

Cyprus Financial Assistance Programme – Memoranda signed with the EU and the International Monetary Fund: Q&A regarding the financial sector

Part A: Key policy questions

Q1: What were the reasons that Cyprus needed international assistance? What caused problems in the banking sector?

The Cypriot authorities requested international financial assistance in June 2012 due to the financial crisis that primarily occurred in the over expanded domestic banking sector, which the Republic was unable to support on its own.

Serious losses were suffered in the recent past by domestic financial institutions, due to *inter alia* overexposure to Greek government bonds and strong domestic lending without adequate risk management.

The Cypriot authorities, in conjunction with its international lending partners, have begun to implement a comprehensive action plan to ensure that banks become again well-capitalised and remain viable. In addition, the regulation and supervision of the banking sector is being strengthened.

Q2: Are deposits in Cypriot banks safe? Will the bail-in of uninsured deposits be used again to recapitalise banks in Cyprus?

There will be no depositor bail-in of uninsured deposits in Cyprus in any bank beyond the one already completed at Bank of Cyprus and Laiki Bank. Based on the EU framework, all deposits up to an amount of €100.000 are guaranteed by the Deposit Protection Scheme.

Q3: How have the capital needs of BoC, Laiki and the cooperative sector been assessed?

The international consultancy firm PIMCO completed a comprehensive stress test of the Cypriot banking system by February 2013. The PIMCO stress tests concluded that sizeable capital injections were required in the four main domestic financial institutions (Bank of Cyprus, Laiki Bank, Hellenic Bank and Cooperatives), because of large expected losses on their Greek and domestic operations. The stress test exercise found that the banking sector would have needed €8.9 billion of fresh capital (equivalent to 50% of Cyprus GDP) under an Adverse economic scenario.

Q4: Why was it necessary to bail in deposits in BoC and Laiki? Could the Cypriot government have stepped in to recapitalise the banks?

According to the Adverse economic scenario of the PIMCO stress test, the capital needs of the BoC and Laiki were very significant relative to the size of the Cypriot economy €7,8 billion or 45% of GDP. The recapitalisation of these banks through taxpayers' money was therefore not feasible

because it would have made Cypriot government debt unsustainable. The two banks were therefore put into resolution. The resolution measures have been designed to protect insured deposits in line with the EU framework.

Q5: Why have the Greek depositors in the Cypriot branches been protected, while the Cypriot depositors have to suffer a bail-in?

As part of the resolution measures carried out in March 2013 there was a carve-out of the Greek operations of the three main Cypriot banks (Bank of Cyprus, Laiki Bank and Hellenic Bank) which were sold to Pireaus Bank in Greece for macro-financial stability reasons. This transaction facilitated the restructuring of the Cypriot banking system, and ring-fenced both the Cypriot and Greek banking systems from possible negative feedback effects of economic and financial developments in the other country.

Q6: Why have BoC and Laiki been merged as a result of the resolution plan? Could they have continued trading as separate entities? Would a separate resolution have been preferable for Laiki or BoC stakeholders?

First, BoC was adequately capitalised through the full contribution of the shareholders and bondholders of the bank and through the partial conversion of uninsured deposits into equity.

The Cyprus Popular Bank was split into a 'good' and a 'bad' bank. Good Laiki could not achieve viability as an independent bank and was folded into Bank of Cyprus. Bank of Cyprus absorbed the 'good' bank, including insured depositors and assets, and took on the Emergency Liquidity Assistance (ELA) that had been given to Laiki by the Central Bank of Cyprus. The uninsured depositors of Laiki Bank will be compensated through the liquidation of the assets in legacy Laiki, which also include shares in Bank of Cyprus equal to 18,1% of shares in the combined group, which correspond in value to the excess of assets transferred over liabilities. The share allotment reflects the contribution of each entity to the value of the combined Bank of Cyprus Group.

Q7: Why is Bank of Cyprus capitalized to 11,8 %? Is it sufficient?

