**CENTRAL BANK OF CYPRUS - PRESS RELEASE**

**RESULTS OF THE INDEPENDENT DUE DILIGENCE EXERCISE**

The Central Bank of Cyprus has identified the capital needs of the banking sector through an independent due diligence exercise, the results of which are published today.

Following the application of Cyprus for a financial assistance program to be negotiated with the International Monetary Fund, the European Commission and the European Central Bank, the authorities had agreed in a draft Memorandum of Understanding ("MoU") to proceed with an independent due diligence exercise of the Cypriot banking system, including an asset quality review and a bottom-up stress test to determine the capital needs of the Cypriot banking system (the due diligence).

Pacific Investment Management Company, LLC ("PIMCO") was engaged in October 2012 to perform the due diligence and was overseen and subject to guidance by a Steering Committee made up of representatives from the Cypriot authorities, including the Central Bank of Cyprus, the Ministry of Finance and the Authority for the Supervision of Co-Operative Credit Institutions, and the international organisations involved in the financial assistance program for Cyprus, namely the European Commission, the European Central Bank, the IMF which participated as an observer, the European Stability Mechanism and the European Banking Authority.

The due diligence which was completed in January 2013 covered 22 institutions representing approximately 73% of the Cypriot banking system's assets:

- Domestic institutions: Bank of Cyprus, Cyprus Popular Bank and Hellenic Bank
- Cypriot subsidiaries of Foreign Institutions: Eurobank EFG Cyprus and Alpha Bank Cyprus
- Co-operative Credit Institutions: Co-operative Central Bank, Limassol Co-operative Savings Bank and a representative sample of 15 co-operative credit institutions affiliated to the Co-operative Central Bank.

The results of the due diligence indicate total additional capital needs of approximately €8,9 billion for the Cypriot banking system across all participating institutions as of the 30 June 2012 valuation date. These capital needs are the result of a comprehensive analysis of the value of credit portfolios and foreclosed assets, and of the earnings capacity of the banks to absorb losses over the next three years under an *adverse* scenario. The table below provides a summary of the results of the exercise.

| **Base Scenario**<br>**€ millions** | **Aggregate** | **Domestic Banks** | **Foreign Banks** | **Co-ops** |
|---|---|---|---|---|
| Total assets (30 June 2012) | 100,050 | 77,006 | 10,364 | 12,679 |
| Total Gross Loans (30 June 2012) | 74,235 | 60,015 | 6,600 | 7,619 |
| New Loans (originated after 30 June 2012) | 8,110 | 5,083 | 2,240 | 787 |
| Risk Weighted Assets (30 June 2012) | 64,743 | 52,967 | 5,353 | 6,422 |
| **Core Tier 1 Capital** | **6.7%** | **4.9%** | **18.1%** | **11.5%** |
| Expected Loss | | | | |

| | | | | |
|---|---|---|---|---|
| **Expected loss on loans and advances** | **(13,999)** | **(12,079)** | **(917)** | **(1,002)** |
| % of gross loan portfolio | 17.0% | 17.6% | 10.4% | 11.9% |
| Loss Absorption Capacity | | | | |
| Core Tier 1 capital (30 June 2012) | 4,312 | 2,600 | 970 | 742 |
| Forecast pre-provision profitability | 3,163 | 2,696 | 299 | 168 |
| Existing cumulative provisions | 6,266 | 5,535 | 455 | 277 |
| Changes in DTAs attributable to capital | (127) | (145) | 8 | 10 |
| Other adjustments to capital | (214) | (202) | (1) | (11) |
| **Total Loss Absorption Capacity** | **13,400** | **10,484** | **1,730** | **1,186** |
| Required Capital | | | | |
| Risk weighted assets (30 June 2015) | 54,868 | 44,431 | 4,355 | 6,081 |
| Required Core Tier 1 at 9% | 4,938 | 3,999 | 392 | 547 |
| Forecast Core Tier 1 (30 June 2015) | (599) | (1,595) | 813 | 183 |
| **Capital (shortfall) @ 9%** | **(5,980)** | **(5,616)** | **-** | **(364)** |

| **Adverse Scenario**<br>**€ millions** | **Aggregate** | **Domestic Banks** | **Foreign Banks** | **Co-ops** |
|---|---|---|---|---|
| Total Assets (30 June 2012) | 100,050 | 77,006 | 10,364 | 12,679 |
| Total Gross Loans (30 June 2012) | 74,235 | 60,015 | 6,600 | 7,619 |
| New Loans (originated after 30 June 2012) | 5,103 | 2,992 | 1,506 | 605 |
| Risk Weighted Assets (30 June 2012) | 64,743 | 52,967 | 5,353 | 6,422 |
| **Core Tier 1 Capital** | **6.7%** | **4.9%** | **18.1%** | **11.5%** |
| Expected Losses | | | | |
| **Expected loss on loans and advances** | **(18,245)** | **(15,603)** | **(1,244)** | **(1,398)** |
| % of gross loan portfolio | 23.0% | 24.8% | 15,3% | 17.0% |
| Securities market value shock | (297) | (289) | (7) | - |
| **Total Expected Loss** | **(18,542)** | **(15,893)** | **(1,251)** | **(1,398)** |
| Loss Absorption Capacity | | | | |
| Core Tier 1 capital (30 June 2012) | 4,312 | 2,600 | 970 | 742 |
| Forecast pre-provision profitability | 2,529 | 2,157 | 249 | 123 |
| Cumulative provisions (30 June 2012) | 6,266 | 5,535 | 455 | 277 |
| Changes in DTAs attributable to capital | 107 | 67 | 18 | 21 |
| Other adjustments to capital | (208) | (203) | (0) | (4) |
| **Total Loss Absorption capacity** | **13,007** | **10,156** | **1,692** | **1,159** |

