Global Capital

CYPRUS IN THE CAPITAL MARKETS

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This report was researched and written by Philip Moore
Georgiades focuses on Cyprus’s core strengths

Harris Georgiades was appointed finance minister of Cyprus in April 2013, and has played a pivotal role in steering Cyprus out of its banking crisis and helping to kickstart the recovery of the economy. In this interview with GlobalCapital’s Phil Moore, Georgiades reflects on what Cyprus has achieved over the last three years, and on the challenges and opportunities that lie ahead.

GlobalCapital: Cyprus seems to have met or surpassed virtually every fiscal and growth target that was set at the start of the IMF/EU programme. How has this been achieved?

We faced an unprecedented crisis with many root causes and manifestations, almost all of which could have been avoided. So it was a very grave and regrettable situation. But the productive sectors of the Cypriot economy never lost their potential. It was these relatively strong productive sectors which spearheaded the recovery of the economy.

The government’s role, in terms of economic policy, was to create the circumstances which would enable the productive forces of the economy to function and to lead us out of the recession and back to growth.

All our policy decisions therefore converged towards the overriding objective of re-establishing the stability and confidence needed to support the recovery.

On the fiscal side, our publically-stated objective from day one was to do whatever was necessary to avoid a negative spiral of continuous tax hikes, because we believed that increasing taxes would only succeed in further eroding economic and investor confidence. Indeed, not a single tax has been raised since we embarked on the IMF/EU-led programme in the spring of 2013.

Instead, we were able to eliminate a deficit which had been hovering for years at around 5% or 6% of GDP by focusing on the spending side.

By taking quick and aggressive one-off corrective action on the spending side, we were able to maintain tax stability and to create a positive environment in the real economy, the results of which are visible today, with the economy having exited from recession sooner than we anticipated.

We expect growth this year in the range of 2.5%-3%. Unemployment is coming down fast. It peaked at 17% and was down to 11.6% in July. And the recovery is feeding into public finances through an increased revenue stream. This has not just allowed us to keep our finances stable, but has also meant that we have been able to provide significant tax breaks, which are giving a further boost to households and businesses.

GlobalCapital: But Cyprus still faces considerable vulnerabilities, doesn’t it? The banking sector, for example, is still constrained by very high NPLs.

We recognise that the productive sectors of the economy need a strongly capitalised and well regulated banking sector if they are to function effectively. So it has been all change as far as the banking sector is concerned. We have introduced stricter regulation and supervision, enhanced corporate governance, brought new foreign ownership and increased capitalisation and solvency requirements.

We now have a much smaller banking sector, which has shrunk to half its size compared to three or four years ago. But as the IMF and others have said, the banking sector has already healed itself to a very significant extent. This has also supported the recovery, because lending rates have come down and because the banks have rebuilt their liquidity positions and are now able to finance investment.

GlobalCapital: But given that NPLs are still among the highest in the world, are banks able to lend to SMEs? And is there demand for credit from the corporate sector?

Demand for borrowing is gathering momentum. But bear in mind that we were coming out of a credit boom at the time of the crisis. So it is reasonable to expect that there would have been a period of deleveraging in the aftermath of the crisis. The good news is that the deleveraging in the private sector has not further depressed the economy, so we are on a much healthier path to economic growth than we were prior to the crisis.

Significant foreign investment is also starting to come back, which is strengthening the liquidity situation in the economy.

The supply side of the equation is also improving, and the large stock of NPLs is gradually being dealt with through a number of instruments — primarily through an aggressive effort to achieve viable restructurings, but also through asset swaps and write-offs. These initiatives have not yet been reflected in the headline NPL percentage numbers for a number of reasons, not least the reporting mechanism which keeps...
INTERVIEW: HARRIS GEORGIADES, MINISTER OF FINANCE

loans in the red for a 12-month period after they have been restructured. So there is a time-lag between the corrective action on the NPL front and its registration.

**GlobalCapital:** What is the outlook for debt, which is 109% of GDP? Presumably it is essential that this is reduced if Cyprus is to continue its journey back to being investment grade?

Since 2014 we have been operating with a balanced budget, which is one prerequisite for bringing the debt down. Excluding the one-off costs of the bank recapitalisations, we are now running a healthy primary surplus.

Secondly, GDP growth will naturally help the debt to come down further. And thirdly, because we acknowledge that debt is still on the high side, we are committed to retaining our focus on fiscal prudence.

Bear in mind that the IMF and EU assumptions were that our debt would reach a peak of 127% of GDP. In fact, it peaked at almost 20% below what was originally anticipated, for a number of reasons. One of these is that the banking sector did not need additional capitalisation with public funds. Additionally, nobody was really expecting that we did not need additional capitalisation with public funds. Additionally, nobody was really expecting that we would be able to balance a deficit of 5% or 6% of GDP within one year.

**GlobalCapital:** So all in all, Cyprus has proved a lot of people wrong.

Yes. But I would re-emphasise what I said at the beginning. I always felt that the Cypriot economy was productive and competitive, and that the crisis had nothing to do with the core strengths of the economy. So our approach was to nurture and protect the underlying strengths and competitive advantages of the economy, instead of becoming embroiled in what I believe to be the false dilemma of growth versus austerity.

What we have shown — and it may be a point worth noting elsewhere — is that it is possible to follow a policy mix which results in both growth and fiscal consolidation. This is one of the most significant lessons we have learned from the post-crisis period.

**GlobalCapital:** You mentioned that unemployment had fallen sharply, but youth unemployment is still over 30%. What is being done to address this? Is there a need to promote increased economic diversification in order to promote job creation?

In a way, this re-orientation and restructuring has already taken place. For instance, we used to have two unsustainably large sectors — the banking sector and the public sector, which were absorbing a significant portion of the workforce. So the fact that the banking sector and the public sector have both consolidated signifies a re-orientation of the economy, which opens up the scope for new as well as established sectors to grow and to seek out new opportunities.

But I don’t think it’s the job of the government, nor of economic policy, to identify or prioritise growth sectors. What we should be doing as a government is creating a stable and pro-business economic environment, and it’s then the responsibility of the private sector to seek out opportunities and create jobs across a range of sectors. Sometimes we see success stories from completely unexpected sources. To give you an example, just across from my office in the finance ministry is the global headquarters of a video-gaming company which during the downturn identified the opportunities and competitive advantages which Cyprus offers. It has established a real physical presence here, as distinct from a shelf company. That is a good example of the re-orientation of the services sector towards real economic activity on the ground here.

**GlobalCapital:** Might this mean Cyprus waters down its ambitions as a regional financial centre?

Not at all. At the peak of the crisis 3-1/2 years ago, there was an erroneous assumption that the reputational damage that we had sustained would destroy the business and financial services sector in Cyprus. But it turned out that sector had much more to offer than low taxes and high deposit rates in the local banks.

The industry has been able to highlight and promote its real strengths, which are based on its skilled human capital, its know-how and expertise, its Anglo-Saxon legal framework, the attractive and stable tax regime and the strong links between Cyprus and jurisdictions across the world. This whole array of advantages has meant that far from being jeopardised, the financial services sector has grown.

**GlobalCapital:** Looking to the much longer term, there seems to be rising optimism that a resolution of the so-called Cyprus Problem may be edging nearer. Can you comment on the potential economic benefits that reunification of the island would bring?

If reunification happens, it will offer a huge economic boost, not only to the local economy. There will also be substantial benefits at a regional level, including for Turkey itself. Cyprus has been playing a leading role in establishing regional networks of co-operation and exchange. We’ve built up excellent relations with our regional neighbours and we would hope and expect that Turkey becomes a full participant in this regional network of economic co-operation which is promising exciting new trade and investment opportunities.

This can only happen if we’re able to resolve the age-long problem of the division of Cyprus. So of course I hope there will be further progress on the political front.

**GlobalCapital:** When you talk about the good economic relations Cyprus has been building with its regional neighbours I guess this is a reference in particular to countries like Egypt and Israel and the development of Cyprus’s natural gas reserves?

Yes, definitely. The recent energy findings in the East Med add a new dimension to regional co-operation and yet another opportunity for economic activity and investment for the benefit of everyone.
INTERVIEW: CHRYSTALLA GEORGHADJI, GOVERNOR OF THE CENTRAL BANK OF CYPRUS

Beware complacency on road to recovery, Georghadji warns

When Chrystalla Georghadji was appointed governor of the Central Bank of Cyprus in April 2014, she had her work cut out. The economy was still in recession and the banking system was weighed down by a vast pile of bad loans. In this interview with *GlobalCapital*, Governor Georghadji shares her views on the progress made over the last two years in overcoming these challenges and on the prospects for the economy and the banking system.

GlobalCapital: The economy grew by 1.6% in 2015. What were the main drivers of growth? Is growth of at least 2.5% this year and next achievable?

Real GDP in Cyprus grew by 1.6% in 2015, mainly driven by resilient private consumption and by exports of services, including transport, tourism and financial services.

The Cypriot economy, a long established tourist destination, managed to accommodate over 2.6m tourists in 2015 which resulted in a 4.4% growth in tourism revenues, helping the economy to exit the recession.

This year is expected to be even better with close to 3m tourist arrivals and a concomitant strong growth rate in revenue.

Furthermore, Cyprus also has a very competitive business sector with the services provided being of the highest quality and standards. Despite the shrinkage of the financial sector since the March 2013 crisis, the Cypriot business sector managed to sustain its market shares during the difficult times and even increase them as the most recent data show.

As regards 2016 and 2017, we expect GDP to grow by at least 2.5%, mainly supported by new investment, especially in the tourism sector. In fact the most recent data for the first half of 2016 indicate a growth of 2.8%, and this does not include the full summer season.

Economic data indicates that the process of economic recovery has begun. It should be stressed, however, that a full recovery should not be taken for granted. There is no room for complacency as the economy still faces a number of significant challenges. These include the high level of non-performing loans (NPLs), the historical high levels of unemployment and public debt as well as a number of structural issues. And this is why we should remain vigilant.

GlobalCapital: Start-ups and SMEs still have very limited access to finance. What is being done to encourage banks to lend more to small companies?

Since the onset of the financial crisis in March 2013, banks have tightened, as expected, their credit to the private sector and access to finance still remains one of the main challenges for businesses, particularly SMEs.

However, the slow but steady decline in NPLs, as well as the acceleration of GDP growth observed thus far, will enable the banks to gradually increase lending to SMEs and, therefore, overcome the remaining obstacles. Indeed, as recent data shows, some new lending to non-financial institutions, mostly SMEs, is already being extended.

At the same time, loans have been secured from various European institutions such as the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) and directed to SMEs through various schemes.

For example, in September 2014 the EBRD completed its first project with its €107.5m participation in the capital of the Bank of Cyprus. In September 2015, a 5.4% equity stake was acquired in Hellenic Bank with an investment of €20m in new shares.

The EBRD has also stepped up its support for Cypriot exporters and importers with trade facilities of €20m, €50m and €20m respectively to Eurobank, Bank of Cyprus and Hellenic Bank, under the EBRD’s trade facilitation programme (TFP) for a three year period.

Through this facility, the EBRD will issue guarantees in favour of international commercial banks covering the political and commercial payment risks of the transactions undertaken by the three banks. In addition, these banks will also benefit from the EBRD’s technical co-operation projects in trade finance.

GlobalCapital: Are you satisfied with the progress that has been made so far in bank restructuring?

Following the March 2013 crisis, the major banks underwent major restructuring of their governance and operations. The banks are now operating with a leaner cost structure and their internal governance is comparable with international standards. In general, there was progress achieved by banks in restructuring their operations. Their efforts are now focused on managing their NPLs.

Chrystalla Georghadji: “A full recovery should not be taken for granted.”

