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European Commission
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This report was prepared in the European Commission's Directorate-General for Economic and Financial Affairs under the direction of Luc Tholoniat (Director), Moisés Orellana (Head of Unit for Cyprus) and Maarten Masselink (Deputy Head of Unit for Cyprus).

The report was approved by Declan Costello, Deputy Director-General ([1]).

Contributors: Paulina Rogowska, Andreea-Alexandra Maerean, Angela Droussiotou, Zivile Didziokaite, Marios Christodoulou, Anda Patarau, Anna Grochowska, Elena Pavlova, Marcus Sonntag, Jaime Ruiz Rocamora, Christos Koulouteris and Vallyon Emese. Assistance was provided by Patricia Bernardos Schepers.

The Post-Programme Surveillance assessment was prepared in liaison with staff from the European Central Bank (ECB) ([2]).

This report reflects information available and policy developments up until 25 October 2021. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission's 2021 Autumn Forecast released on 11 November 2021 (with cut-off date 25 October 2021). References in this report to the Recovery and Resilience Facility do not constitute any assessment of the implementation of the Cypriot Recovery and Resilience Plan and cannot in any way serve to pre-judge the Commission assessment of the implementation of the Plan.

Comments on the report would be gratefully received and should be sent by mail or e-mail to:

Moisés Orellana
European Commission
Directorate-General for Economic and Financial Affairs
CHAR 12/006
B-1040 Brussels
Belgium

e-mail: moises.orellana@ec.europa.eu

([1]) The executive summary of this report was adopted as Commission Communication C(2021) 8556 on 22 November 2021. The rest of the report reflects the findings of the staff working document SWD(2021) 363 accompanying that Communication.

([2]) ECB staff participated in this mission and in the drafting of this report in line with the ECB's competences, providing expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

EXECUTIVE SUMMARY

This report summarises the main findings from the eleventh post-programme surveillance (PPS) mission for Cyprus, which took place from 13-22 September 2021. Given the COVID-19 related travel restrictions, the mission was conducted in virtual format, via video and teleconferences involving European Commission staff, in liaison with staff from the European Central Bank (ECB). The institutions held several online meetings with the Cypriot authorities, major banks and credit-acquiring companies. This report is more limited in scope than usual. Staff from the European Stability Mechanism (ESM) participated in the conference calls on aspects relating to the ESM's Early Warning System. Staff from the International Monetary Fund (IMF) joined as well under the framework of a staff visit.

Economic activity started recovering from the sharp recession as of the first half of 2021, driven mainly by domestic demand, although tourism activity still remains well below the pre-pandemic level. The accelerating pace of vaccination and the improved epidemiological situation in Cyprus and the rest of the EU before summer prompted the rebound of economic activity as of June 2021. According to the Commission services' 2021 Autumn forecast, real GDP is expected to increase by 5.4% in 2021, on the back of stronger domestic demand, helped by measures adopted to mitigate the impact of the crisis. However, receipts from tourism were at around 35% of the 2019-level for the first 7 months of the year and the sector may need 2 more years to return to its pre-pandemic performance. The economic recovery is expected to continue in 2022 and 2023 at a rate of 4.2% and 3.5% respectively, mainly driven by domestic demand. The implementation of the recovery and resilience plan, notably investments, is expected to have a positive impact on real GDP in the order of 1.5% each year in 2022 and 2023. The pandemic's impact on the labour market was cushioned by government support measures. Unemployment has already started to decrease, reflecting the recovery of the economy. However, external imbalances, including a sizeable current account deficit, persist. Inflation has edged up mostly as a result of higher energy prices. A key downside risk to the growth outlook is the persistent uncertainty on the evolution of the pandemic. On the upside, the implementation of the reforms in the recovery and resilience plan and of the Growth Strategy currently under preparation, is expected to have a positive impact on the economy in the medium and long-term.

Cyprus' fiscal situation continues to reflect the impact of the pandemic on the economy and sizable fiscal support measures, although a clear improvement is expected for the next years. According to the Commission Autumn forecast, the general government deficit is expected to narrow from 5.7% of GDP in 2020 to 4.9% of GDP this year. The bulk of fiscal measures adopted to tackle the effects of the crisis, expected to reach around 4.1% of GDP this year compared to 3.5% of GDP in 2020, is foreseen to be phased out by end November 2021. The withdrawal of support schemes and the continued recovery of the economy will positively impact the government balance in 2022 and 2023, with a projected decrease of the deficit to 1.4% of GDP and 0.9% of GDP respectively. The debt-to-GDP ratio is set to resume its downward trend this year, from 115.3% in 2020 to 104.1% by the end of 2021, on the back of high nominal GDP growth and a reduction of the high stock of cash reserves. The fiscal outlook is surrounded by significant downside risks. First and foremost there is continued uncertainty about the evolution of the pandemic. Furthermore, higher than expected costs related to the implementation of the National Health System (NHS) reform could negatively impact the fiscal outlook. In addition, the planned expansion of KEDIPES into a national asset management company could affect public finances in 2022. Further risks stem from contingent liabilities.

The banking sector is weathering the COVID crisis rather well. Bank capital positions remained strong with the CET1 ratio at 17.2% in June 2021. Following a sizeable loss in 2020, the sector returned to a small profit in the first half of 2021. Nevertheless, profitability remains a major challenge given inefficient cost structures, low margins and limited business opportunities. Liquidity in the system remained ample, with deposits growing this year. Non-performing loans (NPLs) continued to decline in the first half of 2021 – albeit marginally. Overall, the NPL ratio has been significantly reduced since the beginning of the pandemic, down from 27.4% in March 2020 to 17.6% in June 2021. Furthermore, the main banks are working on additional NPL portfolio sales. ESTIA (the government's subsidy scheme for debtors with primary residence collateralised loans) has run its course, with a limited impact on reducing bad loans. As of September 2021, a new government scheme (OIKIA) for vulnerable borrowers entered into force, with a small and targeted perimeter. Despite the high take-up of the 2020 moratorium, asset quality remained stable following its lifting – with the ratio of loan exposures presenting arrears at the end of June being 5.2%. Nevertheless, credit risk remains a prominent risk going forward, signalled also by the increase in the volume of loans marked as having a deteriorated credit quality (the 'stage 2' segment of exposures). The foreclosures suspension has been extended several times, which risks a potential weakening of payment discipline. The performance of KEDIPES, the state-owned vehicle managing the predominantly non-performing assets left from winding down the Cyprus Cooperative Bank, has been adversely affected by the COVID crisis, with some improvement registered in the course of 2021. Importantly, the authorities continue working on their plan to transform KEDIPES into a national asset management company. This initiative should be carefully designed and have the necessary built-in features to ensure proper asset management on a par with private investor practices to minimise the risk to taxpayers, ensure sound recoveries of assets and mitigate risks and concerns for the overall payment discipline. A stable and properly functioning foreclosure framework is also key for its success. A well-functioning insolvency framework is important for debt workouts. In this respect, the Department of Insolvency continues to work on its reorganisation and on implementing digital solutions. Draft legislation on a single independent supervisory authority for both insurance and pension funds is pending in Parliament, while staffing issues persist for both supervisors.

Cyprus capacity to repay its debt to the European Stability Mechanism is sound. The government financing needs for 2021 have been covered through the issuance of a 5-year international bond in February 2021 (EUR 1 billion) and by drawing on the large cash reserves (which stood above 15% of GDP at the end of 2020). The cash buffer is expected to decrease by the end of this year but it will continue to be sizeable, meeting the gross financing needs of the following 9-12 months. Looking ahead, gross financing needs for 2022-2023 are expected to be lower, owing to improving primary balances and lower debt redemptions. While public debt increased significantly in 2020, it is projected to decline in the coming years, supported by GDP growth and improved fiscal outlook. Loan repayments to the ESM are not due to start until 2025. Cyprus enjoyed a supportive market environment when tapping the international markets and continues to have an 'investment grade' ranking from three major rating agencies. Furthermore, in July 2021, Moody's changed its rating upward to Ba1, just one notch below investment grade.

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1.1. MACROECONOMIC DEVELOPMENTS IN 2021 (3)

The economic recovery in Cyprus surprised on the upside in the first half of 2021, including in the tourism sector. Following a recession of 5.2% in 2020, real GDP increased by 5.1% in the first half of 2021 compared to the same period in 2020. The level of real GDP in the second quarter of 2021 almost reaches the one in the fourth quarter of 2019. The main driver of growth was domestic demand, underpinned by the fiscal stimulus. The accelerating pace of vaccination and improved epidemiological situation in Cyprus and the rest of the EU before summer have prompted a significant relaxation of travel restrictions since mid-May. This resulted in a relatively good performance of the tourism sector. Tourist arrivals increased by a sizable 153.7% in January-September 2021 and revenues by 206.6% in January-July compared to the same periods of 2020. However, revenues are still only at around 35% of 2019-levels and arrivals at 40%.

