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Cyprus, Autumn 2022

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Cyprus, Autumn 2022

EUROPEAN ECONOMY

Institutional Paper 189

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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 31 October 2022. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission's 2022 Autumn Forecast released on 11 November 2022 (with cut-off date of 31 October 2022). 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's assessment of the implementation of the plan.

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([1]) The executive summary of this report was adopted as Commission Communication C(2022)8555 on 21 November 2022. The rest of the report reflects the findings of the staff working document SWD(2022)374 accompanying that Communication.

([2]) European Central Bank (ECB) staff participated in this mission, and the drafting of this report, in accordance with the ECB's competences and thus provided 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 13th post-programme surveillance (PPS) mission for Cyprus, which took place from 26-28 September 2022. The mission was conducted by European Commission staff, in liaison with staff from the European Central Bank (ECB). The institutions held several hybrid meetings with the Cypriot authorities and major banks. Staff from the European Stability Mechanism (ESM) participated in the meetings on aspects related to the ESM's early warning system. Staff from the International Monetary Fund (IMF) also joined under the framework of a staff visit.

The Cypriot economy surpassed growth expectations in the first half of the year, but the outlook points to a weakening growth momentum. Real GDP growth reached 6.3% in the first half of 2022, compared with the same period of 2021. This was mainly driven by domestic demand and supported by a rebound in tourism. Buoyant private consumption was supported by an increase in employment and accumulated savings during the pandemic period. Investment was boosted by the entry of foreign companies, while construction put a drag on investment growth. It also benefits from the implementation of the Cyprus Recovery and Resilience Plan. In the first three quarters of 2022, the tourism sector outperformed expectations and recovered most of the ground lost by the pandemic with arrivals and revenues reaching almost 80% and 90% of the 2019 levels, respectively, with 2019 having been a record year. However, high energy prices, combined with a general weakening of the EU economy negatively affect the economic outlook. Whereas real GDP growth for 2022 is forecast to reach 5.6%, for 2023 it is expected to decelerate to 1%. Inflation is expected to remain elevated over the coming years, declining gradually from the peak of 8% in 2022. The labour market has performed well with unemployment falling on the back of robust growth. Significant downside risks to the growth outlook remain, mainly due to the uncertainty regarding the economic repercussions of the Russian invasion of Ukraine.

Fiscal performance has been strong, supported by robust growth, but it is expected to weaken in the coming months. In the first nine months of 2022 the preliminary results show a surplus of 2.2% of GDP, which reflects a buoyant revenue increase in parallel with a containment of expenditure due to the withdrawal of Covid-19 support measures. The increase in revenue led to the revenue-to-GDP ratio to grow above historical levels, although it is not clear whether this is structural. The measures implemented to counteract high energy prices have had a moderate fiscal impact so far. According to the Commission Autumn forecast, the general government balance is expected to reach a surplus of 1.1% of GDP in 2022 and remain sound in 2023 and 2024. The fiscal outlook is, however, dogged by downside risks, linked to the heightened macro-economic uncertainty, and possible new or extended measures to counter the high energy prices.

In the banking sector, the stock of non-performing loans (NPLs) remained stable, following last year's sizeable reduction, while the impact of the Russian war of aggression against Ukraine on the financial sector remains contained. After significant progress achieved in 2021 the NPL ratio remained broadly stable, at 11% as of June 2022, amid a decline in the outstanding volume of loans. A large part of the NPL reduction in recent years was the result from transfers from the banking sector to credit acquiring companies. As such, they still burden the economy through high private indebtedness and by reducing the business opportunities for banks in the domestic market. While the pandemic increased the riskiness of the loan portfolios, with a large share of loans classified as exhibiting increased credit risk (stage 2 loans), new defaults have been limited so far. New lending was buoyant, especially in the real estate sector. Profitability improved in 2022 as impairment charges, which had been significant during the pandemic, eased. Going forward, profitability of banks is expected to increase because of increasing interest rates given the significant amount of banks' cash holdings and the predominance of floating rate loans. Cypriot banks are well capitalised, with capital ratios above regulatory requirements. The impact of the Russian war of aggression against Ukraine on Cypriot banks has been contained. The RCB bank is winding down (with no threats to the financial system) and is being transformed into a credit acquiring company. Overall, the direct impact on other banks is limited (given their small exposures to Russia, Ukraine and Belarus).

On the policy side, progress with reforms to facilitate the working out of NPLs has been mixed. In July 2022, a package of amending laws regarding credit acquiring companies (CAC) and credit servicers was adopted, which is expected to improve the working environment for managing non-performing loans. However, Directive (EU) 2019/1023 on preventive restructuring has not yet been transposed into Cypriot law, and the deadline for this has already passed. Recently, the Parliament tabled a new proposal for a further extension of the foreclosure suspension. Any further suspension of foreclosure proceedings hinders the banks' ability to organically deleverage their NPL portfolios, affects the conditions for NPL sales, impacts negatively the credit acquiring companies' (CACs) and loan servicers' capacity to resolve NPLs and undermines payment discipline overall. The suspensions are also affecting the state-owned asset management company, KEDIPES, which is facing delays in the planned resolution of the residential segment of its portfolio. In addition, the sale of a performing loan portfolio (*project Ledra*) by KEDIPES has recently been put on hold. Meanwhile, the government continues to work on a mortgage-to-rent scheme, which will expand the scope of KEDIPES, but in a limited manner. The envisioned scheme is a targeted one and thus, its impact on reducing NPLs is marginal.

Cyprus retains the capacity to service its debt. The government's financing needs for 2022 have been covered through the issuance of a 10-year international bond in January 2022 and by primary surpluses. Looking ahead, due to increasing interest rates and yields, Cyprus is facing risks of higher financing costs when accessing markets. Nevertheless, the projected primary surpluses are expected to keep government gross financing needs for 2023-2024 at relatively low levels. The debt maturity profile is well balanced over the coming years, with below average debt redemptions in 2023. The government debt-to-GDP ratio resumed its declining path in 2021 and it is projected to decrease to 77.7% by the end of 2024, supported by nominal GDP growth, primary surpluses and a projected use of the cash buffer. According to the debt sustainability analysis (DSA), Cyprus is assessed to face low fiscal sustainability risks in the short-term, while medium – and long-term risks appear to be medium. Loan repayments to the ESM are due to start only in 2025. Cyprus has a sizeable cash buffer, covering its financing needs beyond the following 12 months. Cyprus continues to enjoy a favourable market perception as its debt rating has been upgraded by one notch (to BBB, which is two notches within the investment grade area) by two main credit rating agencies in 2022, whilst the outlook has been changed from stable to positive by one main credit rating agency.

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1. INTRODUCTION

Following a request by Cyprus on 25 June 2012, a three year Economic Adjustment Programme was agreed between the Cypriot authorities and the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF) on 2 April 2013; Cyprus exited its economic adjustment programme in March 2016. The programme included an ambitious reform agenda and measures designed to address the financial, fiscal and structural challenges facing the Cypriot economy in a decisive manner so as to return to a sustainable growth path. It provided financial assistance up to EUR 10 billion, with the ESM providing up to EUR 9 billion, and the IMF contributing around EUR 1 billion. Eventually Cyprus used EUR 7.3 bn, EUR 6.3 billion from the ESM and EUR 1 billion from the IMF. Cyprus fully repaid its IMF loan in February 2020.

The repayment of the ESM loan principal by the Cypriot Government (EUR 6.3 billion) will start in December 2025 and be fully completed by 2031. Under the repayment schedule, the first repayment amounts to EUR 0.35 bn and it is due for 2025. In the following years until its full repayment in 2031, repayments will reach EUR 0.9-1.05 bn for each year.

Post-programme surveillance (PPS) ([3]) aims at monitoring economic, fiscal and financial risks, twice a year, also with a view to the repayment capacity of a country having received financial assistance. There is no policy conditionality under the PPS, although the Council can issue recommendations for corrective actions if deemed necessary and appropriate.

This report presents the main findings from the 13th PPS mission. Staff from the European Commission, in liaison with the European Central Bank, carried out this mission, holding hybrid meetings with the Cypriot authorities between 26 and 28 September, 2022. The ESM participated in the meetings on aspects related to its own Early Warning System. Staff from the International Monetary Fund (IMF) also joined under the framework of a staff visit.

This report reflects information available and policy developments that have taken place up to and including 31 October 2022. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2022 Autumn Forecast released on 11 November 2022.

([3]) PPS is established by Art. 14 of the Two-Pack Regulation (EU) N°472/2013. It starts automatically after the expiry of the programme and lasts at least until 75% of the financial assistance has been repaid. Under the current repayment schedule, PPS will last until 2030. The Spring 2022 PPS report was published as Institutional Paper 175 in May 2022.

