EUROPEAN COMMISSION

Brussels, 06.11.2012
C(2012) 7962 final

Subject: **State Aid SA.35499 (2012/N) – Cyprus**
State Guarantee Scheme for Cypriot Banks

Madam,

I. PROCEDURE

1. On 28 September 2012, Cyprus informed the Commission of its intention to establish a guarantee scheme. By electronic mail of 1 October 2012 the Commission submitted further questions to which Cyprus replied on 4 October 2012.

2. On 12 October 2012, Cyprus formally notified the envisaged guarantee scheme (the "Scheme").

3. By electronic mail of 27 October 2012, the Cypriot authorities provided additional information.

4. The Cypriot authorities have exceptionally accepted that the Commission decision be adopted in the English language.

II. DESCRIPTION

1. The objective of the Scheme

5. The objective of the Scheme is, according to the notification, to provide a remedy for a serious disturbance in the economy. The measure should "enable credit institutions to raise medium-term funding, thereby enhancing the liquidity of the Cyprus economy and reducing interest rates towards levels comparable to those in other euro area economies"[1]. […][*].

[1] Letter of 11 October 2012 sent by the Governor of the Central Bank of Cyprus to the services of the Commission.

[*] confidential information

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6. Under current economic conditions Cypriot credit institutions cannot successfully place debt instruments in the market since there is very little market demand for bonds issued by them – even if guaranteed by the State. In view of the banks' restricted access to sources of medium- to long-term funding, the proposed Scheme is, according to the notification, expected to aid credit institutions in meeting their funding needs and reinforce the overall financial stability of the banking system.[2]

7. The legal basis of the envisaged Scheme comprises, first, the draft *Law that Governs the Granting of Government Guarantees for the Conclusions of Loans and/or the Issue of Bonds by Credit Institutions* ("the draft Law") and, secondly, the draft Ministerial *Decree pursuant to section 10* of the draft *Law that Governs the Granting of Government Guarantees for the Conclusions of Loans and/or the Issue of Bonds by Credit Institutions* ("the draft Decree").

2. Description of main features of the Scheme

Beneficiaries

8. Eligible beneficiaries will be credit institutions which are incorporated in the Republic of Cyprus and have been licensed by the Central Bank of Cyprus or the Commissioner of the Authority for the Supervision and Development of Cooperative Societies[3] ("Beneficiaries"). Although cooperative credit institutions are amongst the eligible beneficiaries[4], government guarantees will only be granted to their central body, the Cooperative Central Bank Ltd., which acts as their manager of liquid assets and is the only entity having access to central bank funding. According to the Explanatory Note submitted by the Cyprus authorities, the definition of eligible credit institutions also includes subsidiaries of foreign financial institutions.

Guarantee terms

9. According to the draft Law the Minister of Finance is empowered to proceed with the granting of government guarantees up to a total amount of EUR 6 billion.[5]

10. The maximum amount of government guarantees that may be allocated to any credit institution shall not exceed 15% of the total domestic deposits (excluding interbank deposits) in Cyprus of that credit institution as at 31 December 2011.[6] The guarantees should be granted for a term of no less than three months and no more than five years for new loans to credit institutions or new bonds issued by credit institutions.[7]

11. The guarantees are to be used by credit institutions only as collateral for securing new loans or the issue of bonds for the purpose of funding.[8]

12. According to section 5(10) of the draft Decree the criterion of allocation of the government guarantees to the credit institutions is their contribution, as at 31 December 2011 to

2 Letter of 11 October 2012 sent by the Governor of the Central Bank of Cyprus to the services of the Commission.
3 Section 3 of the draft Law and section 3 of the draft Decree.
4 See Section 2 of the draft Law.
5 Section 3 of the draft Law and section 3 of the draft Decree.
6 Section 11 of the draft Law and section 4 of the Decree.
7 Section 4 of the draft Decree.
8 Section 5(2) of the Draft Decree.

i. The total amount of domestic deposits (excluding interbank deposits), with weight equal to 0.7, and

ii. The total amount of domestic loans (excluding interbank loans), with weight equal to 0.3.

The maximum amount of the government guarantee allocated to each credit institution is calculated by multiplying the market share resulting from points (i) and (ii) above, by the total amount of government guarantees (EUR 6 billion) and is capped at 15% of its total amount of local deposits (see recital 9). In their submission of 4 October 2012, the Cypriot authorities provided a simulation of the maximum amount which could be allocated to each one of a series of banks under those rules.

[…].

13. Amounts from the first allocation which remain unused after five months will be reallocated to any interested credit institution that has received the full amount allocated to it on the first allocation and have not reached the limit of 15% of its total local deposits.

