EUROPEAN COMMISSION

Brussels, 22.10.2009
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COMP Operations

Subject: **State Aid N 511 /2009 – Cyprus**
Special government bonds scheme

Sir,

I. PROCEDURE

1. On 9 September 2009 Cyprus notified a scheme to issue special government bonds as a support measure for the financial sector.

2. Cyprus submitted additional information on 25 September 2009 and 5 October 2009.

II. DESCRIPTION OF THE SCHEME

1. Legal basis and objective of the measures

3. In response to the exceptional turbulence in world financial markets, Cyprus intends to bring forward a support measure through the issuance of special government bonds scheme to credit institutions (hereinafter "the Scheme") designed to reinforce stability in the financial markets and mitigate the detrimental effects of the crisis on the economy as a whole.

4. The proposed measures will be transposed in Cypriot law through the "Law on the issue of special government bonds" (hereinafter 'the Law') and an implementing decree (hereinafter 'the Ministerial Decree').

5. Under the Scheme, the Cypriot government would issue special State bonds (hereinafter " bonds"). The bonds would be lent to credit institutions that would use them as collateral to obtain liquidity from the ECB and interbank markets. The bonds would be lent to the credit institutions against a remuneration and appropriate collateral.

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2. The Beneficiaries

6. Beneficiaries of the Scheme are credit institutions incorporated in Cyprus, including subsidiaries of foreign credit institutions.

7. The eligible credit institutions must be solvent and have a capital adequacy ratio which is over 8%. They must comply with the minimum prudential liquidity ratios and with any other terms and the conditions set by the Ministerial Decree.

3. Description of the Scheme

8. Bonds can only be issued under the Scheme within a window of six months starting from the day that the Ministerial Decree enters into force (but not later than 30 November 2009). The period of issuance will consequently end no later than 31 May 2010.

9. The overall budget of the Scheme is EUR 3 billion. The allocation to credit institutions will be made in packages of 1 million euro. The main criterion of allocation of the bonds is the credit institution's contribution to the provision of finance in the domestic market to small and medium-sized enterprises and housing loans as on 31 December 2008. The amount of the bonds provided to each credit institution is calculated on the basis of the institution's aggregate domestic market share in business and housing loans.

10. The bonds will pay no coupon, will have a maturity of not more than three years and be listed on the Cypriot Stock Exchange. They will be distributed at nominal value, directly and exclusively to the eligible credit institutions. The bonds will be allocated through contracts between the State and the individual beneficiary, at the expiry of which the bonds shall be returned to the State and cancelled.

11. The bonds are provided to eligible credit institutions against a fee and collateral. The fee is payable at the beginning of each semester or at the beginning of the residual time to maturity, if this is less than six months.

12. The fee is calculated based on the recommendations of the European Central Bank concerning guarantees on bank debt (hereinafter the "ECB Recommendation", see in particular points 3 to 8 thereof)[1].

13. For bonds with maturity of 3-12 months there will be a fee of 25 basis points (corresponding to points 6 to 8 of the ECB Recommendations).

14. For bonds with a maturity over one year the fee is calculated as follows:

    (a) For credit institutions with Credit Default Swaps (CDS) data, the fee is set as the minimum between the median value of five year CDS spreads of the credit institution concerned and the median value of five year CDS spreads of a representative sample of eurozone banks with the same credit rating as the credit institution, for the period from 1 January 2007 to 31 August 2008, plus 25 basis points.

    (b) For credit institutions without CDS data, but with a credit rating, the fee is calculated as the median value of five year CDS spreads of a representative sample of large eurozone banks prescribed by the Eurosystem with the same credit rating as the credit institution concerned for the period from 1 January 2007 to 31 August 2008, plus 25 basis points.

[1] Recommendations on Government Guarantees on Bank Debt of the European Central Bank of 20 October 2008.

(c) For credit institutions without CDS data and without credit rating, the fee is calculated as the median value of five year CDS spreads of a representative sample of large eurozone banks prescribed by the Eurosystem with the lowest credit rating, for the period from 1 January 2007 to 31 August 2008, plus 25 basis points.

15. The amount of the fee may be readjusted by the Minister of Finance with the approval, upon notification, of the European Commission.

16. The type of eligible collateral is listed in the Ministerial Decree. The collateral will be in favour of the Cyprus Government and will be monitored on an ongoing basis in order to ensure its adequacy at all times. In order to protect the State against a fall in the value of the collateral, a coefficient of adjustment ("haircut") is applied according to the quality of the collateral.