Based on the results of the KPMG fair value exercise and according to the final bail-in recapitalisation of the uninsured depositors of Bank of Cyprus, the Core Equity Tier 1 ratio of the Group currently stands at 11,8%. In addition there are uninsured deposits that are currently subject to court proceedings that may still be subject to bail-in pending the outcome of the court decisions. If these court proceedings are unsuccessful the CET1 ratio will increase further.

The recapitalisation ensures that the Bank of Cyprus complies with minimum capital requirements over the programme period, in spite of significant loan losses projected by PIMCO and by KPMG.

Q8: My deposit in BoC or in Laiki was bailed in. What will happen next?

Uninsured bailed-in depositors of Bank of Cyprus will receive Bank of Cyprus shares in return and a customer statement / allotment letter will be sent out shortly by the bank.

Uninsured bailed-in depositors of Laiki will participate in the liquidation proceeds of Laiki assets which include remaining overseas operations and the Bank of Cyprus shares received by Laiki as compensation for the transfer of certain assets and liabilities to Bank of Cyprus.

Q9: Are Hellenic and the Cooperatives recapitalized without bailing in depositors?

Hellenic Bank aims at raising private capital by the end of September 2013 in order to meet the capital requirements set under the programme. In case the private sector funds do not fully cover the required capital increase, Hellenic will enter into State aid procedures with programme money available to fill any remaining needs. There will be no need and no requirement to bail in depositors.

Recapitalisation of the credit cooperative sector will occur through state aid. State aid will come from programme money. To this end, €1,5 billion of programme money has been reserved and there will not be a bail-in of depositors.

Q10: Under which conditions will state aid be injected in the banks? Would there be consequences for banks' shareholders and depositors?

In case Hellenic Bank is not successful in raising the required capital through private sources, the bank will have to apply for state aid. In this instance existing bondholders will be written down or converted into shares, which should be sufficient to cover the capital shortfall. If converted rather than written down, bondholders will receive Hellenic Bank shares in return. As a consequence, existing shareholders will be diluted.

With regards to the Cooperative sector, existing members of cooperative credit institutions and existing shareholders of the Cooperative Central Bank will be heavily diluted and the Republic will become the majority shareholder with a shareholding of approximately 99%.

Q11: What are the reasons behind the problems faced by the co-operative credit sector?

The main reasons why the cooperative credit sector is facing problems are (i) poor asset quality and lax arrears management (approx. 40% of all loans are non-performing, i.e. debt service payment are overdue for more than 90 days), (ii) ineffective governance structure (the Cooperative Central Bank which issues instructions and directives to cooperative credit institutions did not have the powers to enforce the compliance of those and (iii) relative high number of non-viable, sub-scale and undercapitalised cooperative credit institutions.

These problems will be addressed in the restructuring plan to be submitted by the end of September.

Q12: How would the co-operative credit sector be restructured?

The cooperative credit sector consists currently of the Cooperative Central Bank (CCB) and 93 cooperative credit institutions (CCIs). In order to restore viability and profitability to the sector, several CCIs will be merged and the current number of CCIs will be reduced to a maximum of 18 CCIs.

The cooperative credit sector will be recapitalised with €1,5bn state aid. The government will inject the capital into the Cooperative Central Bank (CCB) and will become the majority shareholder with a 99% stake. The government will ensure proper governance of the sector in order to protect its sizeable investment.

Furthermore, the supervision of the CCB and CCIs will, before mid-September 2013, be integrated into the Central Bank of Cyprus to ensure that common rules, regulations and supervision are applied throughout all credit institutions.

Q13: I am a customer of a cooperative institution. How would I be affected by the planned restructuring of the cooperatives?

In order to preserve viability and profitability in the sector, several CCIs will be merged and the current number of CCIs reduced to a maximum of 18. This will also include the closure of a significant number of branches. A customer of a cooperative credit institution will only be affected in case his or her local branch will be closed down during the restructuring process. In this case, the next closest branch will perform all the necessary transactions for this particular customer.