14. When applying for the granting of government guarantees, a credit institution must submit a plan of its mid to long-term funding needs to be further approved by the Central Bank of Cyprus.[9]

Guarantee commission (fee)

15. The Scheme provides for a guarantee commission that is calculated in accordance with the *Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis*[10] of December 2012 ("the 2011 Prolongation Communication"). Specifically, the fee will be[11]:

i. For government guarantees with maturity of three to twelve months, the commission amounts at least to the sum of

  - a basic fee equal to 50 basis points (bp), and
  - a risk-based fee equal to
    - 20 bp for credit institutions with a rating of A+ or A
    - 30 bp for credit institutions with a rating of A-
    - 40 bp for credit institutions with a rating under A- or with no rating.

ii. For government guarantees with maturity over one year, the commission is calculated as follows:

  - a basic fee equal to 40 bp, and
  - a risk-based fee equal to the product of 40 bp and a risk metric composed of

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9 Or the Authority for the Supervision and Development of Cooperative Societies, as the case maybe (section 5(8) of the draft Decree).

10 OJ C 356, 6.12.2011, p. 7.

11 Section 5(11) of the draft Decree.

- (a) one half of the ratio of the beneficiary's median five-year senior CDS spread over the three years ending one month before the date of issue of the guaranteed bond to the median level of the iTraxx Europe Senior Financials five-year index over the same three-year period; plus
- (b) one half of the ratio of the median five-year senior CDS spread of all Member States to the median five-year senior CDS spread of Cyprus over the same three-year period. The medians are calculated over the three years ending one month before the date of issue of the guaranteed bond.

iii. For banks without CDS data, or without representative CDS data, but with a credit rating, an equivalent CDS spread should be derived from the median value of five-year CDS spreads during the same sample period for the rating category of the bank concerned, based on a representative sample of large banks in the Member States. The supervisory authority will assess whether the CDS data of a bank are representative.

iv. For banks without CDS data and without a credit rating, an equivalent CDS spread should be derived from the median value of five-year CDS spreads during the same sample period for the lowest rating category.

16. The Cypriot authorities, using recent market data, have provided an indicative fee for each potential Beneficiary based on an application of the formula referred to in recital 15.

17. In particular, none of the domestic banks has a representative CDS. As a result, they would use as input in the formula the median CDS of the representative sample of large European banks provided by the Commission for the lowest rating category[12].

Collateral

18. The draft Decree provides for a general rule according to which the credit institutions have to provide to the government adequate eligible collateral which fully covers the amount of the guarantee allocated to them. Collateral requirement may only be waived in exceptional cases, based on a reasoned opinion of the Central Bank of Cyprus. In such a case the fee for the provision of government guarantees will be 50bp higher than the fee described above under recital 14.[13]

19. Eligible collateral is defined in section 5(12) of the draft Decree as follows:

i. All eligible collateral acceptable by the Eurosystem credit operations, as prescribed in the relevant Directives of the Central Bank of Cyprus.

ii. Claims on regularly serviced loans to businesses for which there is a credit rating by an eligible External Credit Assessment Institution.[14] Claims on regularly serviced loans to

[12] Footnote 12 of the 2011 Prolongation Communication states that the lowest category to be considered is A, as there is insufficient data available for the rating category BBB. However, due to the downgrade of many banks in the framework of the sovereign crisis, there are now many banks with a rating below A with representative CDS. Therefore, the Commission services have been able to establish the sample of European banks with a representative CDS that also includes banks in the "BBB-rating or below" bucket.

[13] Section 5(12) of the draft Decree.

[14] The credit rating for the purposes of the Directive of the Central Bank of Cyprus for capital requirements and large exposures of 2006 to (No. 2) of 2011, as subsequently amended, is classified in credit quality steps 1 to 4.

businesses for which there is no credit rating are eligible subject to haircuts which will depend on the quality of the collateral.

iii. Claims on regularly serviced loans to individuals that are secured by mortgages on residential property (housing loans). Loans are only eligible if the ratio of loan-to-property value is not higher than 80%. The mortgaged property must be situated within the territory of the Republic of Cyprus. [15]

III. POSITION OF CYPRUS

20. Cyprus has notified the Scheme as State aid seeking to remedy the serious disturbance in its economy within the meaning of Article 107(3)(b) of the Treaty on the Functioning of the European Union (TFEU). The serious disturbance in the economy is the result of the international financial crisis and the negative impact of the crisis on the Cypriot real economy evident since a negative rate of economic growth has been recorded for the first half of 2012. Moreover, domestic credit expansion has significantly dropped over the same period.

21. The draft Decree requires credit institutions granted government guarantees to submit a review on their long-term viability without State support to the European Commission (and with notification to the Ministry of Finance) within the quarter from the granting of the government guarantee, if the total of their outstanding guaranteed liabilities exceeds, on a cumulative basis, 5% of their total liabilities and amounts to more than EUR 500 million.[16]

22. Cyprus has provided information on the pricing of guarantees under the Scheme according to the formula recorded in recital 15, and agrees to enable the Commission to assess the effective application of that pricing.