Domestic demand, helped by the government measures to combat the pandemic, was the main driver of growth in the first half of 2021. Private consumption increased by 2% in the first half of the year, partly linked to the slight increase in employment. Government consumption increased by 15.1%, reflecting the fiscal stimulus, increased expenditure on the national health system and a rise in the public sector's payroll (see Section 2 Public Finances). Gross fixed capital formation increased by 25.9% in the first half of 2021 and construction activity for both residential and non-residential buildings by 10.7%. Despite the abolition of the citizenship by investment scheme in November2020, which was boosting construction activity, this sector remains buoyant thanks to increased domestic demand for housing supported by the mortgage subsidisation scheme and external demand – not related to the citizenship scheme – as well as ongoing infrastructure projects in tourism, energy and education. Exports increased by 3.1%, as a result of higher exports of services (both tourism and non-tourism).

For 2021 as a whole, the economy is expected to show a strong recovery and almost regain the ground lost in 2020. Based on the Commission's 2021 Autumn Forecast, real GDP is projected to rise by 5.4% in 2021, i.e. an upward revision by 1.1 percentage points compared to Commission's summer interim forecast. This is due to higher-than-expected growth in the second quarter of the year, the better-than-earlier expected performance of tourism and the continuing positive economic sentiment. Pre-crisis level of GDP would be almost reached in 2021.

The impact on the labour market has been cushioned by the government support measures. After a relatively mild increase in 2020, peaking at 10.4% in May 2021, the unemployment rate has continuously fallen until August (to 4.4%) (4). The fall reflected the economic recovery, especially in the tourism sector. From the onset of the pandemic until spring 2021, between 50-60% of the working population benefited from temporary measures aiming to protect employment (5), which helped to preserve jobs and incomes and contained the increase in unemployment. Following the reopening of the economy as of early summer 2021, the measures have been more targeted at businesses in the tourism sector, which are suffering significant losses in their turnover, i.e. a 40% reduction in comparison to the 2019-level and an occupancy rate of less than 60%. As a result of this targeting, in August the overall uptake of the measures decreased to around 1% of the working population. Wages started to recover in the second quarter of 2021 showing an increase of 1.7% on the second quarter of 2020. For the whole of 2021,

(3) This report reflects information available and policy developments that have taken place until 25 October 2021. However, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2021 Autumn forecast released on 11 November 2021 (with cut-off date 25 October 2021). References in this report to the Recovery and Resilience Facility do not constitute any assessment of the implementation of the Cypriot recovery and resilience plan and cannot in any way serve to pre-judge the Commission assessment of the implementation of the Plan.

(4) The data are not fully comparable as in June the national authorities introduced a methodological change for measuring unemployment.

(5) Cyprus received a loan of EUR 604 mn (2.6% of GDP) under the EU's SURE scheme to finance these measures and address temporary income replacement due to lockdown measures.

employment is expected to increase by around 1.2% in 2021 and the unemployment rate to decrease to 7.5%.

Inflation returned to positive territory in 2021. The harmonised index of consumer prices increased to 1.5% during the period January-September 2021 after registering a negative rate of 1.1% in 2020. This turnaround was mostly linked to higher energy prices, and to a lesser extent to higher non-energy industrial goods and services prices. For 2021 as a whole, headline inflation is expected to edge up to 1.9%. Inflation for 2021 is expected to be contained aided by the government's decision to provide a discount to the consumer electricity bills and the absorption of part of the higher international oil prices by Cyprus's Electricity Authority.

The current account deficit deteriorated further. It stood at 12.7% of GDP in Q2 2021 ([6]). Excluding special purpose entities, the deficit was 10.9%, compared to 6.6% in Q2 2020 and 4.7% in Q2 2019. This is to some extent due to the plummeting of tourism exports. In 2021 as a whole, the current account deficit is expected to reach 9.2% of GDP.

1.2. ECONOMIC OUTLOOK IN 2022 AND 2023

For 2022 and 2023, the recovery is expected to continue, helped also by the implementation of the recovery and resilience plan. Private consumption is set to continue recovering owing to pent-up demand and the positive employment prospects. By contrast, government consumption is expected to decelerate significantly due to the phase-out of support measures. Investment is expected to exceed its 2019-level in 2022, boosted also by the implementation of the recovery and resilience plan and its investments, in particular in the areas of the green and digital transitions and of support to SMEs. Construction activity is expected to continue increasing, mainly supported by the mortgage subsidisation scheme for first residences. External demand for tourism is expected to recover gradually and is projected to reach its 2019-level by the end of 2023. Overall, real GDP is projected to increase by around 4.2% in 2022 and 3.5% in 2023 ([7]). These projections include the impact on the economy of the implementation of the recovery and resilience plan, notably investments, which could increase the real GDP by 1.5% per year in 2022 and 2023 ([8]).

On the back of economic recovery, the labour market is expected to continue to improve in 2022 and 2023. Employment is expected to increase by around 2.2% in 2022 and by 2.3% in 2022. Unemployment will gradually decrease to 7.1% in 2022 and 6.6% in 2023, going below the 2019-level. While the employment support measures have already been phased out in large part, the situation is being closely monitored. The implementation of the recovery and resilience plan is expected to increase employment in the coming years ([9]).

Inflation is expected to moderate in 2022 and 2023. It is expected to decelerate to 1.7% in 2022 and 1.2% in 2023, as oil prices are expected to decrease. Inflation, excluding oil prices, is expected to be around 1.3% in 2022 and 1.5% in 2023.

The gradual recovery in tourism is expected to narrow the current account deficit. It is forecast to fall to 7.3% of GDP in 2022 and to 5.7% in 2023. Despite the improvement, this is well above the current account required to stabilise the net international investment position (NIIP) of Cyprus above the threshold of 35%. In 2020, the NIIP stood at -136.7% of GDP (and excluding special purpose entities at -50.3% of GDP). This remains a source of vulnerability and warrants close monitoring.

Downside risks to the growth outlook remain due to persisting uncertainty, mainly regarding the evolution of the pandemic. A slower progress than anticipated with the vaccination campaign and/or increasing transmission of new variants with less protection from the vaccines, would take

([6]) The figure refers to a four-quarters rolling sum to smooth out the inherent volatility of the series for Cyprus.

([7]) Commission's Autumn 2021 Forecast.

([8]) Commission staff working document 2021, *Analysis of the recovery and resilience plan of Cyprus*. Model simulations conducted by the Commission using the QUEST model.

([9]) The simulations conducted by the Commission using the QUEST model show an increase of around 3 000 additional jobs in 2021-2040 with a more pronounced increase in 2021-2026.

a further toll on consumer and business confidence and the economy. In this context, tourism is particularly vulnerable as holiday planning could be affected. In addition, if the pandemic's impact on the supply chain and logistical disruptions in particular for construction materials continue, this may impede the recovery of certain sectors. On the positive side, so far there are no strong indications of significant scarring effects on the economy from the pandemic as the increase in bankruptcies remained at a modest level. The risk of a surge in new NPLs also seems lower than initially expected, as most businesses have started repaying their loans after the lifting of the moratoria. However, the private sector's repayment performance warrants close monitoring in the coming months in particular regarding tourism and construction, as additional NPLs arising from the crisis could adversely impact the financial sector and the flow of credit to the economy (see Section 3 Financial Sector). Furthermore, the implementation of the reforms in the recovery and resilience plan and of the Growth Strategy currently under preparation, is expected to have a positive impact on the economy in the medium and long-term.

2. PUBLIC FINANCES

2.1. FISCAL PERFORMANCE

The COVID-19 pandemic continues to have a strong impact on the public finances of Cyprus. After a strong fiscal position in 2019 (surplus of 1.3% of GDP), the headline balance recorded a deficit of 5.7% of GDP in 2020. This reversal reflected the considerable fiscal measures to fight the pandemic, support the economy and boost the recovery. During the first 8 months of 2021, with several support measures extended and three supplementary budgets put forward, the government headline balance remained in deficit and reached EUR 504.1 mn (2.2% of GDP), compared to the deficit of EUR 625.2 mn (2.9% of GDP) for the same time horizon recorded in the previous year.