2. MACROECONOMIC SITUATION AND OUTLOOK

2.1. MACROECONOMIC DEVELOPMENTS IN 2022 ([4])

The Cypriot economy surpassed growth expectations in the first half of 2022, mainly on the back of a strong domestic demand. Real GDP increased by 6.3% in the first half of 2022 compared with the same period in 2021. The vigorous increase of private consumption was mainly supported by an increase in employment and the use of savings accumulated during the pandemic period. Investment increased (except in construction) boosted by the inflow of foreign companies, especially in the information, communication and technology (ICT) sector. It is also profiting from the implementation of the Recovery and Resilience Plan. In contrast, investment in construction took a hit due to the supply disruptions and exceptionally high prices for construction material, and more recently by the tightened financial conditions. Growth was also supported by external demand for tourism and other services, notably transport, information and communication and financial.

The tourism sector outperformed and recovered most of ground lost during the pandemic. In the first nine months of 2022, arrivals of tourists reached 78% of 2019, with 2019 having been a record year. Revenues reached 87% of 2019 in the first eight months of 2022. To a great extent, Cyprus managed to replace the large Russian market (around 20% in 2019) through active diversification efforts. There are no signs of scarring effects caused by the pandemic, also thanks to the Covid-related support measures implemented.

ICT foreign companies are establishing their headquarters in Cyprus. The Cypriot government has implemented a set of incentives for foreign companies with staff when establishing their headquarters in Cyprus ([5]). Since the beginning of the year 1100 companies with more than 9000 of employees have been registered in the Business Facilitation Unit of the Ministry of Energy, Commerce and Industry. These companies and employees have supported consumption, professional services and the real estate sector. The full impact on the real economy, the labour market and the external sector is still under examination by the Cypriot authorities.

The real estate sector continues to grow, albeit moderately. In 2021 and up to early 2022 domestic housing demand was supported by the interest rate subsidisation scheme, but its impact has ended with the expiration of the programme and the processing of applications. The expiration of the programme in conjunction with tighter financing conditions are expected, overall, to contain domestic demand. Real estate demand from Russian investors has decreased significantly since the abolition of the citizen-by-investment scheme in 2020 and further since the Russian invasion of Ukraine. There is, however, no evidence that this has had an impact on the housing prices in Cyprus. House price growth in 2022 can be largely explained by high construction costs. Overall, it is estimated at 4% in the first half of 2022 according to Central Bank of Cyprus statistics, which is low compared to other EU countries.

For 2022 as a whole, the economy is expected to show solid growth, though as of the fourth quarter of the year, this growth is set to start weakening. Based on the Commission's Autumn 2022 Forecast, real GDP is projected to rise by 5.6% in 2022, i.e. an upward revision by 2.4 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-expected performance of tourism, as well as the impact of the expanding ICT sector. Robust growth is also estimated for the third quarter of the year due to high demand for

([4]) This report reflects information available and policy developments that have taken place up to 31 October 2022. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2022 Autumn forecast released on 11 November 2022 (with cut-off date 31 October 2022). 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 progress of the Plan.

([5]) Strategy for attracting Businesses and Talent. Incentives include fast track services for setting up companies, a flexible policy for employing highly skilled staff from non-EU countries as well as tax reliefs for some categories of employees. https://mof.gov.cy/en/strategy-for-attracting-businesses/strategy.

tourism, while the final quarter is expected to be negatively affected by the worsening of the external environment and the erosion of purchasing power.

The labour market has shown strength. Employment increased by 1.9% in the first half of 2022, compared with the corresponding period in 2021, and total hours worked by 4.6%. For 2022 as a whole, the unemployment rate is projected to be 7.2% slightly down from 7.5% in 2021. Earnings increased considerably by 7% in the first half of 2022, compared with the same period last year. Cyprus has recently adopted a statutory minimum wage, which will be implemented as of 1 January 2023. The level of the minimum wage corresponds to 60% of the 2020 median wage and it will affect around 10% of employees. It is not expected to have a significant impact on overall wage growth.

Inflation in Cyprus is driven by high oil prices and supply disruptions. HICP inflation increased to 8.1% in the first nine months of 2022, mainly due to significantly higher oil prices, as 95% of energy production comes from oil, but also to commodity supply disruptions. Moreover, higher prices for energy and other goods have pushed up prices for services. As a result, core inflation increased to 5.2% in 2022, following 1% in 2021. For the whole of the year, the HICP is expected to increase by around 8%, as compared to 2.3% in 2021.

The current account deficit deteriorated in the first half of 2022. It stood at 14.4% of GDP in H1 2022 from 11.3% in the same period of 2021. The deterioration was mainly due to the balance of goods deficit resulting from the very high cost of imports of oil and other imported goods, with the services balance only partly offsetting this effect. For 2022 as a whole, the current account deficit is expected to reach 9.6% of GDP.

2.2. ECONOMIC OUTLOOK IN 2023 AND 2024

The weakening of growth in the EU economy, as well as the erosion of purchasing power in trading partners of Cyprus will lead to a considerable deceleration in real GDP growth. The ongoing geopolitical tension and its impact on the EU economy, the worse global growth outlook, as well as the still high inflation and tightening monetary policy are expected to have a noticeable negative impact on the Cypriot economy. Private consumption is being adversely affected by the erosion in purchasing power, even though households' income will be supported by the partial indexation of wages and salaries, to be applied in January 2023, and government measures to cushion the impact of high energy costs. Debt servicing costs are also set to increase as the bulk of debt contracts have variable interest rates. Investment in housing is expected to decrease as a result of the tightening monetary policy, negatively impacting bank lending and mortgage interest rates. On the positive side, big infrastructure projects in the areas of energy, education, health and tourism are projected to continue. Investment is also expected to be supported by the influx of new companies in the ICT sector and the implementation of the Recovery and Resilience Plan and the accompanying investment mainly in the green and digital areas and support for small and medium-sized companies. Demand for tourism is expected to take a hit due to the erosion of disposable income in the main tourist markets of Cyprus as well as high air fares. Overall, real GDP is projected to increase by around 1.0% in 2023 and to pick up to 1.9% in 2024, under the assumption of an improved international environment.

The labour market recovery is expected to continue albeit at a slower pace. Employment is expected to increase by around 0.7% in 2023 and by 1.4% in 2024, very much in line with GDP growth. Unemployment will remain unchanged in 2023 and fall to 6.9% in 2024, going below the pre-pandemic level.

Inflation is expected to slow in 2023 and 2024. HICP is expected to decelerate to 4.2% in 2023 and 2.5% in 2024, as oil and food prices are expected to decrease. Core inflation, i.e. excluding oil and food prices, is expected to be around 5.2% and 3.2% in 2023 and 2024 respectively. Cyprus has a wage indexation system in place and every January wages and salaries of the broader public sector employees and of employees of the private sector covered by collective agreements are adjusted to 50% of the evolution of the consumer prices. This would imply an automatic increase of around 4% for wages and salaries in 2023, for 40-50% of employees. Overall, wages are expected to increase by 7% in 2023 and 4% in 2024,

respectively. Businesses are expected to partly pass the wage increase on to prices. In addition, the impact of the indexation will be bigger on pensions as they will be adjusted to the full impact of the consumer price index around 7.7%. In contrast, the minimum wage is not expected to have inflationary impact, given its minimal impact on the overall wage level.

The anticipated price decreases for oil and other commodities are expected to narrow the current account deficit. The deficit is expected to decrease to around 7.3%% of GDP in 2023 down from 9.6% in 2022 and to narrow further in 2024, to around 6.2%.

Significant downside risks to the growth outlook remain due to persisting uncertainty, arising mainly from the Russian invasion of Ukraine. The ongoing geopolitical tensions, the duration and the magnitude of the impact on the EU economy and non-EU trading partners, are decisive factors on the impact of the Cypriot economy. Additionally, any outbreak in the transmission of new Covid-19 variants would undermine consumer and business confidence. In this context, tourism is particularly vulnerable, as holiday planning could be affected. Furthermore, high oil prices increase the cost of travelling to Cyprus and could impact its attractiveness as a tourist destination. While most businesses started repaying their loans after the lifting of the moratoria, risks remain in particular for the tourism and construction sectors due to the less positive outlook for these two sectors, in conjunction with higher interest rates. Thus, the private sector's repayment performance warrants close monitoring. On the positive side, the economy emerged from the pandemic with no significant scarring effects. Also, the implementation of reforms in the Recovery and Resilience Plan and the indications for an increased relocation of companies to Cyprus are expected to positively affect the economy in the medium and long-term.

