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Cyprus, Spring 2022

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Cyprus, Spring 2022

EUROPEAN ECONOMY Institutional Paper 175

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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 29 April 2022. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission's 2022 Spring Forecast released on 16 May 2022 (with cut-off date of 29 April 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 of the plan.

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([1]) The executive summary of this report was adopted as Commission Communication C(2022)3505 on 20 May 2022. The rest of the report reflects the findings of the staff working document SWD(2022)704 accompanying that Communication.
([2]) ECB staff participated in this mission and in the drafting of this report in line with the ECB's remit, 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 12th post-programme surveillance (PPS) mission for Cyprus, which took place from 11-21 March 2022. The mission was conducted by the European Commission staff, in liaison with staff from the European Central Bank (ECB). The institutions held several 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) joined as well under the framework of Article IV of the IMF's Articles of Agreement.

The Cypriot economy rebounded strongly from the recession related to the COVID-19 pandemic, although Russia's invasion of Ukraine will have an impact on economic activity. Following a recession of 5% in 2020, real GDP increased by 5.5% in 2021, surpassing the 2019 level. Both domestic and external demand contributed to growth. Domestic demand was underpinned by the fiscal measures to address the impact of the pandemic. On external demand the main driver was exports of business and financial services, while the tourism sector recovered only partially. In 2022, it is expected that Russia's invasion of Ukraine and the related sanctions will have a negative impact on exports of tourism, financial services, and business services. Furthermore, the projected pick up of inflation to around 5.2% in 2022, mainly due to higher oil prices, is expected to erode purchasing power with negative repercussions on private consumption. Therefore, real GDP has been revised downwards to around 2.3% in Commission's Spring forecast, that is 1.8 percentage points less compared to the Commission's 2022 Winter interim forecast. The anticipated slowdown is set to affect the labour market with a slight increase of unemployment. The current account deficit is expected to deteriorate due to the expected slowdown of exports of services in conjunction with the increased value of imports of oil. In 2023, economic activity is expected to rise by 3.5%. However, significant downside risks to the growth outlook remain due to persisting uncertainty, mainly due to the on-going aggression of Russia against Ukraine and the scope of sanctions against Russia as well as the future development of the pandemic.

Despite a marked improvement in the fiscal position in 2021, the repercussions of Russia's invasion of Ukraine are also set to raise risks to the fiscal outlook. The general government deficit narrowed to 1.7% of GDP in 2021, from 5.8% of GDP in the previous year. The improvement was mainly driven by the economic recovery, resulting in a 17% increase in government revenues, in particular taxes on production and imports. At the same time, the growth of government expenditures was contained at 6.1%. The general government deficit is expected to improve somewhat in 2022, in spite of the slowdown of the economy and to narrow further next year. The fiscal outlook is surrounded by high downside risks. In particular, tax revenue from tourism and professional services sectors could be affected more than anticipated by the repercussions of Russia's invasion of Ukraine. Furthermore, higher than expected costs related to the implementation of the National Health System (NHS) reform could negatively affect the fiscal outlook. In addition, the planned expansion of KEDIPES, the state-owned asset management company, into a national one could adversely affect public finances in 2022.

The Cypriot financial sector performed well during the COVID-19 crisis and significant further progress was achieved on reducing non-performing loans (NPLs), although Russia's invasion of Ukraine could create new challenges. Bank capital positions are strong and liquidity remains ample. However, profitability is still affected by high impairment charges, elevated operating costs, partly due to labour market rigidities, limited income diversification and compressed lending margins in a small market characterised by strong competition. Although the pandemic has not impeded the work out of NPLs, progress varies across banks. Overall, the stock of NPLs shrank noticeably to EUR 3.0 billion in December 2021 from EUR 5.1 billion a year earlier, while the corresponding NPL ratio declined from 17.7% to 11.1% over this period. The impact of the pandemic is visible in increased share of loans classified as exhibiting increased risk. The interlinkages of Cyprus' financial sector with Russia and Ukraine are limited and not material, except for RCB Bank, the third largest local authorised credit institution, which is undertaking an orderly exit from its banking operations after sanctions were imposed on Russia following its invasion of Ukraine. The main risk to the financial sector stems from the adverse impact on tourism given the banks' exposure to this sector. New lending recovered in 2021, but remained

below pre-pandemic levels overall, although some segments such as mortgage and small business loans expanded more briskly than in previous years. Borrowers took advantage of the interest rate subsidy scheme for housing and corporate loans, which expired at the end of 2021. On the policy side, progress with reforms facilitating NPL work out has been limited. Transposing Directive (EU) 2019/1023 on preventive restructuring into Cypriot law in good time seems to be challenging. The foreclosure framework was safeguarded despite various proposals to amend it. KEDIPES is advancing with the sale of a loan portfolio, predominantly consisting of performing assets. Meanwhile, the government continues developing its plans to expand the scope of KEDIPES.

Cyprus' capacity to repay its debt to the ESM is sound. Gross financing needs for the rest of 2022 are covered through a sizeable cash buffer. Overall, the improved primary balance and lower debt redemptions result in lower gross financing needs for 2022-2023 than in 2021. After increasing significantly in 2020, the debt-to-GDP ratio resumed its pre-COVID declining path in 2021, falling from 115% of GDP in 2020 to 103.6%. Public debt is projected to decline in the coming years, supported by GDP growth and primary surpluses. Loan repayments to the ESM will only begin in 2025. Cyprus enjoyed a supportive market environment when tapping the international markets in January 2022 and it continues to have an 'investment grade' ranking from three major rating agencies.

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1. MACROECONOMIC SITUATION AND OUTLOOK

1.1. MACROECONOMIC DEVELOPMENTS IN 2021

The Cypriot economy rebounded strongly in 2021, regaining the ground lost due to the pandemic. Following a recession of 5% in 2020, real GDP increased by 5.5% in 2021, surpassing the 2019 pre-pandemic level. Both domestic and external demand contributed to growth. Domestic demand was underpinned by the fiscal stimulus. Private consumption increased by 3.7% reflecting pent-up demand and the temporary work schemes that supplemented people's disposable income during the crisis. Investment, excluding ships, also increased by 1.8% due to the buoyant construction activity in infrastructure projects mainly in the areas of ICT, energy, education and health. External demand for goods and services grew significantly thanks to the gradual recovery of the tourism sector and the robust expansion of ICT, transport, financial and business services exports.

However, the tourism sector recovered only partially, reflecting lingering pandemic-related international travel restrictions. In 2021, tourist arrivals reached 48.7% of the 2019-level and 56.4% of the revenues. The real value added of the sector of accommodation and food service activities, which is directly affected by tourism, increased by 37.9% in 2021, regaining most of the loss of 43.8% in 2020. Domestic demand for tourism contributed significantly to this result thanks to the government's income support measures as well as dedicated schemes to boost domestic tourism. The share of overnight stays in tourist accommodation of residents increased from 5.8% in 2019 to around 30% in 2021.

The labour market improved on the back of the strong economic recovery. Employment increased by 1.2% and hours worked by 3.8% in 2021. The unemployment rate resumed its pre-pandemic downward trend and reached 6.6% at the end of 2021. Slack in the labour market was still present last year, but was decreasing with the job vacancy rate rising to 2.3% in 2021 and the inactive population falling. Around 5 000 EU employees mainly in the tourism sector left the country or found a job in another sector as the tourism sector only partially recovered. This has helped reduce the slack in the labour market, but has increased tightness in the tourism sector. Wage growth resumed.