Public expenditure rose in the first 8 months of 2021, mainly on the back of support schemes extended through additional supplementary budgets and the implementation of the health reform. For the period January-August 2021, public spending increased by 10.7% compared to the same time horizon in 2020. Three supplementary budgets ([10]) were approved between June and October 2021, reaching 1.1% of GDP. An upward level shift was observed in social transfers, which increased by more than 14%, reaching 10.5% of GDP. This was mainly due to the gradual implementation since summer 2020 of additional health-related spending for the second phase of the healthcare reform. Support measures for businesses and self-employed to cover part of their operating costs, as well as wage subsidisation schemes boosted the increase of subsidies in the first 8 months of 2021, compared to the same period of 2020 (16.5% y-o-y; 2.3% of GDP) which was however only partly affected by the pandemic. Compensation of employees showed an increase of 5.5% over the same period, bringing their level to 7.9% of GDP ([11]). Between January and August 2021, intermediate consumption recorded a growth rate of 13.4% (2.5% of GDP). This rise is mainly explained by higher spending in the context of the pandemic and National Health System (NHS). Interest expenditure recorded a growth of 4.9% (1.4% of GDP). Gross fixed capital formation increased by around 8% (1.2% of GDP) over the same period.

Government revenue registered a positive development in the first months of 2021, with almost all categories experiencing an increasing trend compared to the previous year. From January to August 2021, public revenue rose by 14.3%, compared to the same time horizon in 2020, mainly due to the recovery of the Cypriot economy and higher business activity. The key driver of this boost – indirect taxes – increased by around 17% (reaching 9.1% of GDP). In particular, VAT collection increased by 18.6% (5.7% of GDP), compared to the previous year, when VAT revenue was significantly impacted by the pandemic. During the period under review, direct taxes recorded a rise of 9.3%, amounting to 6.2% of GDP. This reflects a rise in corporate taxes of 13.1% (2.7% of GDP), an increase in income taxes of employees in private sector and government employees by more than 14.8% (1% of GDP) and around 10% (0.6% of GDP) respectively. Increased social contributions linked to the roll-out of the second phase of the health reform were another important driver for the overall revenue improvement. This category grew by 16.3% (7.4% of GDP) in 2021, compared to the first 8 months of 2020 ([12]). Finally, other revenue recorded an increase of 11.1% (2.5% of GDP).

([10]) Three supplementary budgets were approved in 2021, in addition to the first one voted in April 2021. The second supplementary budget voted in June amounted to EUR 148 mn (0.6% of GDP). The latest reflects spending for wage subsidisation and vaccination (around EUR 30 mn; 0.1% of GDP). An additional supplementary budget was approved in June for an amount of EUR 20 mn (0.1% of GDP), providing support to fire victims. The last supplementary budget was approved in September, reaching EUR 91.7 mn (0.4% of GDP)).

([11]) This increase is mostly associated with the combined effect of the gradual reversal of wage cuts, increments, increased hiring of doctors in the State Health Services Organization (SHSO) and increased gratuity payments.

([12]) This increase only partially offset the rise in social payments related to the NHS. However, the accumulated NHS reserves from the start of the reform – due to frontloaded start of revenue collection by 3 months, resulting in windfall gains in 2019 and 2020 – can cover temporary deficits for a few years ahead.

Initially, for 2020 higher health contributions were planned as of March 2020. However, the increase was suspended by 3 months due to the COVID-19 crisis. In parallel, the provision of additional healthcare services as part of the reform's second phase was also postponed by several

2.2. FISCAL OUTLOOK

The situation is expected to improve in 2021, and more significantly in 2022 and 2023. The expected improvement of the fiscal outlook in 2021 can be explained by higher revenue collection due the improved economic situation. In 2022, the deficit is expected to decrease further on the back of the withdrawal of support schemes and the continuing recovery. Although the budgetary impact of support schemes is foreseen to increase in 2021, the COVID-19 related measures have been gradually phased out and full termination is expected by the end of November 2021, except for the interest subsidy schemes, which are envisaged to last until 2024. According to the Commission 2021 Autumn forecast, the headline balance is expected to remain in deficit in 2021 and reach 4.9% of GDP. Public revenue is projected to increase by 9.6%, reaching 40% of GDP. Public spending is expected to remain high and to rise by 7.4%, reaching 44.9% of GDP in 2021. In 2022 and 2023, the recovery is projected to continue and the deficit is forecast to decrease further to 1.4% and 0.9% of GDP, respectively. The debt-to-GDP ratio is set to resume its downward trend this year – in particular it is forecast to decline from 115.3% in 2020 to 104.1% by the end of 2021, on the back of high nominal GDP growth and the reduction of the high cash buffer accumulated last year to cover financing needs due to the pandemic. Going forward, it is projected to decrease further to 97.6% of GDP in 2022 and to 93.4% in 2023 (see Section 4 – Sovereign financing, and the debt sustainability analysis).

The budgetary impact of support measures related to the pandemic is expected to slightly increase in 2021 compared to their level of 2020. Spending for COVID-19 related measures reached 3.5% of GDP in 2020. In 2021, the budgetary impact of support schemes, previously (under the stability programme) expected at around 3.4% of GDP, is expected to reach 4.1% of GDP since additional COVID-19-related expenditure has been approved, notably in various supplementary budgets. Spending for those measures mostly relates to the wage subsidisation scheme, support for businesses to cover their operating costs and health related spending. In 2022 and 2023, the budgetary impact of support schemes is expected to narrow to 0.2% and 0.1% of GDP respectively.

The fiscal outlook is surrounded by significant downside risks. Uncertainties regarding the evolution of the pandemic and the potential apparition of new variants remain important. In addition, the fiscal sustainability of the NHS in the aftermath of the reform presents downside risks in the medium term. In particular, the SHSO (i.e. public healthcare providers) may not achieve financial autonomy within 5 years (i.e. by June 2024), as envisaged in the law, amongst others due to impact of the pandemic. It may lead to financial deficits of the SHSO of a bigger amount and for a longer period of time than initially expected. There is also a risk of an increased use of healthcare services under the General Health System (GHS), which could lead to increased spending putting pressure on public finances. Another fiscal risk that could materialise in 2022 concerns a negative fiscal impact from KEDIPES' expansion into a national asset management company, including from on-boarding the NPLs from banks, real assets for the mortgage-to-rent scheme and the subsidisation of the borrowers under the scheme. However, the terms of the transaction are still to be set, taking into consideration, among others, the need to contain the fiscal impact. Nevertheless, on the upside the implementation of reforms in the Cypriot recovery and resilience plan and the Growth Strategy for diversification of the economy, which is under preparation, is expected to positively impact the economy in the medium and long-term.

Other adverse risks to the fiscal outlook relate to government guarantees. The government guarantees in nominal terms declined in 2020 compared to the year before to 7.3% of GDP. The latest risk assessment report for government guarantees assesses the amount of potential guarantee calls to be limited, below 0.6% of GDP in 2022 and lower in the following years, of which a part is already included in the fiscal projections. Additional guarantee schemes related to the pandemic could increase the amount of guarantees granted in the next months. The first scheme covered the tourism sector. Its application window has closed and the guarantees to be issued would reach around 0.05% of GDP. A second scheme of around EUR 1 bn (4.55% of GDP) for loans to businesses and self-employed has the application

months. Integration under the NHS of a few remaining services is still pending as of September 2021.

window open until the end of this year. It is noteworthy that the risks from the latter scheme are mitigated through risk sharing with banks, which are expected to cover 30% of loan losses**.**

3. FINANCIAL SECTOR

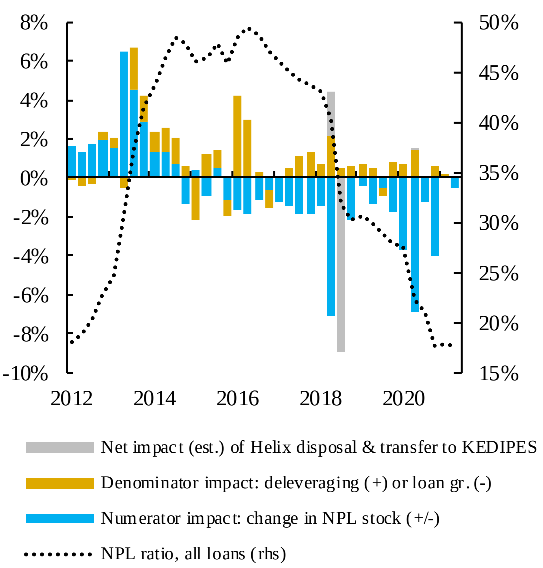
3.1. BANKING SECTOR DEVELOPMENTS

Asset quality

The stock of non-performing loans (NPLs) continued to decline in the first half of 2021 – albeit marginally, following a significant reduction in 2020. NPLs held by the banks stood at EUR 4.99 bn at the end of June 2021, down from EUR 5.11 bn at the end of the previous year. Over the same period, the NPL ratio ([13]) declined marginally to 17.6% from 17.7%, amid a drop in the value of all outstanding loans. Since the beginning of the pandemic, NPLs have been significantly reduced (through large portfolio sales and sizeable write-offs), coming from a ratio of 27.4% in March 2020. The main banks are pursuing further NPL disposal opportunities, with Bank of Cyprus progressing on Helix 3 project, while Hellenic Bank is working on Project Starlight ([14]).

