



European
Commission

ISSN 2443-8014 (online)

Post-Programme Surveillance Report

Cyprus, Autumn 2020

INSTITUTIONAL PAPER 141 | NOVEMBER 2020

EUROPEAN ECONOMY

*Economic and
Financial Affairs*



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Luxembourg: Publications Office of the European Union, 2020

PDF ISBN 978-92-76-16330-5 ISSN 2443-8014 doi:10.2765/647053 KC-BC-20-018-EN-N

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Cyprus, Autumn 2020

ACKNOWLEDGEMENTS

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

The report reflects information available up until 22 October 2020.

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⁽¹⁾ The executive summary of this report was adopted as Commission Communication C(2020) 8040 on 16 November 2020. The rest of the report reflects the findings of the staff working document SWD(2020) 279 accompanying that Communication.

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

EXECUTIVE SUMMARY

Special arrangements were made for the preparation of this ninth post-programme surveillance (PPS) report, due to the exceptional circumstances linked to the Covid-19 pandemic. Given the ongoing developments and related travel restrictions, the mission was conducted in virtual format, via video and teleconferences involving European Commission staff, in liaison with staff from the European Central Bank (ECB). The institutions held several online meetings with the Cypriot authorities, major banks and credit-acquiring companies, while the usual discussions with political parties and civil society were postponed to the next PPS cycle. 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 as well under the framework of their regular staff visits.

In 2020, economic activity in Cyprus is expected to see one of its deepest contractions on record due to the pandemic, with the tourism sector bearing heavy losses, yet the recession is likely to be somewhat less pronounced than anticipated earlier. The good epidemiological situation in the country in May allowed the government to relax lockdown measures, which led to a gradual reactivation of the economy particularly in the third quarter of the year. Domestic demand, mainly helped by the government's fiscal support measures, fared better than expected in early summer notably private consumption. However, the demand for tourism plummeted, with arrivals over the first 9 months of the year around 85% down on 2019. The development of the pandemic is uncertain, including in Cyprus' main tourism markets, and it may take considerable time for the sector to recover. In addition to the impact of Covid-19, the possibility of future EU-UK trading relations on WTO terms could also adversely affect the Cypriot economy, given its close links with the UK. For the year as a whole, the Commission's autumn forecast projects a recession of 6.2% in 2020 and a gradual recovery of 3.7% and 3.0% in 2021 and 2022, respectively. Unemployment has risen, in particular in the tourism industry, but the temporary employment support measures have so far mitigated the impact. External imbalances, including a sizeable current account deficit, persist. Meanwhile, inflation is expected to be negative in 2020, dragged down by energy prices, and to increase gradually thereafter to 1.3% in 2022. Uncertainty remains high and downside risks to the growth outlook significant, with the development of the pandemic being the main one.

The Covid-19 pandemic has taken a toll on public finances. After a strong fiscal performance in 2019, the autumn forecast projects that the headline budgetary balance will turn into a sizeable deficit of 6.1% of GDP in 2020. The deterioration in the fiscal outlook compared to 2019 reflects substantial expected revenue losses, due in particular to lower indirect and corporate tax revenue, as well as additional spending that was necessary to mitigate the impact of the pandemic on the economy, which in the absence of these measures could have been much worse. The expansionary fiscal measures adopted represent almost 4% of GDP and consist primarily of income support schemes to businesses and employees most affected by the recession. Given the expiry of most of the measures in the course of 2020 and an assumed pick-up in revenue collection in 2021 on account of the expected recovery, public finances are projected to improve considerably in 2021. Risks to the fiscal outlook are on the downside. They include negative impacts on revenue collection of a recession that is sharper or more enduring than currently expected and the potential costs of additional policy measures, as well as the state's exposure to explicit and implicit contingent risks relating to the National Health Insurance System and the financial sector.

The effects of the Covid-19 crisis are also seen in the financial sector. The banking sector made losses in the first half of 2020 as provisioning increased, credit activity stalled and significant non-performing loans (NPLs) disposals were postponed. The capital position of banks deteriorated on average. Nevertheless, the sector appears better prepared than it was for the 2011-2013 crisis. However, considerable challenges lie ahead, as support measures, such as payment moratoria and associated regulatory forbearance and relaxation of loan origination requirements, are due to expire at the end of 2020. New lending to the economy decreased up to June this year compared to the corresponding period in 2019. The decrease was driven mainly by reduced lending to the corporate sector, while households contracted less mortgages in view of the uncertain outlook and already-high levels of indebtedness. NPLs

in the banking sector continued to decline in the first half of 2020 and notably the pandemic still allowed a major NPL sale by Bank of Cyprus. Meanwhile, KEDIPES (the government-owned vehicle managing the bad assets left from winding down the Cyprus Cooperative Bank) made slower progress on NPL reduction. Furthermore, KEDIPES is facing delays to have its organisational set-up finalised. The loan service agreement has not yet been concluded and staffing issues persist. The take-up of ESTIA, a government support scheme meant to support the reduction of NPLs in the economy, was disappointing. On the positive side, the implementation of ESTIA should have helped banks identify strategic defaulters. Another impediment to swift NPL resolution is credit-acquiring companies' lack of online access to the land registry. Finally, the amendments to the foreclosure framework adopted by the Cypriot Parliament in August 2019 were confirmed by the Supreme Court in June 2020, and have since entered into force. The foreseen appeal procedure to the Financial Ombudsman may cause delays and undermine legal certainty for creditors. However, the overall impact on payment discipline, strategic defaulters, foreclosure activity and asset sales remains to be seen, especially in view of the foreclosure moratorium in place until September. Outside the banking sector, progress on merging the insurance and pension fund supervisors is slow, while consolidation in these two sectors is long overdue. As regards capital market developments, diversifying the investments and funding possibilities for corporations remains a challenge.

While these are challenging times, Cyprus retains the capacity to service its ESM debt. In order to manage the risks relating to the pandemic, the government has borrowed extensively this year – building a significant liquidity buffer that covers its financing needs for 2020 and 2021, and part of the refinancing needs of the year 2022. Accordingly, public debt has increased significantly, but it is projected to decline in the coming years, supported by an improved fiscal outlook and GDP growth. Despite the pandemic, Cyprus has enjoyed a supportive market environment when tapping the international markets and it continues to enjoy ‘investment grade’ ranking by three major rating agencies. Over the medium term, the state’s financing needs are expected to be contained, with loan repayments to the ESM not due to start until 2025.

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1. MACROECONOMIC SITUATION AND OUTLOOK

The Covid-19 pandemic and the associated confinement measures took a heavy toll on Cyprus' economy in the first half of 2020.

Economic activity contracted by 5.5% year-on-year (y-o-y), with a 1.3% increase in the first quarter (Q1) and a decline of 12.3% in Q2. All domestic demand components, except public consumption, declined considerably with investments affected worst. In particular, private consumption dropped by 9.2% in Q2 and 3.6% in the first half of 2020, y-o-y. Investments⁽³⁾ fell by 43.8% in Q2 and 13.4% in the first half of the year and construction activity by 19.7% and 12.4%, respectively. The relatively contained epidemiological situation on the island allowed for lockdown measures to be gradually relaxed as of May, which led to a partial recovery of domestic demand in Q3. However, economic sentiment and consumer confidence remained depressed in October.

The adverse impact on tourism, a key sector for Cyprus, has been particularly large.

Tourist arrivals decreased by some 85% in January-September 2020 and revenues by nearly 90%, in January-July, compared to the same periods in 2019. Travel restrictions were lifted on 9 June for arrivals from a limited number of countries. Restrictions on travel from the UK – Cyprus' main tourist market – were lifted in August, but travellers were required to present a negative test certificate on arrival. This resulted in a significant decrease in tourist demand from the UK. Travelling for tourism from Russia (the second most important market) is very limited as Russian travellers are required to present a negative test certificate on arrival and to self-isolate for 14 days. In total, exports of goods and services decreased by 16.3% in Q2 and 7.4% in the first half of the year. The decrease for services was more pronounced, 22.5% in Q2, reflecting the fall in demand for tourism.