3. PUBLIC FINANCES

3.1. FISCAL PERFORMANCE

The fiscal performance has been stronger than expected over the past and current year, supported by robust economic growth. In 2021, the general government budget recorded a deficit of 1.7% of GDP, which represents a significant improvement from the deficit of 5.8% the year before. The preliminary results for January-September 2022 show a surplus of 2.2% of GDP. These results reflect the continued strong economic growth in 2022, which in conjunction with high inflation, boosted nominal tax revenue by 19.4%. This was only marginally offset by an increase in public spending of 1.6%.

Revenue growth remained buoyant in the first nine months of 2022, driven by various revenue categories. All main categories of revenue have shown substantial increases. The growth in revenue was in many cases higher than the growth in the underlying tax bases. As a result, the revenue-to-GDP ratio continued to stand above historical levels, but it remains to be seen what part of this is structural. The key drivers were indirect taxation and direct taxation. Indirect taxation increased by 16.9% in the first nine months of 2022, as a result of the strong growth in private consumption and higher consumer prices whereby VAT collection rose by 20.8% in the same period. Direct taxation performed well too, recording an increase of 23.3% during January-September 2022. Corporate tax increased by 24.3%, supported by the improved business activity, whereas the personal income tax grew by 21.3%, supported by the expansion in employment and higher salaries.

Expenditure exhibited a small increase in the first nine months of 2022, as the underlying increase was offset by the phasing out of the Covid-19-related fiscal support measures. In January-September 2022 public spending increased only by 1.6% compared to the same period in 2021, due to the phasing out of the Covid-19 related support measures granted to corporations and employees. This is reflected in a large decrease of 88.8% in the category of subsidies. On the other hand, intermediate consumption increased by 21.0% during the first nine months of 2022, partly reflecting higher expenditure on intermediate inputs, such as energy, water, drugs and vaccines. Social payments increased by 9.7% year-on-year, mainly due to the higher government contributions to the Social Security Fund (increase in nominal wages for public sector employees, mainly due to the gradual termination of wage cuts), increased expenditure for old-age pensions, partly due to the full indexation of pensions to inflation as of 1 July 2022 of the order of 4.2%, and increased Health Insurance Organisation (HIO) compensations to private sector health providers for their services in the context of the National Health System (NHS).

The measures implemented to address high energy prices have had a moderate fiscal impact so far. To address the impact of the high energy prices following the Russian invasion of Ukraine, the government has taken several fiscal measures. These include reducing the excise duty on petroleum products, reducing the VAT rate on household electricity bills (with higher reductions for vulnerable households) and subsidising electricity rates for consumers. These measures are estimated to have a moderate budgetary impact of around 0.7% of GDP for 2022 ([6]).

3.2. FISCAL OUTLOOK

The budget balance is expected to exhibit a surplus in 2022 and remain sound in 2023 and 2024. Given the positive fiscal performance during the first nine months of 2022, and despite the expected weakening of growth in the fourth quarter of 2022, the fiscal position is likely to remain positive, with a budget surplus of 1.1% of GDP in 2022, according to the Commission 2022 Autumn forecast. In 2023 and 2024, despite the slowing economic activity, the headline balance is expected to remain in surplus, reaching 1.1% in 2023 and 1.6% in 2024, on the assumption that energy-related fiscal measures remain moderate. The debt-to-GDP ratio is forecast to decrease over the coming years on the back of expected nominal GDP growth and primary surpluses (see Section 4

([6]) It is noted, however, that the parliament, to alleviate the impact of high energy prices, voted two controversial VAT amendments, which are not compatible with the EU VAT legislation. The President of Cyprus has referred those measures to the Supreme Court. The decision is currently pending.

– Sovereign financing, and the debt sustainability analysis in Annex 2).

The fiscal outlook is surrounded by high uncertainty. Continuing high energy prices pose a risk as they may trigger additional fiscal measures or a prolongation of the existing ones, to alleviate the impact of high energy prices. There is also a risk of a weaker-than-expected collection in tax revenues, particularly corporate and indirect tax revenues, if domestic and global economic activity slows down more than projected. Also, given more challenging market conditions, the cost of refinancing the maturing liabilities for the government may increase. Going forward, it would be important that the Ministry of Finance takes fiscal measures, which are targeted at the vulnerable groups in society and have a limited duration. This would ensure a continued prudent fiscal position in Cyprus.

The fiscal sustainability of the National Health System (NHS) poses a downside risk in the medium term. First, the State Health Services Organisation (SHSO), i.e. the public healthcare providers, may not achieve financial autonomy by June 2024 as stipulated by the law and so may need more support than currently estimated by the authorities, due to lower than budgeted revenue growth stemming from the competitive pressure from the private healthcare providers. Second, there is the risk of higher spending ([7]) or lower-than-budgeted revenue for health services under the NHS. The latter risk is mitigated to an extent by the specific measures taken by the Health Insurance Organisation (HIO) to control expenditure and by the global HIO-NHS budget mechanism, which aims at ensuring that cumulatively expenditure cannot exceed revenue ([8]).

The extension of the activities of the state-owned asset management company KEDIPES poses an additional fiscal risk. The authorities are currently planning the introduction of a mortgage-to-rent scheme, to support the most vulnerable debtors ([9]). KEDIPES will purchase the eligible properties from the participating banks and Credit Acquiring Companies (CACs) and sign a rental agreement with the debtor for up to 15 years (rents to be covered by the State), with a buyback option after the fifth year. The fiscal cost of the scheme is estimated at around EUR 0.2 bn during 2023-2024 and is composed of the one-off cost stemming from acquiring the assets and writing off debt on KEDIPES' own portfolio and the recurring cost related to the rent subsidy. The fiscal cost would increase from a higher-than-expected participation in the scheme or larger write-offs of the repossessed properties by KEDIPES.

The risk related to government guarantees is limited. The general government guarantees in nominal terms declined in the first half of 2022 compared to the year before, to 4.9% of GDP. The latest risk assessment report for government guarantees assesses the amount of potential guarantee calls to be contained compared to the projected budget balance, below 0.6% of GDP in 2022 and much lower in the following years. The risk of those guarantees is considered limited since the related loans are performing and guarantee calls are not likely.

([7]) As illustrated by a significant increase of social payments in kind related to the NHS, in the period January-September 2022 as compared to the corresponding period in 2021.

([8]) The expenditure is set every year through yearly budgets and implemented mostly through a points system: if volume/level of demand increases, the point value decreases. However, the budgets for expenditure are subject to negotiations every year with the healthcare providers, for instance to take into account new services or treatments becoming more expensive, and they are on an increasing trend.

([9]) The scheme will target recipients of social benefits who possess a mortgage for their primary residence with an open market value not exceeding EUR 250,000.

4. FINANCIAL SECTOR

4.1. BANKING SECTOR DEVELOPMENTS

Assets

The banking sector's overall assets increased during the pandemic. Total assets in the banking system amounted to EUR 65.1 bn in June 2022, down from a peak of EUR 66.9 bn at the end of 2021, but still above pre-pandemic levels (EUR 57.9 bn in December 2019). As new lending increased at a lower pace than deposit inflows, most of the additional assets were held as cash with the Eurosystem, leading to a de-risking of the balance sheet. Cash and cash equivalents ([10]) are exceptionally high and comprise 37% of the banking sector's balance sheet in June 2022. They rose by EUR 9.7 bn over the year, to EUR 24.4 bn at end-2021, and then stabilised in 2022 just above EUR 24.0 bn. Loans and advances dropped from EUR 28.9 bn in December 2020 to EUR 26.1 bn in June 2022, driven mainly by non-performing loans (NPLs) disposals. Meanwhile, banks' holdings of Cypriot government bonds dropped, but the reductions were virtually offset by increased purchases of other governments' bonds.

The level of non-performing loans remained stable in 2022, following considerable reductions in 2021. In 2021, NPLs declined from EUR 5.2 bn to EUR 3.0 bn – driven by Bank of Cyprus's *Helix 2* and Hellenic Bank's securitisation *Project Starlight* ([11]). Since the end of 2021, the stock of NPLs has remained stable, with a nominal value of EUR 2.9 bn in June 2022, the lowest level since 2014, when the Cyprus Central Bank changed the definition of NPLs. The NPL ratio remained broadly stable in 2022 and stood at about 11% in June 2022, amid a decline in the outstanding volume of loans following loan disposals. Since part of the remaining stock on NPLs in the banking sector is held by small banks, it may be more challenging to work them out as the portfolios cannot provide the scale of the earlier transactions.