The overall performance of loans exiting the payment moratorium has been encouraging up to June 2021, but risks to asset quality remain significant. Cypriot banks offered their customers two loan moratorium schemes. The first scheme which expired in December 2020, covered EUR 11.7 bn, or 42% of all loans and advances. The second loan moratorium, with considerably stricter eligibility requirements, ran until June 2021 and covered only EUR 59 mn. Following the lifting of the 2020 moratorium, the adverse effects on asset quality have been contained, with the ratio of exposures presenting arrears at the end of June being 5.2% ([15]). Banks engaged proactively with borrowers, resulting in a non-negligible share of restructurings – which mitigated the risk of arrears. However, the full picture of the post-moratorium performance is not yet complete, as not all loans had instalments due by June 2021 ([16]) and the impact of the withdrawal of the government support measures remains to be seen. So far, loans with a total volume EUR 10.9 bn have exited moratorium, of which EUR 8.9 bn have registered a payment due by end June 2021. Of all exposures that exited the moratorium status, 10.9% have been renegotiated. Renegotiations include both distressed and not distressed restructurings, like extension of maturity, instalment reduction, deferral of capital and/or interest payments, reduction of the interest rate, capitalisation of arrears and other measures. Renegotiation ratios varied widely among economic sectors, with construction and accommodation registering the highest ratios of 31.9% and 31.4% respectively ([17]).

Graph 3.1: NPL ratio (rhs) and breakdown of changes (lhs)



Source: Central Bank of Cyprus

The effects of the pandemic can be seen on loans with a deteriorated credit quality, known as 'stage 2' loans, which indicates risks. This segment increased from EUR 2.9 bn in December

([13]) In this report, the NPL ratio (i.e. the NPL stock to total gross loans) includes operations of all domestic and foreign credit institutions operating in Cyprus. Banks' exposures to central banks and credit institutions, or their overseas operations (branches and subsidiaries located abroad) are not taken into consideration.

([14]) Both projects entail NPL portfolio sales.

([15]) The arrears ratio is defined as the % of exposures that present at least one day past due as at June 2021, excluding any exposures for which the repayment schedule has not commenced yet.

([16]) For 19% of loans subject to the moratorium the repayment schedule starts after June 2021 as some business loans have semi-annual or even annual repayment profiles.

([17]) The construction sector covered EUR 1.0 bn of loans that exited the moratorium status by June 2021, while accommodation registered EUR 1.8 bn.

2019 to EUR 4.1 bn in June 2021, by then representing about 15% of all loans and advances. The increase was especially strong for non-financial corporations (NFCs), where 20% of all loans are currently classified as stage 2. The household segment was less affected. Cyprus remains among the EU countries with the highest proportion of stage 2 and stage 3 exposures ([18]). Cypriot banks have large exposures to tourism and transport, both sectors being heavily impacted by the pandemic. Given the still widespread uncertainty in the economy, it remains important that banks have adequate risk management systems in place to detect any deterioration in loan quality early on. The lack of such systems may lead to the reclassification of entire loan segments rather than individual loans (to the stage 2 category, for example). Elevated private indebtedness and a generally weak payment culture increase the importance of such early warning systems.

Cypriot banks may need to increase their levels of provisioning given large volumes of risky exposures. Loan-loss provisions increased slightly from 46.2% in December 2020 to 46.8% in June 2021, following a significant decline in 2020 related to NPL sales. The current coverage ratio is aligned with the euro area average. Nevertheless, given the significantly lower quality of the remaining NPLs, Cypriot banks may need to increase their provision levels. A complicating factor is the suspension of foreclosure activities for primary residences and small business premises, which creates legal uncertainty, hampering the determination of recovery values. Moreover, it risks eroding payment discipline and could thus lead to a further deterioration of loan quality (see Subsection 3.2 on foreclosure developments).

Profitability, capitalisation and liquidity

Profitability remains a major challenge for Cypriot banks given low margins, high operating costs and limited business opportunities. The sector operates in an environment of low margins, high levels of NPLs, and intense competition. Further challenges are the low income diversification, deleveraging and rigid labour relations. The pandemic has exacerbated this situation, with further deterioration of loan quality and limited lending opportunities. The cost-to-income ratio recently reverted to be the second highest in the EU, only exceeded by Ireland. The ratio further deteriorated in Q1 2021 to 71.2% and 69.2% in Q2 2021, after hitting a relatively low level of 63.2% in Q4 2020.

Following a loss in 2020, the sector returned to a small profit in the first half of 2021. The pre-tax loss from continuing operations of EUR 68.6 mn in 2020 was mainly due to impairment charges, which rose to EUR 522 mn in 2020 from EUR 325 mn in 2019. Banks needed to build new provisions to account for possible credit losses caused by the pandemic. These impairments eased in 2021, and banks were able to book a pre-tax profit of EUR 27 mn in the first half of 2021. Other income and cost items were broadly in line with previous trends: net interest income declined moderately to EUR 460 mn in the first half of this year, from EUR 499 mn in 2020. Administrative expenses, including staff costs, were slightly higher than in 2020. The latter, and more generally inflexible labour markets, have been a longstanding problem for Cypriot banks. Labour costs are high and keep on rising as legacy wage agreements remain in force until a new compromise with labour unions is struck. Interest rate margins remained compressed, weighing further on profitability. They were around 2% for households and around 3% for non-financial corporations in 2020 and during Jan.-Aug. 2021. Given the prevailing low interest rate environment, prospects for widening interest margins, and for related higher profits, look unlikely. Thus, lowering administrative costs remains key to boosting structural profitability.

Despite the challenges, banks managed to maintain solid capital buffers. The CET1 ratio improved to 17.6% at the end of 2020 and subsequently dropped slightly to 17.2% in June 2021. The EU Coronavirus banking package, which lowered capital charges for SME exposures, was a major factor that helped banks to alleviate their capital charges in 2020 ([19]). Overall, Cypriot

([18]) Stage 3 loans are considered credit impaired, i.e. a loss has occurred. This is usually a wider definition than NPLs, 90 days past due.

([19]) The Capital Requirement Regulation (CRR) 'quick fix' was part of a package proposed by the Commission and agreed by Parliament and the Council. It implemented some targeted changes to the CRR with the aim of facilitating lending to households and businesses in the EU, in particular to SMEs. Measures included advancing the application of the SME supporting factor, as well as rebanks need to maintain relatively high capital ratios given their comparatively risky loan portfolios.

Liquidity remains ample, with deposits growing in 2021. At the beginning of the pandemic, bank deposits declined in Cyprus as foreign depositors withdrew funds at a higher pace than the growth of domestic deposits. The bottom was reached in July 2020, when total deposits stood at EUR 47.6 bn, down from EUR 48.2 bn in December of 2019 ([20]). However, since March 2021 deposits have grown considerably as domestic deposits of both households and NFCs surged and foreign clients returned. In August 2021, deposits reached a new peak of EUR 50.1 bn. The net stable funding ratio (NSFR) is at a comfortable level of 162% while the liquidity coverage ratio (LCR) is 315% ([21]). These ratios are among the highest in the EU but excess liquidity also constitutes a drag on profitability as banks are struggling to find profitable investment opportunities. Consumer protection legislation does not allow Cypriot banks passing on interest rates to consumers. .

Lending

In 2021, new lending to households recovered to pre-pandemic levels while lending to corporations is lagging behind. Throughout 2020, bank lending to the real economy declined. In 2020, new lending to households dropped by 11.9% and new lending to NFCs fell by 32.9%, compared to the levels of 2019. In 2021, lending recovered, with new lending to households in the year to August reaching EUR 888 mn, up from EUR 623 mn a year before and, exceeding levels registered over the same period in 2019. The gradual withdrawal of COVID-related restrictions helped the corporate lending activity recover gradually. However, in the year to August, new lending to NFCs stood at EUR 941, mn, which was still 32% below the corresponding values in 2019. Mortgage lending expanded particularly strongly over the last months. A major driver of this expansion was the interest rate subsidy scheme, launched in July 2020 and extended until the end of 2021 ([22]). It was used for 47% of new loans in 2020, and for 54% of loans granted in the first half of 2021.

A further boost to lending is expected from the government loan guarantee scheme for the self-employed and enterprises. The European Commission approved the guarantee scheme on 17 August 2021, but the corresponding law still needs to be adopted by the House of Representatives. The total amount earmarked by the government for this scheme is EUR 1 bn for a total loan amount of EUR 1.43 bn. The take-up of the scheme might be held back by the limited time frame for applications for this scheme, i.e. from the scheme's final approval until 31 December 2021.

