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Cyprus, Spring 2020

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Cyprus, Spring 2020

EUROPEAN ECONOMY

Institutional Paper 126

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The report reflects information available up until 23 April 2020.

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([1]) The executive summary of this report was adopted as Commission Communication C(2020) 3353 on 18 May 2020. The rest of the report reflects the findings of the staff working document SWD(2020) 88 accompanying this communication.

([2]) ECB Staff participated in this mission, and in 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 eighth post-programme surveillance (PPS) report was prepared with special arrangements given the exceptional circumstances linked to the outbreak of Covid-19. As a result of the rapid spread of the virus to the EU in early March 2020 and the ensuing travel restrictions, the eighth PPS mission to Cyprus had to be replaced by a set of video and teleconferences involving European Commission staff, in liaison with staff from the European Central Bank (ECB). The institutions held several meetings in this format with the Cypriot authorities, while the usual discussions with banks, political parties and civil society were postponed to the next PPS cycle in view of the exceptional circumstances. This report is, therefore, more limited in scope than usual. Staff from the European Stability Mechanism (ESM) participated in the conference calls on aspects relating to the ESM's Early Warning System. Staff from the International Monetary Fund (IMF) joined in as well under the framework of their regular staff visits.

After several years of remarkably strong growth, the global outbreak of Covid-19 is tilting the Cypriot economy into a deep recession in 2020. Cyprus had enjoyed a period of strong growth in the aftermath of its banking crisis, with real GDP increasing by a quarter from 2014. However, since mid-March 2020, the coronavirus pandemic, which has led to border closures, lockdown measures and the cessation of all non-essential business, including hotel and other tourist accommodation, have had a major impact on the Cypriot economy. The crisis is expected to impact in particular two key pillars of the economy, tourism and shipping. According to the Commission's spring forecast, real GDP is projected to fall by around 7½ % in 2020. It is expected that exports of goods and services will contract significantly. Investment in construction may hold up somewhat better, thanks to the fact that a number of large projects are already under way and due to stretch over several years. Cyprus has adopted a fiscal stimulus plan that should help mitigate the contraction. With exports declining more sharply than imports, the current-account deficit is set to widen further (to around 11% of GDP). However, assuming a gradual exit from the lockdown in the coming months, the Commission spring forecast projects a return to strong growth in 2021 around of 6%, although output is not expected to get back to 2019 levels. At the current juncture, there are very significant downside risks to the growth outlook, particularly as the duration of the pandemic and the lockdown measures are still unknown.

The recession generated by Covid-19 and the necessary policy response are expected to take a heavy toll on public finances in 2020. After a strong fiscal performance in 2019, the spring forecast projects that the headline budgetary balance will turn into a sizeable deficit of 7% of GDP in 2020. This reflects substantial expected losses in revenue collection on the back of weaker economic activity, and substantial additional spending to mitigate the impact of the crisis on the real economy. The expansionary fiscal measures adopted represent about 4½ % of GDP, including income support schemes for businesses and additional healthcare spending. The authorities are working on a large financial package of state guarantees for new loans to support the availability of liquidity to the private sector. Risks to the fiscal outlook are clearly on the downside. They include the implications of a recession that is sharper than currently expected, higher tax revenue elasticities, and the eventual costs of policy measures, including those implying contingent liabilities, to tackle the impact of Covid-19.

The stability of the banking sector improved significantly in recent years, but the economic impact of the pandemic may put the hard-won progress at risk. Banks are on a stronger footing than in the past, following significant balance-sheet clean-up and deleveraging, with a marked decline in non-performing loans (NPLs) and a more consolidated banking system. However, the Covid-19 crisis unavoidably affects the banking system through its impact on profitability and credit risk. In addition, legal uncertainty remains over the August 2019 amendments to the foreclosure law, on which the Supreme Court ruling is still pending. The NPL ratio stood at 28½ % in November 2019. Before the outbreak of Covid-19, further significant progress in reducing NPLs was expected in 2020, mostly on the back of large-scale NPL portfolio sales by the two largest banks. However, these sales have now been postponed, not least on account of the difficulty to appropriately determine asset values in the current environment and increasing uncertainty about investor appetite. In addition, the economic fallout of the pandemic will probably lead to an increase in credit risk, generally and also in Cyprus, and eventually a

renewed increase in NPLs on the back of reduced revenues and net-wealth. Moreover, the lower-than-expected take up of ESTIA – the state support scheme for NPLs collateralised by primary residences – implies a much smaller-than-targeted contribution to NPL reduction. KEDIPES, the state-owned asset management company, has made some progress towards becoming fully operational. Nevertheless, further steps are needed to ensure that it can achieve its main mission of maximising the proceeds from the management and disposal of its assets, including the finalisation of its organisational set-up and governance framework, revising the service level agreement with the loan servicer and starting the implementation of a business plan. Banks continue to operate with a significant liquidity surplus, which is valuable in view of the global turmoil, and their capital buffers exceed minimum regulatory requirements. However, looking forward a prolonged impact of the pandemic on sensitive sectors (such as tourism, wholesale and retail activities, real estate and construction) and deteriorating asset quality could weigh on profitability and capital ratios. Measures taken by the ECB, the Central Bank of Cyprus and the European Banking Authority are expected to support banks to maintain financing for businesses despite challenging economic conditions.

Cyprus' retains the capacity to service its ESM debt, but challenges have increased as a result of Covid-19. The first ESM repayment is not due until 2025. Risks are expected to dissipate gradually once the recovery starts to feed through. Uncertainties and risks have been exacerbated in particular by the sizeable projected budgetary deficit and the significant rise in gross government debt — which is expected to increase to 116% of GDP by end-2020 due to the recent international and domestic bond issuances to cover the state's higher financing needs. Vulnerabilities also stem from the banking sector, which could experience a surge in new NPLs. Although gross financing needs have increased significantly this year due to the pandemic, the government secured its financing early on at favourable market conditions and is thus well positioned from a financing perspective to handle the immediate impact of the health and economic crisis. In the coming years, gross financing needs are expected to remain moderate. Furthermore, the country continues to enjoy 'investment grade' ranking from the three major rating agencies. In the medium-term Cyprus's debt trajectory remains sensitive to macroeconomic and fiscal performance shocks, as well as existing vulnerabilities in the financial system.