Due to the pandemic, banks have moved loans into the higher risk category, especially corporate sector loans. The pandemic led to an increase in stage 2 loans ([12]), which had a nominal value of EUR 3.8 bn ([13]) or 15% of all loans in June 2022. These figures are nearly unchanged from December 2021, but they are above pre-pandemic levels (of EUR 2.9 bn or 9% of all loans and advances in December 2019). Non-financial corporation (NFC) loans were most affected, with 20% of exposures in this category being labelled as stage 2. At the beginning of the pandemic, Cypriot banks moved a large part of their exposures to tourism and transport into stage 2, as both sectors were heavily affected by the COVID-19 crisis. Later on, part of these exposures were reclassified as stage 1 ([14]). Households benefited from income support measures and the ratio of household stage 2 loans of 9% in June 2022 is in line with pre-pandemic December 2019. Coverage of these exposures is quite low (at 2.4%) compared to the EU average (4.0%). Cyprus remains among the EU countries with the highest proportion of stage 2 and stage 3 exposures, together comprising 24% of the loan portfolio ([15]) ([16]) ([17]).

The expiration of the two moratoria schemes generated only a small inflow of new NPLs. The first scheme (with a take-up of EUR 11.8 bn) ended in December 2020, while the second one which was smaller (EUR 59 m), was available until June 2021. By June 2022, the repayment schedule had started again for 95% of these loans.

([10]) Cash on hand, demand deposits and cash equivalents

([11]) The NPL ratios referred to in this report are based on the Central Bank of Cyprus' data and thus they differ from the ratios referred to in the 2022 Cyprus Country Report, which is based on ECB data. In particular, the NPL ratio is calculated as the amount of non-performing loans over the amount of total loans and advances, excluding loans and advances to central banks and credit institutions. See also Annex 1.

([12]) Stage 2 Assets, in the context of IFRS 9 are financial instruments that have deteriorated significantly in credit quality since initial recognition but offer no objective evidence of a credit loss event

([13]) Stage 2 loans were at an all-time high of EUR 4.6 bn in December 2020.

([14]) Stage 1 Assets, in the context of IFRS 9 are financial instruments that either have not deteriorated significantly in credit quality since initial recognition or have low credit risk

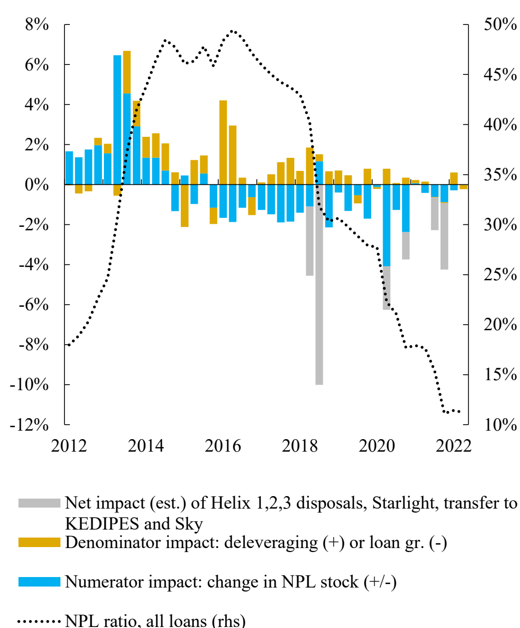
([15]) Stage 3 loans are considered credit impaired, i.e., a loss has occurred. This is usually a wider definition than 90 days past due.

([16]) Austria, Romania and Ireland have a similarly high stage 2 and 3 loan share.

([17]) This number excludes 2% of loans which are recorded as POCI (purchased or credit impaired at origination). Since June 2021, these have been reported outside the staging system.

The emerging picture is quite benign: in June 2022 the total value of exposures with due payments was EUR 9.2 bn. Of these, 15.8% were renegotiated, 6.0% were in arrears and a mere 2.8% have defaulted. The worst outcome was seen in the construction sector, with a renegotiations rate of 55.8%, arrears of 10.6% and a default ratio of 4.0%.

Graph 4.1: **NPL ratio and breakdown of changes**



Source: Central Bank of Cyprus.

Direct exposures to Russia appear small and manageable, except for RCB bank, which has wound down its business and will be converted into an asset management company. Hellenic Bank acquired a significant part of RCB's performing loan book (Cypriot and European exposures) with a transaction value of EUR 356 million. Furthermore, the bank repaid 93% of all deposits and is in the process of converting part of the remaining deposits in 'debt/other liabilities', which will remain in the RCB entity. On 6 July 2022 the entity was licenced by the Central Bank of Cyprus (CBC) as a credit acquiring company (CAC) and as an electronic money institution (EMI) and will *inter-alia* hold these debt obligations. The licenses have not yet been activated. For the other banks, exposure to Russia is more contained, amounting to 8% of Bank of Cyprus's CET1 capital and 5% of Hellenic Bank's. Similarly, deposits from Russian clients are fairly small.

Lending and lending support schemes

Mortgage lending surpassed pre-pandemic lending. In the first half of 2022, EUR 694 m of new mortgages were originated, which was above the equivalent values of 2021 (EUR 520 m) and pre-pandemic 2019 (454 m). Lending to non-financial corporations increased in 2022, reaching EUR 901 m in the first half of 2022, still below 2019 levels. Based on CBC supervisory data, in the corporate sector the exceptions were the construction and real estate industries. In these segments, lending has been above their corresponding level of 2019. Overall, lending was supported by the interest rate subsidy scheme for housing and corporate loans, which expired at the end of 2021. The Cypriot government also offered a loan guarantee scheme, but launched it relatively late, in November 2021 (with the application period running until March 2022). The uptake of the scheme was quite small and thus it did not have a meaningful impact on lending activity.

Profitability

After two years of losses, banks' results for the first half of 2022 were encouraging. The banking sector made a profit of EUR 55.2 m in the first half of this year, which compares favourably with EUR 9.2 m recorded in the previous year. This improvement is largely driven by an easing of impairment charges, which had been quite heavy during the pandemic.

Net interest income (NII) declined to its lowest level ever in the year to June 2022. Narrowing interest margins had been weighing on banks' returns for years. This was driven by the secular decline in interest rates, and by the increase in non-interest-bearing assets, in particular cash balances. Furthermore, the disposal of NPLs also affected NII negatively. Against this background, in the year to June 2022, NII was 431.9 m, which was the lowest half-year result. Generally, banks are continuing to make efforts to reduce their dependence on interest income and bolster their fee and commission income.

Going forward, rising interest rates are expected to increase banks' interest income. In

Cyprus, there is an exceptionally high share of loans with variable rates, about 95%. Rising interest rates therefore have a direct impact on the revenue stream.

Banks made progress in reducing headcount, but staff costs remain high. The number of employees declined to 8,070 in December 2021, down from 8,554 two years earlier. Despite these efforts, staff costs remain high. Aggregate personnel expenses were EUR 253.3 m in the year to June 2022, the highest half-year value since 2018 (EUR 275.6 m). Current collective labour agreements prescribe above-inflation wage increases which make it difficult to bring costs under control.

Capitalisation

Banks are adequately capitalised and have managed to improve their asset quality without eroding their capital base. The CET1 ratio of Cypriot banks stood at 17.5% in June 2022, slightly down from 17.6% in December 2021 ([18]). A further boost is expected from as yet unaudited profits, which should increase the value for June 2022 to 18.0%. Capital buffers are ample and exceeded Pillar 2 guidance by 4.1 percentage points in June 2022. Nevertheless, there is some variation between banks. In June 2022, Hellenic Bank's CET1 ratio was 17.69% whereas, Bank of Cyprus's ratio was at 14.18%. During the pandemic, the overall capital ratio remained stable, while leverage decreased, driven by swelling cash balances amid a reduction in the NPL stock. These developments decreased the risk weight density of the aggregate balance sheet of Cypriot banks. The leverage ratio stood at 7.2% in June 2022, which is among the lowest level ever recorded in Cyprus, but still well above the minimum requirement of 3% and EU average of 5.6% ([19]).

Deposits and liquidity

The Cypriot banking sector is characterised by excess liquidity. Non-MFI deposits have grown steadily over the 18 months and stood at EUR 51.3 bn in June 2022, only slightly down from EUR 51.5 bn in December 2021. The net stable funding ratio (NSFR) of 166% and the liquidity coverage ratio of 314% in June 2022 are among the highest in the EU ([20]). Excess liquidity has been a drag on profitability, however this should become a source of profit as interest rates increase.

Macroprudential oversight and systemic risks

The worsening macroeconomic environment could impact the asset quality of the Cypriot financial sector. A deterioration of asset quality due to rising inflation and indirect repercussions of the Russian invasion of Ukraine is a potential risk. The pandemic disproportionately impacted the tourism sector, which the Cypriot economy is especially exposed to. Tourism may suffer again amid a decline in real disposable incomes.