Inflation started rising significantly at the end of the year, responding to substantial external price shocks. Harmonised consumer price index reached 4.6% in the fourth quarter of 2021, mainly due to soaring global oil prices, as Cyprus depends heavily on oil products. The prices of non-energy industrial products and food also increased at the end of the year, reflecting the supply chain disruptions as well as the knock-on effects from higher energy prices.

The current account deficit fell noticeably in 2021 but remained elevated. The deficit narrowed to 7.2% of GDP in 2021 (8.6% excluding special purpose entities, SPEs) from 10.1% in 2020. This was the result of the still low revenues from tourism – well below the pre-pandemic levels – and a widened deficit in the primary income account. The latter can be linked to repatriation of profits (both distributed and retained) of foreign-owned companies in Cyprus.

1.2. ECONOMIC OUTLOOK IN 2022 AND 2023

In early 2022, Cyprus was on a robust growth path. In the first two months of the year, arrivals of tourists increased further and reached almost 62% of the corresponding level in 2019, with positive expectations for the summer season. In 2022, the sector was expected to reach in 2022 around 75% of its pre-pandemic level. Moreover, consumer confidence and economic sentiment indicators signalled strong growth ahead. The slack in the labour market decreased further with unemployment falling to 6.3% in February.

However, Russia's invasion of Ukraine will have an impact on the economic activity, in particular due to the relatively strong economic ties with Russia. Tourism is a key sector in Cyprus that is expected to be directly affected by the travel restrictions and the financial sanctions imposed on Russia. Indeed, Russia is Cyprus' second most important tourist market after the UK. Its share in total tourist arrivals and revenues hovered around 20% from 2016-2019 (27% in 2021). This market share, together with the 5% of total arrivals from Ukraine, is expected to be lost

in 2022. The government is undertaking a robust campaign to increase arrivals from other markets, a trend which had already started after the pandemic. Rising inflation and increased fuel prices may also have a negative impact on demand for tourism. All in all, while tourist arrivals in 2022 are still expected to somewhat increase compared to the 2021-level, the outlook has become less positive.

Beyond tourism, exports of other services to Russia are also expected to be negatively affected by its invasion of Ukraine. A relatively significant share of transport, ICT, computing, financial and other business services are exported to Russia, almost 17.5% of total exports of services in 2020 and almost 10% of the GDP. Excluding FISIM (financial intermediation services indirectly measured) for financial services, these shares become 11.2% and 6%, respectively. The financial sanctions imposed on Russia will have an impact on these services with negative repercussions on the current account and real GDP in the short run. Furthermore, there are indications of demand from Russian, Ukrainian and Belarusian companies to relocate in Cyprus with their employees, in order to continue their business away from risks related to Russia. This could support professional services in the next couple of years.

Foreign direct investments (FDI) is another significant link with Russia. The FDI annual inflow from Russia (around 8.1% of the GDP on average in the period 2018-2020) are split between: (i) real estate purchased in Cyprus (reduced from 2.6% of GDP in the period 2018-2020 to 1% of the GDP after the abolition of the citizenship-by-investment scheme in November 2020), (ii) transfer of funds by SPEs (3) using Cyprus as a pass-through due to the favourable tax regime, and (iii) transactions of non-SPE financial firms. The FDI flows that are mostly connected with the real GDP, i.e. financial and professional services, are the SPE-related transactions. The annual FDI outflows to Russia, between the years 2018 and 2020, amounted to around 13.3% of the GDP (4). Regarding FDI stocks, in 2020, Cyprus accounted for roughly 30% of FDI in Russia and, conversely, Russia accounted for about 25% of inward FDI stock in Cyprus. On stock assets the vast majority is related to SPEs. On stock liabilities almost 18% of the GDP is real estate owned by Russian non-SPEs. There is still significant uncertainty over the impact disruptions to the FDI flows will have on the economy and therefore warrants close monitoring.

The impact on real estate is set to be muted. Over the last 10 years, Russians have been active in the real estate sector in Cyprus, but less so since the abolition of the citizen-by-investment scheme. In 2021, the share of FDI in real estate from Russia accounted for around 6% of the total value of transactions of immovable property in Cyprus. At the same time, the real estate sector became more dependent on domestic demand in 2021, supported by the mortgage subsidisation scheme. The loss of Russian demand due to the sanctions may be compensated by an increasing demand for summer houses by other foreign markets, as well as increasing interest of foreign companies to relocate in Cyprus in particular in the ICT sector.

Because of the economic impact of Russia's invasion of Ukraine, real GDP is forecast to slow down in 2022. In the baseline (5) projection of the Commission's 2022 Spring forecast, real GDP is projected to expand by around 2.3%, i.e. by 1.8 percentage points less compared to the Commission's 2022 Winter interim forecast. Public consumption is expected to decelerate as all the pandemic-related measures are effectively phased out. Private consumption is also forecast to slowdown to 2.2%, due to the erosion of the purchasing power from increasing inflation. Investment, in particular in construction, is expected to be negatively affected by the significant increases in the price of construction

(3) "SPEs are legal entities registered and tax resident in Cyprus with few employees and/or no production, which are controlled by non-resident entities. They are mainly used by non-residents to channel funds to other non-residents, notably in the case of holding companies or intra-group financing operations. Companies can use SPEs to legally separate risk-bearing activities from other operations and valuable assets, for example at the request of their creditors. SPEs are also legal tools used to protect assets from bankruptcy proceedings. Setting up an investment vehicle, a subsidiary or a company in Cyprus benefits from relatively low taxation and a local pool of specialised expertise." European Commission Cyprus County Report 2018.

(4) The data on FDI come from the Central Bank of Cyprus.

(5) It assumes that the ongoing Russian aggression against Ukraine will keep geopolitical tensions elevated and the current sanctions will be in place throughout the forecast period, supply-chain disruptions will increase in the near term and normalisation will be very gradual. Energy prices will remain high.

material, up by 18% in the first quarter of 2022 compared to the same period in 2021. On the positive side, the implementation of the recovery and resilience plan is expected to cushion the impac on investmentt. The contribution of net exports was also revised downwards as a result of Russia's invasion of Ukraine and the related sanctions. For 2023, the real GDP growth is expected to pick up, by 3.5%, helped also by the implementation of the recovery and resilience plan.

Similar to other countries, inflation has been surging and is expected to remain elevated in 2022. Continued increases in energy prices and shortages of intermediate and final consumption goods are expected to result in a further pick up of inflation to 5.2% in 2022. Russia's invasion of Ukraine is significantly exacerbating the situation, particularly as regards energy prices. Cyprus depends heavily on imported oil products for energy use. Despite the government adopting measures such as reducing VAT and excise duties as well as special discounts for vulnerable groups, a significant increase in oil prices is being passed on to consumers. Moreover, higher prices for energy and intermediate goods are pushing up prices in key sectors such as construction and services. Food prices are also increasing considerably. Inflation will also push wages up. Cyprus has a wage indexation system in place and every January salaries are linked to 50% of the evolution of the consumer prices (through a cost of living adjustment). Some negotiations on wages are expected in 2022, as the collective agreement for the construction sector expires in April 2022 and negotiations have started, while for the tourism sector it expires in December 2022. In 2023, as energy prices are expected to somewhat decrease and goods' shortages ease, inflation is projected at 2.7%.

The slowdown of the economy is expected to be reflected in the labour market. Employment is set to decelerate to around 0.9% in 2022 as opposed to 1.8% in the Commission's 2021 Autumn forecast and the unemployment rate to increase slightly to 7.8%. Some labour shortages for unskilled labour initially expected in the catering industry will be lower given the less positive outlook of tourism in 2022. These shortages are expected to be covered mainly by domestic workers.

