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FOCUS NOTES: CYPRUS

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Cyprus requests external financial assistance from the EU and the IMF

- **Fitch downgrades Cyprus's sovereign credit ratings by one notch to "BB+"**
- **Financial sector under pressure to meet a regulatory capital deadline**
- **Cypriot government bonds are no longer eligible as collateral in ECB refinancing operations**
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Fitch downgrades Cyprus's sovereign credit ratings by one notch

Rating agency Fitch downgraded on Monday Cyprus's long-term foreign and local currency sovereign credit ratings by one notch to "BB+", with negative outlook. The country's short-term ratings were also cut by one notch to "B". For its decision, Fitch cited the significant exposure of the country's banking sector to Greece and the ensuing recapitalization costs that are likely to add further strain on public finances.

The agency estimates that Cypriot banks will likely need a capital injection of €4bn (~23%-of-GDP). This would come on top of required financial support of €1.8bn for Cyprus Popular Bank that needs to be provided by June 30 so as to meet an EBA-set regulatory deadline. Fitch views the probability of generating the necessary capital from private sources as "limited". This suggests that the government will have to step in and provide the funds in order to cushion ensuing risks to the banking system. Under this scenario, Fitch anticipates a spike in general government debt above 100%-of-GDP vs. an earlier forecast of 88% and 71.6% in 2011. It also expects this year's fiscal deficit target of 2.5%-of-GDP to be likely missed by 1.4ppts.

Fitch's move marks the second sovereign credit rating downgrade for Cyprus this month (Table 1). On June 13, Moody's cut Cyprus's government bond ratings by two notches to "Ba3" on similar grounds and placed the ratings under review for further possible downgrade.

Presently, all three major agencies rate Cyprus's sovereign credit ratings as non-investment grade.

Table 1: L-T Foreign Currency Ratings

	Current Rating	Date of last rating action	Action	Outlook
Fitch	BB+	25/6/2012	1-notch down	Negative
S&P	BB+	13/1/2012	2-notches down	Negative
Moody's	Ba3	13/6/2012	2-notches down	Negative

Source: Bloomberg, Eurobank Research

Cyprus requests external financial assistance from the EU and the IMF

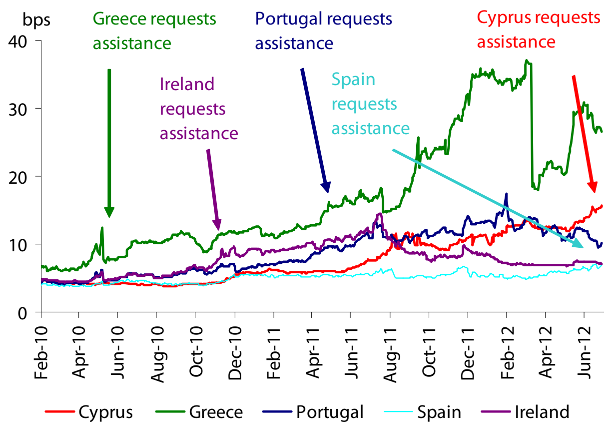
In a move to ensure coverage of its financing needs for this year, the government secured last October a €2.5bn loan from Russia. The loan encompasses a favorable interest rate of 4.5%, well below the current market rates, with a repayment period of 4.5 years. The deal came into effect last January and the funds were received in three tranches in Q1-2012. However, the loan did not account for a potential bailout of domestic banks, whose total assets are estimated to amount to several times the country's gross domestic output (~835% -of-GDP, according to earlier IMF calculations, Nov. 2011).

A few hours after Fitch's announcement on Monday, Cyprus announced its decision to request financial assistance from the EFSF/ESM in order to mitigate risks to the domestic economy, stemming primarily from the financial sector as a result of loans to Greek customers and significant losses incurred by domestic banks due to the Greek debt exchange (PSI). Against this backdrop, Cyprus becomes the fifth country in the Eurozone seeking an EU bailout. The news ended months of speculation about the country resorting to external financial aid.

Financial sector under pressure to meet a regulatory capital deadline

Cyprus has lost access to international financial markets over the last year or so, as government bond yields spiked to record highs amid growing concerns about the state of the domestic banking sector and ensuing worries over the country's fiscal outlook (Graph 1). The largest three Cypriot banks incurred record losses last year, as a result of their exposure to Greek risk and the deterioration in households' as well as in corporate balance sheets due to the domestic economic downturn in H2-2011.

Graph 1: 10-year government bond yields



Source: Reuters, Bloomberg, Eurobank Research

In order to align their capital position with the European Banking Authority (EBA) rules, the two largest domestic banks, Bank of Cyprus and Cyprus Popular Bank, need to meet a 9% core Tier 1 capital ratio by June 30, 2012. To achieve this goal, the EBA estimated last September that Cyprus Popular Bank must lure €1.97bn of capital. However, the bank has fallen short of raising the necessary funds and is currently in need of a capital injection of €1.8bn, an amount equivalent to ca 10% of the country's GDP. In the event that the government has to bailout the bank, this would severely strain public finances.