Soaring energy costs, high inflation, and higher debt service costs due to rising interest rates may put vulnerable borrowers under strain. Household debt ratios have not changed much in the past three years as the rise in nominal debt levels, fuelled by buoyant mortgage lending, was balanced by growing GDP. Debt-service to income (DSTI) ratios are still looking benign but are set to increase amid rising interest rates, at a time when households are struggling with higher costs of living. In particular, energy prices are impacting household finances. Financially weaker households may struggle to service their debt. This is mitigated by the fact that low-income households account for proportionally less bank lending. The risks in the NFC sector are more difficult to quantify as the debt service capacity of businesses crucially depends on the magnitude of the expected economic slowdown. At the same time, the interest coverage ratio at origination of new NFC loans (386.4) remains slightly higher than pre-pandemic levels, and thus provides some

([18]) The Common Equity Tier 1 (CET1) ratio is defined as the ratio of CET1 capital over risk weighted assets. CET1 includes common shares and stock surplus, retained earnings, other comprehensive income, qualifying minority interest and regulatory adjustments

([19]) Capital ratios are still benefitting from the Capital Requirement Regulation (CRR) 'quick fix' introduced in December 2020 to support capital ratios during the pandemic The 'quick fix' implemented some targeted changes to the CRR to facilitate lending to households and businesses in the EU, in particular SMEs. Measures included advancing the application of the SME supporting factor, as well as re-setting IFRS 9 transitional arrangements and preferential treatment for 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 EU average stands at 192% and 168% respectively.

reassurance on the NFC loans' debt servicing capacity. In the mortgage sector, the risks are mitigated by an overall conservative average LTV ratio close to 50%.

The central bank has borrower-based measures in place to contain the build-up of risk in the banks' lending portfolios. A loan-to value ratio (LTV) of 70% for property financing is in place. For mortgages that finance the primary permanent residence of the borrower, the ceiling is lifted to 80%. For loans to real estate developers for luxury properties a LTV of 50% applies. A maximum debt-service to disposable income ratio (DSTI) of 80% applies for euro-denominated loans and 65% for foreign currency loans.

Foreclosure developments

The suspension of foreclosures has been extended several times since the start of the pandemic, weighing on payment discipline. An effective foreclosure framework remains an essential tool to ensure legal certainty, maintain payment discipline, support banks' efforts to reduce NPLs and encourage borrowers to participate in loan restructuring. In March 2020, major banks and credit-acquiring companies suspended foreclosure actions for three months, subsequently extending them until the end of August. Foreclosures resumed in September, but in December 2020 an act of parliament suspended them again. In May 2021, Parliament voted for a further suspension until 31 July 2021. This was subsequently extended until the end of October 2021 with a narrower scope but was referred by the President to the Supreme Court. During the summer of 2022, foreclosures of primary residences with an estimated value of up to EUR 350,000, agricultural land with market value below EUR 100,000 and business premises of companies with up to EUR 750,000 in annual revenue were suspended again as of August 2022 until the end of October 2022. More recently, the Parliament tabled a proposal for a further extension of the foreclosure suspension. Any further suspension of foreclosure proceedings hinders the banks' ability to organically deleverage their NPL portfolios, affects the conditions for NPL sales, impacts negatively the credit acquiring companies' (CACs) and loan servicers' capacity to resolve NPLs and undermines payment discipline overall. In addition, the foreclosure tool remains key for the viability of the envisaged mortgage-to-rent (MTR) scheme which aims to protect the primary homes of vulnerable households, including non-viable borrowers, who had previously applied for the ESTIA debt relief scheme.

Online auction is currently the only sale method applied by banks. In Q2 2022, 105 properties (mainly residential property and farmland) were sold (as compared to 53 in Q1), 51% of which were bought by the mortgage lender as in previous quarters. Total auction success rate for banks (measured as the properties sold in auction/properties sent to auction) stood at 9.7%. The use of online auctions is expected to remain high, as the spectrum of users and familiarity with the platform continue to grow, further helping reduce the NPL stock in Cyprus.

Cyprus Asset Management Company (KEDIPES) and credit acquiring companies

The performance of KEDIPES has been adversely affected by the COVID-19 crisis, with some improvement registered in the course of 2021 and in the first half of 2022. The adverse effects of the pandemic weighed on the speed of recovery and on the recoverable value of assets. Since its inception in 2018, KEDIPES has made cash repayments of EUR 800 m of state aid, with EUR 230 m in 2022 (including EUR 60 m in Q3 2022). In H1 2022, cash inflows amounted to EUR 232 m, (a 17% increase compared to a year earlier). Overall, the actual performance was ahead of the business plan in terms of loss rates, cash solutions, cash recoveries and sales of REO (real estate owned), but below in terms of debt-to-asset swaps (DTAs). The slower than anticipated resolution of the residential segment of the portfolio was due to the recurrent foreclosure suspensions, very low participation in the ESTIA scheme and delays in launching the planned mortgage-to-rent (MTR) scheme. KEDIPES made progress towards reducing its staff by reopening the voluntary redundancy scheme in March 2022 and negotiating a new collective agreement with the unions. The new SLA (service-level agreement) was approved by KEDIPES' Board of Directors on 15 June 2022

The sale of a performing loan portfolio amounting to around EUR 465 million (*project Ledra*) by KEDIPES has recently been put on

hold. The sale was originally expected to be concluded in H1 2022. The authorities' preliminary view on the transaction has turned negative due to the Statistical Service's assessment of the fiscal impact of the transaction, leading to increases in both general government debt and the budget deficit, due to municipality/community loans being reclassified without any corresponding benefit from the cash consideration that could be returned to the State. These developments may weigh on the timely implementation of KEDIPES' business plan, notably as regards the timeline for repaying state aid.

The Ministry of Finance works on progressing with the Mortgage-to-rent scheme, albeit the scheme now plans to target a reduced amount of NPLs. This scheme will lead to a limited expansion of KEDIPES. The envisaged mortgage-to-rent is a targeted scheme, covering defaulted borrowers who receive social benefits. It provides a solution to vulnerable debtors by offering a rent subsidy and a property buy-back option ([21]). KEDIPES is to on-board the eligible properties from the participating banks and CACs. Overall, the scheme will have a small decreasing effect on banks' NPLs as well as a small adverse fiscal impact.

Looking forward, KEDIPES is facing headwinds and increased macroeconomic uncertainties. This is related to inflationary pressures (including rising construction costs), rising interest rates in the euro area, the adverse indirect economic impact from Russia's invasion of Ukraine (e.g., lower tourism flows) and a potential re-emergence of COVID. Future claims under the asset protection scheme (APS) with Hellenic Bank, even if mainly related to retail/household exposures, may be affected by higher defaults ([22]). All these factors could affect the ability of borrowers to service their restructured loans or reach consensual solutions and could also reduce external demand for real estate and land development.

As regards credit-acquiring companies (CACs) and credit servicers, legal changes have been adopted to improve their working environment. The legal amendments adopted by the Cypriot Parliament in July 2022 (initially envisaged for the end of 2021) should overcome functional shortcomings when CACs deal with credit facilities (e.g. the lack of online access to the Land Registry to check collateral values ([23])). Furthermore, the legal amendments grant credit servicers unrestricted access to the data of debtors held in the Artemis Database and in the e-services of the Land Registry. Moreover, credit servicers are granted indirect access (through credit institutions/CACs) to the data of guarantors held in the Artemis Database and in the e-services of the Land Registry. In addition, the legal entities that were operating as credit servicers when the legal amendments were adopted by Parliament in July 2022, need to apply to the CBC for a credit servicer licence and obtain such a license within four months from the Law publication (i.e. until 27 November 2022, if they are to continue operating as credit servicers after that date) and will be supervised by the CBC. The package is part of the Recovery and Resilience Plan and its adoption resulted in the completion of a key milestone of the plan. The entry into force of the specific package is expected to strengthen the working environment for servicing of loans by providing CACs and credit servicers with the tools they need to better work out legacy non-performing loans. This is expected to result in a more effective and efficient management of non-performing loans, compared to the previous legal framework.

4.2. OTHER FINANCIAL SECTOR ISSUES

Insolvency developments

Directive (EU) 2019/1023 on preventive restructuring was not transposed into Cypriot law by the deadline of 17 July 2022. A revised draft bill was submitted to the Cypriot Legal Service in November 2021 and the legal vetting is

([21]) Nevertheless, it remains uncertain whether borrowers have enough incentives to repurchase the properties.