| Required Capital | | | | |
|---|---|---|---|---|
| Risk weighted assets (30 June 2015) | 49,785 | 39,858 | 4,092 | 5,836 |
| Required Core Tier 1 at 6% | 2,987 | 2,391 | 246 | 350 |
| Forecast Core Tier 1 (30 June 2015) | (5,535) | (5,737) | 441 | (239) |
| **Capital (shortfall) @ 6%** | **(8,867)** | **(8,128** | **(149)** | **(589)** |

The following table outlines the macro-economic scenarios for Cyprus used in the due diligence exercise which were approved by the Steering Committee:

| | **Base Scenario** | | | | | | **Adverse Scenario** | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Cyprus** | **2011** | **2012** | **2013** | **2014** | **2015** | **Cum Chg 2012-15** | **2011** | **2012** | **2013** | **2014** | **2015** | **Cum Chg 2012-15** |
| GDP at constant prices | 0.5% | -2.1% | -3.0% | -0.6% | 0.8% | -2.8% | 0.5% | -2.1% | -5.2% | -2.3% | 0.0% | -7.3% |
| Unemployment (%, LFS) | 7.9% | 12.0% | 13.2% | 13.5% | 13.0% | 1.0% | 7.9% | 12.0% | 13.8% | 14.6% | 14.5% | 2.5% |
| 3m Euribor (%) | 1.4% | 0.5% | 0.8% | 1.0% | 1.2% | 70bp | 1.4% | 0.5% | 2.0% | 2.3% | 2.5% | 195bp |
| HICP inflation (%) | 3.5% | 3.1% | 2.0% | 2.1% | 1.5% | -1.6% | 3.5% | 3.1% | 1.2% | 1.3% | 1.1% | -2.0% |
| Core inflation (%) | 1.1% | 1.4% | 1.8% | 1.5% | 1.5% | 0.1% | 1.1% | 1.4% | 1.3% | 0.6% | 1.1% | -0.3% |
| House Price Change (%) | -4.1% | -5.2% | -7.0% | -5.0% | -0.5% | -12.1% | -4.1% | -5.2% | -14.0% | -10.0% | -1.5% | -23.8% |

The due diligence exercise has established the amount of capital that each bank would require to reach a minimum Core Tier 1 ratio of 9% in the base case scenario and 6% in the adverse case scenario. As with any stress test, the adverse case scenario was designed to cover “what-if” situations reflecting even more stressed macro-economic conditions than might reasonably be expected to prevail. Even though macroeconomic projections have since deteriorated, the use of conservative assumptions by PIMCO, described in the following paragraph, provides a buffer for worse than expected macroeconomic environment. Moreover, under the program agreed between the Republic of Cyprus and its international lenders, restructuring measures have been undertaken and funds have been allocated from the financial assistance program to ensure that the banking system will be and remain adequately capitalized.

The methodology and assumptions used by PIMCO to arrive at the results are described in PIMCO’s report which is attached. With a view to fully identify losses for the banks and minimize the risk of further capital shortfalls going forward, a set of conservative assumptions were used. For example, in contrast to comparable stress test exercises where expected loan losses were calculated on an undiscounted basis, the calculation of expected loan losses under this exercise is equivalent to a provisioning calculation under IFRS with projected recoveries discounted at the original effective rate of the loan, except that provisions are not partially released over the forecast period as the assumed

time of recovery is being approached. Also very conservative assumptions were used for estimating the recovery amounts on defaulted borrowers. These include the application of a forced sale discount of 25% on the projected declining market value of property collateral and the assumption that recovery amounts from defaulted borrowers are limited to the liquidation of tangible collateral held by the lending institution.

The MoU agreed with the Troika specifies that the estimation of capital needs published today is an essential element of the plans laid down for the recapitalization and restructuring of the Cypriot banking system. To this end a part of the €10 billion total financial assistance that will be granted to Cyprus will be deposited in a dedicated account with the Central Bank of Cyprus to be used for recapitalising co-operative credit institutions and commercial banks other than Bank of Cyprus and Cyprus Popular Bank. For these two banks, a different route was decided in the 25th of March Eurogroup meeting which is described in more detail in the Central Bank of Cyprus announcement on 30th March 2013 (http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12631&lang=en).

The provision of capital from the financial assistance program will be in line with EU state-aid rules and will be disbursed in consultation with the Troika. The steps that must be taken next are outlined below:

- Co-operative credit institutions will be allowed until 31 July 2013 to cover their capital shortfalls whereas other commercial banks will be allowed until the end of September 2013 to cover their capital shortfalls.
- Any institution that fails to raise the required capital within the timeframe prescribed above and thus requires state-aid, must prepare and submit a restructuring plan within two months from the applicable deadline for raising capital from private sources.
- Credit institutions seeking state-aid will be recapitalised from the funds allocated from the program for Cyprus after their restructuring plans are approved under EU state-aid rules.