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1. MACROECONOMIC SITUATION AND OUTLOOK

1.1. MACROECONOMIC DEVELOPMENTS IN 2019

In 2019, Cyprus recorded strong, albeit moderating, growth in a less supportive external environment. Since 2015, it had showed a remarkable recovery from the deep financial and economic crisis of 2013. [3] By 2017, real GDP had surpassed the pre-crisis level. Following real GDP growth of 4.1% in 2018, growth eased to 3.2% in 2019, reflecting external headwinds. Domestic demand was the main source of growth, whereas net exports made only a marginal contribution. Tourism, one of the key sectors of the economy, showed signs of saturation and was challenged by reduced air connectivity, increasing competition from neighbouring countries and lower demand. On the back of strong growth, employment increased by 3.1% and unemployment fell to 7.1%, which was the lowest rate in 9 years and close to pre-crisis levels. The tightness in the labour market started to feed into higher salaries — by Q4-2019, average monthly earnings had risen by 2.9% y-o-y. Inflation remained low at 0.5%, down from 0.8% in 2018, due to lower energy prices compared to 2018. The current account deficit deteriorated markedly to 6.7% of GDP, from 4.4% in 2018. The activities of special-purpose entities (SPEs) contributed only marginally (0.2pps.).

1.2. ECONOMIC OUTLOOK IN 2020 AND 2021

In early 2020, Cyprus was still on a robust growth path. In the first 2 months, consumer confidence and economic sentiment indicators signalled continued growth. Tourist arrivals were up by 2% from the same period in 2019. The issuing in 2019 of significantly more permits for residential buildings pointed to an increase in construction in 2020, despite a big slowdown in applications for the 'citizenship by investment' scheme following the introduction of tighter conditions in July 2019. In addition, several large-scale infrastructure projects, including marinas, tourist accommodation, energy-efficiency upgrades for buildings and university expansions, were in the pipeline. The positive indicators prompted a slight upward revision of the 2020 GDP growth projection in the Commission's winter forecast (to 2.8%, up 0.2 pps. from the autumn forecast).

However, the global outbreak of Covid-19 has completely changed the picture with the economy heading into a profound recession in 2020. The adoption of travel restrictions, lockdown measures and the closure of all non-essential businesses, including hotels and other tourist accommodation, from mid-March are taking a high toll on the economy. Already in March, tourist arrivals fell by 67.4% compared to March 2019. As in all EU countries, this stems from an abrupt contraction of demand and negative supply-side effects (absent workers, liquidity shortages and increased uncertainty). In the baseline (which assumes up to 8-week lockdown for most economic activities, 15 weeks for hotels and other tourist accommodation and a gradual recovery in Q3-2020, real GDP is projected to fall by around 7½%, i.e. by over 10 pps. compared to the winter forecast 2020. Public consumption is the only component of domestic demand that remains in positive territory, reflecting the government's fiscal stimulus adopted, the increases in compensation of employees stemming mainly from the gradual abolition of wage cuts and additional expenditure on the national health system (see Section 3 – Public finances). Private consumption is forecast to decline by more than 6½%, with the shock cushioned somewhat by the support by the government to households and the expected increase in domestic tourism. However, private consumption is still restricted by the low level of e-commerce compared to the EU average. [4] Investment activity is expected to fall less sharply, due to the multi-year character of a number of ongoing infrastructure projects. By

[3] **Cyprus implemented an economic adjustment programme from April 2013 to March 2016**. The three-year programme was approved by the Council of EU Economic and Finance Ministers (Ecofin Council) and the Board of the International Monetary Fund (IMF) in March 2013. The programme provided about €7.3 billion in financing from the European Stability Mechanism (ESM) and the IMF. Its objective was to put Cyprus' public finances back on a sustainable path, ensure financial stability, implement structural reforms to restore competitiveness, and regain international capital market access at sustainable rates. In February 2020, Cyprus repaid the remaining part of the IMF loan (€716.67 million).

[4] 2020 country report – Cyprus.

contrast, the demand for high-end residential properties, which was until now supported by the citizenship-by investment scheme, is expected to decline. Exports, notably of services, are expected to exhibit a large decline, reflecting the prolonged lockdown period and the severe contraction of tourist demand. Imports are also projected to decline in line with lower final demand and disruptions of global supply chains.

Tourism and shipping are expected to experience the sharpest drops in activity. The travel restrictions are expected to affect the former profoundly, as they will disrupt the high season. Even if restrictions are lifted in the second half of the year, tourist arrivals and revenues from tourism are expected to fall by 60-80% in 2020, due to the complete standstill in spring and early summer, plus the psychological fall-out from Covid-19. The extent of the recession in the sector depends heavily on the duration of travel and other restrictions in the UK and Russia, where most of the tourists come from. The authorities report that the shipping industry was one of the first sectors to be affected by the Covid-19 outbreak. Since January, it has experienced serious disruption, with ships from various places not being allowed to dock. Tourism sector accounts for around 20% of Cyprus' GDP and shipping for around 4% of the gross value added. ([5])

The government's stimulus plan is expected to mitigate the impact of this severe shock. The authorities have adopted a fiscal support package, which is based on measures in place since 15 March and extended on 23 April, of around 4½% of GDP (see Section 3). The package targets the businesses and households most affected by the crisis, aiming to save jobs and support domestic demand and tourism.

Assuming a gradual recovery materialises in the coming months, a turnaround is projected for 2021. In this scenario, private consumption is expected to contribute to growth and investment activity should return to 2019 levels, thanks mainly to the continuation of infrastructure projects. Exports of services (notably tourism) are expected to gradual recover, supported by government efforts to extend the tourism season to the winter months. Overall, real GDP is projected to increase by around 6%. However, output levels are not expected to return to 2019 levels.