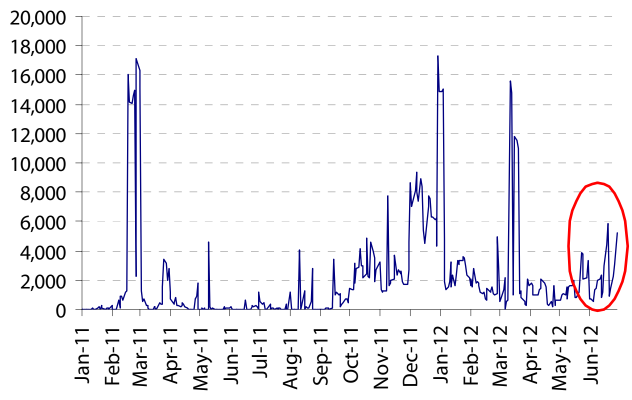
Separately, the country's largest lender Bank of Cyprus (BoC), while outlining its capital enhancement plans in March, noted that it was planning to raise €400mn through a rights issue and €600mn via the voluntary exchange of convertible securities. However, BoC fell short of meeting these targets, raising approximately €160mn in the former operation and €434mn in the latter. This left a €0.4bn hole in its recapitalization requirement. Based on expected profitability until June 30, the BoC has estimated its ensuing funding needs to be half the latter amount. Until recently, it anticipated to generate the remaining required amount of €0.2mn through effective management of risk-weighted assets and the completion of the sale of Bank of Cyprus Australia Ltd. However, in the wake of the government's bailout request announcement, BoC said it would apply to the State for a temporary capital injection of 0.5bn in order to meet the EBA capital requirements. The bank said that it anticipates the support to be in the form of non-equity capital. Including the latter, the amount of financial aid domestic banks will likely require amounts to €2.3bn.

Cypriot government bonds are no longer eligible as collateral in ECB's refinancing operations.

Further exacerbating tensions in the domestic financial sector, the ECB announced on Tuesday that Cypriot government bonds are no longer eligible as collateral in its refinancing operations. The ECB's minimum eligibility criterion is for at least one of the ratings agencies to value government bonds as investment grade. Following Fitch's move earlier this week, all three major agencies now rate Cyprus as "junk".

In order to enhance their liquidity, Cypriot banks may now resort to the more expensive options of overnight ECB borrowing or the domestic Emergency Liquidity Assistance (ELA) facility, provided by the Central Bank of Cyprus. In an indication that euro area banks are increasingly turning to the overnight ECB "emergency" window, the amounts of loans raised through the facility rose to over €5bn as of Thursday June 28, comparing to levels below €500mn in April (Graph 2). However, as it was common practice with other countries under EU rescue packages, the ECB collateral restriction on Cypriot government bonds will likely be waved as formal negotiations over the details of the deal are underway.

Graph 2: ECB O/N borrowing amounts (mn €)



Source: Reuters, Eurobank Research

Details of EU financial aid to be specified in coming days

At a teleconference on Wednesday, Eurozone finance ministers approved Cyprus's request for financial support and, according to an official statement, welcomed the move and the government's decision to also involve the IMF in the deal. The details of the EU bailout have not yet been determined and the full amount of funds required is anticipated to be determined over the coming weeks. Local media suggest the amount may range between € 6bn and €10bn.

It is worth noting that the government envisioned a deficit of around €0.5bn or 2.5%-of-GDP for this year. However, it recently acknowledged that the target was in jeopardy and prepared a new set of measures (estimated at around €200mn) in order to plug the hole. The government is also faced with respective government bonds redemptions of around €2.7bn and €2.2bn this and next year (Bloomberg data). Also taking into account the required bank recapitalization funds, current market estimates regarding the size of the EU-IMF bailout (€6-€10bn) appear plausible.

Finance Minister Vassos Shiarly confirmed that the funds will be utilized to cover bank recapitalization needs as well as fiscal requirements. In the official statement issued on Wednesday, the Eurogroup noted that the financial aid would be subject to a "comprehensive adjustment programme" aimed at addressing "the financial, fiscal and structural challenges" faced by Cypriot economy so as to allow it to return to a sustainable growth path. The programme will be based on measures supporting financial sector stability as well as encompassing fiscal and structural reforms.

A troika envoy is expected to arrive to Cyprus on Monday to start discussions over the exact size and the accompanying terms of the deal. Cyprus's Finance Minister highlighted on Thursday that the country's corporate tax, which is among the lowest in the European Union, would not be on the negotiations agenda.

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