Overview of the largest domestic banks

The Bank of Cyprus (BoC) continues to work on reducing its NPL exposures. In 2020, BoC managed to offload a large share of its NPL exposures through sales (project *Helix 2* portfolio A and B) that collectively reduced the NPL burden by EUR 1.8 bn. In the same year, the bank achieved an organic NPL reduction of EUR 171 mn, through write-offs. BoC is currently working on *Helix 3,* aiming to finish the next phase of the sale by the end of this year. The performance of loans exiting moratorium schemes has been encouraging so far, as only 4% of the EUR 4.7 bn of performing loans subject to moratoria that had a payment due by 12 August 2021 have resulted in arrears, and a further 10% have been restructured. However, risks remain and the bank is actively working on improving its risk management tools to detect in a timely manner any further deterioration in its loan portfolio. BoC's capital position deteriorated slightly to 14.2% in June 2021, from 14.8% a year earlier. While capital buffers are high

setting of IFRS 9 transitional arrangements and the preferential treatment of NPLs guaranteed by the State. See Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic.

([20]) The decline may not be caused by the pandemic as it is the continuation of a downward trend that started in 2013, but the pandemic may have contributed to it. In any case foreign deposits stabilised in 2021.

([21]) The NSFR relates the bank's available stable funding to its required stable funding. It must be equal to or exceed 100%: the LCR expresses the amount of high quality liquid assets a banks holds as a percentage of the total net cash outflow over the next 30 calendar days.

([22]) The subsidy is up to 2 pps for the first 2 years for all businesses, while during the third and the fourth year the loan is subsidised by up to 2 pps for SMEs and by up to 1.5pps for larger enterprises.

compared to banks in other European countries, there are persistent uncertainties in the economy, constrained revenue generation capacity, and difficulties in reducing the cost base. It is reassuring that BoC managed to issue EUR 0.3 bn of MREL eligible preferred notes in 2021. With an MREL ratio of 18.53% in June 2021, the bank has already attained its MREL target for 2021 of 14.94%, the final target for 2025 being 23.3%. BoC had a liquidity coverage ratio (LCR) of 303% in June 2021, which is higher than the EU average and the minimum requirement.

Hellenic Bank (HB) maintained a stable NPL ratio in the first half of 2021, but risky exposures on its balance sheet remain. HB managed to reduce its NPL ratio by 9.5 pps in 2020 to 22.1% at the end of the year through write-offs and two small sales transactions. In 2021, the ratio remained broadly stable and stood at 22.4% in June. The bank is currently working on a project entitled *Starlight*, which entails the sale of EUR 900 mn of NPLs. A rather high share of NPLs (59%) is currently covered by provisions. However, the bank's credit risks remain substantial. The lifting of the moratorium resulted in an increase in arrears (arrears ratio of 5% as of June 2021), and a further deterioration in asset quality is likely. HB benefits from a solid, stable and primarily retail-based pool of deposits, which enables the bank to meet liquidity requirements easily. Its LCR of 510% is among the highest in Europe.

HB's capital position remains solid but the latest stress test pointed to risks. Hellenic Bank has a strong capital position with a CET1 ratio of 19.7% in June 2021, reflecting a solid after-tax profit of EUR 21.1 mn registered in the first half of 2021. Nevertheless, the ECB's stress test cautioned that the bank falls into the lowest CET1 range (below 9%) based on the riskiness of its loan portfolio in the baseline scenario. With an MREL ratio of 18.75%, the bank has already reached its target of 16.57% for the year, but it is still to meet the final requirement of 24.1% which must be met by end-2025. HB is working on a new strategy, including business transformation and restructuring. While the new objectives will require notable investments, they should turn out overall beneficial for the bank in the longer term.

Foreclosure developments

The longer-term perspectives for the foreclosure framework remain uncertain. The foreclosure framework was strengthened in 2018, but in 2019 new amendments were brought in, backtracking on key elements of the previous year's reform ([23]). In 2021, new discussions resurfaced on potential further legislative amendments. An effective foreclosure framework is an essential tool to work out NPLs and is needed to encourage borrowers to participate in loan restructuring.

Legal uncertainty regarding the use of foreclosures has increased. In March 2020, major banks and credit-acquiring companies announced that they would be suspending foreclosure actions for 3 months. The suspension was subsequently extended to the end of August. Foreclosures resumed in September, but in December 2020 an act of parliament suspended foreclosures again. Thereafter, in May 2021, Parliament voted for a further suspension until 31 July 2021 of foreclosures of primary residences, business premises and agricultural land ([24]). In July 2021, the suspension was extended until end-October 2021 with a narrower scope ([25]), but eventually did not enter into force, as it was referred by the President to the Supreme Court. These developments increased legal uncertainty, possibly weighing further on payment discipline, hindering banks' short-term efforts to reduce NPLs and NPL resolution overall.

Since their introduction in September 2020, electronic auctions of foreclosed real estate emerged as banks' preferred option for disposing of mortgage loans. The ongoing pandemic has further supported this shift. While visiting properties became restricted due to the

([23]) The 2019 amendments were confirmed by the Supreme Court in 2020.

([24]) The perimeter of the this suspension covered: (i) primary residences (used for more than 6 months per year), with estimated value up to EUR 500,000; (ii) business premises used by SMEs with up to 10 employees and with an annual turnover below EUR 2 mn; and (iii) agricultural land with estimated value below EUR 250 000.

([25]) The extended suspension covered: (i) primary residences with estimated value up to EUR 350,000; (ii) business premises used by SMEs with an annual turnover below EUR 750,000; and (iii) agricultural land with estimated value below EUR 100,000.

pandemic, online sales saw a slight increase in the first half of 2021. A total of 35 successful electronic auctions took place in the first 6 months of 2021 (mostly related to land and residential property), as compared with 23 in H2 2020. Post-auction failure, the majority of the properties sold has been bought by the mortgage lender. The use of electronic auctions is expected to further increase as the scope of users and familiarity with the platform grow, further helping reduce the NPL stock in Cyprus.

Cyprus Asset Management Company (KEDIPES) and credit acquiring companies

The new service loan agreement (SLA) of KEDIPES reduces servicing fees, while the revised business plan places greater emphasis on restructurings. In July 2021, the key financial terms for the renegotiated SLA with Altamira Cyprus were approved by both parties. The revised agreement entails an overall decline in management, withdrawal and termination fees. The new SLA also places greater focus on improving borrower and loans account data, as this information is essential to achieving higher prices in loan sales. As regards restructurings, the period of performance for restructured loans has been extended to 36 months (instead of 12 months), so Altamira Cyprus has heavier responsibilities in devising long-term restructurings. Overall, there have been improvements to projected servicing fees (over 2020-2027) and the new SLA has greater focus on a performance-based structure of fees. While in its final stages, the SLA has not yet been fully revised and signed off as of September 2021 ([26]). As regards its business plan, KEDIPES devised and agreed a new plan with its adviser BDO Ireland. The revised business plan focuses on reducing the NPL portfolio via restructuring solutions or recoveries and targets full repayment of State aid (currently amounting to around EUR 3.0 bn excluding interest). KEDIPES made progress towards reducing its staff by negotiating with the unions. It expects to sign a new collective agreement for 2019-2022 and launch a new voluntary retirement scheme.

The performance of KEDIPES has been adversely affected by the COVID crisis, with some improvement in 2021. The adverse effects of the pandemic weighed on the speed of recovery and on the recoverable value of assets. Although cash inflows increased in the second half of 2020, they remained well below the pre-crisis level in 2019. Most recently, in Q2 2021, cash inflows reached EUR 95 mn, an increase compared to EUR 53 mn a year earlier, but still lower than in the same quarter of 2019. In addition, claims under the asset protection scheme (APS) with Hellenic Bank weigh on State aid repayments ([27]). The gross book value of the NPL stock declined only marginally (from EUR 6.1 bn to EUR 6.0 bn) throughout 2021, which is comparable to last year's pace of reduction. The suspension of auctions and foreclosures of real estate in 2021 has weighed on debt-to-asset swaps and recoveries. Looking forward, the recent legal uncertainty about foreclosure suspensions might affect NPL workouts, including by KEDIPES**.** As regards ESTIA (see below), the scheme has not materialised as a key driver behind NPL reduction in KEDIPES, due to the very low take-up. Complete applications corresponded to a total of 2 106 accounts and amounted to EUR 493 mn (out of which only EUR 93 mn were assessed as viable by KEDIPES and another EUR 92 mn were approved by the Ministry of Labour), which are far below the originally estimated perimeter of EUR 1.3 bn. The two loan payment moratoria covered a combined perimeter of almost EUR 745 mn or around 12% of the assets under KEDIPES management.