The labour market is expected to be significantly affected by the recession, with the stimulus plan mitigating the impact somewhat. Employment is expected to fall by around 2.5% and unemployment to rise to 8.6% in 2020, a 1.5 pps. increase from 2019 that should be partly reversed in 2021 (7.5%), provided the rebound in the baseline scenario materialises.

Inflationary pressures are expected to remain muted. HICP inflation is expected to be slightly less than in 2019, mainly due to the expected lower price of oil and a significant decline in energy prices. Prices for non-energy industrial goods are projected to continue falling. Overall, inflation is expected to be around 0% in 2020 and 1% in 2021.

As a result of the anticipated sharp contraction in exports, the current-account deficit is expected to deteriorate further. It is expected to widen to around 11% of GDP in 2020 and to narrow slightly in 2021, to around 10%. This underlines Cyprus' dependence on sustained foreign financing flows. The related further worsening of its external position (NIIP) remains a source of vulnerability and warrants close monitoring.

Downside risks to the growth outlook are significant due to uncertainty as to the duration of the pandemic and the timing and nature of the exit scenario. A longer lockdown or a second wave of lockdown measures later in the year would have further significant effects on the economy, probably including GDP losses. The significant private and public sector debt overhang exacerbates the downside risks. As a small, open economy, Cyprus is also highly exposed to knock-on from the economic impact of the pandemic on its main trading partners (the EU, the UK and Russia).

([5]) It is estimated that tourism accounted directly for 7% of GDP and 7% of jobs in 2016 or, if one includes indirect and induced effects, over 20% of GDP and 22% of jobs (World Travel & Tourism Council, 2017). The figure on shipping is reported by the authorities.

2. PUBLIC FINANCES

2.1. FISCAL PERFORMANCE

Fiscal performance in 2019 was strong. The headline government budgetary balance recorded a surplus of 1.7% of GDP in 2019. The budget balance was negatively affected by a change to the Income Tax Law which allowed the conversion of specific Deferred Tax Assets (DTAs) into Deferred Tax Credits (DTCs) ([6]), implying the need to record a one-off spending of 1.3% of GDP in 2019. Net of this one-off, the headline government budget surplus amounted to 3.0% in 2019, compared to a surplus of 2.9% of GDP in 2018, after taking out one-off spending related to the support measures related to the sale of the ‘good’ assets of CCB to Hellenic Bank. Excluding those one-offs, the primary balance reached a surplus of 5.5% of GDP in 2019 compared to 5.3% the year before.

While revenue remained highly buoyant overall, VAT revenue growth slowed down markedly. Cyprus’ total revenue grew by 7.6% from 2018, of which 6 pps. was related to higher social contributions (+27.2%). This strong increase was primarily due to the rise in contribution rates in January 2019 and the introduction of new contributions paid by employees and employers as of March 2019 to the National Health Insurance System (NHIS). The continued improvement in the labour market throughout 2019 further boosted social contributions and tax revenue. Current taxes on income and wealth surged by 8.1%, driven in particular by the strong increase in revenues from corporate income taxation (9.2%). VAT collection growth (a major driver of revenue growth in previous years) slowed significantly to 1.6% in 2019 compared to 12.8% last year. This partly reflects lower collection of VAT tax arrears. Revenue from excise duties fell slightly, reflecting the impact of lower duties on fuels.

Current expenditure increased significantly, **by 13%, compared to 4.4% in 2018**. The growth in compensation of public employees (10.1%) contributed 3.7 pps. of the total, which was driven by a series of factors: the gradual reversal of public sector wage cuts that started in July 2018, the provision of Cost of Living Allowance, new government contributions to the NHIS, changes to the state-employed doctors’ payscale and the unfreezing of promotions. The roll-out of the first phase of NHIS reform accounts for another 3.9 pps. of the total increase. The inclusion of KEDIPES in the general government account also contributed to strong growth in intermediate consumption. Government gross fixed capital formation declined by 69.6%, reflecting the large increase in gross capital formation in 2018 to support the sale of the CCB. The revenues from KEDIPES’ sale of assets were recorded as negative public gross fixed capital formation, further depressing public investment in 2019.

The sizeable headline budget surplus and robust output growth fed into a significant reduction in the public debt-to-GDP ratio. After rising to 100.6% of GDP in 2018 on account of the public support to the banking sector, the debt-to-GDP ratio fell to 95.5% in 2019, supported by the healthy budgetary surplus (1.7% of GDP) and robust nominal GDP growth (3.8%).

2.2. FISCAL OUTLOOK

The Covid-19 outbreak and related containment measures are expected to have a strong impact on public finances. In the Commission’s 2020 spring forecast, the headline budgetary balance is projected to turn into a deficit of 7% of GDP in 2020. This includes the impact of deficit-increasing measures adopted to dampen the social and economic consequences of the crisis, estimated at 4½% of GDP. In 2021, the deficit is expected to decline on the back of the expected recovery and the reversal of crisis measures. The combined effects of deteriorating public finances and output contraction are expected to lead to a substantial rise in the public debt-to-GDP ratio, from 95½% at end-2019 to 115¾% in 2020.

Public expenditure is projected to rise sharply in 2020, reflecting the impact of crisis-related policy measures and the rollout of the second phase of NHIS reform. Current expenditure is projected to surge by about 22½%, in 2020 compared to 13% in 2019. This partly reflects non-

([6]) Pursuant to the said legislation, Bank of Cyprus converted the deferred tax asset that was transferred from Laiki, following its resolution in 2013, into deferred tax credits. This operation resulted in an improvement of Bank of Cyprus s common equity tier 1 (CET1).

crisis-related policies, including the second phase of NHIS reform in June and continued growth of the public wage bill. Measures to deal with the health and economic impact of Covid-19 are expected to increase current spending temporarily in 2020 by 11%, or about 4¼% of GDP. Most of this concerns the 3-month 'operation suspension scheme', which is expected to add 2¾% of GDP. The scheme aims to avoid layoffs by providing benefits equivalent to 70% of each employee's salary to businesses that fully or partly suspend their operations and see their turnover decrease by more than 25%. The other main support schemes (also due to last 3 months) involve:

- income support for self-employed people whose activity is suspended ([7]) (¼% of GDP);
- subsidised leave for parents when schools, nurseries and childcare services are suspended (¼% of GDP); and
- subsidised sick leave to compensate individuals in quarantine and vulnerable workers (¼% of GDP).