GlobalCapital: Are you satisfied with the progress made over the last two years in overcoming these challenges and on the prospects for the economy and the banking system?

Worriedly, it is still too early to discuss the prospects for the next two years. The government, the Central Bank and the banking system are still trying to meet the challenges of the past two years. The government is focusing on the urgent need for debt relief and the introduction of a new fiscal regime. The Central Bank is trying to stabilize the financial system and the banking system is trying to manage its NPLs.

Throughout this process, it is essential to remain vigilant and not to become complacent. The road to recovery is long and difficult. It requires a sustained effort by all stakeholders, including the government, the Central Bank, the banking sector and the private sector. Only then can we achieve a full recovery, Chrystalla Georghadji warns.

Economic data indicates that the economy grew by 1.6% in 2015. What were the main drivers of growth? Is growth of at least 2.5% this year and next achievable? Real GDP in Cyprus grew by 1.6% in 2015, mainly driven by resilient private consumption and by exports of services, including transport, tourism and financial services. The Cypriot economy, a long established tourist destination, managed to accommodate over 2.6m tourists in 2015 which resulted in a 4.4% growth in tourism revenues, helping the economy to exit the recession.

This year is expected to be even better with close to 3m tourist arrivals and a concomitant strong growth rate in revenue. Furthermore, Cyprus also has a very competitive business sector with the services provided being of the highest quality and standards. Despite the shrinkage of the financial sector since the March 2013 crisis, the Cypriot business sector managed to sustain its market shares during the difficult times and even increase them as the most recent data show.

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However, the slow but steady decline in NPLs, as well as the acceleration of GDP growth observed thus far, will enable the banks to gradually increase lending to SMEs and, therefore, overcome the remaining obstacles. Indeed, as recent data shows, some new lending to non-financial institutions, mostly SMEs, is already being extended.

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INTERVIEW: CHRYSTALLA GEORGHADJI, GOVERNOR OF THE CENTRAL BANK OF CYPRUS

A bumper year for tourism in Cyprus will bring welcome revenue for the economy

**GlobalCapital:** According to the European Commission, NPLs still stand at around 55% of total loans to households and non-financial corporations. “High corporate debt makes businesses less competitive and weighs on their capacity to invest and grow,” says the EC. “Banks’ efforts to restructure the debt of viable borrowers have not yet shown tangible results, while the provisioning of their non-performing exposure remains relatively moderate.” What is being done to accelerate the resolution of NPLs? Can economic recovery hope to gain sustainable momentum as long as NPLs remain high?

Given the high percentage of NPLs, which has been the combined result of inefficient banking practices in the past and the financial crisis in early 2013, the restructuring process will undoubtedly be long and difficult. Initially, the emphasis was put on setting the necessary legal and regulatory framework to deal with NPLs. Thereafter, and under the guidance of the CBC, banks began organising their loan restructuring units. It was only then that they could concentrate on providing restructuring solutions.

Figures show that in the past few months, progress has been made. However, a lot more needs to be done if we are going to be able to tackle successfully NPLs. The CBC has set restructuring targets for banks in order to provide incentives for more and better quality restructurings. These are being monitored and revised on a quarterly basis.

Despite the high level of NPLs, banks are providing new lending to the economy for those credit proposals that satisfy their lending criteria. Although the high level of NPLs means that there is limited scope for significant volumes of new lending, those sectors which are viable are able to secure funding from the banks and effectively support the various initiatives for economic recovery.

**GlobalCapital:** The EC adds that weaknesses in contract enforcement and repayment discipline weigh on the capacity to tackle strategic defaults and to stem the formation of non-performing loans. Banks also have limited access to information on borrowers’ income and assets, despite the creation of the credit registry. How are these shortcomings being addressed?

The Central Credit Register (CCR) provides information on the borrowing of each natural and physical person from all financial institutions, thus facilitating the financial institutions in their credit decisions. The CCR does not collect data on deposits and borrowers’ income and assets.

Following parliament’s ratification of the new foreclosure and insolvency framework, we have observed a shift in the behaviour of strategic defaulters. We are observing higher volumes of debt restructurings aiming to help the borrower repay the loans as well as an increase in the cases where borrowers agree to transfer their collateral to banks in settlement of their debts.

Under the framework of the Memorandum of Understanding (MoU) agreed with the troika, the Republic of Cyprus is working on improving court procedures and increasing the availability of information on the financial status of borrowers. In fact, the new insolvency framework includes relevant provisions requiring borrowers who seek protection under the framework to make a sworn statement of their assets and income, and thus provide full information on their financial position to the insolvency practitioner.

**GlobalCapital:** The IMF comments that “the updated restructuring plan for the co-operative banking sector provides a sound basis for bolstering its long-term health. More generally, efforts to enhance financial sector oversight should continue by strengthening the Central Bank of Cyprus’s governance and supervisory capacity.” What steps are being taken to achieve this?

On November 4, 2014, supervision of significant credit institutions in the euro area came under the direct supervision of the Single Supervision Mechanism (SSM) of the European Central Bank (ECB). The CBC is part of the SSM, and the Co-operative Central Bank, Bank of Cyprus, Hellenic Bank and RCB Bank are subject to the centralised direct supervision of the SSM.

The implementation of unified supervisory rules and policies right across the euro area has strengthened, and is expected to further bolster the supervisor’s capacity and enhance oversight of the financial sector. As regards the governance of the CBC, we have recently commissioned a review by a private consultancy firm. Furthermore, the IMF was asked to provide technical assistance on the issue. The recommendations of these two will be used to formulate a proposal regarding the governance structure of the CBC, which will then be submitted firstly to government and then to parliament for legislation.

**GlobalCapital:** Are Cyprus’s banks now adequately capitalised?

The supervisory assessment of the capital adequacy of banks is an ongoing process. For the significant banks this is being carried out by the SSM, while for the less significant banks this is carried out by the CBC, under the indirect guidance of the SSM and applying the same rules and processes. Subject to this proviso, we do not expect that additional capital will need to be injected in the very near future.
Dramatic crisis through to turbo-charged recovery: Hourican’s wild ride

John Hourican is a master of understatement. When he was appointed CEO of Bank of Cyprus in 2013, he was quoted as saying that rebuilding the island's largest bank, and regaining the confidence of its depositors and investors, represented a “significantly interesting challenge”. In this interview with GlobalCapital's Phil Moore, Hourican assesses how far he has come in meeting that challenge.

GlobalCapital: When you took on the job of CEO of Bank of Cyprus in 2013, it looked like a poisoned chalice. What attracted you to the position in the first place?

The crisis that befell Cyprus was dramatic, and the structural damage caused to the economy presented a unique opportunity for me to make a contribution to the company, and also to help the country to recover. This is because while Bank of Cyprus is a modestly-sized bank in an international context, it is large relative to the size of the country, so there is an important symbiotic relationship between the fortunes of the bank and that of the country.

Plenty of people told me that the problems at the bank were so big it wasn't worth even trying to fix them, but I think this made the challenge all the more appealing.

With the help of the government, with hard work from the team and with a little bit of good luck along the way, we've been able to do a reasonable job of getting the bank back on its feet. We've helped to get capital controls lifted, and the ELA [emergency liquidity assistance] we had from the ECB has been reduced from a peak of €11.4bn to €1.5bn at the end of August.

We've also injected substantial new equity into the bank which gives customers the confidence they need to put their deposits with us. Customer deposits in the last quarter alone grew by €600m-plus.

We've just seen non-performing loans (NPLs) fall for the fifth consecutive quarter, with a further €1bn reduction. They’re still very high by any standards but they are coming down quickly, and the coverage ratios are at sensible levels. We now have the machinery inside the bank to support accelerated loan restructurings.

GlobalCapital: And you’ve cut back on your international operations?

Yes. We've de-risked very heavily by selling our Russian, Ukrainian and Romanian businesses. We are reducing our remaining exposures in Romania, Serbia and Greece, which are all what I would describe as adventures of the past. Today the bank is very clearly Cyprus-focused and is consolidating its position as the dominant local bank with a small UK business which will hopefully be able to grow and add value to the group over time.

So all in all it’s like a Lego model — there are lots of interconnecting parts which add up to a compelling recovery story.

GlobalCapital: You were once quoted as saying that the losses incurred by Cypriot depositors as a result of the crisis and the bail-in had created a “psychological scar”. Has the banking industry won back the trust of the general public?

In the first year of our restructuring we did not feel that we had the moral authority to go out and ask depositors to put their money back into the bank. Instead, we focused on stabilising the bank and attracting equity in response to the comprehensive assessment from the ECB.

Having brought in new investors and put a very strong corporate governance culture into the bank, we thought we were able to go out and spread the word about the changes at the bank to the general public.

Over time, this message has clearly been transmitted. We have increased our share of deposits from a low of 23% to 27% today, and our steady growth has seen our loan to deposits ratio improve from a high of 148% to 110%. Our non-resident deposits have also grown very substantially from a low of about 26% to about 34%. So the measure of individuals' confidence in the bank is that deposits are growing and our market share is improving.

We’ve tried to be very humble about marketing the bank and it has been pleasing that the government, the media and the people of Cyprus have recognised how hard we have been working month-on-month to do real things, and to talk about them after we’ve done them, rather than creating some premature fanfare about what we might achieve. That has played a key role in regaining the trust of society.

GlobalCapital: You mentioned the decline in your loans to deposit ratio. Has this been driven chiefly by rising deposits or by a contraction in your loan book? Is the Cypriot banking sector ready to start lending again, not just to large businesses, but also to SMEs, which should be an engine of economic diversification and job creation?

We fundamentally recognise that our role as the largest bank in the country by some distance is to power the recovery of the economy. Since the beginning of last year, we have lent more than €1bn to consumers, businesses and SMEs in Cyprus, and this year alone we have lent just over €500m. So we are making new loans and we are keen to provide more credit to viable households, consumers, SMEs and corporates.

As always, in a recovering economy following a recession you have a contraction in the stock of lending, together with demand from borrowers that may not be as viable as you would like. There is always a degree of tension between what the bank can
INTERVIEW: JOHN HOURICAN, CEO, BANK OF CYPRUS

GlobalCapital: So for the economy, there has been a remarkable turnaround?

Yes. For that, I would give great credit to the government for pushing through essential foreclosure laws and important reforms to the tax system, and for observing the fiscal discipline that have given international investors the confidence to back Cyprus.

GlobalCapital: Is that across the spectrum, from artisans and SMEs all the way up to larger infrastructure projects that need longer dated funding?

We have not yet seen the type of long term demand you’d expect to see from infrastructure projects. So although we are backing a number of larger projects that may or may not come to fruition, the bulk of lending has been concentrated in the SME and smaller corporate space with some demand from a handful of the mid-sized corporates.

Indebtedness gathered pace after the crisis, so there is a natural reluctance among households to consume, and among businesses to invest long term, until confidence is fully restored. But we are starting to see signs of that confidence coming through. New car registrations are rising, real estate prices have stabilised, demand for house purchases is increasing, and there has been an increase in foreign direct investment in the leisure and hotel sector as well as in other sectors.

What is encouraging is that this isn’t coming in a big boom. It is coming slowly and steadily across the board. Limassol in particular is growing again very strongly in terms of investor demand, as are some of the other tourist spots on the island. The rest of the economy is lagging behind a little, but there is positive momentum and recently — for the first time in about 28 quarters — we have seen a rise in demand for investment in the construction sector.

GlobalCapital: I committed at last year’s AGM to be here for two more years. This was due to a mixture of a persuasive chairman and an understanding wife and the fact that there is plenty more to be achieved here.