The impact of Russia's invasion of Ukraine on exports of services as well as higher prices for imports are expected to widen the current account deficit. It is expected to increase to around 8.8% of GDP in 2022 up from 7.2% in 2021 and to narrow again in 2023, to around 7.2%. Beyond the expected negative impact on the trade balance, the current account balance has started to increasingly depend on the primary income account, linked to foreign-owned companies, including credit-acquiring companies, whose activities in Cyprus have been increasing in the last couple of years.

Significant downside risks to the growth outlook remain due to persisting uncertainty, mainly due to the on-going aggression of Russia against Ukraine and the related sanctions against Russia. The duration of the Russian aggression against Ukraine and the EU sanctions is a decisive factor on the impact of the Cypriot economy. Furthermore, the pandemic is not totally over and any new surges in the transmission of COVID-19 variants would take a further toll on consumer and business confidence and the economy. In this context, tourism is particularly vulnerable as holiday planning could be affected. On the positive side, the economy emerged from the pandemic with no significant scarring effects and bankruptcies. In early 2022, the risk of a surge in new NPLs was low, as most businesses started repaying their loans after the lifting of the moratoria. However, this risk has increased again in particular for tourism and construction due to the less positive outlook of these two sectors. Therefore, the private sector's repayment performance warrants close monitoring (see Section 3 Financial sector) ([6]). However, on the positive side, the implementation of reforms in the recovery and resilience plan and of the long-term growth strategy, still to be adopted by the government, as well as the ongoing implementation of the tourism strategy, which is already bearing fruit with regards to the diversification and resilience of the sector, are expected to positively affect the economy in the medium and long-term. Furthermore, there indications of demand from Russian, Ukrainian and Belarusian companies to relocate in Cyprus with their employees in order to continue their business away from risks related to Russia.

([6]) See Cyprus' In-Depth Review 2022 (SWD(2022) 628).

2. PUBLIC FINANCES

2.1. FISCAL PERFORMANCE

The public finances of Cyprus improved significantly in 2021. The general government deficit narrowed to 1.7% of GDP, from 5.8% of GDP in the previous year. The improvement was significantly larger than anticipated by the national authorities (see draft budgetary plan) and by the projections of international institutions (see Commission's 2021 Autumn forecast and the IMF's October 2021 World Economic Outlook). It was mainly driven by the economic recovery, leading to a 17% increase in government revenue, in particular taxes on production and imports. At the same time, the increase in government expenditure was less pronounced, growing by 6.1%, as some supplementary budgets remained unused. Meanwhile, after its strong increase in 2020 to 115%, the debt-to-GDP ratio resumed its downward trend in 2021 falling to 103.6%, on the back of high nominal GDP growth and the reduction of the high cash buffer accumulated in 2020 to cover financing needs arising from the pandemic.

Almost all revenue categories showed substantial increases in 2021. Public revenue amounted to EUR 9.95 bn (42.4% of GDP), up from EUR 8.5 bn (39.3% of GDP) in 2020, exceeding the pre-pandemic level. In particular, VAT collection increased by 22.2% thanks to higher economic activity, more than making up for the 14% decrease in 2020. In terms of direct taxes, corporate taxes showed a considerable increase of 33%, reaching 5.2% of GDP and reflecting improving business conditions. Social contributions, partly due to the increased health contributions resulting from the second phase of the health reform also increased.

Public expenditure increased as well, albeit at a slower pace than revenue. Total government expenditure amounted to EUR 10.3 bn in 2021, compared to EUR 9.7 bn in the preceding year. This represents an increase of 6.1% year-on-year. The highest growth was recorded in social payments (7.1% year-on-year), which can be linked to the health reform. Employees' salaries increased by 3.6% year-on-year in 2021, bringing its level to 12.8% of GDP (7) and are expected to increase further in January 2022 incorporating partially the level of inflation. Intermediate consumption recorded a growth rate of 15.1% (slightly increasing to 4.4% of GDP). This rise is mainly explained by higher spending in the context of the pandemic and the National Health System (NHS). Support measures for businesses and self-employed people to cover part of their operating costs, as well as wage subsidisation schemes kept the wage subsidies at the similar nominal level as in 2020, reaching EUR 0.6 bn (2.5% of GDP). Public investments have been slightly decreasing, with gross fixed capital formation decreasing by around 0.8% (to 2.7% of GDP).

COVID-19 support measures had still a sizeable budgetary impact in 2021, but have mostly been phased out by the end of the year. Spending on COVID-19 related measures reached 3.6% of GDP in 2020 and fell to 3.1% of GDP in 2021. In 2021, most of this spending was on wage subsidisation schemes, which amounted to 1.3% of GDP. One-off grants to businesses to cover parts of their operating costs amounted to 0.8% of GDP, and health related expenditures reached around 0.4% of GDP. The loss of revenues related to wage subsidisation schemes also affected the fiscal performance by about 0.3% of GDP. Other elements accounted for the remaining 0.3% of GDP. As the COVID-19 related measures have been gradually phased out by the end of the year, their budgetary impact is not expected to be significant in 2022, provided that the situation with the pandemic does not worsen.

2.2. FISCAL OUTLOOK

The general government deficit is expected to narrow further in 2022 and 2023. In spite of the slower growth of the economy in 2022, the government deficit is expected to slightly improve compared to the previous year and reach 0.3% of GDP. The reduced public expenditures due to the withdrawal of pandemic related measures, in particular subsidies, contribute to that outlook. Meanwhile, revenues are expected to remain at the

(7) 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 Organisation (SHSO) and increased gratuity payments.

similar nominal level as last year. In 2023, the government balance is expected to improve further, on the back of the foreseen pick-up of GDP growth, reaching 0.2% of GDP.

Due to rising energy prices the Cypriot government has taken fiscal measures to support households and the corporate sector. Since November 2021, the VAT rate on electricity use has been temporarily reduced for vulnerable consumers from 19% to 5%, and for all other consumers from 19% to 9%. Moreover, excise duties on petroleum have been reduced since early 2022. So far, the fiscal impact of those measures has been moderate and amounted to 0.1% of GDP. However, the final impact will depend on the duration of Russia's invasion of Ukraine and the development of oil prices on the global markets. ([8])

Russia's invasion of Ukraine has heightened uncertainty and may affect the fiscal outlook. The main impact is expected in the tourism and professional services sectors, where the loss of tax revenues from companies linked to those sectors may be higher than expected. Tourists coming from Russia made up around 20% of the total arrivals to Cyprus before the COVID-19 crisis. The impact might be lessened by replacements from other markets, i.e. visitors from other countries. The revenues from professional services, such as legal, tax or accounting advisory, are also likely to suffer due to links with Russia, and substitution for that sector will be more challenging.

The healthcare sector and the planned transformation of KEDIPES into a national asset management company pose risks to the fiscal outlook, while the risk of other contingent liabilities appears limited. The fiscal sustainability of the NHS in the aftermath of the reform poses a downside risk to the public finances. According to the Ministry of Finance's estimates, the impact of NHS-related activities on the general government accounts amounted to -2% of GDP in 2021, compared to -1.5% of GDP in 2020, and is set to further increase in 2022 (with the full year impact of inpatient care) ([9]). Moreover, the SHSO (i.e. public healthcare providers) may not achieve financial autonomy by June 2024, as set out in the law, among others due to impact of the pandemic. The SHSO's financial deficits may remain higher and persist for longer than initially expected. There is a risk of an overuse of healthcare services under the NHS, which could lead to increased spending, putting pressure on public finances. Another potential fiscal risk in 2022 concerns KEDIPES' expansion into a national asset management company, including the on-boarding of the real estate mortgaged for NPLs from banks, and transforming the assets into a mortgage-to-rent scheme offered to the borrowers. However, the terms of the transaction are still being designed, taking into consideration the need to contain the fiscal impact. Given the very limited uptake of the guarantee schemes offered by the government during 2021 and the latest guarantee risk assessment report, the fiscal risk related to those contingent liabilities is limited and does not pose a sizeable threat to Cyprus' fiscal outlook.