The restructured cooperative sector will be well capitalised after the state aid injection of €1,5bn and solvent to perform the required service for customers.

Q14: I am a customer of Hellenic Bank. How would I be affected by the planned recapitalisation of the bank?

Hellenic Bank aims at raising private capital by the end of September 2013 in order to meet the capital requirements set under the programme. In case the private sector funds do not cover in full the required capital increase, Hellenic will enter into State aid procedures with programme money available to fill any remaining needs. However, no bail in of depositors will be requested or required. The business operations of Hellenic Bank will not be affected and customers should expect services to be provided as usual.

Q15: Why was there a need to introduce restrictive measures?

The imposition of restrictive measures on transactions was a necessity, given that the banking system underwent a deposit bail-in and a severe blow to depositor confidence.

Although the restrictive measures initially hampered economic activity, they have been notably relaxed since they were initially imposed. Efforts continue to limit their duration and scope to the minimum extent necessary. A further gradual relaxation of the restrictive measures until they are

lifted remains a top priority for the authorities. The authorities have therefore designed a roadmap to relax the measures.

Q16: What measures are still in place?

Current restrictive measures mainly apply to the cashing of cheques, cross border transfers, domestic transfers above a certain amount, the withdrawal or export of cash and the opening of accounts. Other transactions are possible without any restrictions, (e.g. payment card transactions or incoming payments from abroad).

Q17: How long are the restrictive measures going to stay in place?

The aim is to remove restrictive measures as soon as possible. The timing needs to be chosen so as to minimise the repercussions on the financial stability and the liquidity position of the Cypriot banking sector.

The authorities have developed a strategy for the gradual relaxation of restrictive measures through a sequence of steps, triggered by the achievement of key milestones in the programme. This roadmap has been communicated by the authorities and can be found in the CBC website under the heading “Cyprus Financial Assistance Program – Financial Sector”.

Q18: Why did the Central Bank introduce rules which have as an effect that my new deposit bears a lower interest rate?

It is normal practice that when banks have been recapitalised and restructured there is typically a lowering of deposit rates in the overall banking system (e.g. Ireland, Portugal), as the banks continue to repair their balance sheets and improve their viability. However lower deposit interest rates will subsequently also lead to lower loan interest rates.

Part B: Technical questions

Q19: What is the European framework regarding the protection of bank deposits?

A 1994 EU Directive ensures that all EU Member States have Deposit Guarantee Schemes in place. Since the end of 2010, Deposit Guarantee Schemes cover amounts up to €100.000.

Deposits are covered per depositor per bank. This means that the limit of €100.000 applies to all aggregated accounts of one account holder at the same bank. So this will include his or her current account, savings account and other accounts he or she might have in any one bank.

Deposit Guarantee Schemes will protect all deposits held by individuals and small, medium-sized and large businesses. However, deposits of financial institutions and public authorities will not be

covered. The former do not need protection since they are professional market actors and the latter would have easy access to other sources of financing.

Deposits in non-EU currencies will also be covered, which is important for small and medium-sized businesses acting globally. Some more complex products similar to bonds will not be covered. Structured products whose principal is not repayable in full will not be protected (e.g. products whose value is dependent on a share price index).

Q20: Why has it been decided to raise the capital ratio of Cypriot banks to 9%? Is this ratio comparable to other European countries?

Given the deteriorating economic conditions in Cyprus, the minimum capital ratio was decided to be set at 9% in order for the Cypriot banks to be sufficiently capitalised and absorb any future unexpected losses. This ratio is similar to other programme countries, such as Greece and Spain.

Q21: The assets of BoC and Laiki were assessed by KPMG on a fair value basis. Does that mean that the merged BoC is well capitalised? Would it make profits in the near future?

The capital ratio of the new merged BoC was determined taking into consideration the KPMG independent fair valuation exercise. The Bank of Cyprus (BoC) has been fully recapitalised by the overall conversion of 47,5% of uninsured deposits into shares in the bank, thus putting an end to a period of uncertainty. This is the final stage of the bank's resolution process and there will be no further measures under the *Resolution Law*. The recapitalisation ensures that the BoC well exceeds its minimum capital adequacy ratio. Based on the latest financial information, BoC's Common Equity Tier 1 ratio is estimated to stand at 11,8%.