For 2020 as a whole, the economy is still expected to show a deep recession, though perhaps somewhat less pronounced than expected at the onset of the pandemic. Real GDP is projected to fall by 6.2% in 2020, i.e. an upward revision by 1.5 percentage points (pps.) compared

to the 2020 summer forecast. This is due to the better outturn in the first half of the year in particular as regards private consumption. It also reflects the expected stronger recovery of domestic demand in the third quarter, as suggested by high-frequency indicators, such as credit card use and production indices, including a strong rebound of construction activity from May onwards. However, the fourth quarter of the year is anticipated to be less strong as the epidemiological situation in Cyprus and its main trading partners is worsening. Overall, the swift and sizeable support measures adopted by the authorities contributed as well in mitigating the impact of the pandemic shock throughout the year.

In 2021 and 2022, a gradual recovery is expected, driven by domestic demand.

Private consumption is set to continue recovering due to pent-up demand. By contrast, investment, is not expected to return to its 2019 level by 2022. This is due to the anticipated fall in demand for high-end residences, until now supported by the investor citizenship scheme⁽⁴⁾. Meanwhile, large tourism-related infrastructure projects are expected to continue. Public consumption is set to contribute positively to growth, reflecting the government's fiscal stimulus measures, which extend to 2021, the planned increases in employee compensation and health expenditure. Exports, notably of services, are set to recover more slowly than domestic demand, as travellers' confidence has been severely affected by the pandemic, and the sector may not return to its 2019 level before 2024. Overall, real GDP is projected to increase by around 3.7% in 2021 and 3% in 2022. In this case, in 2022 the GDP level, in real terms, would slightly exceed its pre-crisis level.

A move to EU-UK trade relations based on WTO terms would have a negative effect on the Cypriot economy.

Cyprus has close trade relations with the UK, in particular for tourism and trade in goods. Moving to WTO rules for trade between the UK and the EU is likely to reduce Cypriot GDP via a dampened trade channel, especially in early 2021. Moreover, investment in

⁽³⁾ Excluding ships and aircrafts, investments decreased by 52.8% in Q2 and 20.3% in the first half of 2020, y-o-y.

⁽⁴⁾ The government abolished the scheme as of 1 November 2020. The examination of the applications submitted up until that date is planned to continue. However, most of the investments related to these applications have already taken place during the last 3 years.

construction is set to be somewhat adversely affected as demand from UK for holiday houses could slow down. However, the overall impact might not be too pronounced, as there could also be positive trade diversion effects (e.g. in higher education and financial services). The above forecasts take into account the impact of the expected change in EU-UK trade relations.

Downside risks to the growth outlook are significant due to persisting uncertainty, mainly as to the course of the pandemic. Additional lockdown measures in Cyprus in the last two months of the year due to resurgence of infections would have further significant downside effects on the economy. A continuation of the pandemic and accompanying lockdown measures in the coming years, without yet access to a reliable vaccine, would take a further toll on consumer confidence and the economy. In addition, the risks of scarring effects from the crisis and possible excess capacity in the tourism sector could put a drag on long-term growth. The pre-pandemic sizeable private- and public-sector debt and structural impediments (e.g. in the judicial system) exacerbate these downside risks. They also make the recovery of the economy particularly vulnerable to the risk of bankruptcies and an increase in NPLs, notably in the tourism sector. This could adversely impact the financial sector and the flow of credit to the economy.

Temporary income support schemes provide the labour market with a safety net, but the pressure of the pandemic may still have an impact in the period ahead. The unemployment rate rose to 7.4% in August 2020, from 6.1% in February 2020. Accommodation, restaurants and trade have been particularly affected. In addition, youth unemployment is on the rise. The temporary measures adopted by the government to protect employment in particular in the tourism industry (see Section 2 – Public finances) have had a mitigating effect. In the period from mid-March to mid-June, participation in the schemes was up to 65% among eligible employees and 55% for eligible self-employed. All economic sectors benefited from the schemes during the lockdown period. Since summer, the measures have been targeted to tourism and related services and they are expected to remain in place until March 2021. However, employers are obliged not to proceed with layoffs for double the period for which they

receive the support plus 1 month. This has helped to keep unemployment at low levels so far, but if the expected recovery does not materialise in 2021, the impact on the labour market may be greater. Employment is expected to fall by around 2.6% and unemployment to rise to 8.2% in 2020, 1.1 pps. increase from 2019 that should be almost reversed in 2021 and 2022 7.6% and 7.2%, provided the anticipated economic rebound materialises.

Inflation is expected to be negative this year and to recover gradually in the medium term. Headline inflation fell to -1.1% in January-September, y-o-y, driven by lower prices for energy and services. In particular, energy prices fell significantly, by 8.4% on average in the first 9 months y-o-y and by as much as 14.9% in Q3. This trend is expected to continue in the coming months, due to the anticipated fall in oil prices. Overall, inflation is expected to be around -0.9% in 2020, before gradually rebounding to 0.9% in 2021 and 1.3% in 2022.

The current account deficit remains significantly negative. It stood at 6.9% ⁽⁵⁾ of GDP in Q2 2020. Excluding special purpose entities (SPEs), it amounted to 7.6%, as compared to 6.9% in Q4 2019. In 2020, the deficit is expected to increase considerably, on account of lower revenues from tourism, before it starts slightly narrowing in 2021 and 2022. This does not bode well for Cyprus' sizeable negative net international investment position (NIIP), which is almost 130% of GDP in 2020. Although the NIIP excluding (financial and non-financial) SPEs comes down to around 40% of GDP, it is still beyond the MIP ⁽⁶⁾ threshold (-35% of GDP) and remains a source of vulnerability and warrants close monitoring particularly as gross external debt remains relatively high (about 230% of 2019 GDP excluding intra-company debt).

⁽⁵⁾ The figure refers to a four quarters rolling sum to smooth out the inherent volatility of the series for Cyprus.

⁽⁶⁾ Macroeconomic imbalance procedure.

2. PUBLIC FINANCES

Fiscal performance

The economic recession triggered by Covid-19 and the policy response have had a big impact on public finances in 2020. In the first 8 months of 2020, the headline balance turned into a deficit of 2.8% of GDP, compared to a surplus of 2.8% of GDP in the same period last year ⁽⁷⁾.

Public expenditure rose by 12% (about 3% of GDP), reflecting primarily the government's fiscal policy response to combat the crisis. The Covid-19 related support measures amounted to 2.3% ⁽⁸⁾ of GDP in January-July 2020. The fiscal cost of Covid-19 related compensation measures stemmed for the most part from spending on subsidies, which rose by 2% of GDP in January-August. Social transfers increased by 2.4% (0.2% of GDP), reflecting the relatively moderate impact of the crisis on the labour market thus far. Intermediate consumption increased by 44.5% (1.3% of GDP), primarily reflecting the roll-out of the National Health Insurance System (NHIS) – the first phase started in June 2019 and the second in June 2020 – and, to a lesser extent, additional spending to support the health sector in the wake of the pandemic. Compensation of public-sector employees continued to grow steadily, by 5% (0.4% of GDP), reflecting notably the cost of the gradual reversal of wage cuts that started in July 2018. Public investment increased by 48.6% (0.3% of GDP) ⁽⁹⁾.

In parallel, public revenues fell sharply due to the recession and support measures. Overall, public revenue decreased by 9.9% y-o-y (2.8% of GDP) in January-August 2020. The impact of the pandemic and containment measures on the economy, as well as tax deferrals, took a strong toll on tax collection, which decreased by 13.6% (2.3% of GDP). Revenue from social contributions fell by 2.1% (0.2% of GDP) in January-August,

despite increases in health contribution rates during March, July and August 2020. Weak contribution revenues reflect wage compensation measures not subject to social contributions and the cost of delaying by 3 months the planned increase in health contribution rates.

