. One was Goran Strok, a Croatian who made his name as a race-car driver before building a hotel empire stretching to Windsor, England.

Mr. Strok sought a €6.7 million loan from Hypo to buy land from Serbia on a Mediterranean island in 2005. The loan needed approval of top managers because he already had borrowed around €80 million. The bank's CEO and three other executives waved through the request without asking for any additional security, documents reviewed by The Wall Street Journal show.

Two years later, Mr. Strok's investments were in trouble. But when Hypo moved to repossess the island property, it found a problem: The land he had paid Serbia for actually belonged to Croatia.

Hypo is suing some of its own former managers, including Mr. Kulterer, alleging they ignored the ownership uncertainties to make the loan. They have denied its accusations. A lawyer for Mr. Kulterer, now serving a 6½-year prison term for balance-sheet falsification and breach of trust, said he was out of the country and couldn't comment.

Mr. Strok, whom Hypo isn't suing, declined to comment.

The first cracks in Hypo's veneer began to appear in 2006, when Austria's banking supervisor said that Hypo executives had hidden more than €300 million in losses from its accounts. Mr. Haider decried the regulators as "medieval executioners."

Then European Union rules banned new government guarantees for banks, effectively outlawing Hypo's business model.

Hypo's managers began looking for a buyer. In May 2007 BayernLB, a regional bank owned by the German state of Bavaria, bought a majority of Hypo for €1.66 billion. How it came to do so is now at issue in several court cases in Germany.

In one, Munich prosecutors have accused former BayernLB CEO Werner Schmidt and his former deputy, Rudolf Hanisch, of misleading the bank's supervisory board about the deal's risks.

One allegation in the continuing case is that they bribed Mr. Haider, the Carinthian governor, by arranging a €2.5 million soccer sponsorship deal he demanded. The ex- managers deny the formal charges. Mr. Haider died in a car accident in 2008.

What is clear is that months before the takeover talks began, BayernLB asked one of its own analysts to look into Hypo. The analyst dubbed the bank a "squeezed-out lemon," according to a Bavarian parliament investigative committee, and questioned why the Carinthian government wanted to sell it, asking: "Cashing in before the growth story ends?"

His worries proved valid. Two months after the sale closed in late 2007, BayernLB had to inject an extra €441.3 million into Hypo because of losses it had on asset-backed securities.

A year later, the buyer itself was in trouble. Reeling from bad bets on U.S. mortgage securities, BayernLB got a €10 billion bailout from the Bavarian and German governments, of which €700 million went to Hypo.

At the same time, Austria's government injected €900 million into Hypo as part of a stabilization package for the country's lenders.

The losses didn't stop. In early 2009 Hypo lost €200 million in capital after investors triggered put options on shares the bank had issued, forcing it to buy them back, according to a Bavarian inquiry. In a lawsuit in Vienna, BayernLB says Hypo executives hid those put options during the bank's sale.

Hypo's new management doesn't dispute that the put options were kept secret. It says today that, considering that the shares had put options attached, they should have been sold to investors at a higher price.

Later in 2009, Hypo said it needed an extra €1.2 billion to cover rising losses on loans it had made in the Balkans. This time, BayernLB refused.

That left Austrian and European authorities in the lurch. Letting Hypo fail would have triggered €21 billion in guarantees made by Carinthia's provincial government under Mr. Haider—bankrupting the province and overwhelming Austria's deposit-insurance system.

In frantic talks over a weekend in December 2009, including an intervention by ECB then-president Jean-Claude Trichet, the Austrian finance ministry bought Hypo back for a pittance and nationalized it. BayernLB agreed to leave €4 billion in long-term loans in Hypo and booked a loss of €3.7 billion on its investment.

Hypo's sprawling headquarters sit on the outskirts of Klagenfurt, a city of 90,000 near the border with Slovenia.