The projected deep contraction of economic activity is expected to lead to much lower revenue collection in 2020. Total revenue is projected to decline by 3¼% in 2020 compared to 2019. In particular, tax revenue is forecast to fall by 9¾% due to the impact on the tax base of the contraction in economic activity and consumption. Tax revenue on production and imports is projected to decline markedly (by 9%), as is revenue from income and wealth taxes (11%). The VAT payments deferred for 3 months (from February to April) are expected to amount to about €304 million (or 1½% of GDP), but zero fiscal cost is assumed, as all suspended obligations will be paid by 10 November. Social security contributions are projected to increase by ¾%. Lower expected compensation of employees (reflecting the increase in unemployment) are projected to partially offset the positive effect on revenue of higher social contributions from March 2020 in the context of the implementation of the second phase of NHIS reform. In addition, the government suspended the above-described increase in NHIS contributions from April to June. Foregone contributions as a result of this measure are estimated to depress total revenue by 0¼% of GDP in 2020.

Significant risks stem from the potential realisation of past and newly created contingent liabilities. The crisis could make the realisation of explicit contingent liabilities more likely, in particular the government guarantees to state-enterprises (SOEs) and those created under asset protection schemes in the context of the sale of CCB assets to Hellenic Bank. The fiscal impact of NHIS reform remains uncertain going forward, and the government might need to cover potential financial deficits of public hospitals.

Other risks to the fiscal projections are on the downside. First, additional deficit-increasing measures might need to be taken to provide further support to the economy. Secondly, the fall in private consumption, compensation of employees and on firms profits could well exceed expectations in the current macroeconomic climate, exacerbating the effects on revenue collection in 2020 and thereafter. A higher-than-already-assumed elasticity of tax revenue is another risk. It remains unclear whether the expected recovery in 2021 will be reflected in revenue growth rates in line with what was observed in the recent years. At the same time, corporate tax revenue could take time to recover from the crisis. Moreover, it is inherently volatile and subject to possible relocation decisions by (large) companies currently benefiting from Cyprus' taxation arrangements.

A major downside fiscal risk dissipated with the recent Supreme Court decision that public sector wage and benefit cuts during the crisis were constitutional. On 10 April 2020, the Supreme Court confirmed the constitutionality of wage and public pension cuts from 2012, during the economic crisis. The Attorney-General stressed that the ruling sets a precedent for similar decisions in the future. While the government had already started a gradual reversal of the wage cuts in 2018 (to be completed by 2023), a Supreme Court decision in favour of the claimants would have led to a sizeable additional fiscal burden.

([7]) There are exceptions for certain sectors, e.g. supermarkets, doctors and pharmacies.

3. FINANCIAL SECTOR

3.1. BANKING SECTOR DEVELOPMENTS

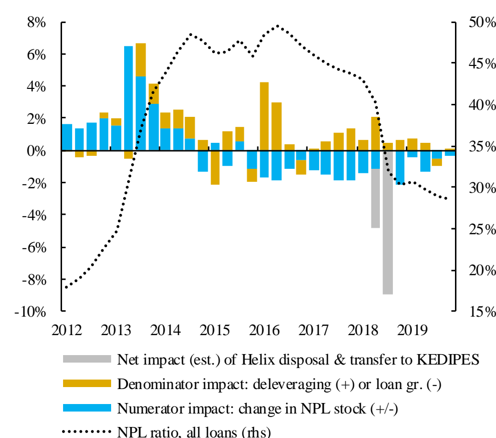
Asset quality

While the ratio of non-performing loans (NPLs) has declined visibly from its peak, progress was more limited last year. After a significant decline in the NPL ratio in 2018, progress was more limited in 2019 (see Graph 3.1). ([8]) Uncertainty stemming from delays in the implementation of the state support scheme for NPLs collateralised by primary residences (ESTIA) and from amendments to the foreclosure framework may have contributed to stalling loan restructuring. In November 2019, the total stock of NPLs stood at €9.4 billion (28.5% of gross loans), down only slightly from €10.3 billion (30.3%) at the end of 2018 (see Annex 1). Resolving the remaining NPLs is particularly challenging in the current economic context whereby the real economy came to a halt.

Prior to the pandemic, NPLs were expected to decline significantly this year on the back of sizeable portfolio sales. Banks had planned large NPL disposals in the course of 2020. Hellenic Bank had expected to launch an NPL portfolio sale (*Project Tide*) by mid-2020 and Bank of Cyprus had received binding bids for the Helix 2 portfolio. However, the final negotiations are delayed due to the current environment, which complicates significantly the appropriate pricing of assets. Moreover, investors' interest may also be, at least temporarily, reduced due to the uncertainty around the pending amendments to the foreclosure framework.

Overall, the Covid-19 crisis is expected to affect asset quality in the banking sector. On 30 March 2020, Parliament approved a legislative moratorium on all principal and interest payments until end-2020 for loans of paying customers experiencing financial difficulties. A prolonged crisis will result in higher unemployment and lower revenues, thus hampering households' and businesses' payment capacities. Vulnerabilities also stem from banks' significant exposures to vulnerable sectors ([9]) and a high level of private indebtedness.

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



Source: Central Bank of Cyprus.