The slump in tax revenue collection is due mostly to lower indirect tax collection and corporate income tax revenues. Indirect taxes were affected most, with VAT collection dropping by 13.1% (0.9% of GDP) and excise on hydrocarbons by 23.1% (0.3% of GDP). As regards VAT collection, the decrease also reflects the 3-month deferral of VAT payments. By August 2020, deferred VAT payments amounted to about 0.8% of GDP. All suspended obligations are due to be paid by 10 November 2020. Revenue from current taxes on income and wealth decreased by 12.2% (0.8% of GDP), reflecting in particular the drop in revenue from corporation tax, by 15.8% (0.4% of GDP).

Fiscal outlook

The direct fiscal impact of measures to deal with the health and economic impact of Covid-19 is estimated at about 3.9% of GDP in 2020 and 0.3% in 2021. The estimated cost in 2020 is slightly lower than assumed in the 2020 stability programme and the Commission's spring 2020 forecast. While the fiscal cost of some of the early measures adopted was revised down, this was partly offset by additional deficit-increasing measures and an extension of some early support measures. The former included grants to support small enterprises and the self-employed; the latter the extension of specific short-term work schemes, in particular in tourism. All support measures with a fiscal cost in 2020 are not planned to be extended beyond 2020. Nevertheless, the government also adopted support measures with a fiscal impact set to be seen from 2021: two interest subsidy schemes for new business and housing loans (estimated cost of 1.1% of GDP in 2021-2024), and tax credits for voluntary rent reduction (0.1% of GDP in 2022).

The bulk of the fiscal impulse in 2020 is set to come from temporary expenditure measures. Expenditure measures are estimated to cost about 3.3% of GDP in 2020 and concern in particular the

⁽⁷⁾ The turnaround was even more pronounced when compared with last year's surplus excluding the one-off impact of the conversion of specific Deferred Tax Assets into Tax Credits (4.1% of GDP).

⁽⁸⁾ This estimate excludes an extra budget of EUR 100 million for the strengthening of the health services

⁽⁹⁾ Other current expenditure decreased by 36.1%, reflecting the one-off fiscal impact of 1.3% of GDP in March 2019 due to the change to the conversion of specific Deferred Tax Assets (DTAs) into Deferred Tax Credits (DTCs).

various wage compensation schemes. The cost of revenue-side measures in 2020 is estimated at 0.7% of GDP, of which 0.5% of GDP relates to foregone social contribution revenue, because subsidies provided under the wage compensation schemes were not subject to social contributions. The temporary suspension of higher social security contributions to NHIS is estimated to have a fiscal cost of around 0.2% of GDP. The reduction of special VAT rates on accommodation and catering services is estimated to cost 0.1% of GDP.

The Commission's 2020 autumn forecast factors in a marked deterioration of public finances in 2020, and a partial recovery in 2021 and 2022. The general government headline balance is projected to record a deficit of 6.1% in 2020. A substantial rise in the public debt-to-GDP ratio is projected, from 94% at end-2019 to 112.6% in 2020⁽¹⁰⁾. In 2021-2022, the general government balance deficit is expected to narrow gradually to 2.3% of GDP, while the public debt-to-GDP ratio is set to decline to 108.2% and 102.8% of GDP on the back of the projected partial recovery and the lifting of most of the crisis measures.

The fiscal outlook is surrounded by sizeable risks and uncertainties. The impact of the recession on revenue collection in 2020 and onwards is difficult to estimate at this juncture. The fall in private consumption, employee compensation and firms' profits could become larger than expected depending on the evolution of the pandemic, further weakening the effects on revenue collection. Corporate tax revenue, which is particularly uncertain and typically volatile, could take time to recover from the recession. In addition, the VAT deferrals could ultimately lead to losses of fiscal revenue above those assumed in the projection. Estimates from the tax administration suggest that about 0.5% of GDP of VAT deferrals will not be repaid in 2020. At the same time, additional deficit-increasing measures might be needed to provide further support to the economy in 2021, in particular in the event of a subdued recovery. In addition, Cyprus can count in

the coming years on substantial EU support from Next Generation EU, for recovery-focused investments and key growth-enhancing reforms. The fact that the current projections do not include RRF-related measures constitutes a positive risk to the fiscal outlook.

Contingent risks relate mostly to the state's exposure to the financial sector and the NHIS.

The on-going implementation of the second phase of the NHIS reform poses several risks in the current context. Subdued health contributions in January-August 2020 are expected to lead a deficit for the Health Insurance Organisation (HIO), which could persist next year. In the view of ensuring the long-term sustainability of the reform, the authorities intend to fill the potential gap by taking cost-saving measures, together with drawing on last year's HIO surplus. While a gradual return to a balanced HIO budget by 2023 is expected, this hinges critically on future developments as regards health contributions. Moreover, the government might need to cover potential financial deficits of public hospitals (which were given government guarantees for the first 5 years) until public hospitals become financially autonomous. Other downside risks stem from the state's explicit contingent liabilities to Hellenic Bank (through the asset protection schemes) and implicit contingency risks to the financial sector as a whole.

⁽¹⁰⁾ The debt ratio figure relies on the assumption that the government will redeem earlier, by the end of 2020, the 12-month domestic bonds issued in April this year. Otherwise, the debt ratio for 2020 is expected to be much higher, at around 118% of GDP. See Section 4 for more details on the government's borrowings in 2020.

3. FINANCIAL SECTOR

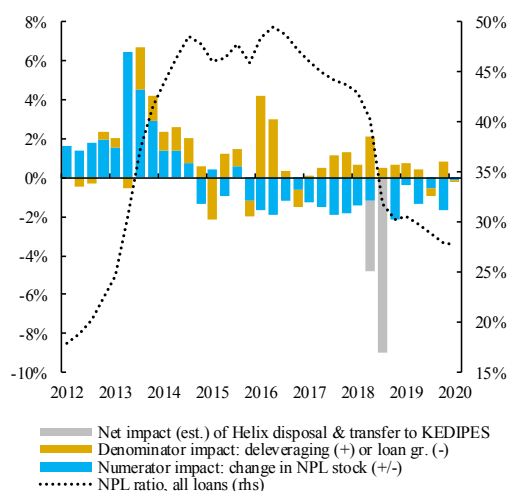
3.1. BANKING SECTOR DEVELOPMENTS

Asset quality

The reduction in non-performing loans (NPLs) has slowed down on the back of the pandemic.

As of May 2020, the total stock of NPLs held by the banks stood at EUR 8.5 billion (26.7% of gross loans), down from EUR 10.1 billion (30.8%) a year earlier (see Graph 3.1) ⁽¹⁾. While the decline was limited in the first quarter of the year, the second quarter registered a more substantial reduction on the back of NPLs sales and write-offs. One welcome development was the progress made by the Bank of Cyprus (BoC) on its *Helix II* portfolio disposal. In August, BoC reached an agreement on selling a first tranche of the portfolio. Meanwhile, Hellenic Bank's discussions with investors on the *Project Tide* asset disposal came to a halt and are unlikely to resume in 2021. In this context, the bank focused on organic NPL reduction, through sizeable write-offs.

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



Source: Central Bank of Cyprus

The moratorium on loan repayments has had significant take-up in Cyprus, helping to alleviate the impact of the Covid-19 crisis on the financial sector in 2020. The take-up of the legislative moratorium introduced on 30 March 2020 has been substantial. As of early August, it covered about 41% of the total volume of loans in the banking sector. Take-up is particularly high for non-financial corporations involved in tourism related activities, including accommodation and food, arts, entertainment and recreation, and construction. Although data availability renders a complete cross-comparison impossible, information from local sources suggests that the level of take-up of the moratorium in Cyprus is one of the highest for such schemes introduced recently in the EU.