([8]) The Cypriot energy mix consists of 85% imported oil, therefore the price of oil on the global markets has a large impact on its energy prices.

([9]) Furthermore, with regards to inpatient care, the Cypriot authorities aim to introduce tools that will allow the Health Insurance Organisation to differentiate the base rates between hospitals based on specific qualitative criteria, whilst at the same time achieving the gradual convergence of current individual hospital base rates to a common basic base rate.

3. FINANCIAL SECTOR

3.1. BANKING SECTOR DEVELOPMENTS

Asset quality

There was considerable further progress made in reducing non-performing loans (NPLs) in the banking sector in 2021. The stock of NPLs shrank to EUR 3.0 bn in December 2021, from EUR 5.1 bn a year earlier. The corresponding NPL ratio ([10]) declined to 11.1% from 17.7% over the same period. A large part of the reduction in 2021 is attributed to Bank of Cyprus selling its *Helix 3* NPL portfolio and Hellenic Bank's project *Starlight*, which relieved its NPL stock by around EUR 760 m. While the overall stock of NPLs in the banking sector has been significantly reduced, the remaining stock may be increasingly difficult to work out, as a proportionally rising share is comprised of mortgages, which are more difficult to solve due to socially sensitive issues. The remaining stock is also spread across smaller portfolios in smaller banks, making it more difficult to package and sell them.

Overall assets in the banking sector increased, driven by deposit inflows and operations with the Eurosystem. Total assets in the banking system amounted to EUR 67 bn at the end of 2021, an increase of EUR 8 bn over the year. While overall assets rose, banks reduced the riskiness of their assets, as they held larger cash balances and deposits with the Eurosystem.

Loans that benefited from moratoria have mostly resumed a regular repayment schedule, although a large share were renegotiated. A total of EUR 12.3 bn of loans participated in either of the two moratoria schemes. The take-up was much larger in the first scheme (EUR 11.8 bn), which ended in December 2020, than in the second (EUR 59 m), which was available until June 2021. A small percentage (8.6%) of the loans have not had a payment due yet. This applies only to a small fraction, 2%, of household loans, but a sizeable share, 12%, of business loans, and 15% of loans to other financial corporations. These loans are either a bullet type or revolving facilities and are therefore not paid back in instalments, but become due in full at maturity. Of those with payments due, 16% have been renegotiated, 3% have defaulted and the remainder returned to their regular repayment schedule. Renegotiation ratios varied widely among economic sectors, with construction and accommodation registering the highest ratios of 44.2% and 36.9% respectively ([11]). Several renegotiations granted concessions to the borrowers that made it easy to comply with the repayment schedule in the short term. Therefore, there is a need to continue monitoring NPL inflows as repayment schedules become more demanding, particularly at a time when a new adverse shock is affecting the economy.

The impact of the pandemic is visible in the rising share of loans classified as exhibiting increased risk. Stage 2 loans grew from EUR 2.9 bn in December 2019 to EUR 3.8 bn in December 2021, by then representing about 14% of all loans and advances and with lower coverage ratio compared to other countries. The increase was especially strong for non-financial corporations (NFCs), where 21% of all loans are currently classified as stage 2. Cyprus remains among the EU countries with the highest proportion of stage 2 and stage 3 exposures, together comprising 23% of the loan portfolio. ([12]) ([13]) This may be due to Cypriot banks having large exposures to the tourism sector, which was heavily affected by the pandemic.

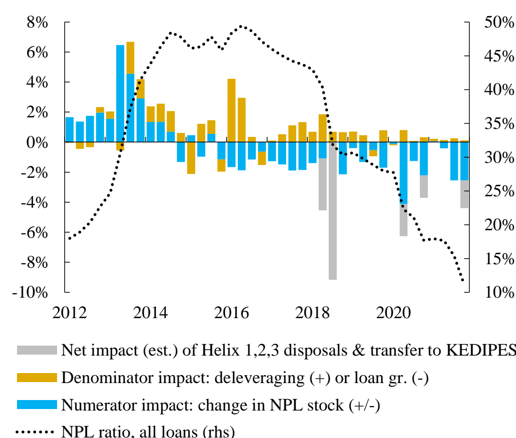
([10]) The NPL ratios referred to in this report are based on the Central Bank of Cyprus' data and thus they differ from the ratios referred to in the 2022 Cyprus Country Report, which are based on ECB data. In particular, the NPL ratio is calculated as the amount of non-performing loans over the amount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

([11]) The construction sector covered EUR 0.7 bn of loans that exited moratorium status by December 2021, while accommodation covered EUR 1.8 bn.

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

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

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



Source: Central Bank of Cyprus

New risks are emerging in relation to Russia's invasion of Ukraine, but for the banking system, exposures to both countries appear small and manageable. Most exposures are concentrated in one bank, RCB, the third largest local authorised credit institution (7% market share in terms of total assets as at the end of 2021 vis-à-vis 36% and 28% of Bank of Cyprus and Hellenic Bank respectively). As announced on 24 March, RCB is ceasing its banking operations and surrendering its banking licence without any impact on its depositors or the state finances. The bank is in the process of selling a performing loan portfolio to Hellenic Bank, paying out depositors in full and transforming itself into an asset management company. This decision resulted from an increasingly challenging operating environment for RCB. The Single Supervisory Mechanism is closely monitoring the transition and a temporary administrator has been appointed to work with current management and monitor the bank's liquidity and capital. For the other banks, exposures to Russia and Ukraine are small and do not pose a significant direct risk to their asset quality. For the banking sector as a whole, the entire exposure (EUR 470 m of loans and advances) to Russia and Ukraine corresponds to less than 0.8% of assets based on FINREP data. With respect to deposits, 4.7% of them are linked to Russia and Ukraine. Beyond this direct impact, banks are likely to feel the indirect negative spillover effects through the wider macroeconomic impact of Russia's invasion of Ukraine, mainly from the adverse impact on tourism given the banks' exposure to this sector.

Lending and lending support schemes

New lending recovered in 2021, but remained below pre-pandemic levels, even though some segments, notably mortgage and small business loans of up to EUR 1 m, expanded more briskly than in previous years. In 2020, new lending to households declined by 11.9%, while new lending to non-financial corporations (NFCs) fell by 32.9%. In 2021, lending to households rebounded. Banks extended new loans of EUR 1.4 bn to households, exceeding pre-pandemic 2019 levels by EUR 175 m. Borrowers took advantage of the interest rate subsidy scheme for housing and corporate loans, which expired at the end of 2021. Overall, the scheme benefitted mortgage loans of EUR 900 m. New business loans of up to EUR 1 m were EUR 539.0 m in 2021, exceeding pre-pandemic 2019 levels by EUR 101.4 m.

Lending to companies has not yet recovered to pre-pandemic levels. Banks extended pure new loans of EUR 1.5 bn to NFCs in 2021, still below the 2019 level of EUR 2.0 bn. Unlike most other European countries, the Cypriot government did not offer a loan guarantee scheme in the first year of the pandemic. This changed on 20 November 2021, when the government launched a loan guarantee scheme for businesses and the self-employed. The total amount earmarked by the government is EUR 1 bn, for a total loan amount of EUR 1.43 bn.