While the use of foreclosures as an NPL workout option increased in 2019, banks are suspending foreclosures in the current situation. The proportion of successfully finalised foreclosures continued to rise steeply in 2019, reaching around a third of all initiated cases at year-end (see Graph 3.2). The number of initiated cases rose sharply in Q4 of 2019, ending the downward trend since end-2018, as banks appeared to be willing to proceed with collateral enforcement cases in the pipeline, following the finalisation of the ESTIA scheme. The number of foreclosures resulting in a repossession of the collateral property by banks (i.e. on-boarding) continues to be high. Overall, these developments indicate that the strengthening of the foreclosure framework in 2018 has borne fruit – with foreclosure gradually becoming a credible threat that helps to reduce NPLs and improve payment discipline. However, foreclosure activity will slow down in the coming months, as Cypriot banks and several credit-acquiring companies, including KEDIPES, have announced the suspension of

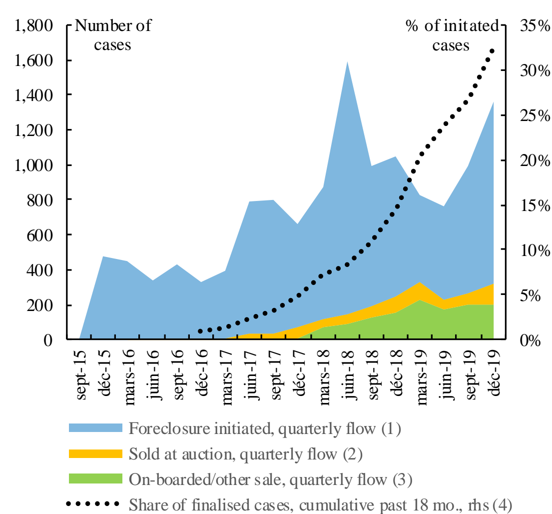
([8]) The NPL ratios (i.e. ratios of NPL stock to total gross loans) in this report are based on the Central Bank of Cyprus' (CBC) data and scope definition. In particular, no account is taken of banks' exposures to central banks and credit institutions, or their overseas operations (branches and subsidiaries located abroad). Therefore, the NPL ratios differ from those in the *2020* Cyprus Country Report, which are based on the ECB definition.

([9]) The total credit exposures of the banking sector to sectors that are expected to be heavily impacted by the containment measures (i.e. construction, wholesale, retail, transport, storage, arts and recreation) represent around two thirds of total corporate loans and more than twice the available CET1 capital – the highest proportions in the EU.

foreclosure procedures until mid-June 2020 in response to Covid-19. Also, to protect homeowners and businesses in exceptionally difficult times, the government has suspended evictions for 2 months. ([10])

Coverage levels continued to increase gradually last year. In September 2019, the average coverage ratio for the banking sector was 52.4%, up from 51.9% a year earlier. Some of the overall provisioning is explained by the offsetting of accrued interest on NPLs. While the aggregate coverage level continues to exceed the EU average (45.8%), this reflects the significantly lower quality of the remaining NPLs.

Graph 3.2: Evolution of foreclosure activity



(1) Properties for which notification has been served in the relevant quarter of the intention to sell. (2) Properties successfully sold in an auction within the quarter. (3) Properties sold or repossessed and held on the balance sheet of the originating bank following an unsuccessful auction. (4) The ratio shows the proportion of cases that were finalised with a sale or repossession in the past 18 months.

Source: Central Bank of Cyprus.

Profitability, capitalisation and liquidity

Overall, the banking sector continued to become profitable in 2019, but profitability will come under severe strain this year. The sector's aggregate pre-tax profit was €178.7 million in September-2019, up from €123 million in June 2019. Nevertheless, profitability in the first 9 months of the year was slightly weaker than in the same period in 2018 (€196 million). Net interest income was marginally higher than a year earlier (up from €745 million to €785 million), while provisioning costs declined from a year ago. The cost-to-income ratio increased to 64.9% in Q3-2019, from 60% a year before, mainly due to higher expenses. It remains substantially higher than the EU average, despite being artificially lowered by the inclusion of accrued interest income on impaired assets but not the offsetting provisioning charges (which are significant in Cyprus, due to the high NPL ratio). Overall, Cypriot banks' capacity to generate profits continues to be challenged by low interest margins (1.9% in 2019), the rigid cost structure and a high level of NPLs. The Covid-19 outbreak is likely to weigh heavily on profits in 2020. Lower credit demand, the 9-month moratorium on principal and interest payments, and calls from the authorities to apply lower interest rates and fees on new loans to affected borrowers will probably lower banks' income. ([11]) More generally, profitability will be negatively affected by rising unemployment and falling business revenues.

While the banks' capital buffers improved slightly in 2019, maintaining them through the current crisis will be very challenging. According to ECB data, the banking sector's common equity tier 1 (CET1) capital ratio was 16.6% in September 2019, up from 14.9% a year before, while the overall solvency ratio rose from 16.5% to 19%. The improvement in aggregate capital positions was helped by the March 2019 change to the Income Tax Law, whereby deferred tax assets could be converted to deferred tax credits, which Bank of Cyprus made use of. While the CET1 ratio is still higher than the EU average (around 15%), the Cypriot banks have to maintain a higher capital ratio to absorb further shocks associated with weak asset quality. With ongoing balance-sheet deleveraging, weak profitability and the impact of Covid-19 on the Cypriot economy, it might be challenging to maintain adequate capital buffers given the prospects of surging credit and refinancing risks in both retail and corporate portfolios.

([10]) This measure was adopted on 27 March 2020.

([11]) Banks may start imposing negative interest rates on a broader proportion of their deposits, which would only partly offset this development.

Excess liquidity is weighing on profitability prospects. Cypriot banks continue to maintain significant excess liquidity. Several are trying to reduce customer deposits by cutting interest rates to historical lows (0.1-0.3% for new business). However, these efforts have not been successful to date, with deposits growing by €0.8 billion (2.6%) in 2019, partly due to the lack of alternative low-risk investment opportunities for retail savers. Going forward, depositors may increase precautionary savings while credit demand declines, exacerbating the issue of excess liquidity.