Going forward, asset quality may be impacted in 2021, following the lifting of the moratorium and on the back of existing vulnerabilities. One of the main concerns is whether borrowers currently benefiting from the moratorium will resume their contractual payments following the expiry of the scheme. A prolonged crisis resulting in higher unemployment and lower revenues could hamper the payment capacities of both households and businesses. As a result, asset quality could worsen to some extent. Vulnerabilities also stem from banks' significant exposures to vulnerable sectors ⁽¹²⁾ and a high level of private indebtedness. The very large scale of the loans under moratorium suggests that the usual risk metrics may not be accurate indicators of expected future credit losses, resulting in divergent provisioning practices across banks. Another concern is the presence of strategic defaulters. The lower take-up of the ESTIA scheme suggests clearly that 'strategic default' behaviour is widespread (see Section 3.2 for more details). The uncertainties arising from the implementation of the recent amendments to the foreclosure framework add to these concerns. To sum up, with a high proportion of legacy NPLs, the reduction of bad loans is expected to remain challenging,

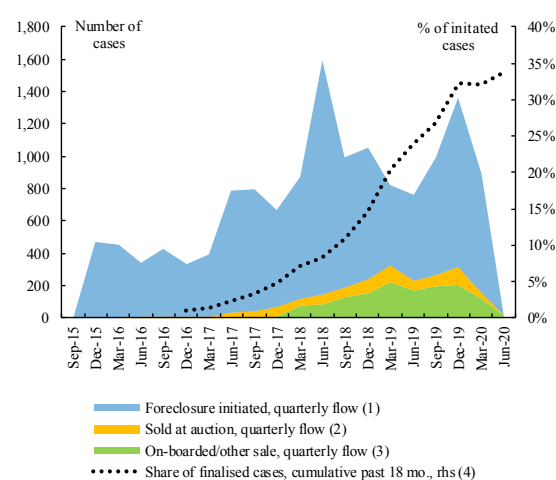
⁽¹⁾ The NPL ratios (i.e. ratios of NPL stock to total gross loans) in this report are based on the data and scope used by the Central Bank of Cyprus. In particular, no account is taken of banks' exposures to central banks and credit institutions, or their overseas operations (branches and subsidiaries located abroad). Therefore, the ratios differ from those in the *2020 Cyprus country report*, which are based on the ECB definition.

⁽¹²⁾ The total credit exposures of the banking sector to sectors expected to be heavily impacted by the containment measures (i.e. accommodation and food service, 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.

especially given the uncertainty as to the future course of the pandemic and existing vulnerabilities.

New provisioning helped increase coverage levels. In May 2020, the average coverage ratio for the banking sector was 54.7%, up from 52.2% a year earlier. A significant part of the development was driven by new provisioning charges due to expected credit developments following the expiry of the payment moratorium. While the aggregate coverage level continues to exceed the EU average (47.6% as of March 2020), this reflects the significantly lower quality of the remaining NPLs. A particularly important risk factor is the size of loans currently covered by the payment moratoria and the adequacy of current provisioning on them following the expiry of the schemes. In line with the Central Bank code of conduct, banks are proactively engaging with borrowers to identify issues and work out possible solutions early on.

Graph 3.2: **Developments in foreclosure activity**



(1) Properties for which notification has been served or an intention to sell in the relevant quarter.

(2) Properties successfully sold in an auction in the quarter.

(3) Properties sold or on-boarded (by the originating bank) following an unsuccessful auction.

(4) This gives the total market value of successful auctions over all foreclosures initiated in the preceding 18 months.

Source: Central Bank of Cyprus

Foreclosure activity has come to a halt and is expected to remain relatively low in the coming months. Banks and credit-acquiring companies suspended all foreclosure activity, including the delivery of notices and auctions, from March 2020,

and the suspension was in place until the end of August⁽¹³⁾. This followed a relatively high level of activity at the end of 2019 and in the first quarter of 2020. The proportion of successfully finalised foreclosures over the past 18 months has plateaued at around a third of all initiated cases at year-end (see Graph 3.2). Foreclosure activity is expected to be slow in the coming months due to a number of issues, including most notably the difficulties that credit-acquiring companies have in accessing the land registry electronically. More generally, it is not clear how willing the banks will be to proceed with foreclosures in the current climate, especially if a second wave of containment measures is announced or if real-estate prices drop significantly.

Profitability, capitalisation and liquidity

The pandemic has exacerbated the existing profitability challenges faced by the banking sector. Low margins, a high level of NPLs, intense competition and high operating costs have been adversely affecting banks' profitability in recent years. The sector's aggregate after-tax profit was around EUR 172 million in 2019, somewhat above the 2018 outcome⁽¹⁴⁾. Net interest income and net fee/commission income were slightly higher than a year earlier, while provisioning costs declined. Profits turned negative in the first quarter of 2020 on the back of higher impairments. The expected loss for the first half of 2020 is primarily attributed to BoC recording a loss on the sale of NPLs, and higher provisioning across the system due to the deterioration of economic prospects. The 'cost to income' ratio was 72.3% in Q4 2019, up from 62.5% a year earlier, but it declined to 67.1% in Q1 2020⁽¹⁵⁾. Cypriot banks' capacity to generate profits continues to be challenged by low interest margins (which increased slightly, from 2.0% in Q1 2019 to 2.4% in Q1 2020). Overall, the Covid-19 outbreak is likely to weigh further on profits in 2020. Lower credit demand and calls

⁽¹³⁾ There is no indication of further voluntary suspensions.

⁽¹⁴⁾ The 2018 aggregate pre-tax profit included negative goodwill at EUR 297.9 million linked to Hellenic Bank's acquisition of the Cyprus Cooperative Bank at a price below the fair value of its net tangible assets.

⁽¹⁵⁾ The 'cost to income' ratio is 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).

from the authorities to apply lower interest rates and fees on new loans to affected borrowers will probably lower banks' income. More generally, profitability will be affected by rising unemployment and falling business revenues.

Banks' capital buffers improved slightly, but maintaining them might not be easy given their weaker profitability. According to ECB data, the banking sector's 'common equity tier 1' (CET1) capital ratio increased to 16.8% in March 2020 from 15.7% a year before, but this represented a decline compared to the level at the end of 2019 (17.4%). The improvement of aggregate capital positions was helped by the March 2019 law on the conversion of deferred tax assets to deferred tax credits, which BoC made use of. However, Cypriot banks have to maintain a higher capital ratio to absorb further shocks associated with weak asset quality. Moreover, in the context of the ongoing pandemic, balance-sheet deleveraging and weak profitability, it might be challenging to maintain adequate capital buffers going forward.

The banking system remains liquid, despite a fall in deposits since the Covid-19 outbreak. So far, the impact of negative interest rates for large corporate depositors has been contained. Total deposits were down by 1.1% (EUR 547 million) at end-August 2020 compared to a year earlier, having dropped more sharply in March-July, immediately following the outbreak. The liquidity coverage ratio exceeds 200% (well above the EU average), so the banks' business models continue to be based on ample availability of deposits, which leads to excess liquidity for which it is difficult to find a profitable use in a context of a pronounced economic slowdown, high private indebtedness and high NPL levels.