KEDIPES is planning the sale of a loan portfolio and the implementation of a mortgage-to-rent scheme. A sale of up to EUR 1 bn of loans (*Project Ledra*) is envisaged in tranches, starting in 2021. In July 2021, KEDIPES announced the sale of a first tranche of performing loans of up to EUR 465 mn with a target execution date of December 2021 and with cash receipts expected in Q2 2022, after regulatory approvals. In addition, to enhance progress with reducing legacy NPLs in the banking system, the authorities are considering expanding the scope of KEDIPES.

([26]) The financial terms will be retrospectively applied from 1 January 2020.

([27]) Under the APS, the State would bear 90% of the approved credit risk losses, while HB would be exposed to 10%. The APS was initiated in 2018, with a duration of 10 to 12 years, depending on the loans. The assets under the APS initially amounted to approximately EUR 2.8 bn in gross book value. For more details on the APS, see Post-Programme Surveillance Report Cyprus, Autumn 2018.

The initiative could entail KEDIPES purchasing NPLs collateralised by primary residences or primary business premises with a market value of up to EUR 350 000. Work on a new mortgage-to-rent (MTR) scheme by KEDIPES is also ongoing, targeting NPLs backed by a primary residence or by prime commercial property worth up to EUR 350 000 and providing a buy-back option. In this context, it is important that such initiatives are carefully designed and assessed, the fiscal impact is contained, an efficient workout of NPLs is ensured and ensuing risks and concerns for overall payment discipline are mitigated ([28]). A stable and properly functioning foreclosure framework remains key for enabling the success of these initiatives.

As regards credit-acquiring companies (CACs), legal changes have been proposed with a view to strengthening their ability to better acknowledge and assess risks and to enhancing their governance and management. An amendment of the Evidence Law aims to enhance the admissibility of statements of loan accounts presented by credit acquiring companies before court, in the same manner as credit institutions. Furthermore, the Central Bank of Cyprus has assessed CACs compliance with the provisions of the Governance Directive as regards organisational arrangements and internal control systems, with the majority of CACs currently assessed as compliant.

Government schemes for reducing NPLs

The ESTIA scheme, designed for borrowers with NPLs backed by primary residences has run its course. The scheme had a very low take-up and in turn its impact on reducing NPLs in the economy has proven to be small. The scheme had a total of 6 393 applications among which 4 374 were fully completed ([29]). Overall, only 18% of the complete applications were approved, amounting to around EUR 200 mn. Around 79% of the completed applications were rejected. Nevertheless, the scheme supported banks in collecting information on its borrowers and in identifying strategic defaulters (i.e. the applications rejected due to breaches of income and asset criteria which indicate that there is financial capacity on behalf of the borrowers to service or settle the loans).

In April 2021, the government approved OIKIA, a new and highly targeted loan support scheme for vulnerable households. The scheme targets households that have previously obtained loans under the *Government Housing Plan* ([30]). The estimated perimeter is 1 850 loans with a total gross value of up to EUR 165 mn. The application period for the scheme is set at 6 months starting from 1 September 2021. The loan workout option (loan restructuring or repayment of the remaining capital) should be implemented within 6 months of the date of the borrower's application. It remains to be seen how effective the scheme will be.

3.2. OTHER FINANCIAL SECTOR ISSUES

Insolvency developments

A draft bill to transpose into Cypriot law the Directive (EU) 2019/1023 on preventive restructuring is planned to be formally presented to Parliament in Q4 2021. Due to technical inconsistencies the Law Office of the Republic of Cyprus rejected a previous draft that went through consultation and pre-legislative scrutiny before the summer. Several uncertainties remain from a technical standpoint. The legislative process to approve the bill is expected to last 6-8 months. The deadline to transpose the Directive expires on 17 July 2022.

Work to amend the Companies Law, which is important for enhancing debt restructuring, will commence in January 2022. This reform was

([28]) This would include moral hazard and strategic defaulters. In parallel, KEDIPES would need to also fulfil the original task of repaying the fiscal costs arising from the orderly market exit of the Cyprus Cooperative Bank in 2018.

([29]) Applications could be completed between 1 September - 31 December 2019 and once more between 1 - 15 June 2020, while the deadline for submitting supporting documents to complete applications was extended twice, with a final deadline of 31 July 2020. Creditors assessed the applications by end-November 2020, while the final approval of applications by the Ministry of Labour and Social Insurance took place by end-March 2021.

([30]) Introduced before Cyprus joined the EU, the Government Housing Plan provided subsidised interest loans to vulnerable and low-income individuals who did not own any property, and to households with special social characteristics, such as refugees, large families, single-parent families, families living in remote areas or in areas near the ceasefire line.

first announced in the autumn 2020 post-programme surveillance mission, but had to be put on hold due to parliamentary elections in Cyprus. The new legislation is expected to facilitate access to, and boost the use of 'examinership' (a process whereby viable debtors are court-protected in order to restructure their debt), and to introduce an out-of-court restructuring procedure. The Ministry of Finance and the Cypriot Bar Association are leading this initiative, with an open call looking for experts running until mid-November 2021.

The reorganisation of the Department of Insolvency (DoI), necessary for improving its operations and increase its efficiency, continues. Most managerial positions within the organisational structure will be filled in Q1 2022. Arrangements as regards personnel (definition of core functions, duties and salary scales) were formally agreed in Q3 2021, several months after the law establishing the DoI was adopted (i.e. in the first half of 2020). The Cypriot Committee of Public Service will appoint the Director-General of the DoI and several senior officers in the first quarter of 2022. These appointments will make it possible to implement the new framework governing the continuous professional development of insolvency practitioners (IPs), a crucial step towards the professionalisation of IPs in Cyprus. The new website of the DoI has been online since Q3 2021 but with limited functionality. Core functions such as the eligibility and the budgeting online tools are already available and some e-certificates can be generated online (e.g. about non-bankruptcy and liquidation), while certain e-payments can be processed entirely online. The objective is to make approximately 70 functions available through the new website. The digitalisation of all these procedures is expected to reduce the persistent backlog of cases in Cyprus, and to prevent an additional increase in the aftermath of the COVID-19 pandemic.

Insurance and pension funds

The insurance sector remained relatively resilient while supervisory authorities continue to face staffing challenges. The sector registered high growth in premiums in 2020, linked to an increase in income tax exemptions. High compliance costs, low profitability and the need for consolidation in the sector constitute key challenges. Draft legislation on a single independent supervisory authority for both insurance and pension funds was submitted to Parliament end-2019, envisaging an increase in staffing and the introduction of fees by the new supervisory authority. Discussions took place in Parliament, but the proposal did not gain support. For the time being, the two supervisory authorities remain separate and continue experiencing staff shortages and difficulties in recruiting experts (even on a temporary basis).

Capital markets

The investment fund sector expanded markedly in the first half of 2021. Assets under fund management totalled EUR 10.7 bn in June 2021, up from EUR 8 bn a year earlier. Investments continue to be mainly targeted at equity (with no significant change in investment policies since the start of the pandemic), while less than 1% of investments relate to sustainable finance and fintech. Brexit had a negligible impact on the fund industry in Cyprus so far; the Temporary Permissions Regime ([31]) runs until end-2021. The plan to privatise the Cyprus Stock Exchange has recently received new impetus, which would be an important step in modernising the infrastructure and increasing its reputation, and consequently attracting new listings and enhancing trading liquidity.

([31]) In the context of Brexit, the authorities established a Temporary Permissions Regime, which does not require physical presence in Cyprus for UK firms when providing investment services to professional clients and eligible counterparties, based in Cyprus. The initiative aimed at facilitating a smooth transition to new contracts post-Brexit and for UK firms (who wish to continue soliciting Cypriot professional clients and eligible counterparties) to establish a physical presence in Cyprus.

4. SOVEREIGN FINANCING AND ABILITY TO REPAY

While the debt-to-GDP ratio increased significantly in 2020 owing to the COVID-19 pandemic, it is set to resume its downward path this year. Between end-2019 and end-2020, the level of general government debt increased from 91.1% of GDP to 115.3% of GDP ([32]). The increase was due to additional borrowing to build a significant cash buffer, unfavourable snowball effects driven by the decrease in nominal GDP, and the large primary deficit that emerged in 2020. According to the Commission 2021 Autumn forecast, public debt is foreseen to decrease to 104.1% of GDP by end-2021, reflecting the expected economic recovery and the drawing down of the sizeable liquidity buffer accumulated since the beginning of the pandemic ([33]). For 2022 and 2023, the debt ratio is expected to decrease further to 97.6% of GDP, and 93.4% of GDP, respectively (see the debt sustainability analysis in the Annex).