([22]) 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*.

([23]) CACs had unrestricted access to ARTEMIS with the amendment of the law in 2018 (86(I) 2018. Artemis Credit Bureau Ltd is Cyprus's credit register.

still pending. The next steps after the legal vetting process has been completed by the Legal Service is the submission of the draft bill to the Council of Ministers and Parliament.

The set-up of an out-of-court/hybrid preventive restructuring tool to enhance the insolvency law, including an early warning mechanism, is still under discussion. The Ministry of Energy, Commerce and Industry (MECI) is assessing the possibility of introducing the new tool by amending articles in the existing Companies Law.

The recruitment process to fill the vacancies within the organisational structure of the Department of Insolvency (DoI) has not been completed. The managerial and officers' positions of the DoI are expected to be filled in by the end of 2022. The implementation of continuous professional development for insolvency practitioners, with the participation of the Cyprus Bar Association, is expected to start before the end of 2022. The Annual Training and Development Plan for DoI staff is under finalisation and training sessions in cooperation with the Academy for public servants are expected to start in 2022.

The digitalisation of insolvency procedures in Cyprus, including the digitalisation and modernisation of the DoI's operations, is expected to be implemented by 2025. The digitalisation of the DoI will take place by setting up an automated system to handle insolvency cases electronically. MECI will launch the call for the tender procedure in Q1 2023, aiming to have the automated system running by 2025. The current DoI website has been online since Q3 2021 but still has only limited capabilities. The DoI launched a project to design a new website as an intermediate solution, pending the deployment of the new automated system (expected in 2025). The implementation of the project to set up a digital archive of insolvency proceedings, which consists of an enhanced organisation of the DoI's filing system and digitalisation of files, is expected to start in January 2023 and will have a duration of maximum 24 months.

5. SOVEREIGN FINANCING AND ABILITY TO REPAY

The government debt-to-GDP ratio resumed its declining path in 2021 and is projected to continue decreasing over the 10-year projection period. In 2021 public debt fell by 12.5 percentage points to 101% of GDP, while by the end of 2022 it is expected to decrease further to 89.6% of GDP. For 2023 and 2024, the debt-to-GDP ratio is forecast to fall to some 84% and 77.7%, respectively ([24]). This reduction is mainly driven by (i) the projected economic growth, in conjunction with high inflation, (ii) fiscal primary surpluses, and (iii) a reduction of the cash buffer accumulated since the beginning of the pandemic. Thereafter, the government debt ratio is projected to continue its downward path and to gradually decline over the coming decade (see Graph 1 in annex 2 on the European Commission Debt Sustainability Analysis (DSA)).

The Cypriot government tapped international markets at highly favourable market conditions in January 2022, issuing a EUR 1 billion bond (3.8% of GDP). The bond has a 10-year maturity with a fixed interest rate of 0.95%. According to the Public Debt Management Office, the new benchmark attracted a diverse set of investors. The bond covered a large part of the gross financing needs for 2022 ([25]).

Government financing needs for 2023 are expected to be low, supported by an improved primary surplus and low debt redemption needs. Excluding T-bills, gross financing needs for 2023 are estimated at around EUR 1.1 bn or 3.9% of GDP (consisting of EUR 1.4 bn of debt redemption needs, which are partly offset by EUR 0.7 bn of revenue from the projected headline surplus) ([26]). As regards 2024, gross financing needs are estimated to be about EUR 2 bn or some 6.8% of GDP. The current cash buffer is significant, covering the financing needs beyond the coming year.

The debt maturity profile is well balanced over the coming years, with below average debt redemptions in 2023. In 2022, capital repayments amounted to about EUR 2 bn (about 7.5% of GDP) while in 2023, capital repayments are expected to be lower, at EUR 1.4 bn (approx. 5% of GDP). The average annual debt redemption for the coming decade is about EUR 1.9 billion, with 2028 showing the highest concentration of debt maturing at about EUR 2.7 billion. Cyprus relies on medium- and long-term debt (i.e. with 99% of its outstanding debt stock as medium and long-term debt, by original maturity at issue). As of June 2022, the weighted average maturity of debt was 7.7 years – which is lower than the EA average (8.6 years). However, the shares of debt falling due within 1 year and 5 years respectively, are below the euro area averages ([27]). Going forward, the government plans to continue issuing on the long part of the yield curve, targeting bonds with maturities of 10 and 20 years with the objective of increasing the average maturity of debt. As regards the interest rate distribution of the debt, 71% of the debt has fixed rates, and the remaining 29% has a floating rate, which is well above euro area average (of 9.3%). Cyprus' debt is issued in euro and thus there is no foreign currency risk.

Cyprus has EUR 6.3 billion (23.7% of GDP) of outstanding loans to the ESM, constituting about 26% of total debt. Cyprus will start to repay in 2025, with repayments scheduled to end in 2031. Under the current repayment schedule, the first repayment amounts to EUR 0.35 bn in 2025. In the following years until its full repayment in 2031, repayments will reach EUR 0.9-1.05 bn for each year (on average EUR 0.99 bn per year).

While sovereign yields increased this year, Cyprus benefited from upgrades in its debt ratings. Over this year, the yields on Cyprus' bonds have increased, against the background of a volatile global geopolitical situation, increasing inflation and tightening of monetary policy. The yields have broadly followed European trends. In mid-October, the yields on the 10-year bond stood at around 4.1%, while the 10-year spread was 1.7%. At the same time, DBRS and S&P upgraded Cyprus' rating by one notch in April and September 2022, respectively (to BBB, which is two notches within the investment grade area). The

([24]) According to the Commission's 2022 Autumn forecast.
([25]) The gross financing needs for 2022 are estimated to be EUR 1.7 bn (6.4% of GDP), being covered by the January issuance and primary surpluses.
([26]) The figure for the fiscal surplus is derived from the Commission's 2022 Autumn forecast.
([27]) The share of debt maturing within 5 years is 43%, whereas the euro area average is 45.7%.

main credit rating agencies rate Cyprus' sovereign debt at investment grade, with the exception of Moody's. The credit outlook is stable according to S&P, Fitch and DBRS, while Moody's switched to a positive outlook in August 2022.

Cyprus retains the capacity to service its debt. On the background of increasing interest rates and yields, Cyprus is facing higher financing costs when accessing markets. Besides increasing interest rates, further risks relate to the macroeconomic outlook and risks to the fiscal balance (due to potential energy-related measures and health care costs). According to the DSA, Cyprus is assessed to face low fiscal sustainability risks in the short-term, while medium- and long-term risks appear to be medium ([28]). Importantly, Cyprus has a large cash buffer, which could cover gross financing needs beyond the following 12 months. Furthermore, Cyprus is projected to have primary surpluses, which will help keep the government's gross financing needs for 2023-2024 at relatively low levels.

([28]) See annex 2 on the DSA, which assesses fiscal sustainability risks over the short-, medium- and long-term.

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				2022			
	Dec	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Apr	May	Jun
NPLs*, all loans (EUR billions)	23.8	20.6	10.3	9.0	5.1	5.1	5.0	4.3	3.0	2.9	2.9	3.0	2.9
NPLs*, all loans (% of total)	47.2	43.7	30.3	27.9	17.7	17.9	17.7	15.4	11.0	11.4	11.4	11.4	11.2
NPLs*, loans to NFCs (% of total)	56.4	50.3	33.2	24.5	14.5	14.6	14.3	12.1	8.1	9.1	9.0	9.1	8.7
Restructured non-performing (% of total)	25.8	22.8	14.4	10.8	6.4	6.3	6.8	5.8	4.0	4.3	4.4	4.4	4.2
Restructured performing (% of total)	9.4	8.6	6.8	4.5	3.1	4.7	7.7	9.3	10.7	11.9	11.7	11.6	11.4
NPLs*, loans to households (% of total)	56.0	53.9	37.6	35.2	23.7	23.6	23.1	19.7	14.7	14.0	13.9	13.8	13.4
Restructured non-performing (% of total)	20.1	19.7	17.1	15.7	10.4	10.3	10.1	8.4	6.2	5.9	5.9	5.8	5.6
Restructured performing (% of total)	7.7	8.3	7.1	4.8	4.6	4.4	4.0	4.0	3.7	3.3	3.2	3.1	3.0
Coverage rate (Impairments / NPLs)*	40.3	45.9	49.6	55.2	46.2	47.1	46.8	45.7	42.7	45.7	45.4	45.7	46.2
Cost-to-income ratio	52.6	53.6	62.5	72.3	63.2	73.6	69.2	72.3	71.9	75.7	..	..	71.7
Lending margin	2.5	2.4	2.7	2.7	2.7	2.7	2.7	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	17.2	17.6	17.2	..	..	17.5
Return on assets (annualised)	-0.3	-1.1	0.3	0.3	-0.2	-0.1	0.0	0.0	-0.1	0.1	..	..	0.2

(1) 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

This Annex assesses fiscal sustainability risks for Cyprus over the short-, medium- and long-term. It follows the same multi-dimensional approach as the 2021 Fiscal Sustainability Report using the projections of the Commission 2022 autumn forecast ([29]).