Looking forward, Cyprus has very exciting prospects. The ability to extract and earn revenues from large reserves of gas and the longer term potential for reunification of the island will add a halo affect and significantly turbocharge the recovery of the economy. But even without these elements I think Cyprus is on the right path.
Nimble Cyprus back on course after economic tailspin

The economic recovery in Cyprus that has gathered pace since the depths of the 2013-14 recession has taken even local bankers by surprise. However, there is no shortage of formidable challenges that the island needs to overcome if it is to build on the successes that have been chalked up since the crisis and deliver long term, sustainable growth.

WHEN CYPRUS exited its macro-economic adjustment programme in March, it represented an important landmark in a heartening story of collapse and recovery. Not only was Cyprus able to walk away from the programme two months ahead of the scheduled IMF expiration. It did so having used only €7.3bn of the €10bn that was made available when the programme was mandated in 2013. That is quite a turnaround for a country which many economists originally thought would need another bail-out (at best), or tumble out of the eurozone (at worst).

Cyprus’s recession was not quite as ruinous as Greece’s. But it came close. An economy brought to its knees at least in part by recklessness on an industrial scale by some of its banks had suffered a cumulative loss of output of 11% by the end of 2014, according to Fitch. By the same date, unemployment had reached 16.2%, compared with a pre-crisis average of 4.4% between 2000 and 2009.

Bank of Cyprus summarises the events of the last three years in its most recent economic update. “Cyprus is coming out of a long and relatively deep recession, which, even if milder than initially anticipated has left the country at a considerably lower level of output than when the crisis had started,” it notes. It adds that the crisis fuelled “a higher unemployment rate, a high level of public and private debt relative to GDP and a more fragile banking sector under the weight of a high level of non-performing loans”.

The recovery that has gathered pace since the depths of the 2013-14 recession has taken even local bankers by surprise. “The Cypriot economy has managed to defy all expectations by constantly outperforming projections by substantial margins,” says Michael Louis, CEO of Eurobank Cyprus. “I think Cyprus had the fastest crash and the fastest recovery in Europe,” says John Hourican, the former RBS man who since 2013 has been CEO at Bank of Cyprus, where he has been overseeing a recovery that has been critical to the broader fortunes of the Cypriot economy.

Confident society

It has not been an easy job. But the increasing confidence of Cypriot society in its banks has been given more than a helping hand by an acceleration in the island’s economic renaissance. “Macro-economic outcomes have so far come out better than expected in the initial and revised programme forecasts,” notes a recent economic update written for Eurobank Cyprus by Gikas Hardouvelis, professor of finance and economics at the University of Piraeus. Hardouvelis knows a thing or two about the impact of the economic crisis in southeast Europe, having served as Greece’s finance minister between June 2014 and January 2015.

After nosediving by 5.9% in 2013 and 2.5% in 2014, modest growth was restored in 2015 with a 1.6% expansion in real GDP, driven mostly by private consumption, which rose by 1.9%, and the beginnings of a recovery in the housing construction sector.

In the first half of 2016, growth has accelerated, with seasonally-adjusted GDP expanding by 2.7% on an annualised basis in each of the first two quarters of the year. According to Bank of Cyprus research, much of this growth was driven by private consumption, the construction-related components of fixed income, and exports, where the recovery has been especially noteworthy, with net exports contributing 12.8% to total GDP growth.

To put this into perspective, according to Moody’s, export growth in the first quarter of 2016 was the strongest performance by the export sector in two decades. Stronger exports, twinned with the low oil price, have supported a continued erosion of the current account deficit, which reached a massive 15% of GDP in 2008, aggravated by a decline in savings and the domestic construction boom.

A range of other economic indicators also reflect the strength of the Cypriot economic rebound. Industrial production in the year to April 2016 rose 10.5%. Tourism arrivals in the first half of this year were up by more than 20%. Cement sales increased by over 30% as the modest but long-overdue recovery in the construction sector gathered momentum.

Against this backdrop, it is unsurprising that the Ministry of Finance
has recently bumped up its forecasts for growth in 2016. It is now projecting GDP growth of between 2.5% and 3% in 2016, well above the latest IMF forecast of 1.6%. If the government’s projections are closer to the mark than the IMF’s, this should support a continued reduction in unemployment, which fell from a peak of more than 16% at the height of the crisis to 14.9% in 2015 and 12.9% in the first quarter of this year. Although this fall exceeded expectations, Bank of Cyprus sounds a cautionary note about the unemployment data, pointing out that the reduction was attributable more to a decline in the size of the labour force than an absolute rise in the number of people in jobs.

Importantly for its credit ratings, which are still below investment grade, Cyprus’s government has also outperformed on its fiscal targets, generating a primary surplus of 2.6% of GDP in 2014, and 2.8% in 2015, compared with primary deficits of 1.8% in 2013 and 2.9% in 2012. As the IMF commented earlier this year: “The programme’s fiscal performance continues to run ahead of expectations. This reflects the authorities’ commitment to reform as well as a better economic environment that has contributed to reducing unemployment social transfers.”

These results, says the IMF, should help Cyprus achieve its medium-term fiscal targets, which are a primary surplus of 3% of GDP in 2017, rising to between 3% and 4% of GDP in 2018 and beyond. Better than expected performance on Cyprus’s fiscal targets is improving the country’s debt trajectory. At 109% of GDP, Cyprus’s total debt is a vulnerability. But as Moody’s points out, the debt also remains affordable, with interest payments representing a manageable 7.3% of government revenues in 2015. In its most recent update on Cyprus, Moody’s advises that it expects debt affordability to be maintained “thanks to the prevailing low interest rate environment and modest near-term financing needs”.

Success story
In his recent update on the Cyprus economy, Hardouvelis sees four broad reasons to explain why the island was able to pull itself out of its economic tailspin much faster than other eurozone economies that were bailed out during the crisis. The first and perhaps most important of these was the endorsement that the economic adjustment programme won from most political parties. “This political agreement — which contrasts to what happened in Greece — filtered through to the population and, unlike in Greece, society was not split into two groups, for or against the MoU,” Hardouvelis notes. “Thus the political and social tensions were relatively modest despite the painful decisions.”

Clearly, the small size of the Cypriot population made popular support for the programme easier than it was in Greece. Cyprus has about 850,000 people to keep happy; Greece has almost 11m. But as Hardouvelis observes, their forbearance was also a credit to the resilience of the Cypriot people. “Cypriots have shown great adaptability and willingness to compromise their living standards, thanks also to the dramatic episodes in their post-war history, which has shaped a certain population psychology of sticking to each other at times of adversity,” he notes.

The second reason for the programme’s success, according to Hardouvelis, was that it was executed “remarkably well”, with the Cypriot authorities showing a consistent commitment to the conditions of the programme. The third was the institutional and administrative capacity of the Cypriot government sector which is very close to the European Union average.

A fourth driver of the Cyprus success story was that the island started with fiscal imbalances that were lower than in other programme countries. Additionally, notes Hardouvelis, “the fiscal adjustment was front-loaded, splitting the burden almost equally between revenue enhancing and expenditure spending cuts, thus making the policy much of the measures balanced”.

Another key reason for the success of Cyprus’s recovery programme was that the cause of its economic crisis was relatively self-
MACROECONOMIC OVERVIEW

contained and identifiable. This was one of the factors that attracted the US billionaire, Wilbur Ross, to Cyprus. Ross, who is now vice chairman of Bank of Cyprus, led a group of international investors in the €1bn capital issue by the island’s largest bank in 2014, which is regarded as a landmark in the economic rehabilitation of the country. Ross says that Cyprus was especially badly hit by two external events — the implosion of the Greek economy and the tensions between Russia and Ukraine. “We felt that while the challenges Cyprus faced were huge, they were inherently one-off problems,” he says.

Inevitably, says Ross, comparisons have been drawn between Cyprus’s crisis and the meltdown in Greece. But he argues that there are plenty of differences between the two economies, most of which suggest that Cyprus is a stronger credit. These include its standards of education, which Ross says are higher than most other European countries, and the pedigree of its business services sector, which has much more substance behind it than an attractive tax regime.

Another difference between the two, adds Ross, is their respective political culture. “Like all European countries, Cyprus has its political extremes to the left and the right,” he says. “But unlike Greece, it has a government that is relatively close to the centre.”

While Ross is eager to emphasise that he is delighted with his investment in Greece’s Eurobank, he also insists that it is essential that investors understand the very substantial contrasts between Greece and Cyprus. He says that aside from boosting the liquidity of the bank’s stock, one of the many reasons Bank of Cyprus will be relocating its principal listing from the Athens Stock Exchange to London is to clarify to investors that its fortunes are not linked to Greece’s.

Challenges to overcome

Although Cyprus continues to surprise largely on the upside, there is no shortage of formidable challenges that the island needs to overcome if it is to build on the successes that have been chalked up since the 2013 crisis and deliver long term, sustainable growth.

Still standing head and shoulders above the other impediments to growth is the problem of non-performing loans (NPLs) or non-performing exposures (NPEs) which continue to hamstring the country’s banking industry. The legacy of a frenzied hunt for yield which saw the banks gorging on real estate and Greek debt in the years leading up to the crisis, NPLs in Cyprus peaked at a shocking 55% of system-wide gross loans in September 2015.

Melina Skouridou, assistant vice president at Moody’s in Limassol, says that a combination of accelerating economic growth and continued progress on restructuring will support a further decline in NPLs this year, with Moody’s forecasting a rate of 43%-45% by the end of 2016. But she cautions that the NPL challenge remains formidable.

“Theatre has certainly been a lot of very positive change in terms of the independence and competence of management, the quality of banking supervision and the strength of the banks’ capital buffers,” she says. “But the high level of NPLs means that the banks will be challenged for some time to come. No other banking system in our ratings universe, including Greece, has asset quality problems as high as those in Cyprus.”

Although the banking sector has deleveraged substantially over the last three years, Moody’s continues to identify a “very large and fragile banking system” as one of main risks to Cyprus’s B1 rating.

It is easy to see why the continued weakness in the banking sector is a big drag on Cyprus’s ratings, given its knock-on effect across the rest of the economy. In its most recent analysis, the European Commission identifies the fragility of the country’s banks as one reason why the level of investment to GDP is among the lowest in the EU.

Another concern is the patchy progress of the privatisation programme, which has encountered furious opposition from the political left and the unions, much to the frustration of international observers. As the IMF said when it completed the ninth review of its Extended Fund Facility in January, “pressing ahead with a comprehensive privatisation programme and concrete actions to improve the business environment, while abstaining from relying on tax incentives, would stimulate investment and improve efficiency.”

Others agree. Hardouvelis notes in the conclusion to his recent assessment of the economy that if Cyprus can implement the reforms that are necessary to address its structural shortcomings, it has the chance to “turn the recent crisis into a lasting opportunity”.

Brexit opportunity

One of these opportunities may, perhaps surprisingly, come from Brexit. Natasa Pilides, director general of the Cyprus Investment Promotion Agency (CIPA) says that the island is upbeat about the potential for business to relocate from the UK to Cyprus following the shock
outcome of the UK’s referendum on EU membership. She points to an area like the funds business, where Cyprus has seen a tripling of assets under management (AUM) since 2013, as one where the island could be a beneficiary of the UK’s decision to leave the EU.

Ross agrees. He says he remains enthusiastic about the outlook for Cyprus’s ambitions as a regional financial centre, the credentials of which were temporarily damaged — but apparently not destroyed — by the island’s financial crisis. “Aside from Ireland, Cyprus has the most attractive tax regime for financial institutions in the EU,” he says. “This, together with the fact that English is the language of business, makes Cyprus very well positioned to act as a location for the redomiciliation of financial institutions uneasy about Brexit.”

CIPA’s Pilides says that the island’s favourable tonnage tax system means that shipping, which accounts for about 7% of Cyprus’s GDP, is another sector where Cyprus stands to gain from events overseas such as the upheavals in Greece and the recent political twists in the UK.