Lending

New lending to the real economy has decreased in 2020. As expected, the supply and demand shock caused by the pandemic has significantly affected new lending, with the total new lending recorded in Q2 2020 reaching a historical trough. The gross volume of new loans (excluding renegotiated loans) to households and non-financial corporations (NFCs) reached EUR 1 billion in the first half of 2020, down from EUR 1.8 billion a year earlier. This was driven by a reduction in new loans to NFCs exceeding EUR

1 billion (down by EUR 500 million) as well as mortgage lending to households (down by EUR 150 million). Total new lending recovered in July 2020 as housing loans increased, possibly due to the incentives of the new interest subsidy scheme (see Box A2.1) and borrowers postponing their loan applications during the lockdown. Loan interest rates do not seem to have been materially affected by the pandemic and have remained relatively stable in 2020 for both NFCs and households. 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

The Bank of Cyprus, the largest domestic bank, made progress in improving asset quality, but its profitability has deteriorated. Its CET1 ratio stood at 14.3% in the second quarter of 2020, slightly down from 14.8% at the end of 2019. In the first half of 2020, BoC reduced its NPL stock by EUR 1.1 billion (through sales, but also by organic reduction), despite Covid-19. In Q2 2020, NPLs accounted for 21.4% of the loan portfolio (down from 28.5% at end-2019). The capital-neutral sale of EUR 133 million of NPLs (*Velocity 2*) was completed in May. On 3 August 2020, BoC announced the sale to funds affiliated with the Pacific Investment Management Company (PIMCO) of a EUR 0.9 billion NPL portfolio (part of *Project Helix II*), including mainly retail and SME loans, with a net book value of EUR 0.4 billion. The transaction is expected to be finalised in the first quarter of 2021. According to the results for the first half of 2020, BoC recorded an after-tax loss of EUR 126 million (compared with EUR 97 million profit a year earlier), on the back of provisions and the net loss from NPL sales.

Going forward, BoC aims to improve profitability by increasing the use of digital banking and relying less on branches. Currently, 72% of customers interact with the bank online and the plan is to increase this further. The latest voluntary staff exit scheme led to BoC's personnel falling by 475 (over 10% of the total), at a cost of EUR 79 million (recorded for Q4 2019). Total operating expenses were reduced, leading to a

decline in the ‘cost to income’ ratio to 61% in Q2 2020 (from 64% in Q1).

Hellenic Bank’s asset quality improved, but profitability weakened in the first half of 2020.

Its CET1 capital ratio remained broadly unchanged at 19.8% in June 2020, as compared with 20% at the end of 2019, although crisis-related lower capital requirements would allow for more flexibility in the current challenging environment. The NPL ratio was 26.4% in the second quarter of 2020, which is lower than at the end of 2019 (31.4%), whereby part of the bank’s assets is covered by the asset protection scheme. The planned sale of a large NPL portfolio (*Project Tide*) has stalled due to the Covid-19 crisis. While the bank benefits from the high-yielding government bonds received as part of the Cyprus Cooperative Bank (CCB) acquisition package, it has been facing pressure on net interest income and low demand for loans, as well as the additional headwinds from the pandemic, which challenge its profitability. In the first half of 2020, the bank recorded after-tax profits of almost EUR 18 million (compared with EUR 59 million a year earlier), including impairment losses of EUR 42 million.

Hellenic Bank continues to have a high ‘cost to income’ ratio and excess liquidity, amid important management changes. The ‘cost to income’ ratio rose to 66% in the first half of 2020 (from 63.4% a year earlier), due *inter alia* to higher staff costs and lower revenues. Liquidity remains high (42.1% ‘loan to deposit’ ratio), with a solid, primarily retail, deposit base, while the net interest margin remains subdued. In response, Hellenic decided to apply negative interest rates (-60 bps) to corporate account balances exceeding EUR 100 000 as of 3 March 2020, which has so far led to only limited deposit outflows. Management stability and business continuity will remain important following the recent resignation of the CEO.

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

Foreclosure developments

The Supreme Court upheld the amendments to the framework governing foreclosures, which

are now in force. In June 2020, the Supreme Court confirmed the constitutionality of the legislative changes adopted a year earlier. The changes backtrack on key elements of the 2018 reform that streamlined enforcement proceedings. However, the scope of application of the reform is limited to certain eligible borrowers, estimated (by the authorities) to represent only 11% of the total stock of NPLs, although it may have a greater impact on certain companies, such as KEDIPES.

The rules governing the newly adopted mechanism for mediation before the Financial Ombudsman remain unclear.

Under the foreclosure reform, eligible borrowers can ask the Ombudsman to mediate in the event of alleged misconduct by banks or credit-acquiring companies regarding the application of the Central Bank of Cyprus (CBC) Directive on Arrears Management and the legal framework governing foreclosure. The outcome and duration of this procedure, which precedes the foreclosure procedure, is uncertain. The process may overburden the Ombudsman’s office and add to existing backlogs in the judicial system. In the light of the above-mentioned Supreme Court decision, the arbitration mechanism on which the CBC had been working has been set aside and no further amendments to the legislative framework governing foreclosures are foreseen in the near future.

The authorities are preparing legal changes to the frameworks governing credit-acquiring companies.

The Ministry of Finance in collaboration with the Central Bank of Cyprus, has prepared a package of legislative proposals improving the regulatory framework for servicers and acquirers of credit facilities, by overcoming functional shortcomings in their efforts to service credit facilities. Furthermore, an amendment of the Evidence Law, is currently being discussed at the House of Representatives, to enhance the admissibility of statements of loan accounts presented by credit acquiring companies before Court, in the same manner as credit institutions.

The use of electronic auctions remains moderate to low.

A total of 72 auctions took place between December 2019, when the e-platform came into operation, and March 2020, when all auctions were suspended due to the Covid-19 outbreak. Despite positive feedback from platform

users, only 17 sales were concluded successfully. The authorities remain confident that more use will be made of electronic auctions going forward, an important step towards the reduction of the NPL stock in Cyprus.

Cyprus Asset Management Company (KEDIPES)

KEDIPES continues to address existing challenges such as finalising the service-level agreement (SLA) and reorganising the structure of the company. The state-owned asset management company finalised the sale of its shares in the current loan service provider, Altamira Cyprus. In early August, KEDIPES announced the appointment of the Director of Deleveraging and Portfolio Supervision, which is a welcome development. Overall, four non-executive director positions have been filled, while the fifth is still awaiting the necessary approvals, including ‘fit and proper’ assessments by the CBC. The renegotiation of the SLA with Altamira Cyprus, which lapsed in November 2019, is still ongoing. KEDIPES management expects the SLA to be finalised by early 2021. Its absence has been a major roadblock for the completion of the overall strategy. The management has decided to shelve discussions on asset disposals due to market uncertainty amid the pandemic and unknowns regarding the foreclosure framework. Staffing issues and improving the quality of data on loans are still areas that need to be addressed. Faster progress is needed in improving operational capacity and effectiveness on the basis of a viable strategy, an efficient organisational structure and a new business plan.

An initial assessment of KEDIPES’ operations points to considerable challenges ahead. Between September 2019 and end-August 2020, the gross book value of the NPL stock declined from EUR 6.6 billion to EUR 6.3 billion. Cash collections on loans, which include both principal and interest payments, continue to be lower than the 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 EUR 3.2 billion) by 2028⁽¹⁶⁾. There have

⁽¹⁶⁾ KEDIPES has repaid a total of EUR 240 million to the state since October 2019. Meanwhile, it has disputed a recent asset protection scheme claim by Hellenic Bank.

also been far fewer ESTIA applications for loans held by KEDIPES than originally expected. Complete applications represent a total nominal loan amount of EUR 359 million, far below the estimated eligible perimeter of EUR 1.3 billion.

ESTIA scheme

Take-up of the ESTIA scheme has been lower than expected. The authorities extended the end-2019 deadline by allowing more time to supplement incomplete, and submit new, applications over the summer, with a final deadline of end-July 2020. A total of 6 441 complete applications were received, corresponding to a value of around EUR 1.3 billion (around 40% of the originally estimated eligible amount). However, not all the applications have been transmitted to the Ministry of Labour, Welfare and Social Insurance: rejected applications account for around two thirds of all applications assessed. A significant proportion (63%) of the rejections are due to failure to meet the eligibility criteria; only a quarter of the rejections are due to the non-viability of the borrower. Although several factors might have contributed to the low take-up of the scheme, a key issue was many debtors’ reluctance 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 foreclosure amendments) are also likely to have been significant drivers.