Short-term risks

Cyprus is assessed to face low fiscal sustainability risks in the short-term. The Commission's early-detection indicator (S0) does not signal major short-term fiscal risks. Government gross financing needs are expected to remain relatively low, at around 7.5% of GDP in the short-term (i.e. over 2023-2024), and declining compared with the recent peak in 2020 ([30]) (Table 1). Cyprus continues to enjoy a favourable market perception. Its debt rating has been upgraded by one notch (to BBB, which is two notches within the investment grade area) by two main credit rating agencies in 2022. The outlook has been changed from stable to positive by one credit rating agency, which still upholds a rating of one notch below the investment grade.

Medium-term risks

Medium-term fiscal sustainability risks for Cyprus appear medium overall. According to the Commission Debt Sustainability Analysis (DSA) baseline scenario, the government debt-to-GDP ratio is expected to continue its steady decline which started in 2021 and reach a **low** level over the medium-term (at 46% of GDP in 2033) (Graph 1) ([31]). These baseline projections rest on a 'no-fiscal policy change' assumption where no additional fiscal measures are incorporated beyond the forecast horizon (2024) ([32]). The assumed structural primary balance (SPB) appears relatively ambitious compared with past fiscal performance ([33]). Moreover, the baseline projections up to 2033 benefit from a favourable nominal interest-growth rate differential, notably thanks to the favourable impact of NextGenerationEU, with real GDP growth at around 1.8% of GDP over 2025-2033. Government gross financing needs are expected to remain relatively low over the projection period, reaching around 4% of GDP in 2033, below the level forecast for 2024.

These baseline projections are stress-tested against alternative assumptions. Four alternative scenarios around the baseline illustrate the impact of changes in key assumptions (Graph 1) ([34]).

Reverting to historical fiscal trajectories under the 'historical structural primary balance' scenario would increase the government debt ratio compared with the baseline. If the SPB gradually converged to a surplus of 1.5% of GDP (its historical average over the past 15 years), worsening the SPB with respect to the baseline, the projected debt-to-GDP ratio would be about 6 pp higher in 2033 than in the baseline.

([29]) The assumptions underlying the Commission's 'no-fiscal policy change' baseline notably comprise: (i) a structural primary surplus, before ageing costs, of 2.4% of GDP as of 2024; (ii) inflation converging linearly towards the 10-year forward inflation-linked swap rate 10 years ahead (which refers to the 10-year inflation expectations 10 years from now); (iii) the nominal short- and long-term interest rates on new and rolled over debt converging linearly from current values to market-based forward nominal rates by T+10 (as for all Member States); (iv) real GDP growth rates from the Commission 2022 autumn forecast until 2024, followed by EPC/OGWG 'T+10 methodology projections between T+3 and T+10, i.e. for 2025-2033 (on average 1.8%); (v) ageing costs in line with the 2021 Ageing Report (European Commission, Institutional Paper 148, May 2021). For information on the methodology, see the Fiscal Sustainability Report 2021 (European Commission, Institutional Paper 171, April 2022).

([30]) The strong reduction of GFN since 2021 is based on the assumption that GFN would be partly covered by the use of cash deposits.

([31]) The baseline debt projections shows the projected government debt and its breakdown into the primary balance, the snowball effect (the combined impact of interest payments and nominal GDP growth on the debt dynamics) and the stock-flow adjustment.

([32]) The projections beyond 2024 do not take into account legislated future increases to the General Social Insurance Scheme contribution rate over the period until 2039.

([33]) Based on past historical performance, this value falls within the *higher* range of the distribution.

([34]) The 'historical SPB' scenario assumes that the structural primary balance (SPB) gradually returns to its past (15 years, i.e. 2007-2021) average level. In the 'lower SPB' scenario, the SPB level is permanently reduced by half of the cumulative forecast change (i.e. over 2022-2024) in the Commission 2022 autumn forecast. The 'adverse interest-growth rate' scenario assumes a less favourable snowball effect than in the baseline (i.e. the differential between market interest rates and nominal GDP growth is permanently 1 pp. higher). In the 'financial stress' scenario, the country temporarily (one year) faces higher market interest rates in 2023 (i.e. market interest rates are assumed to increase temporarily by 1 pp. in 2023). Moreover, a risk premium is added for those countries with a debt-to-GDP ratio exceeding 90% of GDP in 2022. This risk premium is equal to 0.06 times the excess of the 2022 debt level over 90% of GDP.

Stress test scenarios would lead to worse results, with particularly adverse developments under the lower SPB scenario. A permanent worsening of the macro-financial conditions, as assumed under the 'adverse interest-growth rate differential' scenario would result in a persistently higher government debt-to-GDP ratio, by around 5 pp of GDP by 2033, as compared with the baseline. A temporary worsening of financial conditions, as reflected in the 'financial stress 'scenario, would lead to a similar public debt-to-GDP ratio by 2033 (+0.3 pp of GDP) compared to the baseline. The 'lower structural primary balance' scenario would lead to a higher government debt-to-GDP ratio by 2033 (+7.2 pp of GDP) compared to the baseline.

Stochastic projections show a medium sensitivity of these projections against plausible unforeseen events, driving the DSA and medium-term risk classification ([35]). These stochastic simulations point to 6% probability of the debt ratio in 2027 being greater than in 2022, entailing medium risk given the current moderate level of debt at 89.6% of GDP. In addition, such shocks point to significant uncertainty surrounding the government debt baseline projections (Graph 2) ([36]).

On the other hand, the fiscal effort required to bring the debt ratio below 60% of GDP within 15 years indicates low risk. The S1 indicator shows that, compared to the baseline, no additional fiscal consolidation would be needed, in cumulated terms over 5 years, to bring the debt-to-GDP ratio to the Treaty reference value of 60% by 2039 ([37]). This result is mainly driven by the favourable initial budgetary position (contribution of -4.0 pp of GDP), partly offset by the current distance of the Cypriot government debt ratio from the 60% reference value (contribution of 1.3 pp of GDP) and, to a lower extent, by the projected ageing-related public spending (contribution by 0.2 pp of GDP) (Table 2 and 3).

Long-term risks

Long-term fiscal sustainability risks for Cyprus appear medium overall. The S2 indicator points to low fiscal sustainability risks ([38]). The indicator shows that, relative to the baseline, the SPB would not need to improve to ensure debt stabilisation over the long term. This result is underpinned by the favourable initial budgetary position (-1.9 pp of GDP) and only partly offset by the projected increase in ageing-related costs (contribution of 1.0 pp of GDP). Ageing cost developments are primarily driven by the projected increase of public pension expenditure (contribution of 0.9 pp of GDP), health, and long-term care spending (joint contribution of 0.5 pp of GDP) (Table 2 and 3). Yet, when combined with debt vulnerabilities, as highlighted by the DSA, long-term risks are assessed as medium.

Finally, several additional risk factors need to be considered in the assessment. On the one hand, risk-increasing factors are related to the country's negative net international investment position, increasing yields, and risks to the budget balance due to potential additional energy-related measures and health care costs. On the other-hand, risk-mitigating factors include the lengthening of debt maturity in recent years, relatively stable financing sources, including from official lenders, and the currency denomination of debt. Furthermore, Cyprus has a large cash buffer, which could cover the gross financing needs beyond the following 12 months, which mitigates any immediate need for Cyprus to tap the international markets.

([35]) The stochastic projections show the joint impact on debt of 2000 different shocks affecting the government's budgetary position, economic growth, interest rates and exchange rates. The cone covers 80% of all the simulated debt paths, therefore excluding tail events.

([36]) The level of uncertainty is measured by the difference between the 10th and 90th debt distribution percentiles.

([37]) S1 measures the consolidation effort, in terms of the 5-year cumulative change in the structural primary balance compared to the baseline, needed to bring debt to 60% of GDP in 15 years. The risk classification based on S1 depends on the amount of consolidation required. If the S1 value (in pp of GDP) is negative, the country is deemed at 'low risk'; if S1 value is between 0 and 2.5, the country is assigned 'medium risk'; and if S1 value is above 2.5, the country is assigned 'high risk'.