Beyond the potential of traditional sectors such as tourism, business services and shipping, Ross points to two much longer term elements that could act as a permanent game-changer for Cyprus and its economy.

He says that for investors in Cyprus such as himself, both these elements offer considerable upside but virtually no downside. “The first, which is coming closer and closer to reality, is the potential of Cyprus’s offshore natural gas fields,” he says. “These appear to be an extension of the deep water fields offshore in Israeli waters. The recent auction of another block of concessions attracted the participation of some major international companies. This, together with the drilling that has already been done, demonstrates that it is probable that there is a lot more natural gas offshore Cyprus than we could have counted on when we made our original investment in the country.”

“Given how small Cyprus is, if it really does have something like 50 trillion cubic feet (tcf) of natural gas, it could be transformative for the economy,” Ross adds. “This would be first by lowering the cost of electricity, and second by becoming a huge source of revenue for the government. This is probably still a couple of years away from realisation, but it is moving in the right direction.”

End to the Cyprus Problem?
The second potentially seismic event that would permanently change Cyprus’s socio-economic fortunes for the better would be an end to the so-called “Cyprus Problem” that has been a source of tension in the eastern Mediterranean since 1974, when Turkish forces invaded and occupied the north of the island. Reunification appears to take a step forward in June with constructive talks between the Cypriot president, Nicos Anastasiades, and Turkish Cypriot leader, Mustafa Akinci.

UN special adviser Espen Barth Eide was quoted in March as saying that the sky is the limit for the economic benefits to be derived from reunification in the form of new trading and investment opportunities. This echoes comments made last year by Anastasiades, who quoted studies by the Cyprus Chamber of Commerce and others suggesting that all-island GDP could double over the next 20 years in the event of reunification.

Others are less convinced about the economic benefits of an end to the Cyprus Problem, with one recent assessment suggesting that compensation claims could bankrupt the island. Nor is there universal political support for reunification, which is opposed by the far-right Elam party.

But as Ross says, reunification would be especially good news for Bank of Cyprus, which has substantial property holdings in the north, currently valued in the bank’s books at zero. “If there were reunification there would either be some form of compensation for the expropriation, or we would get the properties back, or some combination of the two,” he says. “Either way, it would be a big windfall for the bank and for other Greek Cypriot businesses which had property in what is now the Turkish part of the island.” ▲
Return to market respectability: sovereign’s hard work pays off

As far as sovereign bond issuance goes, Cyprus has been one of the great eurozone success stories of the last few years, winning back its previous broad base of stable government bond investors. A return to investment grade would complete the hard journey back to recovery.

FELIX ORSINI, head of public sector debt origination at Société Générale, is one of several bankers who say Cyprus’s management of its funding programme since its return to the market in 2014 has been textbook. “Cyprus’s success in the international capital market has had nothing to do with chance,” he says. “Alongside Ireland, I would say it has been one of the great eurozone success stories of the last few years.”

The journey back began in June 2014, when as a Caa3/B-/credit Cyprus priced at mid-swaps plus 414bp. But the 4.72% coupon was appreciably below the 5% that hedge funds were reportedly demanding, and a €2bn book suggested investors were happy to welcome Cyprus back at a reasonable premium over Greece. When it returned at the end of April 2015, Cyprus was able to increase the size of its benchmark, lengthen the maturity and knock a chunk off the price. The €1bn seven year issue via Barclays, HSBC, Morgan Stanley and SG CIB was priced at a coupon of 3.875% and generated orders of €1.9bn from over 140 investors.

The most important feature, however, was the increase in real money accounts. This was in evidence again last October in the republic’s third deal since the crisis. Hedge funds took 27% of the five year in 2014, but their share of the 10 year €1bn Reg S in October 2015 was reduced to 21.5%. The October trade, led by Barclays, Goldman Sachs, HSBC and Nomura, was priced with a coupon of 4.25%, or 341.6bp over swaps.

An important component of the 10 year issue last October was its incorporation of an innovative liability management component. About half the proceeds were used to buy back existing debt, thereby extending maturities and reducing refi-nancing risk.

Investor evolution

The metamorphosis of Cyprus’s investor base, which is a cornerstone of the Public Debt Management Office’s funding strategy, has gathered momentum this year. Its most recent benchmark was a seven year €1bn trade led in July by Barclays, JP Morgan, Morgan Stanley, SG and VTB, which was another landmark as it was its first issue since its exit from the Economic Adjustment Programme in March 2016.

July’s benchmark was priced with the lowest re-offer yield (3.8%) and the equal-lowest coupon (3.75%) ever achieved by Cyprus for a euro benchmark, and generated orders of €2.5bn from 180 accounts. The final distribution showed an increase in offshore US accounts, which took up almost a quarter of the bonds, and the sharp drop in the share of hedge funds, which accounted for just 7%.

“Cyprus was rewarded for its very intensive roadshowing and investor marketing with a book that was very different from 2015,” says Orsini. “It achieved a great result not just from a financial perspective with its lowest ever pricing, but also in terms of the quality and diversity of the book.”

Lee Cumbes, head of EMEA public sector debt and risk solutions at Barclays, says order book diversification was important. “One of Cyprus’s key objectives is to widen its group of real money investors and add to those important buyers that supported earlier deals in 2014 and 2015, winning back its previous broad base of stable, government bond investors,” he says.

July’s benchmark suggested that Cyprus has already taken a big step in that direction. The lower yield perhaps took the shine off the credit for hedge funds, while confidence in the prospects for a return to investment grade emboldened some government bond funds to get a foot in the door. Certainly, investors seem to regard a return to investment grade as probable. “Some of the feedback we had from investors was to ask why Cyprus had such a low rating, given the strength of its fundamentals,” says Andrew Salvoni of Morgan Stanley’s debt capital markets team in London.

Salvoni adds that a critical part of Cyprus’s message was that those fundamentals meant it could access the market as a standalone credit. “Having left the Economic Adjustment Programme, but not being investment grade, Cyprus was not eligible for the ECB’s Public Sector Purchase Programme (PSPP),” he says. “So it was important for Cyprus to demonstrate that its bonds could continue to trade well without the ECB bid.”

Cyprus achieved this objective with a flourish in July, successfully issuing soon after the UK’s referendum on EU membership. Having announced its return to the club of eurozone sovereign issuers so decisively over the last 24 months, Cyprus can be expected to return on a regular, rather than a frequent basis, given its modest funding needs. The DMO’s programme for 2016-2020 will chiefly be on the strategic management of its yield curve and on the further expansion of its investor base.
Cyprus in the Capital Markets

Cyprus sovereign debt and economic roundtable: Cyprus continues to surprise on the upside, with a number of recent forecasts suggesting that growth this year is likely to come in well ahead of initial projections. What is driving this extraordinary economic revival?

George Panteli, Ministry of Finance:
Based on our latest forecasts, we’re expecting growth in 2016 to be around 2.7%-2.8%. The economy is performing better than anybody anticipated, and there is a significant positive deviation between our forecasts and the earlier predictions by international institutions such as the International Monetary Fund (IMF) and the European Commission (EC) which were forecasting growth for this year to range between 1.4%-1.6%.

Growth is being driven by a wide range of sectors. Tourism is having its best year since 1990, supported in part by geopolitical developments. Arrivals in the first half of the year were up by 22% which is being reflected in a strong performance in the industry’s revenues. Additionally, the shipping sector is performing well, with a number of ship management and ship owning companies relocating to Cyprus from other jurisdictions. More generally, the business services sector is also performing well. So in spite of the challenges of recent years the rebound in economic activity is strong.

Consumption is also picking up. We’ve been seeing a rise in consumers’ disposable incomes as well as corporate earnings. These elements strongly indicate that the rebound in activity is here to stay.

Ioannis Tirkides, Bank of Cyprus:
We also see growth at around 2.5%-3% this year. On a sectoral basis growth is broadly based, driven mainly by a steep increase in tourist activity and continued growth of the business services sector. On the expenditure side, consumption was resilient during the recession years, dropping noticeably less than real GDP. In contrast, fixed investment was about halved from 2010 to end 2014 before starting to recover more recently. However, investment has been improving although it has been fluctuating quite widely due to its transport equipment component. Other components of fixed investment like machinery and housing construction have been rising.

Panteli, Ministry of Finance: The crisis was really a wake-up call for Cyprus. The economy had been performing well in the past, but it was living beyond its
means. Over recent decades, loss of competitiveness was significant.

During the crisis, the economy showed remarkable flexibility, especially in areas such as the labour market. Wage levels came down very quickly, which led to the restoration of much of Cyprus’s lost productivity and competitiveness. Following the crisis, a lot of people were expecting the whole model of the island to change. But this didn’t materialise. The business services sector exhibited considerable resilience and maintained market share.

**GlobalCapital**: Phaedon, have investors been surprised at what they’ve seen in Cyprus in the last three years?

**Phaedon Kalozois**, Debt Management Office (DMO): Yes. But it’s not just investors who have been pleasantly surprised. So have the Troika institutions. They have been very pleased by the progress made by the economy as a whole and by the results achieved through the diligent implementation of the economic adjustment programme under the Memorandum of Understanding (MoU).

The proper implementation of the economic adjustment programme has facilitated the restoration of the government’s credibility, which is a key word for investors. Cyprus’s credibility has been safeguarded along with fiscal sustainability, which has supported an upgrade of our sovereign credit ratings.

We have been upgraded during the last three years by seven to nine notches. Although we are still below investment grade, our ratings trajectory is clearly improving, which is very important in achieving sustainable market access. Investors also like the outlook on our rating, which is either stable or positive with all the agencies.

This is why, just one year after the conclusion of the MoU, we were able to access the market and attract strong investor demand.

**GlobalCapital**: Mike, Eaton Vance is one of those investors, right?

**Michael Cirami**, Eaton Vance: Yes. We’re a holder of Cypriot debt.

Our view on Cyprus is that the growth numbers are good, the labour market is improving and there has been some recovery in the banking sector. But the bigger picture is that we have always had a constructive view on the country and the economy going back many years. The Cypriot crisis was not a result of a fundamental problem in the country. This is in contrast to Greece, which had profound structural and fundamental problems.

It was not a surprise to us that the country has been capable of taking tough decisions. We think of Cyprus as a country that will outperform its eurozone peers in terms of growth. It has good natural resources supporting its tourism sector and in the very near future it will have natural gas. Longer term, the potential for reunification is another positive catalyst for growth.

So we expect growth to surprise to the upside, and unemployment to drop faster than consensus.

**Tirkides**, Bank of Cyprus: On the subject of the resilience of the economy, it is quite remarkable that in spite of the bail-in, and in spite of the losses sustained by businesses, there was no meaningful destabilisation of the economy at a popular level.

On the contrary, there has been a general consensus regarding the implementation of the economic adjustment programme, which underpinned the internal devaluation that was achieved through wage and other cost cuts. This showed the flexibility of the economy and helped in competitiveness gains.

Interestingly, the tourism industry was in a cyclical upswing at the time of the crisis. So while other sectors were contracting, tourism, on average, was making a positive contribution which helped to offset part of the decline in the broader economy.

The bail-in meant that a lot of companies lost money, which forced many of them to cut back on their operations. So the drop in output was due mostly to steep cutbacks in investment expenditures.

If we adjust for the positive contributions from net exports and inventory changes in the recession years, almost 60% of the cumulative contraction was accounted for by the drop in fixed investments. This of course reflected the sharp drop in construction which had reached bubble levels by 2008. When the construction bubble burst, everybody stopped investing in building and engineering projects.

But the strength of the economy also relies on two things which won’t change: Cyprus’s strategic location and the quality of its human capital. This has allowed us to continue to attract foreign businesses in spite of the crisis.