The authorities might consider complementing ESTIA with a more targeted scheme for the most vulnerable households. The orientation of ESTIA towards borrowers with significant wealth and income has been one of the sources of concern regarding the scheme⁽¹⁷⁾. The authorities announced that they were considering a complementary scheme targeting vulnerable borrowers deemed ‘non-viable’ under ESTIA, but discussions are still at an early stage and may be delayed due to the pandemic⁽¹⁸⁾.

⁽¹⁷⁾ 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.

⁽¹⁸⁾ The new scheme is expected to target ESTIA applicants who would not become viable even with the subsidy,

3.3. OTHER FINANCIAL SECTOR ISSUES

Insurance and pension funds

The merger of the supervisors of pension funds and insurance companies is progressing slowly.

The draft legislation on the functioning of the new independent supervisory authority was submitted to Parliament at end-2019. So far the draft legislation has been discussed in two sessions at the House of Parliament, while the Ministry of Finance has had another round of discussions both with interested parties and the staff of the current supervisory authorities. However, it remains unclear when the legislation may be adopted. Staff transfers and funding issues remain the main problems delaying the entry into force of the long-due legislation. The increased supervisory powers and capacities of the new authority should trigger a consolidation of the funds.

Capital markets

Diversifying the investment and funding possibilities for corporations remains a challenge.

Cyprus ranks lowest in the EU in terms of non-bank financing for NFCs, as listed shares account for only around 2% of businesses' total financial liabilities. Households hold nearly two thirds of their financial assets as cash and bank deposits, the highest ratio in the EU. The local stock and bond markets are small, especially since the 2001 crash and the more recent 2013 financial crisis, which discouraged investment in capital market instruments. In addition, the poor protection of minority shareholders and the ineffective insolvency procedures inhibit capital market development. The Securities and Exchange Commission is making efforts to develop the alternative investment fund industry, following the example of Luxembourg and Ireland. The long-overdue plan for privatising the Cyprus Stock Exchange has recently received new impetus prompted by the findings of a study commissioned by the Ministry of Finance in October 2019. If materialised, the privatisation would be an important step in attracting new listings and providing the market with more liquidity.

e.g. very low- or no-income borrowers, such as single parents or older defaulters.

Insolvency developments

Amendments to transpose Directive (EU) 2019/1023 on preventive restructuring are under public consultation.

Member States are to transpose the Directive by July 2021, with the option of requesting a 1-year extension before January 2021. Cyprus does not currently intend to request an extension. The transposition is expected to improve the culture of restructuring in Cyprus, where the use of 'examinership' (a process whereby the courts protect viable debtors while they restructure their debt) is residual. Bankruptcy and liquidation remain the most common solutions for companies in financial distress.

The authorities have announced a major overhaul of the Companies Law.

The reform is expected to recast and considerably simplify the disparate mechanisms and complex procedures that co-exist in the legislative framework governing insolvency in Cyprus. The reform could take up to 3 years.

The Department of Insolvency will deploy its new organisational structure in January 2021.

In June 2020, the House of Parliament enacted a law governing the Department of Insolvency and related matters. It is expected that the schemes governing its staff's services will be approved in November 2020. In parallel, the authorities are working to develop a new insolvency portal and an online eligibility tool. The digitalisation of insolvency proceedings is crucial to achieving an efficient and effective framework in Cyprus.

Resolution cases

The liquidations of FBME Bank and Laiki Bank are still pending and have not progressed particularly in 2020.

On FBME, the Court decided to hear two liquidation applications, one by CBC and one by the Tanzanian liquidator. Objections persist as to whether the appointment and distribution should be made under Tanzanian law (based on the parent bank's location) or Cypriot law, given that FBME operated as a branch in Cyprus. As for Laiki Bank, its restricted banking licence was revoked by the CBC in September 2020, while applications for its liquidation and the appointment of a liquidator are in the process of being prepared and submitted to the Court.

4. SOVEREIGN FINANCING AND ABILITY TO REPAY

The state's financing needs have increased in 2020 due to the adverse impact of Covid-19, yet Cyprus has managed to cover its financing needs and build a significant liquidity buffer.

Excluding T-bills, gross financing needs for 2020 are estimated at around EUR 3.6 billion or 17% of GDP, made up of EUR 2.3 billion debt redemption needs (including an early repayment of EUR 0.7 billion to the IMF in February) and fiscal needs estimated at around EUR 1.3 billion arising from the projected budgetary headline deficit⁽¹⁹⁾. The key remaining debt redemption for this year is the repayment of a domestic bond held by Hellenic Bank (EUR 750 million, maturing in December). On the back of the bond issuances made throughout the year, the current cash buffer is significant and is estimated to cover in full the financing needs for 2021 and part of the refinancing needs for the year 2022.

In order to manage the risks relating to the pandemic, Cyprus has borrowed extensively this year.

The government has relied significantly on international bond issuances – borrowing a total of EUR 4.5 billion (21% of GDP) – and also made use of the domestic market by issuing 12-month bonds worth EUR 1.25 billion to local banks⁽²⁰⁾. Cyprus tapped the international markets in January and April (for a total of EUR 3.5 billion), followed by another issuance in July (EUR 1 billion)⁽²¹⁾. The latter consisted of a dual-tranche re-opening of two existing benchmark-sized euro medium-term notes: the 5-year bond maturing in December 2024 and the 20-year bond maturing in January 2040. The primary yields were 0.349% and 1.493%, respectively. The July issuance helped to strengthen further the already sizeable cash reserves (thus avoiding any liquidity risks stemming from the unprecedented uncertainty of the pandemic) and benefited from the supportive market environment prevalent at the time. In the

light of this extra borrowing public debt has increased significantly in 2020⁽²²⁾.

Cyprus enjoys a favourable market perception.

The main credit rating agencies, with the exception of Moody's, continue to rate Cyprus' sovereign debt at investment grade. The credit outlook is stable by S&P, Fitch and DBRS, while Moody's maintains a positive outlook⁽²³⁾. More recently, S&P and Fitch affirmed the stable outlook (on 4 September and 2 October, respectively). Over the year, the yields of Cyprus' bonds have broadly followed European trends, exhibiting some spikes and swings in mid-March and April, followed by a decrease in May and remaining stable during the summer. Since September, they gradually came down. In mid-October, the yields of the 10-year and 15-year bonds stood at around 0.4% and 0.7% respectively, while the 20-year and 30-year maturity bonds were at 0.8% and 1.3%. At the shorter end of Cyprus' yield curve, the yield for 3-month Treasury bills on the primary market moved back to positive territory since April (recording a weighted average yield of 0.14% in August).

Financing needs for 2021 are expected to decrease on the back of expected lower fiscal and debt redemption needs.

Gross financing needs for 2021 are estimated at around EUR 2.7 billion (12% of GDP), excluding T-bills. The bulk consists of EUR 2.2 billion of debt redemption needs, while fiscal needs are estimated at around EUR 0.5 billion. Over the medium term, total financing needs are expected to be contained (on average 8% of GDP in the period to 2025). ESM loan repayments are expected to start in 2025.

⁽¹⁹⁾ The figures for fiscal needs are derived from the Commission's autumn forecast.

⁽²⁰⁾ The domestic bonds were issued on 15 April 2020 and mature in April 2021. It was reported that eight banking institutions participated in the process.

⁽²¹⁾ For more details on the January and April issuances, see *Post-programme surveillance report – Cyprus (spring 2020)*.