23. The Cypriot authorities commit that no more than one third of the total budget of the scheme will be used to issue guarantees on debt longer than 3 years.

IV. ASSESSMENT

1. State aid character of scheme

24. As set out in Article 107(1) TFEU, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

25. The Commission agrees with the position of Cyprus that the Scheme constitutes aid to the Beneficiaries pursuant to Article 107(1) TFEU.

26. The provision of guarantees by the State involves State resources. Those guarantees allow the Beneficiaries to obtain liquidity at conditions which would not be available to them under market conditions and thereby provides them with an advantage. The advantage is selective since it only benefits the financial institutions using the Scheme. That economic

[15] Regarding regularly serviced loans to businesses and individuals, they are defined as the loans that have not been classified as non-performing loans in accordance with the “Classification of Non-Performing Facilities Directive of 2008” of the Central Bank of Cyprus.

[16] Section 5(9) of the draft Decree.

advantage to the Beneficiaries strengthens their position compared to that of their competitors in Cyprus and other Member States. It must, therefore, be regarded as distorting competition. In light of the fact that Cypriot banks are active in other Member States and that subsidiaries of banks headquartered in other Member States are active on the Cypriot banking market, the Scheme is capable of affecting trade between Member States.

2. Compatibility

Application of Article 107(3)(b) TFEU

27. Cyprus intends to provide aid under a guarantee scheme to assist credit institutions having access to liquidity.

28. Article 107(3)(b) TFEU enables the Commission to declare aid compatible with the internal market if it is necessary *"to remedy a serious disturbance in the economy of a Member State"*.

29. The Commission considers that the exceptional circumstances envisaged in Article 107(3)(b) TFEU exist and, therefore, recognises the need for the introduction of the Scheme. In particular, the persisting tensions in sovereign debt markets and the exposure of many Cypriot banks to the Greek sovereign crisis, has put the country's banking sector under increasing pressure, particularly in terms of access to term funding. Those difficulties are confirmed by the Central Bank of Cyprus in its letter of 11 October 2012.

30. The Commission therefore finds that the scheme aims at remedying a serious disturbance in the Cypriot economy.

Conditions of compatibility under Article 107(3)(b) TFEU

31. In line with point 15 of the Banking Communication[17] any aid or aid scheme in order to be compatible under Article 107(3)(b) TFEU it must comply with the general criteria for compatibility:
    a. *Appropriateness*: The aid has to be well-targeted in order to be able to effectively achieve the objective of remedying a serious disturbance in the economy. It would not be the case if the measure were not appropriate to remedy the disturbance.
    b. *Necessity*: The aid measure must, in its amount and form, be necessary to achieve the objective. Thus it must be of the minimum amount necessary to reach the objective, and take the form most appropriate to remedy the disturbance.
    c. *Proportionality:* The positive effects of the measure must be properly balanced against the distortions of competition, in order for the distortions to be limited to the minimum necessary to reach the measure's objectives.

[17] Communication from the Commission on The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270, 25.10.2008, p. 8.

Appropriateness

32. In line with point 23 of the Banking Communication, the scheme is limited to senior loans to financial institutions and senior bonds issued by such institutions. Subordinated debt is excluded.

33. As regards appropriateness, the objective of the guarantee scheme is to support access to liquidity of credit institutions. Under the current economic conditions in Cyprus, credit institutions have been facing increasing difficulties in raising funds. The Commission considers that such a liquidity scheme can help to overcome that market situation, by aiding credit institutions to obtain medium- to long-term funding and thereby enhancing the liquidity of the Cypriot economy.

34. In addition, as required by point 18 of the Banking Communication, the scheme is open to all credit institutions incorporated in Cyprus, including subsidiaries of foreign banks. On that basis the Commission concludes that the Scheme is appropriate.

Necessity

35. The measure is also limited to the minimum necessary in scope and time. Guarantees granted under the Scheme are for a term of no less than three months and no more than five years for new loans to credit institutions or new bonds issued by credit institutions until 31 December 2012.

36. With regards to the size of the measure, the Commission notes that the budget is limited to a maximum amount of EUR 6 billion.

37. The use of the Scheme should be limited to the minimum necessary by the requirements set by Cypriot authorities that the credit institutions will have to provide adequate collateral to fully cover the amount of the guarantee allocated to them and that a higher guarantee commission (by 50 bp) will be paid by those credit institutions where the collateral requirement is, exceptionally, waived (see recital 19).