**GlobalCapital**: Given the importance of human capital to the economy, did Cyprus suffer a brain drain during the crisis?

**Tirkides**, Bank of Cyprus: We have had brain drains in the past, but each time people have returned and imported new skills to the economy.

This time around we lost quite a few professionals from construction and other sectors, but in the areas where our human capital has a competitive advantage, such as accountancy and the legal profession, we have seen growth rather than a brain drain. The fact there are so many well known accountancy firms on the island attracts people to the business services sector, and those companies have expanded their operations since the crisis in response to demand from Eastern Europe, for example.

**GlobalCapital**: Michele, when you speak to investors, do they believe they’re buying a country on its way back to investment grade?

**Michele Cortese**, Société Générale: Clearly on an absolute basis investors regard Cyprus as an improving credit and an attractive story. But the other angle for investors is the relative value story Cyprus offers. Let’s not forget that Cyprus is part of the euro area and a story with this sort of positive momentum and risk-return profile is not easy for investors to find in that area.
the moment, investors are pleased if they can get a zero percent return in Euroland sovereigns.

Another important point from the perspective of investors has been the shift in demand for Cyprus away from hedge funds and towards real money accounts. We’re talking about European insurance companies, which undertake thorough and lengthy credit analysis for long-term credit decisions. These investors have given an encouraging stamp of approval for all the work that the Cyprus government has done.

GlobalCapital: What about the stock of NPLs at the banks? Clearly things are improving. But how would you respond to an investor who says he can’t buy the debt of a country in which every second bank loan is non-performing?

George Panteli
Ministry of Finance

Panteli, Ministry of Finance: I would agree that the biggest challenge the economy is facing stems from the financial sector, and more specifically the NPLs, which are indeed very high.

But I think you also need to look at the reasons behind the NPLs and how the island is dealing with them. We had some very exceptional circumstances in 2013 which led to a significant increase in NPLs. But with the help of international institutions, the government has managed to create an environment which introduces the right incentives for banks and borrowers to come to terms with reality and restructure their loan books.

We now have a much more effective arrears management framework in place. We have insolvency and foreclosure legislation which is very effective compared to what we had in the past. And we also have an efficient framework for the sale of loans. So the necessary instruments have been put in place for the stock of NPLs to decline and become more manageable.

Towards the end of 2015, after we had introduced a series of tax incentives to promote loan restructurings, we saw a decline in NPLs, especially those that are 90 days past due. These have come down from close to €23bn to around €19bn, and the performance of restructured loans has generally been good.

Restructured NPLs need to perform for 12 months in order to be removed from the NPL categorisation, and we are optimistic that between now and early 2017 we will continue to see significant improvement in this area.

GlobalCapital: Is this a prerequisite to getting the banking industry lending again, especially to SMEs?

Panteli, Ministry of Finance: Of course. The banking industry has taken up a very conservative position, and is cautious about providing any new lending to the economy. But recently we have seen a pick-up in lending activity both among local banks and international institutions such as the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD), which are channeling lending through domestic banks.

As NPLs come down and there is an improvement in the loan portfolio of banks, we expect to see an increase in their lending to the domestic economy.

Tirkides, Bank of Cyprus: We are encouraged by the results of the new foreclosure and insolvency framework in terms of changing attitudes towards restructuring and workouts with clients. Intensive efforts on the part of the banks and innovative initiatives are beginning to have significant results.

There are two phenomena happening at the same time. One is deleveraging and the other is restructuring of NPLs. In absolute terms, we have seen a significant decline in NPLs over the last year or so of around €3bn, during which period the NPL ratio had risen as loans outstanding dropped by far more than the decline in NPLs. Significant work has been done in terms of loan restructuring and workouts. At the end of last May for instance, more than 40% of NPLs, or more than €10bn, consisted of restructured loans. If all these restructured loans are reclassified into performing over the next 12 months, the NPL ratio will drop below 30%. Even if you assume a lower success rate, the numbers will improve considerably over the next year or so. We certainly feel comfortable that we have enough collateral on our books, and enough provisions, to meet the challenges we face. It is interesting to note that at the end of May, total provisions in the banking system were about 38% of NPLs.

On the subject of credit expansion, of course banks can’t lend as much as they used to. Nobody expects them to. Indeed, we still need to deleverage further. But the economy is now producing its own cash. Companies in growth sectors such as tourism and business services do not need much credit.

So as the main drivers of economic growth are using their own funds for investment, the amount of capital we need to support continued growth is not that high. As this is a human capital based economy, the amount of investment we need for it to grow is modest. Bear in mind that traditionally more than two-thirds of fixed investment in Cyprus consisted of housing and other construction works.

The construction sector today accounts for a little more than 3% of GDP in real value added terms compared with more than 10% at the peak in 2008. As excess housing supply gradually dissipates, construction activity will grow faster to around 7%-8%. In a few years, we should start seeing demand for infrastructure and other construction activity contribute more significantly to growth.

GlobalCapital: Do investors worry about the NPLs?

Cirami, Eaton Vance: I wouldn’t say the issues in the banking sector have been resolved, but I’m satisfied that the industry is heading in the right direction. NPLs are obviously too high, and they need to keep coming down.

Kalozoi, DMO: Investors don’t expect the NPLs to be managed overnight. They understand that management of the NPLs is a long term process. What investors want to see each time we visit them is evidence that material progress is being made.
Cyprus Sovereign Debt and Economic Roundtable

Of course, they also use the NPLs as a reason to ask for higher pricing on our bonds. But thanks to the low interest rate environment we are already able to provide high returns relative to other euroland sovereigns without compromising our fiscal sustainability.

Cortese, Société Générale: Investors are sophisticated enough to look through the NPL question. Of course there is an issue with NPLs, but this is fully discounted by the capital market base.

Investors are less concerned about the absolute number of NPLs and more interested in looking at the framework that the Republic of Cyprus has put in place to address the issue. The framework is well understood and appreciated by investors. They recognise that the NPL problem is not one that will be resolved in a couple of days. But equally, the measures George [Pantell] was describing earlier make them comfortable with the way Cyprus is tackling this issue.

Kalozois, DMO: I’d like to emphasise the point raised by Michele earlier, which is that the improvement in the economic situation including the NPLs is reflected in the evolution of our investor base.

If you compare our first EMTN issue in June 2014 with the latest issue last year you will see there has been a reduction in the participation of hedge funds by at least 20 percentage points, which can be explained largely by the improvement in our ratings and the reduction in our yields. But the reduction in the yields can’t explain the increase in the participation of real money investors, such as insurance companies and pension funds, which increased during this reference period by nine percentage points. This indicates the credibility we built during this period with respect to the economy and the NPLs.

GlobalCapital: Where does Cyprus sit within the investment universe? Is it seen as high yield, or investment grade in waiting? An emerging or developed market? Part of Europe or the Middle East?

Cirami, Eaton Vance: I don’t know. But that is one of the beauties of the opportunity it presents to investors. I don’t dwell on such distinctions. My team here covers every country that has a capital market — which means every market from the US to markets like Zambia. So I don’t worry about credit ratings or index inclusion or other market categorisations.

Obviously, Cyprus being in the eurozone is extremely important. We have our thoughts about how Cyprus fits into the eurozone and what that means for the credit. But the person in my team who covers Cyprus focuses primarily on the Middle East. We call the region he covers the ‘Greater Middle East’. I would expect that Cyprus will converge from a ratings perspective with other eurozone members. I think of it as a better credit than places such as Italy and Spain, and I expect that to be reflected in Cyprus’s ratings over time. But I don’t let that influence how I cover a country and whether or not I regard it as an attractive investment opportunity. It suits me when credits aren’t easy to categorise, because it means it may fall through the cracks and command less investor interest. I say shame on those investors who don’t pay attention to a market just because it isn’t easy to categorise.

Cortese, Société Générale: I can’t disagree. But let me say something before: on a relative basis I’d compare Cyprus more to a speedboat, whereas some other eurozone countries are more like oil tankers — it takes much more time and effort to turn them around.

But it’s also challenging for investment banks to know where to position Cyprus. I can say from Société Générale’s perspective that I’m responsible for investment grade sovereign origination, so for us it’s very clear that Cyprus is an investment grade sovereign which has been through a period of crisis and is now moving back to the investment grade world.

I’d also like to underline that Cyprus is part of the euro area. The central bank is part of the Eurosystem. The Ministry of Finance of Cyprus is part of the Eurogroup, and has all the infrastructure of the eurozone behind it.

So what we recommend a lot to investors is a convergence trade, realigning Cyprus to the rest of the euro area government bond market. In the medium to long term we see no danger of Cyprus leaving the Eurosystem or losing all the European infrastructure it has at its disposal. Following the MoU and the recommendations from the EU and the IMF shows how committed Cyprus is.

Of course on the investor side there are still emerging market funds that invest in Cyprus, and we saw demand from them in the latest transaction. But more important is the support we now see from investment grade investors. We see participation from both types of account which helps to maximise demand.

In line with improvements in Cyprus’s rating, the more upgrades there are in the future, the more investment grade funds will be involved.

GlobalCapital: Doesn’t this risk making the same assumptions that Cypriot banks made when they bought so many Greek government bonds? In other words, that a country’s membership of the eurozone will safeguard investors in perpetuity from the risk of any default or haircut?

Tirkides, Bank of Cyprus: The fact is that the euro is part of Cyprus’s strength. Nobody here, with few exceptions, thinks we could leave the eurozone and be better off as a result. The euro is a must for us. So we can and will do whatever it takes to ensure that we remain in the euro by behaving in ways that are compatible with what is required of a euro member country. In other words, this country needs the euro more than the euro needs us.

Kalozois, DMO: Pre-crisis it was enough to assume that membership of the eurozone was a passport to market access. Now, the whole financial landscape is different.

One of the lessons we learned in the crisis is that we need to be more proactive, we need to be more flexible and to think outside the box for devising new strategies to approach the market. In this context, we have adopted a completely new approach to investors.

For example, we are heavily committed to going on non-deal roadshows to meet investors. We don’t visit investors when we need cash. We visit them in order to update them on the prospects as well as the challenges for the economy.

For their part, investors have started to do much more thorough research on Cyprus which is something they did not do in the past because of the small size of the
market. They now produce their own internal research, and that is why they buy Cyprus’s government bonds in spite of them not being investment grade.

Kalozois, DMO: I’d like to emphasise that rebuilding our credibility was not an easy task. The first time we went on a roadshow, investors — especially in London — asked us why we were looking to access the market at a time when we could borrow much more cheaply from the ESM and the IMF.

It took a lot of effort, resources and diligence on our part to demonstrate that we weren’t coming to the market to avoid implementing our commitments under the Economic Adjustment Programme. We explained to them that we were accessing the market because we had devised a new strategy under which we were aiming to bridge the programme and post-programme periods.

So, on the basis of our public debt management strategy, we go to the market even if we don’t need the funding for financing purposes. If you only go to the market when you need the cash, you tend to be a price-taker. If you want to take advantage of opportunities in the market without being opportunistic — i.e. speculative — you need to have a clear three-to-five year medium-term strategy. On this basis you draft your annual financing plan, the major component of which for Cyprus is the EMTN issue in the international financial market. This plan is published and is a commitment of the government.

Investors understood that we raised funding not because we planned to increase expenditure, nor to increase the level of the public debt. We were explicit that we were using the extra funding in order to smooth out the maturity of the public debt, to fix the errors of the past in the management of the debt, and to take advantage of lower interest rates.

On the one hand we managed to reduce the refinancing risk because there was a concentration of maturities in a number of specific years, and on the other we were able to be in the market without having any current financing needs. This is what we call liability management.

If we had not gone to the market four times during the programme period, the share of the EMTN in our total public debt would have been only 2%. Now it accounts for 18%, which makes it our most important source of borrowing after the official funding from the ESM and the IMF. But we knew the official funding was not going to be there for ever, so we had to be prepared.