([38]) S2 measures the consolidation effort required to stabilise debt over an infinite horizon. If the S2 value (in pp of GDP) is lower than 2, the country is assigned 'low risk'; if S2 is between 2 and 6, the country is assigned 'medium risk'; and if S2 is above 6, the country is assigned 'high risk'.

Table A2.1: **Key debt sustainability figures**

Table 1. Baseline debt projections	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Gross debt ratio (% of GDP)	**113.5**	**101.0**	**89.6**	**84.0**	**77.7**	**73.0**	**68.9**	**65.3**	**61.7**	**58.0**	**54.7**	**51.5**	**48.7**	**46.0**
Change in debt	23.1	-12.5	-11.5	-5.6	-6.3	-4.7	-4.1	-3.6	-3.6	-3.7	-3.3	-3.1	-2.8	-2.7
of which														
Primary deficit	*3.7*	*-0.1*	*-2.6*	*-2.5*	*-2.9*	*-2.6*	*-2.4*	*-2.2*	*-2.2*	*-2.5*	*-2.3*	*-2.2*	*-2.1*	*-2.0*
Snowball effect	*7.4*	*-8.2*	*-8.1*	*-3.2*	*-2.4*	*-2.1*	*-1.7*	*-1.4*	*-1.4*	*-1.2*	*-1.1*	*-0.9*	*-0.7*	*-0.7*
Stock-flow adjustment	*12.0*	*-4.1*	*-0.8*	*0.1*	*-1.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Gross financing needs (% of GDP)	25.5	6.3	8.4	8.5	6.5	7.8	9.5	9.1	8.7	8.1	7.4	7.1	4.4	4.1

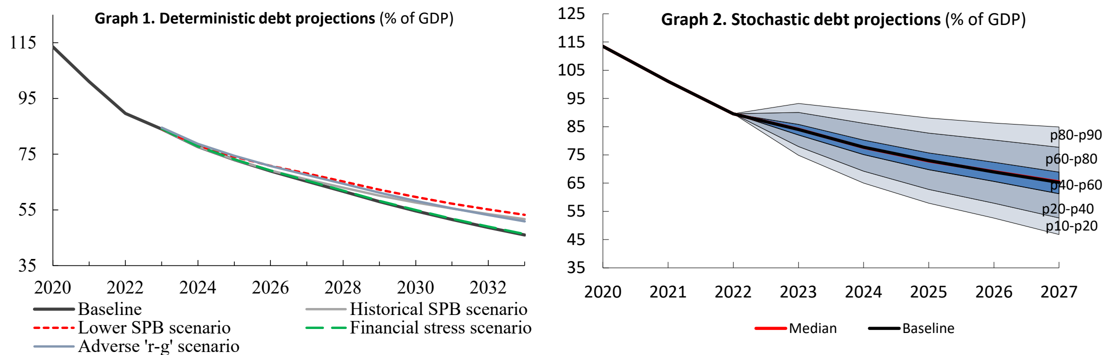


Table 2. Breakdown of the S1 and S2 sustainability gap indicators

		S1	S2
Overall index (pps. of GDP)		**-2.4**	**-0.8**
of which			
Initial budgetary position		-4.0	-1.9
Debt requirement		1.3	
Ageing costs		0.2	1.0
of which	*Pensions*	*0.3*	*0.9*
	Health care	*0.1*	*0.3*
	Long-term care	*0.1*	*0.2*
	Others	*-0.2*	*-0.4*

Source: European Commission.

Table A2.2: **Heat map of fiscal sustainability risks for Cyprus**

Short term	Medium term										Long term	
			Debt sustainability analysis (DSA)									
					Deterministic scenarios							
Overall (S0)	Overall (S1+DSA)	S1	Overall		Baseline	Historical SPB	Lower SPB	Adverse 'r-g'	Financial stress	Stochastic projections	S2	Overall (S2+DSA)
LOW	MEDIUM	LOW	MEDIUM	Overall	LOW	LOW	LOW	LOW	LOW	MEDIUM	LOW	MEDIUM
				Debt level (2033), % GDP	46	52	53	51	46			
				Debt peak year	2022	2022	2022	2022	2022			
				Fiscal consolidation space	33%	37%	37%	33%	33%			
				Probability of debt ratio exceeding in 2027 its 2022 level						6%		
				Difference between 90th and 10th percentiles (pps. GDP)						38		

(1) *Debt level* in 2033. Green: below 60% of GDP. Yellow: between 60% and 90%. Red: above 90%. (2) The *debt peak year* indicates wether debt is projected to increase overall over the next decade. Green: debt peaks early. Yellow: peak towards the middle of the projection period. Red: late peak. (3) *Fiscal consolidtation space* measures the share of past fiscal positions in the country that were more stringent than the one assumed in the baseline. Green: high value, i.e. the assumed fiscal position is plausible by historical standards and leaves room for corrective measures if needed. Yellow: intermediate. Red: low. (4) *Probability of debt ratio exceeding in 2027 its 2022 level*. Green: low probability. Yellow: intermediate. Red: high (also reflecting the initial debt level). (5) the *difference between the 90th and 10th percentiles* measures uncertainty, based on the debt distribution under 2000 different shocks. Green, yellow and red cells indicate increasing uncertainty.

Notes: The heat map presents the overall fiscal sustainability risk classification. The *short-term risk category* is based on the S0 indicator, an early-detection indicator of fiscal stress in the upcoming year. The *medium-term risk category* is derived from the debt sustainability analysis (DSA) and the S1 indicator. The DSA assesses risks to sustainability based on several criteria: the projected debt level in 10 years' time, the debt trajectory ('peak year'), the plausibility of fiscal assumptions and room for tighter positions if needed ('fiscal consolidation space'), the probability of debt not stabilising in the next 5 years and the size of uncertainty. The *long-term risk category* is based on the S2 indicator and the DSA.
Source: European Commission (for further details on the Commission's multidimensional approach, see the 2021 Fiscal Sustainability Report).

ANNEX 3

European Commission macroeconomic and fiscal projections (2022 Autumn Forecast)

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

	2018	2019	2020	2021	2022	2023	2024
Real economy			*(percent change)*				
Real GDP	5.6	5.5	-4.4	6.6	5.6	1.0	1.9
Domestic demand incl. inventories	3.5	6.1	-3.7	3.0	3.7	0.5	1.4
Private consumption expenditure	5.1	3.9	-6.8	4.5	4.9	1.2	1.3
Government consumption expenditure	3.6	11.9	11.6	6.6	2.8	-0.3	0.6
Gross fixed capital formation	-4.9	6.9	4.5	-4.2	0.7	-0.7	2.1
Exports of goods and services	7.2	8.7	2.2	13.6	8.0	1.4	2.1
Imports of goods and services	4.3	9.5	3.2	9.0	5.9	0.9	1.6
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	2.8	5.5	-1.6	3.2	3.6	0.5	1.4
Foreign trade	2.1	-0.5	-0.7	3.6	2.0	0.5	0.5
Changes in inventories	0.7	0.5	-2.0	-0.1	0.0	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	1.0	1.3	-1.2	2.9	4.6	4.3	2.6
HICP	0.8	0.5	-1.1	2.3	8.0	4.2	2.5
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	8.4	7.1	7.6	7.5	7.2	7.2	6.9
Employment	5.3	3.8	-1.2	1.3	1.6	0.7	1.4
Compensation per employee	1.5	4.4	-0.5	3.8	4.7	7.0	3.8
Labour productivity	0.3	1.7	-3.2	5.3	4.0	0.3	0.5
Unit labour costs	1.2	2.7	2.9	-1.4	0.7	6.6	3.3
Public finance			*(percent of GDP)*				
General government balance	-3.6	1.3	-5.8	-1.7	1.1	1.1	1.6
Total revenue	39.0	39.4	38.8	41.4	41.3	41.6	42.0
Total expenditure	42.6	38.1	44.6	43.1	40.2	40.4	40.4
General government primary balance	-1.3	3.5	-3.7	0.1	2.6	2.5	2.9
Gross debt	98.1	90.4	113.5	101.0	89.6	84.0	77.7
Balance of payments			*(percent of GDP)*				
Current external balance	-3.9	-5.5	-10.0	-6.8	-9.6	-7.3	-6.2
Ext. bal. of goods and services	1.4	1.0	-1.4	2.9	0.1	0.1	0.2
Exports goods and services	75.0	76.5	81.4	86.6	92.3	93.5	93.2
Imports goods and services	73.6	75.5	82.8	83.7	92.2	93.4	93.1
Memorandum item			*(EUR bn)*				
Nominal GDP	21.7	23.2	21.9	24.0	26.5	28.0	29.2

Source: European Commission.

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