Overall, lending remains structurally weak as high indebtedness limits non-financial sector's capacity to borrow. The debt-to GDP ratio stands at 85.8% in the household sector and it equals 91.3% for NFCs excluding special purpose entities (SPEs). The structural weakness is compounded by cyclical uncertainty. While the impact from the pandemic may be waning, new uncertainties from Russia's invasion of Ukraine are further dampening the appetite for loans.

Profitability

The banking sector remained loss-making in 2021, amid a subdued profit outlook. The sector incurred a pre-tax loss of EUR 27.8 m in 2021, which marks an improvement over its pre-tax loss of EUR 97.2 m in 2020, as the heavy impairment charges in 2020 were not repeated in 2021. The overall improvement masks a decline in operating

income ([14]), which stood at EUR 1.3 bn in 2021, falling by EUR 186.5 m, or 12.7%, below the previous year's value. Net interest income (NII) declined to its lowest level ever in December 2021, due to low interest margins and due to the increase in non-interest-bearing assets, in particular cash balances. Steeper losses from de-recognition of financial assets also contributed to the decline. The sector's return on equity of -1.6% in the first three quarters of 2021 indicates a recovery after the 3.3% fall in 2020, but it compares unfavourably with the EU average of 7.1% in 2021 and 2.2% in 2020.

Profitability remains a major challenge for Cypriot banks given low margins, high operating costs and limited business opportunities. A rigid labour market limits the possibilities to reduce staff costs, which keep rising despite efforts to reduce staffing levels. On the income side, banks aim to raise fee income and reduce their reliance on NII, but this has triggered resistance from consumer associations. The high amount of deposits parked at the ECB, further weighs on profits. Going forward, NII is expected to continue declining as high-yielding Cypriot government bonds are maturing and will have to be replaced with lower yielding assets. Interest margins remained compressed, around 2.0% for households and around 2.8% for NFCs. Strong competition in a small domestic market also puts downward pressure on profitability.

Capitalisation

Cypriot banks maintained adequate capital levels above the regulatory minima throughout the pandemic, but the amount of risk exposures on their balance sheets is still sizeable. The CET1 ratio dropped slightly to 17.5% in 2021 from 17.6% at end 2020, as the reduction in capital was accompanied by a decline in risk weighted assets (RWAs). Notably, banks managed to increase their buffers above pillar 2 guidance during the pandemic. The reduction in RWAs stems from the declining NPL stock. At the same time, the total amount of assets have increased which reflects the improved asset quality. Lower capital combined with growing assets translated into the leverage ratio dropping to its lowest ever recorded in December 2021, but remaining well above the EU average and regulatory the requirement. Capital ratios are benefitting from the Capital Requirement Regulation (CRR) 'quick fix' introduced in December 2020 to support capital ratios during the pandemic ([15]). Banks appear well capitalised, but there is still a sizeable credit risk on their balance sheets. Taking into account the unprovisioned NPLs which totalled EUR 1.7 bn in December 2021 these amount to 6.3% of all loans or 39% of CET1 capital ([16]). Stage 2 and stage 3 loans combined amount to 133.5% of CET1 capital. The aggregate CET1 ratio masks significant variations among institutions: Hellenic Bank is better capitalised with a fully loaded CET1 ratio of 18.6% compared with Bank of Cyprus with 13.7% (transitional ratios of 19.3% and 15.1%, respectively).

Deposits and liquidity

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 48.7 bn in December of 2019 ([17]). However, since March 2021 deposits have grown considerably as domestic deposits of both households and NFCs surged and foreign clients returned. In December 2021, deposits reached a new high of EUR 51.5 bn. The net stable funding ratio (NSFR) was at a comfortable level of 162% in December 2021, while the liquidity coverage ratio (LCR) was 313% ([18]). These ratios are among

([14]) This includes net interest income, income from fees and commissions, and value adjustments of financial assets, but not administrative expenses such as staff costs.

([15]) The CRR '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 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.

([16]) Latest available CET1 value is available for December 2021.

([17]) The decline is the continuation of a downward trend that started in 2013, but the pandemic may have contributed to it.

([18]) 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

the highest in the EU. However, excess liquidity also constitutes a drag on profitability, as banks are struggling to find profitable investment opportunities in a small market. Consumer protection legislation does not allow Cypriot banks to pass on negative interest rates to consumers.

Overview of the largest domestic banks

Unimpeded by the pandemic, Bank of Cyprus (BoC) made further progress on reducing its NPL holdings. The disposal of the *Helix 2* portfolio, together with a smaller organic reduction brought the NPL ratio down to 12.4% in December 2021 from 25.2% a year earlier. A further reduction came from the sale of the *Helix 3* portfolio, signed in November 2021. It results in a pro-forma NPL ratio of 7.5% in December 2021.

BoC's capital position remains solid, and is benefiting from a return to profitability in 2021. The bank returned a profit of EUR 30 m in 2021, after a loss of EUR 171 m in 2020. The result of 2020 was weighed down by impairment charges which eased in 2021. NII declined to EUR 295 m from EUR 330 m in 2020. NII remains under pressure from low interest rates and increased competition for clients in Cyprus amid restricted demand for new credit on the side of the economy and very abundant liquidity on the side of banks. Profitability has been volatile and weak mainly due to high impairment charges and one-off charges relating to large NPE trades. BoC's CET1 ratio improved to 15.1% (transitional for IFRS 9 basis) at end-2021 from 14.8% a year earlier. This was driven by a decline in RWA-intensity as CET1 capital declined despite increasing total assets by EUR 3.5 bn over the year to EUR 25.0 bn. The decline in RWAs was driven partly by NPL sales as well as an increase in cash holding. BoC's loan portfolio is concentrated in Cyprus, with limited exposures to Romania and Greece. Since September 2020, BoC has not recorded any significant risk exposures to Russia. The bank aims to return to paying a dividend again in 2024, based on the results of 2023.

An expensive staff exit programme raises expectations that the cost base will be reduced. A voluntary staff exit programme was completed in December 2021 with an overall cost of EUR 18 m and envisaged annual savings of EUR 6 m. The cost-to-income ratio is still high but dropped lower to 65% in Q4-2021. With a minimum requirement for own funds and eligible liabilities (MREL) ratio of 18.53% in June 2021, the bank attained its MREL target for 2021 of 14.94%, with the final target for 2025 being 23.3%. BoC had an LCR of 303% in June 2021, which is higher than the EU average and above the minimum requirement.

After only small organic improvements in its NPL ratio, Hellenic Bank (HB) is looking to sell NPLs. HB's NPL ratio remained high at 21.0% in December 2021, after declining only marginally over the course of the year. Excluding loans in the asset protection scheme (APS), the NPL ratio is more moderate at 14.4%. The bank is currently working on project *Starlight*, which entails the securitisation and sale of EUR 900 m of NPLs. Accounting for the sale and excluding loans covered by the APS, the NPL ratio stands at 3.6% pro forma at end 2021. A rather high share of NPLs (70%, excluding exposures covered by the APS) is currently covered by provisions. The lifting of the moratoria has not resulted in a major asset quality deterioration. 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 499% is among the highest in Europe. However, given limited lending opportunities, the bank has deposited a large part of this liquidity, corresponding to 35% of total assets, at the ECB.

HB is well capitalised, but significant risks remain on the bank's balance sheet. HB has a strong capital position with a transitional CET1 ratio of 19.3%. The bank incurred a loss of EUR 11.7 m in 2021 due to increased impairment charges related to its NPL sale. With an MREL ratio of 21.67%, above its interim requirement of 19.95% for 2021 the bank is making progress towards its 2025 target of 27.63%. The bank's loan book is well diversified, but the bank remains reliant on NII. The bank has remained in disagreement with trade unions over a staff exit programme, which is delaying its cost cutting process. As of December 2021, HB cost-to-income ratio was 73.4% in comparison with 67.5% a year before.

liquid assets a bank holds as a percentage of the total net cash outflow over the next 30 calendar days.