Cyprus has received loans of EUR 603 mn (2.6% of GDP) under the EU's SURE instrument. The SURE loans assist Member States in addressing increased expenditure related to preserving employment during the pandemic. Under the scheme, the Commission originally approved a nominal loan of EUR 479 mn to Cyprus, with an average maturity of 15 years. The first disbursement of EUR 250 mn took place in November 2020, while the remaining EUR 229 mn was received in February 2021. Subsequently, on 11 May 2021, the European Commission and Cyprus signed a Supplementary Loan Agreement, totalling EUR 124 mn, to cover additional measures taken. On 25 May 2021, the Commission disbursed the additional instalment to Cyprus.

In September 2021, Cyprus received EUR 157 mn (0.7% GDP) in pre-financing under the Recovery and Resilience Facility. The Council approved Cyprus' recovery and resilience plan in July 2021. The country is set to receive EUR 1.2 bn (5.1% GDP) in total over the lifetime of its recovery and resilience plan, with EUR 1 bn in grants and EUR 200 mn in loans. On 9 September, the European Commission disbursed EUR 157 mn in pre-financing to Cyprus, equivalent to 13% of the country's financial allocation ([34]).

The structure and cost of Cypriot debt developed favourably throughout 2020 and 2021. Cyprus' weighted average cost of outstanding public debt was reduced from 2.2% in 2019 to 1.8% in 2020, and further to 1.7% as of June 2021, on the back of lower costs of new debt at issuance. In terms of the structure of debt, following three international issuances in 2020, the share of foreign bonds exhibited a significant increase of about 10 pp, reaching 50% of the total general government debt at the end of 2020. As of June 2021, the two largest categories of outstanding debt concerned foreign bonds (55%) and official loans (33%). In the past, domestic bonds were one of the main financing instruments, with an average contribution of around 25% for the 2010-2013 period. However, since 2014, the share of domestic bonds in public debt has declined significantly. As of June 2021, about 13% of the central government debt is held by the domestic market ([35]). Going forward, financing is planned to come mainly from international capital markets, while the domestic debt market is expected to continue to serve as a complementary financing source.

The average maturity of debt has increased in recent years, reaching 8 years at the end of June 2021. In 2019 and 2020, the weighted average maturity of debt increased due to the issuance of longer term international bonds and the early repayment of the IMF loan maturing in the period 2020-2026, which was replaced by longer debt maturities. The bulk of the foreign bonds (euro medium-term note – EMTNs) issued in the last 2 years had maturities longer than 10 years.

([32]) Figures take into account GDP data revisions from October 2021.

([33]) Starting with March 2020, Cyprus' cash balance was strengthened as a result of the Public Debt Management Office (PDMO) policy to enhance the government's cash position in order to cope with the COVID-19 pandemic and manage liquidity risks. The cash buffer peaked in October 2020, reaching EUR 4.8 bn (above 20% of GDP). At the end of 2020 it stood at EUR 3.6 bn (above 15% of GDP).

([34]) The bulk of the pre-financing received takes the form of grants (EUR 131 mn) whereas the remaining part constitutes a loan (EUR 26 mn).

([35]) As of June 2021, the outstanding central government debt was split between the foreign market (87%) and domestic market (13%). See the Quarterly Bulletin of the Public Debt Management Office, in particular the review for Q2 2021.

The government financing needs for 2021 have been covered through the February bond issuance and by using cash reserves. Gross financing needs (GFN) for this year are estimated at about EUR 3.3 billion (14% of GDP), excluding 13-week T-bills. The bulk of the financing needs consists of EUR 2.2 bn of debt redemptions, while fiscal needs are estimated at around EUR 1.1 bn ([36]). A key source of financing was through the issuance of a 5-year international bond in February 2021 (EUR 1 bn). Another significant part of the 2021 GFN is being covered by drawing on the cash reserves, which are expected to decrease by the end of this year. Nevertheless, the cash buffer will continue to be sizeable, meeting the gross financing needs of the following 9-12 months, in line with the 2021-2023 Medium-Term Debt Management Strategy. Looking ahead, GFN for 2022-2023 are expected to be lower. In 2022, GFN are estimated to be significantly lower than this year (about 9% of GDP (excluding T-bills), while for 2023 they are expected to decrease further (to about 6% of GDP), supported by much lower debt redemptions and improving primary balances.

S&P, Fitch and DBRS have maintained their ratings unchanged for Cyprus in the first 9 months of 2021, while Moody's upgraded its rating from Ba2 to Ba1. The main credit rating agencies, with the exception of Moody’s, continue to rate Cyprus’ sovereign debt at investment grade. Nevertheless, in July Moody’s changed its rating upward by one-notch to Ba1. The key drivers for the rating action were the decrease in the banking sector risks, the resilience of the economy to the pandemic shock and robust medium-term GDP growth prospects. Moody’s also updated the outlook from positive to stable, aligning it with Fitch and DBRS. In the beginning of September, S&P changed its outlook from stable to positive and in October, DBRS changed its outlook from stable to positive.

([36]) The figure for fiscal needs is derived from the Commission’s 2021 Autumn forecast.

ANNEX 1

Soundness indicators for the banking sector in Cyprus

Table A1.1: **Soundness indicators for the banking sector in Cyprus**

	2016	2017	2018	2019	2020	2021		
	Dec	Dec	Dec	Dec	Dec	Jan	Mar	Jun
NPLs*, all loans (EUR billions)	23.8	20.6	10.3	9.0	5.1	5.1	5.1	5.0
NPLs*, all loans (% of total)	47.2	43.7	30.3	27.9	17.7	17.7	17.9	17.6
NPLs*, loans to NFCs (% of total)	56.4	50.3	33.2	24.5	14.5	14.4	14.6	14.2
Restructured non-performing (% of total)	25.8	22.8	14.4	10.8	6.4	6.4	6.3	6.7
Restructured performing (% of total)	9.4	8.6	6.8	4.5	3.1	3.1	4.7	7.7
NPLs*, loans to households (% of total)	56.0	53.9	37.6	35.2	23.7	23.8	23.6	23.0
Restructured non-performing (% of total)	20.1	19.7	17.1	15.7	10.4	10.4	10.3	10.0
Restructured performing (% of total)	7.7	8.3	7.1	4.8	4.6	4.4	4.4	4.0
Coverage rate (Impairments / NPLs)*	40.3	45.9	49.6	55.2	46.2	46.1	47.1	46.8
Cost-to-income ratio	52.6	53.6	62.5	72.3	63.2	..	71.2	69.2
Lending margin	2.5	2.4	2.7	2.7	2.7	2.7	2.7	2.7
Common Equity Tier 1 ratio	15.9	14.9	15.1	17.4	17.6	..	17.4	17.2
Return on assets (annualised)	-1.3	-4.2	1.1	1.2	-0.2	..	0.0	0.0

The figures cover the Cyprus operations of all domestic and foreign credit institutions operating in Cyprus on a consolidated basis. * Local NPL definition was used until end-2014. Starting with 2015, the EU NPL definition was used, as defined in Commission Implementing Regulation (EU) 2015/227, later amended by Commission Implementing Regulation (EU) 2015/1278. Figures exclude exposures to central banks and credit institutions.
Source: Central Bank of Cyprus

ANNEX 2

European Commission Debt Sustainability Analysis

While government debt is projected to decrease, the debt sustainability analysis (DSA) indicates that Cyprus continues to face risks to fiscal sustainability over the medium term. This assessment is based on the DSA results from the baseline, debt scenarios relevant for the risk classification, and stochastic projections. The baseline as well as all deterministic scenarios which introduce adverse conditions to key underlying variables of the baseline, such as primary balance or the differential between the interest rate and the economy's growth rate, show that the Cypriot debt-to-GDP ratio is set to follow a downward trajectory in the coming years (see Graph A2.1). Nevertheless, by the end of the projection period, government debt is projected to remain well above the Treaty's reference value of 60% of GDP – driving the DSA assessment. Stochastic projections based on the historical volatility of the Cypriot economy show that the baseline debt projections are surrounded by considerable uncertainty (see Graph A2.2) ([37]).

Under baseline projections, Cyprus' debt-to-GDP ratio follows a downward path, falling below 80% in 2032. The baseline is a *no-fiscal policy change* scenario, which assumes that the government primary balance (in structural terms and before ageing costs) remains constant at its last forecast value (2023) for the remainder of the 10-year projections. In contrast, in previous reports, since the Autumn 2020, the standard baseline fiscal assumption had been adjusted in light of the unprecedented impact of the COVID-19 crisis, also on the structural primary balance ([38]). The assumptions on real GDP growth continue to build on the latest short-term Commission forecast for the years 2021-2023. For the period 2024-2032 the projections now include the expected growth impact of NextGeneration EU, including the investments under the Recovery and Resilience Facility based on the Commission's standard T+10 simulations adjusted on the basis of the QUEST model ([39]). This simulation is carried out simultaneously for all Member States, hence it also includes spill-over effects. Inflation assumptions beyond the short term build on market expectations measured by the '10-year 10-year' inflation-linked swaps ([40]) until the tenth forecast year, hence they are consistent with the market expectations on sovereign financing costs. Having peaked in 2020, the debt-to-GDP ratio is projected to decline gradually to 77.8% by the end of 2032 (see baseline scenario in Graph A2.1).