When Mr. Böhler arrived here in the summer of 2011, invited by Hypo to build up its small internal forensics unit, he had previously investigated Hypo for more than a year as part of a special police task force and then at consultancy KPMG.

"Now I'll go into the lion's den," he recalls thinking.

He took over rooms formerly occupied by the corporate-loans team, hired 15 lawyers and accountants, and began the hunt for Hypo's lost billions.

The search has taken the team from the snow-licked mountains of Carinthia down the Adriatic coast of Italy, Croatia and Montenegro all the way to the Bulgarian Black Sea.

Along this route, Hypo financed luxury resorts, cars and boats, as well as thousands of mortgages and personal loans that it says have gone bad.

A leasing subsidiary in Bulgaria that wrote almost 1 billion Bulgarian lev (around $650 million) in deals in 2007 now has 95% of its loans in arrears, according to Mr. Böhler. Investments in three luxury resorts on the Croatian coast have cost Hypo more than €700 million, the bank says.

At times, the forensics team's investigations raise more questions than they answer. In April last year, the Greek coast guard found an abandoned yacht in the waters off Kyparissia, a small town in the Peloponnese, according to a coast guard report. On board the yacht, which had been financed by Hypo, was a wallet containing a Croatian passport and 5,000 North Korean won, worth around $5.50.

The yacht had been registered as stolen by a Montenegrin charter company that leased it from Hypo—a company the bank has sued for the return of nine leased boats. Predrag Bozovic, former owner of the now-defunct Montenegro Charter Co., declined to comment on the yacht but labeled Hypo's suit "without foundation."

With each unprofitable investment, Mr. Böhler's investigators must distinguish between over-exuberant lending and possible criminal behavior—whether bank employees were duped or deliberately ignored risks for personal gain. The forensics unit has investigated 160 instances of suspected fraud, responsible for an estimated €1.6 billion in losses, documents reviewed by the Journal show.

"It was a mix of greed, criminal energy and utter chaos," Mr. Böhler said.

So far, Austria's federal government has supported Hypo with €5.35 billion in capital and guarantees.

This summer, the government took some steps to limit taxpayers' bills. It said it wouldn't repay €800 million that BayernLB had left in Hypo, and it voided €890 million in subordinated bonds issued by Hypo even though they carried guarantees from Carinthia province. Vienna said the move was in line with EU law mandating that investors share in the burden of a bank's failure.

The fallout was swift. Within days, Moody's Investors Service downgraded the credit rating of 11 other Austrian banks. The International Monetary Fund, whose sister organization the World Bank held €150 million of Hypo bonds, condemned the repudiation. The World Bank said it is weighing its legal options.

German Finance Minister Wolfgang Schäuble also was unhappy. "Whoever wants to sue against this national law, or the implementation of this national law, knows the relevant courts," he said.

In a sign that Austria's government could be in for a lengthy battle, the affected bond investors include Aurelius Capital Management LP, one of the hedge funds that recently fought a 2001 debt restructuring by Argentina all the way to the U.S. Supreme Court. Asked about the Austrians' move, Aurelius Chairman Mark Brodsky said, "I think that, unfortunately, the only path that [Austrian officials] have left open after annihilating €800 million of subordinated debt is for the holders to seek legal redress."

The final bill from the Hypo disaster for Austria's taxpayers will also depend on Mr. Böhler and his team. So far, they have recovered around €180 million, far from the €1.6 billion in suspected losses from fraud.

Mr. Böhler believes it could take another three years to go through Hypo's remaining documents, and many more years until the last court case has been fought. "The whole thing will be over when the last court case is over and the final payment has been collected," he says.

—Geoffrey T. Smith and Nicole Lundeen contributed to this article.

Corrections & Amplifications

The government of the Austrian region of Carinthia guaranteed much of the liabilities of Hypo Alpe-Adria-Bank International Group AG. A previous version of this article incorrectly said the guarantees were written for the bank's loans. (Aug. 29, 2014)

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