In the aftermath of the sanctions imposed on Russia following its invasion of Ukraine, RCB Bank is undertaking an orderly exit from its banking operations. On 24 February 2022, RCB announced that the Russian state-owned VTB Bank was exiting its shareholding structure. On 22 March 2022, RCB Bank agreed with HB the sale of a performing loan portfolio (with a gross book value of around EUR 556 m) for a total amount of around EUR 500 m, comprising mainly corporate loans split into two tranches. The sale of Tranche A (around EUR 292 m) was completed on 24 March 2022, while the sale of Tranche B is expected by the end of May 2022. The sale helps the bank increase its liquidity to service deposit withdrawals. The remaining part of the business will be transformed into an asset management company. RCB has ceased accepting deposits and granting loans. A temporary administrator was appointed to supervise the process.

Foreclosure developments

The longer-term perspectives for the foreclosure framework remain uncertain. The foreclosure framework was strengthened in 2018. In 2019 new amendments were brought in (backtracking on key elements of the previous year's reform ([19])), which only apply to new procedures that were initiated after the law came into force. Therefore, in practice the framework has not yet been tested on a larger scale by the courts. In 2021, new discussions on potential further legislative amendments resurfaced, including proposals to create a new jurisdiction at district courts level that would examine disputes between borrowers and credit institutions with regard to loan balances and charges. An effective foreclosure framework is an essential tool to ensure legal certainty, maintain payment discipline, support banks' efforts to reduce NPLs and encourage borrowers to participate in loan restructuring.

Several foreclosures were suspended during the pandemic. 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 did not enter into force, as it was referred by the President to the Supreme Court (a hearing took place on January 2022). Any further suspension of foreclosure proceedings may hinder the banks' ability to organically deleverage their NPL portfolios and affect the conditions for NPL sales.

Electronic auctions of foreclosed real estate remained the banks' preferred option for disposing of mortgage loans. The pandemic contributed significantly to the shift to electronic auctions for all property types. In Q3 2021, the average rate of e-auctions stood at 80% of all auctions. In Q4-2021, 119 properties (predominantly land and residential properties) were disposed of by the mortgage lender, compared with 52 in the previous quarter, whereby the bulk of the properties (71%) were bought by the mortgage lender (i.e. the banks). The use of electronic auctions is expected to further increase, as the spectrum of users and familiarity with the platform continue to grow, further helping reduce the NPL stock in Cyprus. Planned supervisory action to increase provisions for impairments on real estate properties retained in a bank's balance sheet should also push the number of auctions.

Cyprus Asset Management Company (KEDIPES) and credit acquiring companies

The new service loan agreement (SLA) of KEDIPES aims to reduce 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 agreed by both parties, entailing increased responsibility in devising long-term restructurings and placing greater focus on improving borrower and loans account data. Projected servicing fees (over 2020-2027) have been reduced and the new SLA places greater focus on a performance-based structure of fees. Following a lengthy negotiation and approval process, parts of the SLA were approved by KEDIPES' Board of Directors in Q1-2022 ([20]).

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

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

KEDIPES devised and agreed a business plan that focuses on reducing the NPL portfolio via restructuring solutions or recoveries and it targets full repayment of State aid. KEDIPES made progress towards reducing its staff by negotiating a new collective agreement with the unions. This has already been signed, with the terms of the agreement applied to all staff. A voluntary redundancy scheme has been announced, targeting the exit of around 100-130 staff members.

KEDIPES' performance has been adversely affected by the COVID-19 crisis. The adverse effects of the pandemic weighed on the speed of recovery and on the recoverable value of assets. Cash inflows increased over the course of 2021, reaching the pre-pandemic 2019 amount. Claims under the asset protection scheme (APS) with Hellenic Bank weigh on State aid repayments ([21]). In total, EUR 250 m of State aid was repaid in 2021 and EUR 570 m since September 2018. Future repayment of State aid may be reduced or delayed due to the planned use of own funds for the potential expansion of KEDIPES into a national asset management company. The gross book value of the NPL stock declined throughout 2021 (from EUR 6.1 bn to EUR 5.8 bn), which is comparable to last year's pace of reduction. The suspension of auctions and foreclosures of real estate in 2021 weighed on the amount of debt-to-asset swaps and recoveries.

The economic implications from Russia's invasion of Ukraine may have an adverse impact on KEDIPES' operations. The effect on economic activity (e.g. on the tourism and services sectors) could weigh on loan recoverability and real estate property sales. Future APS claims, even if mainly related to retail/household exposures, may be affected by higher defaults.

KEDIPES is advancing with the sale of a loan portfolio and with its implementation of a mortgage-to-rent scheme. A sale of up to EUR 1 bn of loans (*Project Ledra*) was envisaged in tranches, starting in 2021. In July 2021, KEDIPES announced the sale of a first tranche of performing loans of up to EUR 476 m, expected to be concluded in the first half of 2022, with the second phase of *Project Ledra* to be launched late in 2022 or early 2023. To step up progress on reducing legacy NPLs in the banking system, the authorities are also preparing to expand the scope of KEDIPES, as some key parameters of the scheme remain to be specified. In this context, it is important that (i) such initiatives are carefully designed and assessed, (ii) the fiscal impact is contained, and (iii) ensuing risks and concerns for overall payment discipline are mitigated and efficient workout of NPLs is ensured ([22]). A stable and properly functioning foreclosure framework remains key to the success of these initiatives.

As regards credit-acquiring companies (CACs) and credit servicers, legal changes have been proposed to help better assess risks and to enhance governance and management. The Ministry of Finance in collaboration with the Central Bank of Cyprus (CBC) prepared and submitted to Parliament a package of legislative proposals that aimed to improve the regulatory framework for servicers and acquirers of credit facilities. The proposal 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 and unrestricted access to ARTEMIS ([23])). Furthermore, an amendment to the Evidence Law has been discussed in Parliament to ensure that loan account statements presented by CACs before the Court have the same level of admissibility as those presented by credit institutions. The entry into force of these laws was originally envisaged for the end of 2021.

3.2. OTHER FINANCIAL SECTOR ISSUES

Insolvency developments

Transposing Directive (EU) 2019/1023 on preventive restructuring into Cypriot law by the deadline of 17 July 2022 is proving to be a challenge. A revised draft bill was submitted to

([21]) 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*.

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

([23]) Artemis Credit Bureau Ltd is Cyprus' credit register.

the Cypriot Legal Service in November 2021 and is still pending for confirmation. The next step is to submit the draft bill to the Council of Ministers and Parliament.

The improvement of the insolvency law is expected to focus on setting up an out-of-court/hybrid preventive restructuring tool that also includes an early warning mechanism. The new tool's objective is to set up an expeditious restructuring mechanism that will also address the weaknesses of the 'examinership' procedure (i.e. a process whereby viable debtors are court-protected in order to restructure their debt).

The filling of vacancies within the organisational structure of the Department of Insolvency (DoI) is progressing slowly. Most managerial and officers' positions within the DoI will be filled in the second half of 2022. The job descriptions for DoI staff (defining the mandate, core functions, duties) and the salary scales of the personnel of the DoI were formally approved in Q3-2021. The call for the positions of the Director-General of the DoI and several senior officers was closed in March 2022, to be finalised by the end of 2022. A Committee for the continuous professional development of the insolvency practitioners was set up with the participation of the Cyprus Bar Association. The DoI is preparing training sessions for the current and new personnel ([24]).