Now we are visible in the market. We have managed to build a complete yield curve. We have five, seven and 10 year benchmarks in the market and in the near future we will probably be issuing 15 year bonds.

At the same time, the implementation of this strategy facilitated the restoration of our credibility. It gave us the opportunity to be in touch with investors on a very frequent and regular basis. They now know us personally. They expect to see us regularly. And I’m sure they would worry if we don’t show up.

Our strategy is to go to the EMTN market once a year. But at the same time we are continuously doing non-deal roadshows. This year we have already roadshowed three times. As well as visiting the core financial centres of Europe, such as London, Paris, Frankfurt and Munich, for the first time we sent a team to cover the east coast of the US. This may explain the increased participation of US investors in our last issue.

We also covered some non-traditional areas of Europe, such as Scandinavia, Switzerland, Austria and Italy.

Michele Cortese
Société Générale Corporate and Investment Banking

Cortese, Société Générale: On the subject of the marketing of Cyprus’s bonds, we think this has been a textbook case of how to manage an issuance programme. The strategy of visiting all the major financial centres, trying to diversify into the US, the Nordics and so on, has generated very positive results. As well as seeing more real money participation, we have seen better geographical diversification, with a reduced concentration on the UK’s hedge fund community. In fact, if you look at the placement of the most recent transaction, it was very similar to the distribution of any European sovereign issue.

I agree that Cyprus should continue with its non-deal roadshows on a regular basis, but the next target needs to be the penetration of the real money investor base even further to ensure that they are involved more regularly in Cyprus’s transactions.

Kalozois, DMO: I agree that this should be our ultimate objective. We need to see a stabilisation in the participation of asset managers and at the same time an increase in the participation of insurance companies and pension funds.

GlobalCapital: But if you’re an insurance company or pension fund, if you get Italy or Spain right, you’ll perform OK. Get them wrong and you’re in trouble. But Cyprus is so small it won’t move the needle in terms of performance. How can large investors be persuaded that it’s worth their while to look at this market, given Cyprus can only issue €1bn a year?

Cirami, Eaton Vance: Shame on them. My team manages $12bn and looks for good investment opportunities throughout the world in large as well as small markets. One of those opportunities is Cyprus, where it is possible to put a reasonable amount of money to work.
Kalozois, DMO: We don’t have any serious problem arising from the size of our funding programme. We know that if investors have a strong appetite for our bonds which are sub-investment grade, but according to their own analysis are actually investment grade and at the same time pay a relatively higher interest rate. This is because they believe strongly in the prospects of the Cyprus economy, which is reflected in the positive or stable outlook for our ratings.

One problem, however, may be the small size of each issuance, and the potential for limited liquidity as a result. We’re trying to address this problem to the maximum possible extent by engaging from time to time in liability management. For instance, we issued a new 10 year bond in November 2015 combined with an exchange of existing MTNs. This was a so-called switch transaction which offered investors an additional option of allowing them to trade easily out of the old MTN and reinvest in a new and more liquid 10 year issue.

Of course we can’t be compared with bigger countries like Italy or Spain or France, which issue several billion euros in single trades. We recognise that we have this disadvantage. But the market discounts this disadvantage by charging us a relatively higher premium. Some market observers in Cyprus complain that we apparently pay higher rates than our peers. But they don’t acknowledge that this is not just a function of our rating. Even if we improve our credit rating there will be a slight premium to pay due to the relatively small size of each issuance.

Cortese, Société Générale: In terms of market size, Cyprus is not Spain, not Italy. From a liquidity standpoint it is in a different situation from those European governments that issue every fortnight. We advise Cyprus to make the best use of all the instruments it has available to maximise the liquidity and smooth their redemption profile as much as they can. Slowly but surely, this should also decrease the premium that Cyprus pays.

Moreover, in this very low rate environment, the type of returns that Cyprus offers can still make an attractive difference to institutional investors that are still buying into a eurozone government with a positive yield.

Last but not least, a funding programme is a function of the size of a country and its needs. It would be worrying if Cyprus’s were as large as those of the most liquid eurozone sovereigns.

Kalozois, DMO: Cyprus’s bonds have performed well since we exited the programme, reflecting fiscal consolidation and the good performance of the economy. Economic sentiment and confidence indicators are back to pre-crisis levels. Last June, Ecowin decided to abrogate the excessive deficit procedure on Cyprus.

The Ministry of Finance continues with the implementation of economic policies that safeguard fiscal targets, modernise the public sector and improve the efficient functioning of the economic system. Price formation on our bonds is based on secondary market yields which already incorporate a premium associated with the bonds’ ECB non-eligibility feature as the market has already discounted this.

It must be stressed that the major benefit from the ECB’s QE for Cyprus’s government bonds was never the direct purchase of our bonds by the ECB but the lowering of the yields across the whole spectrum of the EU sovereign markets. As long as this policy continues, the low yield environment will be maintained and its benefit for Cyprus is of paramount importance since it also provides the time for Cyprus’s sovereign ratings to gradually move towards investment grade. Despite the fact that our bonds per se are currently non-eligible, it is my personal opinion that one of the biggest winners and beneficiaries of the ECB’s PSPP is Cyprus’s EMTN programme.

Cortese, Société Générale: Cyprus bonds have performed well in the secondary market since the exit from the support programme at the end of March. Since primary pricings are derived from secondary market levels, all things being equal and market environment being supportive, a better secondary level should translate in a better level for new issuance. Cyprus recorded its lowest coupon and yield ever for a new issue in its recent seven trade.

Kalozois, DMO: It is certainly our intention to issue a 15 year bond in the near future, because we would like to build a yield curve which includes the 15 year tenor. We would also like to take advantage of the low interest rate environment. Currently on the basis of our maturity structure, there is a very good window for another seven year bond, but after that the best window would be for a 15 year issue.

We don’t want to rush to international markets now with a benchmark-sized 15 year deal when there is room to issue a seven year bond. In the meantime, we may have the opportunity of further improving our ratings, because one of our medium term goals is to minimise the cost of servicing the public debt. But certainly, issuing a 15 year tenor in the next 12-15 month period is part of our strategy framework.

This does not preclude the possibility of issuing a small 15 year bond in the local market earlier.

Kalozois, DMO: Phaedon, you mentioned that you might do a 15 year deal. Given how much investors want yield, were you tempted to do something a bit longer when you accessed the market in July?

GlobalCapital: Has the loss of eligibility for the ECB’s PSPP since exiting the EAP made any material difference to Cyprus’s pricing, either in the secondary market or in the primary market in July?

Phaedon, Eaton Vance: Of course I wouldn’t pre-commit to anything, but yes, depending on the pricing, there is no reason why we wouldn’t be interested in buying longer dated Cypriot debt. I think spreads will come down, so duration is on my side in that respect. My guess is that in a couple of years’ time spreads on Cypriot debt will be a lot lower than they are today. The fact that the ECB is no longer buying Cyprus is part of the story, but that will change when there is a ratings upgrade.

If you look at the fundamentals, of course things aren’t perfect in Cyprus. But I scratch my head to think of reasons why people think Spain is a better investment opportunity at current levels.

GlobalCapital: Does this mean you are optimistic about the prospects for Europe as a whole?

Phaedon, Eaton Vance: No. I’m not so optimistic about the outlook for the eurozone. I’m investing in Cyprus on a spread basis. We’re extremely flexible about how we manage our exposure, so we hedge out the currency risk and we also hedge out what I call the base rate. So we
short German Bunds and some other European markets which we think are trading too tight. My only interest is in the potential for spread narrowing, which I think will happen in the case of Cyprus’s bonds.

GlobalCapital: We’ve spoken a couple of times about the potential for Cyprus’s rating returning to investment grade. But this is presumably contingent on reducing the debt, which is still 109% of GDP.

Panteli, Ministry of Finance: It is correct to say that we are on our way back to being investment grade. I agree that the reduction of debt to GDP to below 100% would be conducive to achieving that rating. We expect to achieve this by the end of 2018 driven by a number of factors. Continuing with a prudent fiscal policy will allow us to maintain high primary surpluses, while asset swaps and privatisation proceeds are other channels that will facilitate a reduction in the public debt to GDP ratio.

The privatisation plan prepared by the government is currently being implemented. Back in April we completed the licensing for the port at Limassol, which is now being operated by two international companies, one from Germany and the other from Dubai.

We are in the process of progressing with other privatisations such as the state lottery and the licensing of a casino. The most challenging one is the privatisation of the telecoms company. This was especially controversial during the election campaign which took place before the summer. Now the Minister of Finance is contemplating presenting the necessary bills to parliament to re-enact the process of privatisation in the telecoms sector.

The proposal being contemplated is to invite an institutional investor to hold a minority stake in the company but with full control of the management.

GlobalCapital: Given that Cyprus has done so well on the fiscal front, is there a temptation to shelve the privatisation programme because the government now knows it can meet its fiscal targets without arousing public anger over the sensitive sale of public utilities?

Panteli, Ministry of Finance: Privatisation is not all about fiscal prudence and generating revenues for the government. It is also about promoting increased productivity as a means of attracting more foreign investment. We have already seen this happening in the case of the Port Authority, where the private investors are committed to expanding the capacity of the port and creating a business hub in the area in order to maximise the return on their investment.

GlobalCapital: This is what I was alluding to when I suggested it was politically sensitive. It’s one thing to tell the man on the street that privatisation is essential to balance the books. It’s quite another to say it’s important to help foreign investors maximise their returns.

Panteli, Ministry of Finance: I agree that it is a delicate exercise politically.

Tirkides, Bank of Cyprus: We need growth, and we need an efficient public sector, so continued structural reform is crucial.

Kalozois, DMO: I’d like to make an additional point in response to an earlier question about the level of the public debt and the possibility of reducing it. Without trying to modify the statistical methodology, it’s worth pointing out that about 5% or more of the public debt is accounted for by the cash buffer we hold as part of our medium term strategy.

It’s one thing to have a public debt to GDP ratio of 109% without having this buffer; it’s another to have it with this solid cash buffer. This year we have actually surpassed our cash buffer target, which is due to the fact that we have been proactive in raising funding in advance of any needs. With just a slight improvement in the management of our cashflows, we would be able to reduce the level of the public debt by at least two percentage points.

To put this in perspective, at the end of 2012 the cash which was available to finance the needs of the next 12 months was only 8% of the government’s total refinancing needs. Today, it is about 120%, which means that simply with the cash we are holding now, we can refinance our financing requirements for the next 15 months. This needs to be taken into account when you’re looking at our total debt.

Another point is that the market and the ratings agencies take into account not just the explicit amount of the public debt but also the contingent liabilities mainly in the form of government guarantees. I’m very glad to say that the stock of these government guarantees has recently been reduced by €1bn, which is the equivalent of 32% of the entire stock of government guarantees or 6% of GDP.

This reduction is due to the decision by the Bank of Cyprus to cancel two of their government guaranteed bonds amounting to €1bn. This represents an improvement in the financial profile both of the bank and the government. All other things being equal, factors like this should support a further upgrade of the Republic of Cyprus.

GlobalCapital: You mentioned the local market earlier. Do retail investors buy government bonds?

Kalozois, DMO: Yes, they do. We have two different types of government bonds in the local market. One of these is purchased mainly by institutional investors, while the other is targeted more at the retail market.

Local institutionally targeted bonds constitute about 10% of the total public debt. This market is dominated by banks, which account for about 86%. The rest is distributed among insurance companies, pension funds and provident funds.

With respect to the retail bond, this only represents about 2% of the public debt. In absolute terms that equates to approximately €400m. But we need to take...
into account that we only introduced these retail bonds in mid-2014. Even though in absolute terms the participation of retail investors may not look material, in strategic terms it is very important.