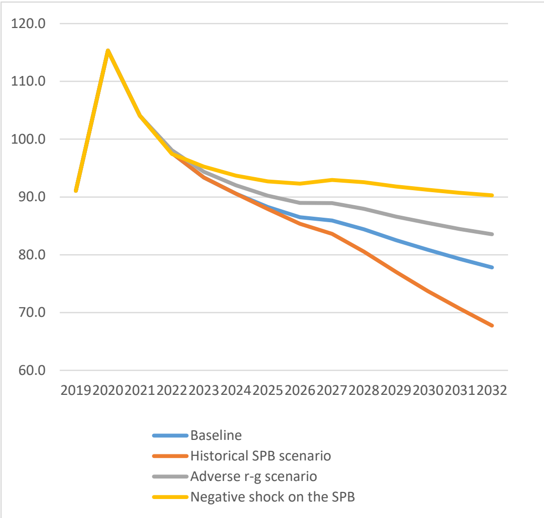
([37]) Stochastic debt projections allow assessing the uncertainty surrounding macroeconomic and fiscal projections. Projections have a 5-year projection horizon. Results are based on 80% of all possible debt paths obtained by simulating 2 000 shocks to the primary balance, nominal growth and interest rates (the lower and upper lines delimiting the cone represent respectively the 10th and the 90th distribution percentiles). In the chart, the projected debt path under the baseline (around which shocks apply) is reported as a solid black line at the centre of the cone. The differently shaded areas within the cone represent different portions of the distribution of possible debt paths. The dark blue area (delimited by the 40th and the 60th percentiles) includes the 20% of all possible debt paths that are closer to the baseline.

([38]) In the previous reports, since Autumn 2020, rather than assuming a constant structural primary balance at its last forecast value, the baseline assumed a correction of fiscal positions over the medium term (i.e. the structural primary balance was set to converge back to its pre-crisis forecast value). This adjusted baseline aimed at accounting for the fact that the last forecast value (for year 2022) for the structural primary balance was strongly affected by the COVID-19 crisis, and by the temporary measures adopted as a response to the crisis, thereby providing an inadequate reference to set an assumption for the medium term fiscal position assumption. This is not the case anymore as the last forecast value now refers to the year 2023 in the Commission Autumn 2021 forecast.

([39]) Simulations by the Commission services show that recovery and resilience plan, together with the rest of measures of the European Union Recovery Instrument, has the potential to increase the GDP of Cyprus by between 1.1% and 1.8% until 2026, not including the possible positive impact of structural reforms, which can be substantial. This, *ceteris paribus*, contributes to influence positively the debt sustainability.

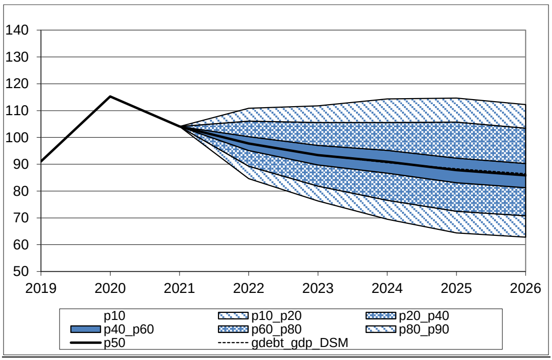
([40]) The 10-year forward swap rate 10 years ahead refers to the ten-year inflation expectations ten years from now.

Graph A2.1: **Deterministic government debt scenarios, 2021-2032, Cyprus, % of GDP**



Source: European Commission

Graph A2.2: **Stochastic projections of government debt, 2021-2026, Cyprus, % of GDP**



Source: European Commission

Under fiscal assumptions reflecting historical patterns, the debt ratio would be lower by the end of the projection period. Assuming a reversal of the structural primary balance (SPB) in the 4 years following 2023 to its historical (2005-19) average, the government debt ratio in 2032 will be lower than in the baseline scenario (see the *historical average SPB* scenario in Graph A2.1).

Under the assumption of permanently higher interest – growth rate differentials, the debt-to-GDP ratio will decrease more slowly than in the baseline. In the *adverse 'r-g' scenario*, the interest – growth rate differential is permanently increased by 1 pp. compared to the baseline. This higher differential is obtained by applying simultaneous shocks to (short and long-term) market interest rates and economic growth. The scenario illustrates the risk of a reversal of the interest – growth rate differential, which is relevant because the assumptions under the baseline rest on persistently favourable financial markets' expectations. Under this adverse scenario, the Cypriot debt ratio in 2032 would be about 6 pps. of GDP higher than in the baseline.

A negative shock to the structural primary balance would deteriorate significantly debt dynamics. Under the *negative shock to the SPB* scenario, the structural primary balance is assumed to fall by half of the SPB's cumulative change over the two forecast years ([41]). This assumption has large adverse effects on the Cypriot government debt ratio – which is projected to stand at 90% of GDP at the end of the projection period under this scenario (see the *negative shock to the SPB* scenario in Graph A2.1). As such, prudent fiscal policies and implementing growth enhancing structural reforms are key to reducing debt vulnerabilities over the medium term.

([41]) Under this assumption, a forecast surplus will be smaller, while a forecast deficit will be larger, and then stay constant at this lower level over the remaining projection period till 2032. This scenario incorporates a feedback effect on GDP growth whereby a fiscal expansion of a 1 pp. of GDP impacts positively baseline GDP growth by 0.75 pp in the same year.

ANNEX 3

European Commission macroeconomic and fiscal projections (2021 Autumn Forecast)

Table A3.1: **Selected economic indicators**

	2017	2018	2019	2020	2021	2022	2023
Real economy			*(percent change)*				
Real GDP	5.9	5.7	5.3	-5.2	5.4	4.2	3.5
Domestic demand incl. inventories	7.9	3.5	5.9	-3.3	4.4	2.5	2.1
Private consumption expenditure	4.8	5.1	3.0	-5.0	3.1	1.9	1.0
Government consumption expenditure	1.8	3.6	12.7	15.0	7.6	1.6	2.4
Gross fixed capital formation	21.2	-4.9	2.9	0.0	5.2	4.9	4.8
Exports of goods and services	11.2	7.3	7.5	-5.1	6.2	7.4	6.8
Imports of goods and services	14.3	4.3	8.3	-2.5	4.9	5.1	4.9
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	7.3	2.9	4.3	-0.7	4.5	2.6	2.1
Foreign trade	-2.0	2.2	-0.5	-1.9	0.8	1.6	1.4
Changes in inventories	0.5	0.7	1.5	-2.6	-0.7	0.1	-0.7
Inflation			*(percent change)*				
GDP deflator	1.0	1.0	1.1	-1.2	2.4	1.6	1.0
HICP	0.7	0.8	0.5	-1.1	1.9	1.7	1.2
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	11.1	8.4	7.1	7.6	7.5	7.1	6.6
Employment	5.4	5.3	3.8	-0.6	1.2	2.2	2.3
Compensation per employee	1.5	1.5	4.4	-3.1	2.5	2.7	2.4
Labour productivity	0.4	0.3	1.4	-4.7	4.1	1.9	1.2
Unit labour costs	1.1	1.1	2.9	1.6	-1.6	0.8	1.2
Public finance			*(percent of GDP)*				
General government balance	1.9	-3.5	1.3	-5.7	-4.9	-1.4	-0.9
Total revenue	38.5	39.2	39.7	39.4	40.0	39.5	39.2
Total expenditure	36.5	42.7	38.4	45.1	44.9	40.9	40.0
General government primary balance	4.4	-1.1	3.5	-3.6	-3.0	0.2	0.4
Gross debt	92.9	98.4	91.1	115.3	104.1	97.6	93.4
Balance of payments			*(percent of GDP)*				
Current external balance	-5.0	-3.9	-5.7	-10.1	-9.1	-7.3	-5.7
Ext. bal. of goods and services	-0.5	1.3	0.2	-2.5	-2.5	-1.1	0.2
Exports goods and services	73.9	75.1	75.6	76.0	75.4	78.1	81.0
Imports goods and services	74.4	73.8	75.4	78.6	77.9	79.3	80.7
Memorandum item			*(EUR bn)*				
Nominal GDP	18.9	20.1	21.4	22.3	21.1	22.1	23.1
Memorandum item			*(EUR bn)*				
Nominal GDP	20.2	21.6	23.0	21.5	23.3	24.6	25.7

Source: European Commission

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