The digitalisation of insolvency processes includes different actions such as improving DoI's effectiveness (through the new web portal and the set-up of a digital archive) and the automation of insolvency cases. The DoI's website has been online since Q3-2021 but still with limited capability. The e-certificates for non-bankruptcy and liquidation are available online. The DoI launched a project on designing of a new web portal, to be completed at the end of 2022. A project to set up a digital archive of insolvency proceedings, which involves improving the organisation of the DoI's filing system and digitalising files is expected to be launched by Q2-2022 for 24 months. A project to digitalise the handling of insolvency cases was launched in July 2021 and is expected to be completed by the end of 2022.

Liquidation framework

The court procedure for opening the liquidation of the Cyprus Branch of FBME Bank faced unexpected headwinds, while the authorities work on streamlining the liquidation framework. On FBME, the Court decided in 2020 to hear two liquidation applications, one by the CBC submitted in February 2019 and one by the Tanzanian liquidator submitted in May 2017. The CBC holds the position that the appointment and distribution of the Branch's assets to the Branch's depositors should be made under the hierarchy of creditors specified in the Cypriot law. In February 2022, the administrative court in Cyprus ruled on procedural grounds against the CBC decision to resolve the Cyprus Branch of FBME, which has resulted in the CBC appointed special administrator being removed. In March 2022 the CBC filed an appeal with the Supreme Court against the administrative court's decision as well as an application with the administrative court requesting suspension of the execution of its decision till the adjudication of the appeal. On Laiki Bank, the CBC finalised the resolution process and consequently revoked its restricted banking licence in September 2020. The CBC submitted applications for Laiki Bank's liquidation and the appointment of a liquidator to the Court in January 2021. Three objections against the CBC's applications were filed by shareholders and creditors of Laiki Bank. The hearing of the said objections was completed in February 2022 and the Court reserved its judgement on the CBC's applications. Given the difficulties with resolving FBME and Laiki Bank, the CBC in cooperation with the MoF is working on a draft law amending the liquidation framework (envisaged to be submitted to Parliament in 2022). This law aims to simplify the conditions for the court to decide on liquidation, grant specific powers to the temporary administrator and allow the sale of business in liquidation.

([24]) The appointment of DoI staff as well as providing them with training are among the reforms to be implemented by Cyprus in its recovery and resilience plan.

4. SOVEREIGN FINANCING AND ABILITY TO REPAY

The debt-to-GDP ratio resumed its pre-COVID declining path in 2021 falling from 115% of GDP in 2020 to 103.6%. According to the Commission's 2022 Spring forecast, public debt is expected to decrease to 93.9% of GDP by end-2022, reflecting (i) the nominal economic growth, (ii) the drawing down of the sizeable liquidity buffer accumulated since the beginning of the pandemic ([25]) and (iii) the improved primary balance. In 2023, the debt ratio is expected to decrease further to 88.8% of GDP (see the debt sustainability analysis in Annex 2).

The structure and cost of Cypriot debt improved throughout 2021. Cyprus' weighted average cost of outstanding public debt decreased from 1.8% in 2020 to 1.6% as of end-2021, on the back of lower costs of new debt at issuance. In terms of the structure of debt, as of January 2022, the two largest categories of outstanding debt were foreign bonds (58%) and official loans (33%). As of December 2021, about 10% of central government debt is held by the domestic market ([26]). In the future, there are plans for financing to come mainly from international capital markets, while the domestic debt market is expected to continue to serve as a complementary financing source, if needed.

The average maturity of debt slightly decreased to 7.6 years in 2021 compared to 7.9 years in 2020. In 2021, the weighted average maturity of debt decreased mainly due to the seasoning of debt ([27]) and foreign bond issuance of relatively shorter-term maturity of 5 years. At the same time, most of the foreign bonds (euro medium-term notes – EMTNs) issued in the last few years had maturities of 10 years or more.

([25]) 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. At the end of 2020, it stood at 17% of GDP and at about the same level of 16% of GDP at the end of March 2022.

([26]) As of December 2021, the outstanding central government debt was split between the foreign market (90%) and domestic market (10%). See the Quarterly Bulletin of the Public Debt Management Office, in particular the review for Q4 2021.

([27]) The amount of time that has passed since a debt security has been issued.

The government financing needs for 2022 have been covered through the January bond issuance and previously accumulated cash reserves. Gross financing needs (GFN) for 2022 are estimated at about EUR 2.1 bn (8.5% of GDP), excluding 13-week T-bills ([28]). The bulk of the financing needs consists of EUR 1.9 bn of debt redemptions, while fiscal needs are estimated at around EUR 0.2 bn ([29]). A key source of financing was through the issuing of a 10-year international bond in January 2022 (EUR 1 bn). Another significant part of the 2022 GFN is expected to be covered by means of drawing on the cash reserves, which will continue to be sizeable, meeting the GFN for at least the following 6-9 months, in line with the 2022-2024 medium-term debt management strategy. GFN for 2023 is expected to be lower, at about 5.4% of GDP, mainly owing to much lower debt redemptions.

Subject to commitments being fully met, Cyprus is to receive EUR 85 m (0.3% GDP) and EUR 200 m (0.7% of GDP) in 2022 and 2023, respectively, in financing under the Recovery and Resilience Facility. The Council approved Cyprus' recovery and resilience plan in July 2021, after which the European Commission disbursed EUR 157 m in pre-financing to Cyprus ([30]). The country is set to receive EUR 1.2 bn (5.2% of 2019 GDP) in total over the lifetime of its recovery and resilience plan, with EUR 1 bn in grants and EUR 200 m in loans.

S&P and Fitch kept their ratings unchanged for Cyprus in 2021 and first half of 2022, while Moody's and DBRS upgraded theirs. The main credit rating agencies, except for Moody's, continue to rate Cyprus' sovereign debt at investment grade. In July 2021, Moody's upgraded its rating by one notch to Ba1, yet placing it one notch below investment grade. In September 2021, S&P changed its outlook from stable to positive and maintained it in March 2022. In April 2022, DBRS upgraded Cyprus' rating by one notch to BBB (two notches above investment grade), changing its outlook from positive to stable.

([28]) Short-term government securities.

([29]) The figure for fiscal needs is derived from the Commission's 2022 Spring forecast.

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

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	Mar	Jun	Sep	Dec
NPLs*, all loans (EUR billions)	23.8	20.6	10.3	9.0	5.1	5.1	5.0	4.3	3.0
NPLs*, all loans (% of total)	47.2	43.7	30.3	27.9	17.7	17.9	17.7	15.4	11.1
NPLs*, loans to NFCs (% of total)	56.4	50.3	33.2	24.5	14.5	14.6	14.3	12.1	8.2
Restructured non-performing (% of total)	25.8	22.8	14.4	10.8	6.4	6.3	6.8	5.8	4.1
Restructured performing (% of total)	9.4	8.6	6.8	4.5	3.1	4.7	7.7	9.3	9.9
NPLs*, loans to households (% of total)	56.0	53.9	37.6	35.2	23.7	23.6	23.1	19.7	14.8
Restructured non-performing (% of total)	20.1	19.7	17.1	15.7	10.4	10.3	10.1	8.4	6.2
Restructured performing (% of total)	7.7	8.3	7.1	4.8	4.6	4.4	4.0	4.0	3.7
Coverage rate (Impairments / NPLs)*	40.3	45.9	49.6	55.2	46.2	47.1	46.8	45.7	43.1
Cost-to-income ratio	53.0	54.5	61.8	71.9	69.3	69.7	71.0	73.5	72.5
Lending margin	2.5	2.4	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	17.5
Return on assets (annualised)	-0.3	-1.1	0.3	0.3	-0.2	0.0	0.0	0.0	..