On the one hand, retail investors fuel the regular and orderly functioning of the market. We issue retail bonds once a month, and these, combined with the Treasury Bills we issue to the banks, are the two main instruments which are issued on a regular basis.

At the same time, retail investors are very important because they form a basis on which we can further develop the local market.

Unlike the big European economies, we don’t have a primary dealership system in the local market, but it is worth mentioning that we are currently considering setting up a system of primary dealers, and we have received technical advice on this from the IMF and the European Commission.

We won’t rush this. It will be a project that we implement in a series of phases, because we want to give insurance companies and pension funds enough time to become familiar with this system, which we expect will also support the further development of the retail bond market.

**Phil Moore**
**GlobalCapital**

In addition, when we appoint primary dealers in Cyprus, they will also be used for our international issuance, so they will have an important role to play on a number of levels.

To sum up, currently there are no funding reasons for developing a retail market, but there are good strategic reasons for encouraging its growth. The same holds true for the Treasury Bills market, which according to our strategy should not exceed 4% of our total borrowing per year. Like retail bonds, their share in the public debt is about 2%.

Treasury Bills are a very low cost source of funding — currently below 1% — but we use them mainly for strategic reasons, in order to keep the market activated. Their very short tenor (a maximum of 52 weeks) makes them a flexible instrument for us to use for adjusting our cash balances depending on the revenue and financing needs of the government.

**GlobalCapital: Is building a deeper and more liquid domestic bond market also very important in helping to establish a benchmark for a local corporate bond market?**

**Kalozois, DMO:** Yes, it is. But it is equally important to utilise the sovereign international issuance as a benchmark for domestic borrowers, accessing the international market. This is especially relevant for the banks, given the close linkage between the banking sector and the government.

Personally, I believe that Cyprus’s banking institutions are now more or less ready to access international markets.

**GlobalCapital: Would you go along with this, Michele?**

**Cortese, Société Générale:** Yes. I strongly believe that an efficient sovereign capital market driven by government bond issues creates a better trading and pricing environment for corporates and financial institutions in that country.

Acting as a benchmark for other borrowers is a part of debt management offices’ jobs these days — not just in Cyprus, but across Europe.

**GlobalCapital: How important have domestic investors been as a source of demand for the recent international benchmarks?**

**Kalozois, DMO:** There has been a strategic shift of domestic demand from local bonds to our foreign EMTN market which the DMO considers the market most likely to lead to the achievement of medium term debt management objectives under the current strategy.

As a result, most of the domestic demand has been absorbed in our international government bond issuances. Domestic demand is dominated by banking institutions. Its share in each of our EMTN issues reached about 14% of the total nominal value and it has remained at these levels in the last two issues.

**GlobalCapital: Finally, what would reunification mean for the economy and for the Republic of Cyprus as an issuer?**

**Panteli, Ministry of Finance:** We now have leaders both on the Greek-Cypriot and the Turkish sides who are very much in favour of finding a solution to the Cyprus problem. But there are a number of financial challenges associated with reunification, so we are currently discussing how we would create a unified economy, and how this could unleash the growth potential of the whole island. We have requested the support of the IMF and the World Bank on this, and they are currently providing assistance on how an economic federation should function.

**Tirkides, Bank of Cyprus:** Reunification is part of a long term story. If things come together and we can get past the inevitable short term problems, it will greatly add to the attractiveness of the island for investors.

**Cortese, Société Générale:** I’m no expert in the regional politics of the Eastern Mediterranean. But I think it’s very interesting that at a time when so many people in Europe are talking about secession, Brexit or Scottish independence, on this side of the Mediterranean they are talking about federation or unification. Could that be an example for the rest of Europe?
Banks optimistic for brighter future despite NPL shadow

By 2013, Cypriot banks had assets of €126bn, almost seven times GDP. Small wonder that when the bubble burst, the impact was spectacular. But the recovery has been equally impressive, due in no small part to the quick and decisive action taken through capital controls and recapitalisations. However, whether that recovery can be maintained remains to be seen, as the mountain of impaired debts continues to weigh heavily.

"There is absolutely zero complacency here," says Nick Smith, director of the restructuring and recoveries division at Bank of Cyprus in Nicosia. "We know we still have a huge problem to deal with."

Huge indeed. Although it has been reduced sharply since Smith joined Bank of Cyprus last August, the bank's balance sheet continues to creak under its €9bn or so of problem loans, defined as those that are 90 days or more past due.

Smith, who has more than 20 years of workout experience, most recently at RBS and KPMG, leads a team of about 500 professionals located throughout Cyprus. Their job is to identify and implement solutions to Bank of Cyprus's weighty portfolio of non-performing loans (NPLs) — ideally on a consensus basis.

That mountain of NPLs is part of the legacy left by the appalling mismanagement of banks' lending departments and feeble oversight of the Cypriot banking system in the years following the island's accession to the EU.

The story of the collapse of the Cypriot banking sector is all the more remarkable because of the conservative pedigree of the industry, according to Sofronis Clerides of the Economic Research Centre at the University of Nicosia. His excellent account of the Cypriot banking crisis, published in the Cyprus Economic Policy Review in 2014, explains that "up until 2000, Cyprus ran a closed and tightly controlled financial system and its banks were conservative, inward-looking institutions."

Change of behaviour

To understand why Cypriot banks loaded up with dubious loans as though their lives depended on it, you need to turn the clock back to Cyprus's entry to the EU in May 2004. That unleashed an inflow of foreign capital the like of which Cyprus had never seen. It also fuelled intense competition among the local banks — which in the late noughties were joined by Greek banks — to offer depositors mouth-watering returns.

With deposit rates reaching 5% or 6% by the end of the decade, Cyprus's banks were pushed into an increasingly desperate hunt for returns.

The result was a credit boom out of all proportion to the size of the economy. According to Clerides, up until the end of 2005, credit to the real estate and housing sector had been growing by about 6% or 7% annually. By the first quarter of 2008, it was growing at a jaw-dropping annual rate of 43.9%.

It was when this loan book started to go bad that Cyprus's banks turned to Greek Government Bonds (GGBs) and other overseas assets in search of returns. According to one report, by 2009 about 30% of Bank of Cyprus's pre-tax profits were accounted for by its GGB-related activity. System-wide, according to the EC, by 2012 direct loans to Greece had reached €20bn, or about 110% of Cyprus's GDP.

The result was that the Cypriot banking sector mushroomed into one of the largest in Europe relative to the size of its economy. By 2013, according to a report published that year by RBS, Cypriot banks had assets of €126bn, almost seven times GDP.

Small wonder that when the bubble burst, the impact was spectacular. The haircut suffered by Bank of Cyprus and Laiki Bank amounted to a combined loss of €4.5bn, or about 25% of Cypriot GDP, according to Clerides's numbers. It was this that ultimately drove Cyprus cap in hand to the troika, in turn setting the stage for Europe's first depositor bail-in.

Reporting — or not reporting

The true magnitude of the NPL problem was hidden by Cyprus's unusual mechanism for reporting (or not reporting) impaired loans. Melina Skouridou, assistant vice-president at Moody's in Limassol, explains that in most economies, exposure past due by more than 90 days would be classified as non-performing. Not so in Cyprus, where there was no requirement for any loans fully covered by real estate collateral to be reported as impaired.

The impact was that it encouraged banks to overload their portfolios with loans that — on paper at least — were collateralised. As Smith puts it, "this bank was addicted to collateral."

It is tempting to conclude that the result was the creation of a bloated loan boom collateralised against little more than thin air. After all, according to the Clerides account, by August 2014, almost three in every four loans to the construction sector were non-performing.

"I haven't done a benchmarking of gross loan values to collateral across Europe," says Smith. "But my gut feeling is that collateral values now relative to loan amounts in Cyprus are good compared to other southern European jurisdictions. The issue was a combination of loans to value (LTV) which were too aggressive and the structuring of short term facilities against long term assets, which made refinancing impossible when the value of the collateral started to fall."

"As there was little or no equity
THE BANKING SECTOR

cushioning against these loans, when asset prices fell, the problem of NPEs [non-performing exposures] emerged with a period of about three quarters.”

Ross to the rescue
The good news is that Cyprus grasped the nettle of its banking crisis quickly and decisively, imposing capital controls which lasted for two years and recapitalising the banks either through state aid or via substantial injections of foreign capital. The most significant of these was the €400m investment made in Bank of Cyprus in August 2014 by a consortium led by the US-based Wilbur Ross, founder and chief strategy officer at the private equity firm, WL Ross & Co. Ross, whose net worth Fortune puts at $2.9bn, has developed an appetite for bombed-out European banks, having also invested in Bank of Ireland and Greece’s Eurobank.

“The fact that there have been inflows into the banking system since the withdrawal of capital controls is a vote of confidence”

Antonis Antoniou, Eurobank

NPL mountain
So far, so good. The problem, as central bank governor Chrystalla Georghadji acknowledged in a recent speech, is the mountain of impaired debts that continues to weigh on the banking system. “The sheer size of NPLs relative to Cyprus’s GDP makes it the biggest problem facing our banking system,” she said. The IMF puts the NPLs at about 150% of GDP.

Bank of Cyprus has already made impressive progress in addressing its NPL problem, delivering a 27% decrease in its stock of 90 days-plus arrears since they reached a peak of €13bn in March 2015. More specifically, says Smith, NPLs at large companies have been cut by almost 50%, while those at mid-sized corporates are down by about 70%. Smith says he is most encouraged by the inroads Bank of Cyprus has made into its book of NPLs to SMEs, which have been pared by 25%. “High volume, low value credits are always the most difficult,” he says, “so I’m hugely please by the volume of SME NPLs that we have dealt with on a consensual basis.”

This progress has in part been a natural by-product of an improved macro-economic environment. It has also been driven by debt for equity swaps and the use of innovative solutions such as junior non-cash pay-
THE CORPORATE SECTOR

Green shoots hint at corporate finance recovery in Cyprus

With the stock exchange and the country’s banking sector regaining strength, the real economy is beginning to feel the benefit. This is crucial, as capital being readily available to SMEs is fundamental to accelerating economic revival in Cyprus.

“We WERE hit harder by the crisis than any other part of the economy, given that 75% of our turnover was in bank shares,” says Nondas Metaxas, director general and CEO of the Cyprus Stock Exchange. That is debatable, because the number of companies listed on the tiny exchange, together with its market capitalisation and trading volumes, were all in free-fall long before 2013.

Nevertheless, Metaxas is confident that the worst is over. “We’re playing catch-up, but we’re now close to breaking even and we believe trading volumes will double this year. Although we have seen no IPOs in recent years, we are in discussions with a number of companies about the possibility of new listings next year,” he says.

Metaxas hopes that the exchange will have a key role to play in supporting the sustainable recovery of the economy and giving smaller companies an alternative to bank finance.

The European Commission has identified factors in why such bank lending remains elusive. Among them, it says high corporate debt makes businesses less competitive and curbs any capacity to invest and grow. Bank efforts to restructure debt have not yet produced results, it adds. “Banks also have limited access to information on borrowers’ income and assets, despite the creation of the credit registry.”

But bankers say progress in addressing non-performing loans (NPLs) is helping to underpin a recovery in credit to the corporate sector.

“Our capital adequacy level is no constraint to our ability to lend,” says Nick Smith, director of the restructuring and recoveries division at Bank of Cyprus in Nicosia.

“We lent over €0.5bn in the first seven months of this year, which is equal to about 3% of our gross loans book today. Roughly half of this was to consumers and SMEs with the balance to corporates, so we are clearly lending to the real economy.”