Although the Single Resolution Board (SRB) announced some short-term flexibility, meeting the minimum requirement for own funds and eligible liabilities (MREL) remains challenging. Due to their heavy reliance on deposit funding, the banks will need to raise more non-deposit funding to meet their MREL requirements. This could put additional pressure on banks already facing profitability and asset quality challenges. Going forward, several banks may need to compete for investors' interest for the same MREL-eligible instruments in a very difficult environment.

Lending

While new lending increased last year, it is expected to remain subdued in 2020. The gross volume of new loans to households and non-financial corporations (NFCs) reached €4.4 billion at the end of 2019, up by €674 million from 2018. This was driven by new loans to NFCs (up from €2.3 billion to €2.9 billion), while new loans to households increased only slightly. Overall, lending was constrained by subdued credit demand and the scarcity of profitable investment opportunities. Meanwhile, strong competition, subdued demand for loans, low interest rates and the ample supply of liquidity have exerted downward pressure on loan rates. More recently, the European and Cypriot supervisory authorities have introduced a number of measures supporting bank lending during the pandemic, including temporary capital relief and regulatory forbearance. However, heightened uncertainty will weigh on credit demand and supply, as banks' assessment of firms' medium-term profitability prospects is becoming significantly more challenging.

Overview of the largest domestic banks

Bank of Cyprus, the largest domestic bank, improved its asset quality and profitability. Its CET1 capital ratio rose to 15.2% in September 2019 from 11.9% at the end of 2018. In the first 9 months of 2019, it reduced its NPL stock by €684 million and seems on track to deliver its overall target reduction of about €800 million in 2019. ([12]) NPLs represented 31% of the loan portfolio, while the provisioning coverage was up slightly, to 51%. At the same time, the bank's direct real-estate exposure was still large, at around €1.5 billion in September 2019, primarily because of debt-to-asset swaps and the repossession of foreclosed assets. In the first 9 months of 2019, Bank of Cyprus recorded profits of €116 million, compared to losses of €37 million a year earlier. Net interest income declined due to a narrowing net interest margin and a shrinking loan portfolio (because of NPL sales), while the cost-to-income ratio rose to 65% in Q3-2019.

Going forward, Bank of Cyprus's efforts to improve profitability and reduce NPLs are facing increasing headwinds. The bank aims to improve profitability by increasing the use of digital banking and closing more branches. Its latest voluntary redundancy scheme cut staffing by around 11%, at a cost of €79 million (recorded for Q4-2019). Expecting credit losses under IFRS 9, the Bank of Cyprus announced additional provisions of around €75 million (with -45 basis points capital impact) in Q4-2019. Due to Covid-19 pandemic, the NPL portfolio sale (Project Helix 2) will most likely take longer than expected.

Hellenic Bank improved its capitalisation, but profitability was weak in 2019. Its CET1 capital ratio rose to 19% in September 2019 from 15.8% at the end of 2018, mainly due to a €145 million capital raise that took place in early 2019. Its NPL ratio was 31.8% at end-September 2019, close to that at the beginning of the year. While the bank benefits from the high-yield government bonds it received as part of the Cyprus Cooperative Bank (CCB) acquisition package in 2018, it has been

([12]) CBC is responsible for most of the overall decline in the stock of bad loans in the banking system, which was approximately €800 million in the first 9 months of 2019 (see Annex 1: Soundness indicators for the banking sector in Cyprus).

under pressure on net interest income. Furthermore, it faces severe constraints on the growth of its loan portfolio given the prevailing high indebtedness of NFCs, which also challenges profitability. In the first three quarters of 2019, its pre-tax profit declined to €89 million (compared with €292 million in 2018), mostly due to higher administrative and staff costs following the CCB asset acquisition, and higher depreciation and amortisation costs. Remarkably, the CCB integration process was finalised in Q3-2019 without major issues. Hellenic Bank developed into a retail bank, with the biggest branch network in the country.

Hellenic Bank continues to adjust its business model and address its high cost-to-income ratio and excess liquidity. The cost-to-income ratio rose to 67.3% in Q3-2019 (from 57.8% at the end of 2018), due *inter alia* to higher staff and administrative costs. Excess liquidity (41.5% loan-to-deposit ratio) continues to be a major challenge, while the net interest margin remains subdued. In response, Hellenic decided to apply negative interest rates (-60 bps) to corporate account balances exceeding €100,000 as of 3 March 2020.

The liquidations of FBME Bank and Laiki Bank are still pending. In February 2019, the court application to appoint a liquidator for the former was re-submitted, but encountered objections as to whether the appointment should be made under Tanzanian law (based on the parent bank's location) or Cypriot law, given that FBME operated as a branch. The application for the liquidation of Laiki Bank under a court order and the subsequent appointment of a liquidator are pending. The timeline of the court decision depends on potential objections by interested parties. In the meantime, the suspension of resolution means that the special administrator can stay in office and safeguard Laiki's assets and documentation.

3.2. FOLLOW-UP ON THE 2018 THREE-PILLAR NPL REDUCTION STRATEGY

Foreclosure developments

The future of the foreclosure framework is still uncertain. At the request of the President of Cyprus, the amendments to the foreclosure framework approved by Parliament on 2 August 2019 were referred to the Supreme Court for a decision on their constitutionality. The final hearing was scheduled for the beginning of April, but has now been postponed due to the Covid-19 outbreak. Meanwhile, the strengthened foreclosure framework as adopted by Parliament in July 2018 currently remains in place. The 2019 amendments constitute significant backtracking on key elements of the 2018 reform and threaten a further weakening of payment discipline and NPL resolution. Their enactment would negatively affect investor perceptions as to the stability of Cyprus' legal framework. Several banks and private credit-acquiring companies have confirmed that they would have a perceptible impact on pricing.

The Central Bank of Cyprus (CBC) and the Ministry of Finance have been working on an arbitration mechanism. Under this complaints resolution mechanism, eligible borrowers with non-performing loans can file complaints for potential misconduct of banks or credit acquiring companies regarding the application of the CBC Directive on Arrears Management and the foreclosure framework, prior to the initiation of a foreclosure procedure.