⁽²²⁾ During the mission discussions in September, the authorities were planning to reduce the debt level by the end of the year, by bringing forward the redemption of the 12-month local bond issued in April. See Section 2 for government debt projections for the period from end-2020 to 2022.

⁽²³⁾ In view of the pandemic, DBRS changed the outlook from positive to stable, on 15 May.

ANNEX 1

Soundness indicators for the banking sector in Cyprus

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

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | | | | 2020 | | |
|--|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| | Dec | Dec | Dec | Dec | Dec | Dec | Dec | Mar | Jun | Sept | Dec | Mar | Apr | May |
| NPLs*, all loans (EUR billions) | 15.6 | 26.0 | 27.3 | 26.7 | 23.8 | 20.6 | 10.3 | 10.1 | 9.7 | 9.5 | 9.0 | 8.9 | 9.0 | 8.5 |
| NPLs*, all loans (% of total) | 22.6 | 41.5 | 47.8 | 45.8 | 47.2 | 43.7 | 30.3 | 30.6 | 29.8 | 28.8 | 27.9 | 27.7 | 27.7 | 26.7 |
| NPLs*, loans to NFCs (% of total) | .. | .. | 58.0 | 56.0 | 56.4 | 50.3 | 33.3 | 31.5 | 29.7 | 28.5 | 24.5 | 24.2 | 24.2 | 23.1 |
| Restructured non-performing (% of total) | .. | 12.5 | 23.3 | 25.9 | 25.7 | 22.8 | 14.4 | 14.1 | 13.0 | 12.4 | 10.8 | 10.7 | 10.7 | 10.7 |
| Restructured performing (% of total) | .. | 12.2 | 5.3 | 7.5 | 9.4 | 8.6 | 6.8 | 6.2 | 6.1 | 5.8 | 4.5 | 3.9 | 3.7 | 3.6 |
| NPLs*, loans to households (% of total) | .. | 43.3 | 52.7 | 56.2 | 55.9 | 53.9 | 37.6 | 37.8 | 37.0 | 36.5 | 35.2 | 35.0 | 35.1 | 34.0 |
| Restructured non-performing (% of total) | .. | 6.7 | 13.9 | 18.0 | 20.0 | 19.7 | 17.1 | 17.1 | 16.5 | 16.2 | 15.7 | 15.4 | 15.4 | 15.5 |
| Restructured performing (% of total) | .. | 10.4 | 8.9 | 6.7 | 7.7 | 8.3 | 7.1 | 6.2 | 5.8 | 5.1 | 4.8 | 4.5 | 4.4 | 4.5 |
| Coverage rate (Impairments / NPLs)* | 47.9 | 37.7 | 32.9 | 37.8 | 41.7 | 46.8 | 51.3 | 52.3 | 52.9 | 54.1 | 55.0 | 57.1 | 57.1 | 54.7 |
| Cost-to-income ratio | 55.6 | 53.4 | 40.4 | 44.1 | 52.5 | 53.6 | 62.5 | 70.3 | 62.0 | 64.9 | 72.3 | 67.1 | n.a. | n.a. |
| Net interest margin | 2.3 | 2.4 | 2.9 | 2.8 | 2.6 | 2.3 | 1.8 | 2.0 | 1.9 | 1.9 | 1.9 | 2.4 | n.a. | n.a. |
| Common Equity Tier 1 ratio | .. | .. | 14.2 | 15.6 | 15.9 | 14.9 | 15.1 | 15.7 | 16.3 | 16.6 | 17.0 | 16.8 | n.a. | n.a. |
| Return on assets (annualised) | -3.4 | -4.3 | -0.6 | -0.6 | -0.3 | -1.1 | 0.2 | 0.7 | 0.8 | 0.6 | 0.4 | -0.2 | n.a. | n.a. |

*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. From 2015, the EU NPL definition was used (see Commission Implementing Regulation (EU) 2015/227, later amended by Commission Implementing Regulation (EU) 2015/1278). Figures exclude exposures to central banks and credit institutions.

Source: Central Bank of Cyprus

ANNEX 2

Covid-19 - Financial measures

Box A2.1: Covid-19 financial measures

The Cypriot authorities have introduced a number of measures to mitigate the impact of the Covid-19 outbreak on the financial system:

- On 18 March 2020, major banks and credit-acquiring companies announced that they would be suspending foreclosure actions for 3 months. The suspension was subsequently extended to the end of August.
- The Central Bank of Cyprus (CBC) relaxed underwriting standards for new short-term loans to affected viable businesses, including the use of overdrafts and bullet payments to cover current needs (e.g. payroll, rent and debt payments).
- On 30 March, the government introduced a 9-month legislative (i.e. mandatory) moratorium on all principal and interest payments on performing loans. The payment breaks are available to borrowers who were less than 30 days in arrears as of 29 February 2020.
- On 27 May, the government announced a EUR 180 million interest-rate subsidy scheme for companies of all sizes ⁽¹⁾. Firms can apply until end-2020 and the subsidies are available for up to 4 years. The overall subsidy per recipient cannot exceed EUR 800 000, while the qualifying loan principal is capped according to annual earnings and/or turnover. The margin that a bank can charge cannot exceed 4%.
- On the same day, the government announced a EUR 100 million subsidy scheme providing small businesses and self-employed individuals with one-off grants of EUR 1 250-6 000, depending on the scale of their operation. The scheme is available to businesses that did not lay off workers during the lockdown ⁽²⁾.
- The May support package also contained an interest subsidy of up to 1.5% for up to 4 years on new housing loans not exceeding EUR 300 000. The loans cannot be used to repay existing borrowing on housing. The total estimated support of the scheme is around EUR 45 million.

⁽¹⁾ A EUR 2 billion credit guarantee scheme providing affected companies guarantees was originally proposed in March, but failed to achieve majority support in Parliament.

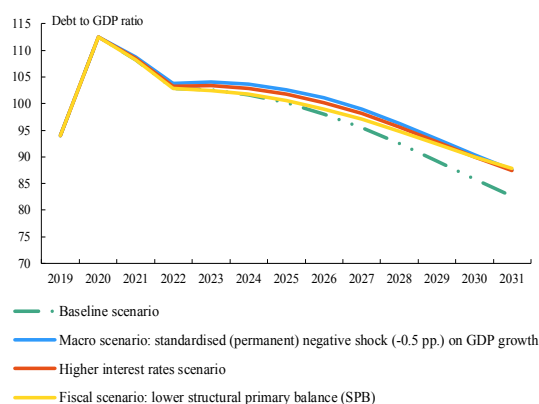
⁽²⁾ Under the Commission's State aid Temporary Framework, the two subsidy schemes for non-financial corporations are available to all affected business that were not experiencing difficulties (as defined in Council Regulation (EC) No 651/2014) at end-2019.

ANNEX 3

European Commission Debt Sustainability Analysis

The Commission's autumn 2020 forecast and the debt sustainability analysis (DSA) ⁽²⁴⁾ show that the government debt-to-GDP ratio is expected to increase significantly in 2020, but to resume to a declining path afterwards over the 10-year projection period. While in 2019 Cyprus reduced its public debt ratio to 94% of GDP, the government debt ratio is projected to reach 113% by end-2020 on the back of the pandemic and measures to protect the economy. The increase is explained by an unfavourable snowball effect driven by a drop in nominal GDP, additional borrowing to build a significant cash buffer, and the large primary deficit. For 2021 and 2022, the debt-to-GDP ratio is forecast to fall to 108% and further to 103%, respectively. This is mainly underpinned by output growth, use of cash reserves and an improved fiscal performance. Afterwards, under the baseline, the government debt ratio is projected to gradually decline to less than 85% of GDP by end of 2031 (see Graph A.3).