Michael Louis, CEO of Eurobank Cyprus, says lending to SMEs is fundamental to economic revival. “SMEs are the backbone of the economy as they fuel new job and wealth creation,” he says. “The banks have recognised the importance of SMEs and have been making big efforts to increase lending to the sector. This has also been boosted with the support of an EIB programme which is collaborating with local banks to promote lending to SMEs.”

More broadly, one constraint on growth in Cyprus is the inefficiency that still characterises much of its public sector. Labour productivity is low, and the costs of some basic utilities are high, especially in the telecoms sector. The EC says: “Competition remains moderate as reflected in the relatively high level of prices, notably with regards to broadband.”

“High prices, together with relatively low digital skills, result in lower than average internet usage,” the EC adds, observing that more than a quarter of Cypriots have never used the internet, which it says is “likely to weigh on overall productivity growth”.

Small wonder that Cyprus has been prioritising investment in technology R&D, and is evaluating tenders for the development and operation of a science and technology park at Pentakomo in Limassol. “There is no doubt that e-services are essential for creating more efficiencies across the public sector,” says Yiorgos Lakkotrypis, minister of energy, commerce, industry and tourism. He has a strong background in technology, having spent six years at IBM and 10 at Microsoft, before moving into politics.

Privatisation delays

It was hoped that privatisation, which was a key part of the economic adjustment programme, would help address some of these inefficiencies. Under the original programme, it was intended that the sale of state-owned public utilities such as the telecoms operator (CYTA), the Electricity Authority (EAC) and the Port Authority (CPA) would generate revenues of €1.4bn by the end of 2018.

Privatisation, however, has run into fierce opposition from the political left. In March, the government pushed through legislation allowing for the privatisation of Limassol port. But it did so with a small majority and only after agreeing measures to safeguard jobs at the Port Authority to prevent a recurrence of the four-day strike earlier this year by workers opposed to the privatisation plan.

Progress on the privatisation of the other main public utilities has been much slower, with legislation on the sale of EAC and CYTA both having run into delays.

Up to a point, the failure of the privatisation programme to live up to expectations matters less than it would have done had the authorities not outperformed on fiscal targets, as this has relieved the pressure on the government to reduce public debt.

But as economists point out, the benefits of accelerating the privatisation programme would extend beyond its value as a fundraising exercise. As Gikas Hardouvelis notes in his recent analysis of the Cypriot economy for Eurobank, privatisation would also help to foster more competition and attract inward investment, which in turn would support job creation.
Reinvigorated tourism sector warms to the task

Cyprus might have the sun and the sea, but its share of the global tourist market has stagnated at about 2.5m visitors a year, while worldwide the total number of tourists has skyrocketed.

Meanwhile, Brexit has cast a shadow. But rather than kicking back on the lounger, the government is implementing a 10 year strategic plan, focusing on quality rather than quantity.

IN COMMON with a number of hotel operators in Cyprus, Thanos Michaelides was uneasy following the UK’s referendum on EU membership. He is managing director of Thanos Hotels and Resorts, which owns three upmarket properties within easy reach of Paphos International Airport.

The hotels cater to tourists who are perhaps less cost-sensitive than the customers of some mass market properties elsewhere on the island.

Nevertheless, the fear in Cyprus was that the impact on sterling of the referendum would reduce the appeal of the island to British holidaymakers, who account for more than a third of non-resident tourism.

Tourism contributes about 7% of Cyprus’s gross added value, and the heavy dependence of the industry on British visitors is one reason why, before the referendum, Standard & Poor’s had identified Cyprus as one of the eurozone members with the most to lose from a Brexit vote.

Moody’s has expressed similar concerns. In its most recent update it said that while the Brexit vote probably came too late to have a major impact on the 2016 summer season, Cypriot tourism could see a “material decline in visitor numbers from the UK in 2017 if sterling remains weak against the euro”.

Some argue that the impact of Brexit on British tourists is a red herring, given that so many of their favoured locations for sun, sea and sand will be equally affected by the value of sterling against the euro. Greece, Spain and Portugal could all be more expensive for British tourists in the post-Brexit world. Although some will stay at home or choose non-eurozone destinations such as Turkey, many will simply absorb higher costs driven by any weakness in sterling.

There are other reasons why, for now, the Cyprus tourism industry is more relaxed about the impact of Brexit. One of these is that number of visitors from the UK has been in sharp decline for a decade. According to Moody’s, the UK’s share of tourist arrivals fell from 58% in 2003 to 39% in 2015. Much of this decline has been compensated for by a sharp rise in arrivals from Russia.

The most obvious explanation for the relaxed response, however, is the buoyancy of the sector over the last 18 months. “We’re having a very good season,” says Michaelides. “Although we have noticed a slight decline in incidental spending in our hotels, which may be as a result of Brexit, our revenues are up.”

The industry also seems to be constructive about prospects for next year. “It’s probably too early to say what the impact of Brexit will be,” says John Hourican, CEO of Bank of Cyprus. “We’ll know more when we see next year’s bookings, but all the intelligence we’re receiving from our portfolio of leisure operators suggest that 2017 will also be a good year.”

It’s not just bookings that are up. Buoyant investor demand for exposure to the tourism sector is also helping Bank of Cyprus to restructure its portfolio of non-performing exposures (NPEs) in the industry much faster than expected. “Tourist assets are performing extremely strongly, with huge interest from domestic and international investors,” says Nick Smith, director of restructuring and recoveries at Bank of Cyprus. “We recently sold three hotels to an investor who was completely new to the island.”

Clawing back competitiveness

Although the divided capital city of Nicosia is only 220 miles from Aleppo, Cyprus’s tourism industry has been an indirect beneficiary of the tragedy that has unfolded in Syria over the last three years. No Cypriot tourism official will say so in as many

“We have to admit that Cyprus has been losing competitiveness in the tourism sector” Yiorgos Lakkotrypis, minister of energy, commerce and tourism words, but television images of refugees arriving on the shores of Greek islands over the last 18 months, added to terrorism outrages in Tunisia and Egypt, can only have added to the relative appeal of Cyprus among visitors from western Europe.

At the same time, the deteriorations in relations between Russia and Turkey over the Syrian crisis and the downing of a Russian airliner over Egypt at the end of October 2015, has clearly enhanced Cyprus’s appeal among tourists from Russia.

While destabilising geopolitical developments among Cyprus’s neighbours may have supported an increase in the numbers of tourists arriving on the island, the news on revenues from the tourism sector is mixed. Outwardly, these look reasonable, with receipts reaching a record in nominal terms of €2.1bn in 2015.

Those receipts continued to climb in the early months of 2016, rising by 12% between January and April. Receipts per tourist, however, fell in the same period by 8.1%, from €650 to €598. As Bank of Cyprus cautions in its most recent economic update: “The single most important driver to rising tourist receipts this year was neither spending per tourist nor length of stay, but rather the increasing number of arrivals.”

This is one reason why Yiorgos Lakkotrypis, Cyprus’s minister of energy, commerce, industry and tour-
TOURISM AND INFRASTRUCTURE

Away from swanky marinas and casinos, Cyprus is exploring other ways to diversify its tourism. Natasia Pilides, director general at the Cyprus Investment Promotion Agency (CIPA), points to medical tourism and film-making as two areas where Cyprus is attracting visitors interested in activities other than sea and sun, which will also support off-season arrivals.

A well run and financially sound airline would certainly help Cyprus to expand and diversify its tourism industry. Cyprus Airways, closed in January 2015, bankrupted by an order by the European Commission to repay €65m in illegal state aid. A new low-cost carrier, Cobalt, began operations at the start of June and now offers services from Larnaka to cities such as London (Stansted), Manchester, Dublin and Athens.

Although it has been dogged in its early operational life by managerial upheavals and a series of technical glitches which have disrupted its scheduling, Cobalt is not short of ambition. Its new CEO is Andrew Madar, a US citizen born in Iran who was previously at Boeing and GE.

Madar says he sees no reason why Cobalt should be unable to leverage Cyprus’s geographical position to replicate what Emirates has achieved in Dubai, albeit on a smaller scale.

In particular, Madar has his eyes on the potential of the Chinese market, wondering why tourists from Asia should hike down via Dubai to Indian Ocean islands like Mauritius and the Seychelles when — given the appropriate infrastructure — they could go to Cyprus instead. Madar says that Cobalt, which is 49% owned by the Cyprus subsidiary of the Hong Kong-based AVIC Joy Holdings, is assessing its options for adding long-range aircraft to its fleet to service a number of second-tier Chinese cities.

The Poseidon adventure
To maximise value added from its tourism industry, the government is implementing a 10 year strategic plan to differentiate the island from competing Mediterranean holiday destinations, with new golf courses, up-market marinas and an integrated casino resort. The Poseidon Grand Marina in Paphos, for example, which was given the go-ahead in May, is a 42,000 square metre development which will provide berths for around 1,000 yachts.

Our share of the global market has stagnated at about 2.5m tourists a year, while the total number of worldwide tourists has skyrocketed, he adds. “We are working hard to increase this share by diversifying our tourism offering and focusing on quality rather than quantity.”

The Poseidon Grand Marina Project — part of Cyprus’s new plan

Cyprus: the new lucky country?
Besides tourism, the other area of the Cypriot economy that is expected to attract rising volumes of long-term investment is the natural gas sector, which local economists and policymakers hope will be transformational. Extensive gas reserves were discovered in the Levant Basin in 2011, of which 13 were offshore gas blocks located within the Cypriot Republic’s Exclusive Economic Zone (EEZ).

The discovery of these reserves prompted considerable excitement among international commentators, with RBS advising in a report published in January 2013 that “Cypriot gas reserves are enormous and will turn Cyprus into a net international creditor”. Specifically, said RBS, initial gas reserves were likely to be worth 300% of GDP. This, said RBS at the time, makes Cyprus “the new lucky country”.

Yiorgos Lakkotrypis, Cyprus’s minister of energy, commerce, industry and tourism, prefers to use the expression “cautious optimism” to describe his thoughts about the potential for Cyprus’s offshore gas sector. Noble Energy of the US announced the first natural gas discovery — named the Aphrodite field — in Cypriot territory in January 2012, and as the EEZ shares the same geological properties as Egypt’s waters, Cyprus is hopeful about the potential for more Aphrodite-style finds.

“We’re still in our infancy in terms of discoveries,” says Lakkotrypis. “But it is estimated that the Aphrodite field has reserves of 4.5tr cubic feet (tcf). To put that number into perspective, for our own electricity production Cyprus needs about 0.5tcf every 20 years. In other words, the Aphrodite field alone has enough gas to cover our needs for the next 200 years.”

This explains why Cyprus is hoping to sell much of the Aphrodite gas to Egypt. Although Egypt’s offshore Zohr gas field dwarfs Aphrodite, with reserves estimated at 30tcf, the country’s demographics are such that it will need to import gas to meet domestic demand. Given that Port Said on Egypt’s northern coast is only 240 miles from Limassol, this makes Egypt an obvious export market for Cypriot gas.

No wonder Lakkotrypis is spending much of his time shuttling between Nicosia and Cairo as well as number of other key regional cities. “Regional cooperation is absolutely critical for us to create the secure investment environment demanded by the international companies,” he says. “There is work to be done to put in place bilateral and tri-lateral agreements in the region and to build the infrastructure necessary for the eastern Mediterranean to realise its potential as an alternative source of energy supplies for the EU.”

No wonder, either, that Cyprus is already making plans for how to manage the revenue streams that will be generated by its gas reserves. According to Lakkotrypis, the government is already setting up a sovereign wealth fund based on the Norwegian model to safeguard against Dutch disease.
Ahead.

For over a century, we’ve been the leading bank in Cyprus for personal, corporate, and investment banking services. We’re continuing to grow. And with our international outlook and network, our clients know they can rely on our knowledge and expertise. That’s why they choose us as their financial partner.