38. In respect of pricing, the Commission notes the terms and conditions for the granting of guarantees under the Scheme are in line with the 2011 Prolongation Communication. The Commission has not found traded CDS for Cypriot domestic banks and therefore accepts that, when applying the formula, the authorities use as input the median CDS of the sample of European banks rated BBB and below provided by the Commission services. The Commission observes that the Cypriot authorities will request banks to provide collateral and, if they do not do so, they will have to pay an add-on fee of 50 bp. The Commission recalls that it has identified conditions and fees which are ordinarily the minimum that would have to be charged by Member States for State aid in the form of guarantees to banks during the financial crisis to be compatible with the internal market. However, it does not object to Member States setting higher remuneration requirements as long as they are applied on a non-discriminatory basis.

39. The Commission notes positively that the Cypriot authorities have committed that no more than one third of the total budget of the scheme will be used to issue guarantees on debt longer than 3 years. This ensures that the entire budget is not solely used to guarantee debt instrument for four and five years, which would have seemed unbalanced, but it will also be used to guarantee shorter instruments where appropriate.

Proportionality

40. As regards the proportionality of the Scheme, the distortion of the competition is minimised by various safeguards. The Commission notes that the Scheme contains a system for the allocation of the amount of the government guarantees to Beneficiaries. It is based on the market share of the participating credit institution as of 31 December 2011 in domestic deposits and domestic loans (see recital 12), while the total amount to any Beneficiary is capped at 15% of its total amount of local deposits.

41. It is true that the Scheme also foresees that amounts from the first allocation which remain unused after five months will be reallocated to any interested credit institution that reached the full amount allocated to it on the first allocation but did not reach the limit of 15% of its total local deposits. However, the present approval is limited to a two-month period. As a result, that reallocation is not covered by the present approval and the present approval is limited to the amounts described in recital 11.

42. In line with point 27 of the Banking Communication, the Cypriot authorities impose through the draft Decree additional safeguards on financial institutions benefiting from State guarantees: (a) any bonuses of the President, Managing Director and the rest of the members of the Board or Committee and General Managers, Secretaries and their replacements are abolished; (b) no purchase of own shares by the credit institution is allowed; (c) the credit institution shall not adopt aggressive market strategies, including advertising of the support it receives; the annual increase of the balance sheet of the credit institution shall not exceed the annual increase of the balance sheets of the banking system in the Cyprus Republic over the ten-year period preceding the granting of the state guarantee.

43. […].

44. As regards the combination of the Scheme with other aid measures, as indicated in the Annex to the Restructuring Communication[18], any restructuring plan should take account of all State aid received as individual aid or under a scheme during the restructuring period and such restructuring plan needs to satisfy all criteria prescribed by the Restructuring Communication (i.e. return to viability, own contribution by the beneficiary and limitation of competition distortion). Accordingly, once a Member State is under an obligation to submit a restructuring plan for a certain aid beneficiary, the Commission needs to take a view in its final decision as to whether any aid granted during the restructuring period satisfies the criteria required for the authorisation of restructuring aid. To that end, an individual, ex ante, notification is necessary. Furthermore, the Commission recalls that based on point 16 of the Restructuring Communication, if aid not initially foreseen in a notified restructuring plan is necessary for the restoration of viability that additional aid cannot be granted under an approved scheme and will be taken into account in the Commission's final decision on that bank.

45. In the present case, the Commission notes that Cyprus Popular Bank has to submit a restructuring plan following its recapitalisation of June 2012[19].

46. The Commission observes that the amount of guarantee which can be granted to each bank (including Cyprus Popular Bank) during the two-month period covered by the present decision is limited to the amounts mentioned in recital 11. Those amounts cannot

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18 Communication from the Commission on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rule, OJ C 195, 19.08.2009.

19 Commission Decision of 13 September 2012 on the Rescue Recapitalisation of Cyprus Popular Bank (ex Marfin), not yet published

be considered to be disproportionate in light of the size of the balance sheets of potential Beneficiaries.

47. The Commission also notes that any Beneficiary whose total of outstanding State-guaranteed liabilities exceeds, on a cumulative basis, 5% of its total liabilities and the amount of EUR 500 million must submit a review on its long-term viability without State support to the Commission within the quarter from the granting of the government guarantee. That requirement is an adequate safeguard, since the Scheme should not enable Beneficiaries with structural weaknesses in their business models to postpone or avoid the necessary adjustments.

48. On the basis of the above, the notified measure is compatible with the internal market until 31 December 2012.

V. DECISION

The Commission has decided not to raise objections against the notified measure until 31 December 2012, since it fulfils the conditions to be considered compatible with the internal market pursuant to Article 107(3)(b) of the Treaty on the Functioning of the European Union.

The Commission notes that Cyprus has exceptionally accepted that the decision be adopted in the English language.

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Yours faithfully,
For the Commission

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