Graph A3.1: DSA scenarios



Source: European Commission

The DSA indicates that Cyprus faces risks to fiscal sustainability over the medium term. This outcome is driven by results from the baseline scenario in combination with alternative stress test scenarios. The baseline scenario generally assumes a progressive unwinding of the extraordinary negative impact of the Covid-19 crisis on public

finances ⁽²⁵⁾. Under this scenario, the debt-to-GDP ratio peaks in 2020 and then follows a downward path. Nevertheless, by the end of the projection period government debt remains well above the Treaty's reference value of 60% of GDP, thus pointing to risks.

The analysis shows that the debt path is vulnerable to macroeconomic and fiscal shocks, as confirmed by the Covid-19 crisis and as shown in the adverse scenarios. According to the baseline and in the alternative adverse scenarios, the Cypriot debt-to-GDP ratio is set to follow a downward trajectory in the coming years (see Graph A3.1). Nevertheless, because of the pandemic shock and its repercussions, Cypriot debt dynamics deteriorated as compared to the autumn 2019 DSA – in which the debt ratio was expected to drop below 60% by the end of 2030. This confirms the sensitivity of the government debt-to-GDP ratio to macroeconomic and fiscal developments, including to nominal growth-interest rate differentials.

The DSA alternative scenarios show that the pace of reduction of government debt could be slower than in the baseline, depending on the shock. The lower growth scenario is a standard macroeconomic shock that assumes a lower real GDP growth (by 0.5 percentage point (pp.)) compared to the baseline over the entire projection period. In this scenario, the debt reduction decelerates compared to the baseline scenario, with government debt standing at a higher level, above 85% of GDP at the end of the projection period. Under the higher interest rate scenario, which simulates a permanent deterioration of sovereign financing conditions (with market interest rates increased by 1 pp. compared with the baseline), the debt trajectory would be similar to the one in the growth stress test. The fiscal scenario ('lower structural primary balance (SPB) shock' scenario), which assumes a weaker fiscal improvement ⁽²⁶⁾

⁽²⁴⁾ The debt sustainability analysis uses the Commission's autumn 2020 forecast (2020-2022) as a starting point to ensure consistency across EU Member States. Furthermore, for more information on the Commission's fiscal sustainability assessment framework, see European Commission (2020), Debt Sustainability Monitor 2019, European Economy Institutional Paper, No. 120.

⁽²⁵⁾ In particular, the structural primary balance is set to progressively adjust over the projection period, converging back to a level close to its pre-crisis forecasted value (i.e. the level forecasted by the Commission services in the autumn forecast 2019 for the year 2021). Other assumptions are set in line with the Commission standard DSA methodology (see Debt Sustainability Monitor 2019).

⁽²⁶⁾ This could be the case if some exceptional measures adopted during the crisis had more permanent impact than assumed in the baseline. In particular, under this stress test,

results in a slower debt reduction, with a debt ratio also above 85% of GDP by 2031.

While the DSA points to risks in the medium term, Cyprus's government debt-to-GDP ratio is expected to be sustainable. Risks to the projected debt path are tilted to the downside given the uncertain impact of Covid-19 on revenue collection, the potential costs of additional policy measures, financial sector vulnerabilities and contingent liabilities linked to the health sector reform. In view of these risks and the high level of debt, continuing with prudent fiscal policies and implementing growth-enhancing structural reforms will help to ensure that debt remains sustainable over the medium term.

the SPB convergence value is reduced by half compared with the baseline.

ANNEX 4

European Commission macroeconomic and fiscal projections (2020 Autumn Forecast)

Table A4.1: **Selected economic indicators**

| | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---------------------------------------|--|------|------|------|-------|-------|-------|
| <i>Real economy</i> | | | | | | | |
| | <i>(percent change)</i> | | | | | | |
| Real GDP | 6.4 | 5.2 | 5.2 | 3.1 | -6.2 | 3.7 | 3.0 |
| Domestic demand incl. inventories | 8.4 | 7.2 | 2.7 | 4.9 | -1.8 | 3.8 | 2.5 |
| Private consumption expenditure | 5.1 | 4.9 | 4.7 | 1.8 | -4.1 | 2.8 | 2.2 |
| Government consumption expenditure | -0.9 | 2.1 | 3.5 | 14.2 | 17.8 | 7.9 | 2.8 |
| Gross fixed capital formation | 49.5 | 21.3 | -5.2 | 2.0 | -11.1 | 2.6 | 3.0 |
| Exports of goods and services | 7.2 | 9.9 | 8.0 | -0.4 | -17.7 | 7.2 | 8.1 |
| Imports of goods and services | 10.0 | 12.9 | 4.5 | 2.0 | -11.5 | 7.0 | 7.0 |
| <i>Contribution to growth</i> | | | | | | | |
| | <i>(percentage points)</i> | | | | | | |
| Domestic demand (excl. inventories) | 9.7 | 7.4 | 2.5 | 3.6 | -1.9 | 3.9 | 2.6 |
| Foreign trade | -1.7 | -1.9 | 2.6 | -1.7 | -4.3 | -0.2 | 0.3 |
| Changes in inventories | -1.5 | -0.3 | 0.2 | 1.2 | 0.0 | 0.0 | 0.0 |
| <i>Inflation</i> | | | | | | | |
| | <i>(percent change)</i> | | | | | | |
| GDP deflator | -0.6 | 1.1 | 1.2 | 0.9 | 0.8 | 1.3 | 1.2 |
| HICP | -1.2 | 0.7 | 0.8 | 0.5 | -0.9 | 0.9 | 1.3 |
| <i>Labour market</i> | | | | | | | |
| | <i>(percent change, unless otherwise stated)</i> | | | | | | |
| Unemployment rate (% of labour force) | 13.0 | 11.1 | 8.4 | 7.1 | 8.2 | 7.8 | 7.2 |
| Employment | 4.7 | 5.4 | 5.3 | 3.1 | -2.6 | 1.1 | 1.5 |
| Compensation per employee | -0.9 | 1.7 | 1.3 | 1.8 | -2.5 | 1.7 | 1.8 |
| Labour productivity | 1.7 | -0.2 | -0.1 | -0.1 | -3.7 | 2.6 | 1.4 |
| Unit labour costs | -2.9 | -2.6 | 1.9 | 1.4 | 1.9 | 1.3 | -0.9 |
| <i>Public finance</i> | | | | | | | |
| | <i>(percent of GDP)</i> | | | | | | |
| General government balance | 0.3 | 1.9 | -3.5 | 1.5 | -6.1 | -2.3 | -2.3 |
| Total revenue | 37.7 | 38.7 | 39.5 | 41.5 | 41.3 | 42.7 | 41.9 |
| Total expenditure | 37.5 | 36.8 | 43.0 | 40.1 | 47.4 | 45.0 | 44.2 |
| General government primary balance | 2.9 | 4.4 | -1.1 | 3.8 | -3.7 | -0.2 | -0.4 |
| Gross debt | 103.1 | 93.5 | 99.2 | 94.0 | 112.6 | 108.2 | 102.8 |
| <i>Balance of payments</i> | | | | | | | |
| | <i>(percent of GDP)</i> | | | | | | |
| Current external balance | -4.2 | -5.3 | -3.9 | -6.3 | -10.4 | -10.1 | -9.9 |
| Ext. bal. of goods and services | 1.7 | -0.4 | 1.5 | -1.1 | -4.7 | -4.5 | -4.3 |
| Exports goods and services | 70.5 | 73.5 | 75.2 | 71.9 | 60.3 | 61.3 | 64.6 |
| Imports goods and services | 68.8 | 73.9 | 73.7 | 72.9 | 65.0 | 65.8 | 68.8 |
| <i>Memorandum item</i> | | | | | | | |
| | <i>(EUR bn)</i> | | | | | | |
| Nominal GDP | 18.9 | 20.1 | 21.4 | 22.3 | 21.1 | 22.1 | 23.1 |

Source: European Commission

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