The first electronic auctions were at the end of 2019, but only a few properties were sold. The e-platform was launched in November 2019 and 66 auctions were held between December and end-February 2020. Despite significant interest and positive feedback from platform users, only eight sales were concluded (mostly of land/building plots). The authorities are confident that greater use will be made of the platform going forward. This is important for improving the foreclosure success rate.

Cyprus Asset Management Company (KEDIPES)

KEDIPES has made some progress towards becoming fully operational, but further efforts need to be accelerated. Important steps have been taken, including the sale of its shares in the current loan service provider, Altamira Cyprus, and the selection of a CEO and two non-executive directors (still awaiting the necessary approvals, including 'fit and proper' assessments by the

CBC). However, there are a number of pending steps that KEDIPES needs to take to finalise its organisational set-up and governance framework. These include revising the service-level agreement with the loan servicer (which lapsed in November 2019) and commencing with the implementation of a long-term business plan. In addition, there are significant data quality and staffing issues (excess staff in some areas, skills shortages in others) that need to be addressed. Faster progress is needed in these areas, so that KEDIPES can focus on improving its operational capacity and effectiveness by developing a strategy, operational procedures and a new business plan.

An initial assessment of KEDIPES' operations points to considerable challenges ahead. KEDIPES continues to assess its performance based on its original (July 2018) business plan. Between September 2018 and December 2019, the nominal value of its assets declined from €8.2 billion to €7.7 billion (only 5.7%). Cash collections from customers represented around 4.3% of the average gross value of remaining loans, which did not even cover contractual interest payments. At this rate, KEDIPES will most likely not be able to recover all its assets or fully repay the remaining State aid (around €3.4 billion) in the 10-year period originally foreseen. ([13]) There have also been far fewer ESTIA applications for loans held by KEDIPES than originally expected, as was the case for the broader banking sector. Furthermore, the suspension of foreclosure procedures during the Covid-19 crisis will slow down the workout of assets.

ESTIA scheme

Take-up of the ESTIA scheme has been lower than expected. By the end of 2019 deadline, the total number of applications stood at 5,638, corresponding to a value of around €1.7 billion, or half of the estimated eligible amount. A significant proportion of the applications had incomplete paperwork. Nevertheless, the applicants can complete the documentation by the end of June 2020. Banks will have until end-July to assess the eligibility and viability of the borrowers and to submit the applications to the Ministry of Labour, Welfare and Social Insurance for final verification. The authorities will then take final decisions by autumn 2020. Although several reasons might have contributed to the low take up of the scheme, a key factor was the reluctance of a large number of debtors to reveal their net-wealth position (as required by the application guidelines) – suggesting a large proportion of 'strategic defaulters'. Expectations of a more generous scheme or a less stringent approach to collateral enforcement (as implied by the August 2019 amendments) are also likely to be significant drivers.

The authorities have announced that they might consider complementing ESTIA with a more targeted scheme for the most vulnerable households. The orientation of the ESTIA scheme towards borrowers with significant wealth and income has been one of the sources of concern regarding the scheme. ([14]) Preliminary evidence suggests that a non-negligible proportion of ESTIA applicants could be turned down on viability grounds. In March 2020, the authorities announced that they were considering a complementary scheme targeting those borrowers, but discussions are still at an early stage and subject to further information on the extent of ESTIA rejections.

([13]) KEDIPES made two €60 million repayments to the state (October and December 2019). Meanwhile, it has disputed a recent asset protection scheme claim by Hellenic Bank.

([14]) For a more detailed discussion of the concerns raised by the design and implementation of ESTIA, see *Post-programme surveillance report – Cyprus* (autumn 2019), p. 24.

4. SOVEREIGN FINANCING AND ABILITY TO REPAY

Cyprus has tapped the international markets twice in 2020, borrowing a total of €3.5 billion. On 14 January, the government issued a €1 billion bond with 10-year maturity and a primary yield of 0.73%, and (for the first time) a 20-year bond of €750 million, at a primary yield of 1.33%. As a result, the 20-year tenor on Cyprus' yield curve has now been filled. The second issuance took place on 7 April, when Cyprus borrowed another €1.75 billion in a new dual-tranche transaction. It issued €1.25 billion through a 7-year bond (primary yield: 1.56%) and €0.5 billion via a 30-year bond (primary yield: 2.339%). The coupons were of 1.5% and 2.25% respectively.

The government continued to engage in active debt-management operations, repaying the remaining part of the IMF loan at the end of February 2020. In October 2019, the Minister of Finance officially requested ESM approval for the early repayment of the remaining part of the IMF loan (granted in the context of the economic adjustment programme agreed in April 2013). The outstanding amount was around €717 million (570 million special drawing rights), while the interest rate on the credit was slightly over 1.7%. On 6 February 2020, the ESM Board of Directors agreed to waive Cyprus' ESM loan repayment obligation in connection with the early IMF repayment. The transaction was executed at the end of February. The instrument used for refinancing (the 20-year bond issued in January) has a longer maturity and lower cost than the IMF loan, thus generating financial benefits for Cyprus and an extension of the maturity profile.

Cyprus fulfilled a large proportion of this year's debt repayment obligation at the beginning of the year. Excluding T-bills, Cyprus' debt redemption needs for 2020 amount to about €2.3 billion. ([15]) The bulk of this (€1.38 billion) materialised in the first quarter, when the IMF loan was repaid and a euro medium-term note (EMTN) bond reached maturity. Debt amortisations are very low in Q2 and Q3-2020; they do not increase until the end of the year, notably in December. ([16])

The state's financing needs for 2020 are projected to increase due to the adverse impact of Covid-19 on public finances. Excluding T-bills, Cyprus' gross financing needs for 2020 are estimated at around €3.7 billion (around 18¼ % of GDP), i.e. the above-mentioned debt redemption needs (€2.3 billion) plus fiscal needs (estimated at around €1.43 billion) arising from the budgetary headline deficit. ([17]) The general government balance is projected to be in deficit by 7% of GDP on the back of lower economic activity, lower tax collection and fiscal stimulus measures adopted to address the impact of the coronavirus pandemic (see Section 3).