According to MOU requirements, the bank is currently preparing the combined group restructuring plan which will be submitted by the end of September and which will set the bank's future plans.

Q22: Was the transfer of Laiki assets and liabilities positive for BoC? Would it contribute to the viability of BoC?

The transfer of Laiki's assets and liabilities to BoC brings value to the combined BoC, reflected in the 18,1% stake taken by the Old Laiki in BoC.

Significant synergies are expected to be materialised from the integration of Laiki into BoC which will contribute to the Group's future profits and viability.

Q23: Are other disposals of foreign assets planned by BoC and Laiki, beyond the carve-out of their Greek operations?

According to MOU requirements, Bank of Cyprus is currently preparing the combined group restructuring plan which will be submitted by the end of September. Any potential disposals of

foreign assets will be examined as part of the new group restructuring process. **Laiki Bank, which is still under resolution, aims at selling all its overseas operations.**

Q24: Will the Central Bank of Cyprus adjust its supervisory methodology and internal organisation? What are the supervisory measures/powers foreseen to prevent future imbalances in the Cypriot financial system?

Regulation and supervision will be strengthened to ensure a more credible, robust and resilient financial sector. The main steps undertaken in this area are:

Cooperative credit institutions, which up to now were not subject to the supervision by the CBC, will, before mid-September 2013 be supervised by the CBC to ensure that common rules, regulations and supervision are applied throughout all credit institutions.

To better assess the credit worthiness of borrowers and therefore to enable better pricing of loans in accordance with the entire indebtedness of borrowers, the authorities will set-up a central credit register by the end of September 2014.

To strengthen the credit institutions' ability to withstand shocks, the CBC will review the current regulatory framework with respect to the entire loan process, including approval and provisioning to identify any gaps and address them accordingly.

Given the criticism about the governance structures that existed until very recently, the CBC will introduce tighter rules on the composition of the boards of credit institutions and on lending to board members, to ensure a more transparent and effective corporate governance.

The authorities will introduce a framework to be adopted by credit institutions when dealing with troubled borrowers.

The authorities will introduce structured mandatory intervention based on capitalisation levels which will lead to taking prompt corrective action as banks' capital position deteriorates.

Q25: Which benefits are expected from the new definition of non-performing assets and the new framework for loans approval and provisioning?

These measures are a significant step towards a better assessment of bank loans value by banks' stakeholders and supervisors. They will ensure the proper identification of credit risk beginning from the approval of loans and expanding to the whole lifetime of loans. In addition, the disclosure of non-performing loans in banks' financial statements will assist readers in making decisions with respect to the Cypriot banks, and help restoring confidence in the Cypriot banking system. Similar measures have also been introduced in other programme countries (i.e. Ireland).

Q26: Why is the decision of the Governing Council of the ECB on the counterparty status of Bank of Cyprus important?

The ECB Governing Council has approved the application of the Central Bank of Cyprus for restoring Bank of Cyprus's counterparty status on Wednesday 31 July. This provides the Bank of Cyprus with access to cheaper ECB normal monetary operations, which will immediately enhance the bank's liquidity situation.

Q27: What is the reasoning behind downsizing the Cypriot financial sector as a percentage of GDP?

An oversized banking sector represents a contingent liability of the state, which cannot be really supported since it will create an unsustainable fiscal situation. The key measure for a size of a country's banking sector is total banking assets to GDP. The EU average is around 4 times GDP and Cyprus was around 8 times GDP, similar to Ireland before it received a bail-out. Another feature was the size of the two main banks (Bank of Cyprus and Laiki Bank) in comparison to the economy in that they were each 2 times the country's GDP. The main purpose of the restructuring operations in March was to reduce the size of the banking sector. This was one of the considerations underpinning the sale of the Greek operations to Pireaus Bank.