(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.

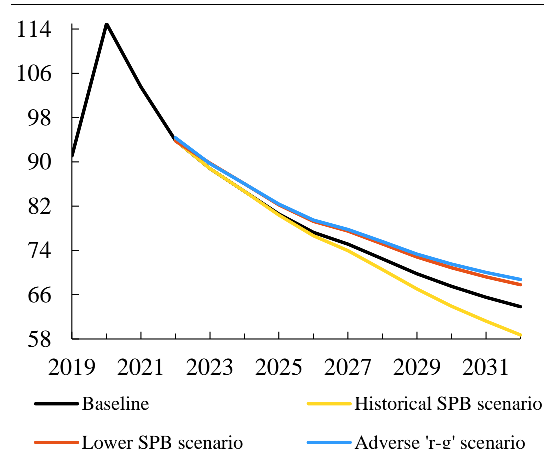
Source: Central Bank of Cyprus, European Central Bank

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 ([31])**.** This assessment is based on the DSA – results from the baseline, alternative debt scenarios relevant for the risk classification, and stochastic projections ([32]). The DSA baseline as well as all deterministic scenarios that introduce adverse conditions to key underlying variables of the baseline (such as the 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 distinct downward trajectory in the coming years (see Graph A2.1). Nevertheless, by the end of the projection period, in 2032, government debt is projected to remain above the Treaty's reference value of 60% of GDP. Stochastic projections based on the historical volatility of the Cypriot economy show that the baseline debt projections are surrounded by considerable uncertainty, although in most of simulated shocks public debt is expected to decline (see Graph A2.2). ([33])

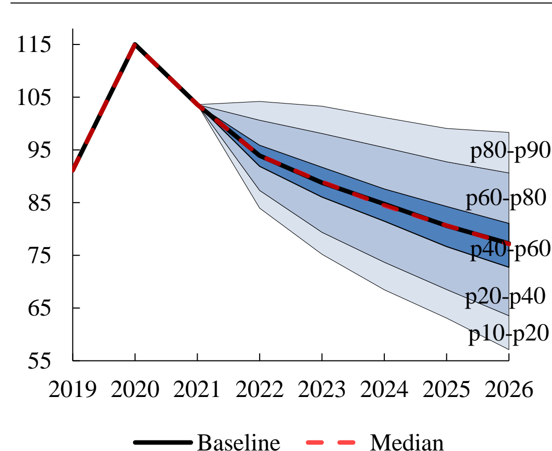
Under baseline projections, Cyprus' debt-to-GDP ratio is projected to continue falling significantly, to around 64% in 2032. The baseline is a *no-fiscal policy change* scenario, which assumes that the government primary balance (in structural terms and before ageing costs) remains constant at its last forecast value (2023) for the remainder of the projections. Having peaked in 2020, the debt-to-GDP ratio is projected to decline sizeably to around 64% by the end of 2032 (see baseline scenario in Graph A2.1). ([34])

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 15-year historical average, the government debt ratio in 2032 will be

([31]) See Annex 20 to 2022 Cyprus' Country Report SWD(2022)604 final.

([32]) The debt sustainability analysis (DSA) uses the Commission's 2022 Spring forecast (2022-2023) as a starting point to ensure consistency across EU Member States. For more information on the Commission's fiscal sustainability assessment framework, see European Commission, Fiscal Sustainability Report 2021 at https://ec.europa.eu/info/publications/fiscal-sustainability-report-2021_en .

([33]) 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.

([34]) This debt sustainability assessment takes into account the Next Generation EU (NGEU) investment. The implementation of NGEU is expected to have a positive and persistent impact on economic growth of Cyprus in the coming years, and this, ceteris paribus, contributes to influence positively the debt sustainability.

lower than in the baseline scenario and below 60% (see the *historical average SPB* scenario in Graph A2.1).

A negative shock to the structural primary balance would somewhat deteriorate debt dynamics. Under the *negative shock to the SPB* scenario, the structural primary balance is assumed to be reduced by half of the SPB's cumulative change over the two forecast years ([35]). This assumption has contained adverse effects on the Cypriot government debt ratio – which is projected to stand at 68% of GDP at the end of the projection period under this scenario (see the *negative shock on the 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 an increase in the interest – growth rate differential, which is relevant because the assumptions under the baseline rest on fairly favourable financial markets' expectations. Under this adverse scenario, the Cypriot debt ratio in 2032 would be about 5 pps. of GDP higher than in the baseline. These results underscore the importance of continued prudent fiscal policies and implementing growth enhancing structural reforms for reducing debt vulnerabilities over the medium term.

([35]) 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 until 2032. This scenario incorporates a feedback effect on GDP growth whereby a fiscal expansion of a 1 pp. of GDP impacts positively GDP growth by 0.75 pp in the same year.

ANNEX 3

European Commission macroeconomic and fiscal projections (2022 Spring 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	-5.0	5.5	2.3	3.5
Domestic demand incl. inventories	7.9	3.5	5.9	-3.1	2.1	2.9	2.7
Private consumption expenditure	4.8	5.1	3.0	-5.0	3.7	2.2	2.0
Government consumption expenditure	1.8	3.6	12.7	14.8	8.0	3.1	1.8
Gross fixed capital formation	21.2	-4.9	2.9	0.0	-6.3	5.4	5.8
Exports of goods and services	11.2	7.3	7.5	-5.1	14.0	1.7	4.6
Imports of goods and services	14.3	4.3	8.3	-2.5	9.2	2.5	3.7
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	7.3	2.9	4.3	-0.8	2.7	2.9	2.8
Foreign trade	-2.0	2.2	-0.5	-1.9	3.4	-0.6	0.7
Changes in inventories	0.5	0.7	1.5	-2.3	-0.6	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	1.0	1.0	1.1	-1.1	2.7	4.5	3.2
HICP	0.7	0.8	0.5	-1.1	2.3	5.2	2.7
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	11.1	8.4	7.1	7.6	7.5	7.8	7.3
Employment	5.4	5.3	3.8	-0.5	1.2	0.9	1.8
Compensation per employee	1.5	1.5	4.4	-3.2	4.7	4.1	4.5
Labour productivity	0.4	0.3	1.4	-4.5	4.3	1.4	1.6
Unit labour costs	1.1	1.1	2.9	1.4	0.4	2.7	2.8
Public finance			*(percent of GDP)*				
General government balance	1.9	-3.6	1.3	-5.8	-1.7	-0.3	-0.2
Total revenue	38.4	39.1	39.7	39.3	42.4	40.7	39.9
Total expenditure	36.5	42.7	38.4	45.1	44.1	41.0	40.0
General government primary balance	4.4	-1.3	3.5	-3.6	0.2	1.3	1.1
Gross debt	92.9	98.4	91.1	115.0	103.6	93.9	88.8
Balance of payments			*(percent of GDP)*				
Current external balance	-5.0	-3.9	-5.7	-10.1	-7.2	-8.8	-7.2
Ext. bal. of goods and services	-0.5	1.3	0.2	-2.5	1.1	-1.7	-1.0
Exports goods and services	73.9	75.1	75.6	75.8	81.0	79.8	79.6
Imports goods and services	74.4	73.8	75.4	78.3	79.9	81.5	80.6
Memorandum item			*(EUR bn)*				
Nominal GDP	20.2	21.6	23.0	21.6	23.4	25.1	26.7

Source: European Commission

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