Nevertheless, Cyprus is in a comfortable position from a financing needs perspective. The significant bond issuances at the beginning of the year (€1.75 billion) and the April issuances (also €1.75 billion) led to a substantial cash buffer held at the central bank. ([18]) Moreover, to boost its liquidity further, on 15 April the government raised €1.25 billion more from local banks by issuing domestic bonds with 12-month maturity. ([19]) As a result, Cyprus has sufficient liquidity to cover its financing needs for this year and beyond, and is thus well equipped from a financing perspective to weather the health and economic crisis.

Going forward, gross financing needs are expected to remain contained. Total financing needs are expected to decrease next year, on the back of lower fiscal and debt redemption needs. Overall, Cyprus' financing needs are expected to remain contained in the medium term (on average 8% of GDP in the period to 2025) thanks to the long maturity of the ESM loans and projected government surpluses.

([15]) The total redemption needs of €2.3 billion (excluding T-bills) consist of long-term debt redemptions (€1.6 billion) and the early IMF repayment (€0.7 billion).

([16]) The key debt redemption in Q4-2020 is the repayment of a €750 million domestic bond held by Hellenic Bank, which is maturing in December.

([17]) The figures for the fiscal needs are derived from the Commission's spring forecast.

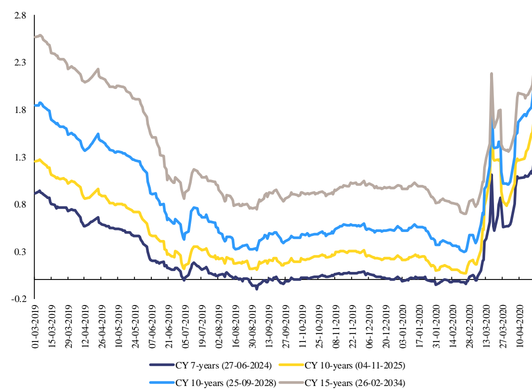
([18]) The government's cash buffer at the very start of the year was already sizeable, so the January and April bond issuances further strengthened its liquidities.

([19]) The additional domestic issuance enhanced further the cash buffer, exceeding Cyprus' projected needs for the year (as estimated at the time of writing).

Before the Covid-19 outbreak, Cyprus was assessed positively by the rating agencies. With the exception of Moody's, the main agencies have rated its debt at investment grade since September 2018. More recently, S&P (on 6 March) and Fitch (3 April) changed the outlook from positive to stable, in view of the pandemic. Nevertheless, both confirmed Cyprus' investment rating. ([20])

On the bond markets, Cypriot sovereign yields experienced some volatility in early spring, in line with other European bonds. Cypriot yields were stable until early March, when the pandemic pushed them up, with a marked spike in mid-March (see Graph 4.1). They decreased afterwards to lower levels, following the announcement of ECB intervention (18 March). Towards the end of April, the yields of the 10- and 15-year bonds stood at around 2% and 2.2% respectively, while those of the 20- and 30-year bonds were 2.2% and 2.4%.

Graph 4.1: **Cypriot bond yields**



Source: Bloomberg.

([20]) The upcoming rating actions are by DBRS (15 May) and Moody's (19 June).

ANNEX A

Annex A: Soundness indicators for the banking sector in Cyprus

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

	2012	2013	2014	2015	2016	2017	2018				2019			
	Dec	Dec	Dec	Dec	Dec	Dec	Mar	June	Sept	Dec	Mar	Jun	Sept	Nov
NPLs*, all loans (EUR billions)	15.6	26.0	27.3	26.7	23.8	20.6	19.9	16.6	11.0	10.3	10.1	9.7	9.5	9.4
NPLs*, all loans (% of total)	22.6	41.5	47.8	45.8	47.2	43.7	43.0	40.3	31.8	30.3	30.6	29.8	28.8	28.5
NPLs*, loans to NFCs (% of total)	..	..	58.0	56.0	56.4	50.3	48.4	39.4	36.3	33.3	31.5	29.7	28.5	28.3
Restructured non-performing (% of total)	..	12.5	23.3	25.9	25.7	22.8	22.3	16.4	15.4	14.4	14.1	13.3	12.4	12.4
Restructured performing (% of total)	..	12.2	5.3	7.5	9.4	8.6	7.9	8.6	8.3	6.8	6.2	5.4	5.8	5.5
NPLs*, loans to households (% of total)	..	43.3	52.7	56.2	55.9	53.9	53.6	52.5	38.0	37.6	37.8	37.0	36.5	36.3
Restructured non-performing (% of total)	..	6.7	13.9	18.0	20.0	19.7	19.8	19.4	16.8	17.1	17.1	16.5	16.2	16.0
Restructured performing (% of total)	..	10.4	8.9	6.7	7.7	8.3	8.0	7.6	8.5	7.1	6.2	5.8	5.1	4.8
Coverage rate (Impairments / NPLs)*	47.9	37.7	32.9	37.8	41.7	46.8	48.6	48.3	51.9	51.3	52.3	51.1	52.4	52.8
Cost-to-income ratio	55.6	53.4	40.4	44.1	52.5	53.6	63.9	74.3	60.0	62.4	70.3	62.0	64.9	n.a.
Net interest margin	2.3	2.4	2.9	2.8	2.6	2.3	2.2	2.3	1.8	1.8	2.0	1.9	1.9	n.a.
Common Equity Tier 1 ratio	..	..	14.2	15.6	15.9	14.9	14.1	14.2	14.9	15.1	15.7	16.3	16.6	n.a.
Return on assets (annualised)	-3.4	-4.3	-0.6	-0.6	-0.3	-1.1	0.9	0.3	0.4	0.2	0.7	0.8	0.6	n.a.

(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.

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