17. Depending on the residual maturity for *fixed* interest rate business loans with credit quality steps[2] 1 to 2 a haircut of 10-45% will be applied, for similar loans with quality step 3 a haircut of 15-45% and for loans with quality step 4 a haircut of 20-50% will be applied[3].

18. For business loans with *floating* interest rate, the following haircuts will apply:

    – if the borrower's credit assessment is in credit quality steps 1 to 2, the value of collateral is reduced by 10-15% (10% when the residual period to repayment is less than 5 years and 15% when the residual period to repayment is over 5 years);

    – if the borrower's credit assessment is in credit quality step 3, the value of collateral is reduced by 15% - 20% (15% when the residual period to repayment is less than 5 years and 20% when the residual period to repayment is more than 5 years); and

    – if the borrower's credit assessment is in credit quality step 4, the value of collateral is reduced by 20% - 25% (20% when the residual period to repayment is less than 5 years and 25% when the residual period to repayment is more than 5 years).

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[2] The Scheme's "credit quality steps" correspond to the following credit rating agencies' assessment of credit rating:

Credit quality step	Fitch's assessments	Moody's assessments	S&P assessments
1	AAA to AA-	Aaa to Aa3	AAA to AA-
2	A+ to A-	A1 to A3	A+ to A-
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-
4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-

The Cypriot authorities consider the use of the above credit quality steps to be practically more efficient than the setting of haircuts against different credit ratings of each External Credit Assessment Institutions (Moody's, S&P etc).

[3] In particular, business loans with fixed interest rate with residual maturity 0-1 year and quality steps 1-2, 3 and 4 haircuts of respectively 10%, 15% and 20% will be applied. Business loans with fixed interest rate with residual maturity 1-3 years and quality steps 1-2, 3 and 4 haircuts of respectively 15%, 20% and 25% will be applied. Business loans with fixed interest rate with residual maturity 3-5 years and quality steps 1-2, 3 and 4 haircuts of respectively 20%, 25% and 30% will be applied. Business loans with fixed interest rate with residual maturity 5-7 years and quality steps 1-2, 3 and 4 haircuts of respectively 25%, 30% and 35% will be applied. Business loans with fixed interest rate with residual maturity 7-10 years and quality steps 1-2, 3 and 4 haircuts of respectively 30%, 35% and 45% will be applied. Business loans with fixed interest rate with residual maturity more than 10 years and quality steps 1-3 and 4 haircuts of respectively 45% and 50% will be applied.

For all housing loans, the amount of collateral is reduced by 20%, irrespective of the residual maturity or whether the interest rate is fixed or floating. For loans in foreign currency, an additional haircut of 15% will be applied on the initial value of the collateral.

19. The credit institutions to which the bonds are allocated shall use the proceeds of the liquidity raised for the granting of housing loans and loans to small-and medium-sized enterprises on competitive terms. The bonds can only be used by the credit institutions as collateral in the refinancing transactions or marginal lending facilities of ECB or as collateral in interbank transactions.

20. The beneficiaries shall apply the following behavioural constraints:

- refrain from aggressive market strategies, including advertising of the support received, to the detriment of competitors that do not receive similar support;
- ensure that the balance sheet of an institution does not exceed:

(a) the annual growth rate of the GDP of the Cypriot economy of the previous year; or

(b) the average rate of growth of the balance sheet of the financial sector of Cyprus for the period 1988 – 2008; or

(c) the average rate of increase of the size of the balance sheets of the financial sector of the EU for the previous six months

21. whichever of the above is highest.Cyprus shall provide the Commission with a report on the use of the Scheme every six months after the Scheme enters into force (and at least one month before any possible prolongation). The report shall include, amongst other, a list of all beneficiary companies, indicating, for each one of them, the necessary data to enable understanding of the full scope of the support provided under the Scheme.

22. In the case where a bank is unable to return the bonds and the collateral provided is not sufficient, Cyprus commits itself to notify a restructuring or liquidation plan for that institution to the Commission within 6 months from that event.

III. POSITION OF CYPRUS

23. The Cypriot authorities acknowledge that the Scheme contains State aid elements. They have highlighted, however, that in designing these measures they have applied the recommendations of the Eurosystem, formulated to ensure a coordinated approach to bank support measures between Member States.

24. The Cypriot authorities seek authorisation for the Scheme to counteract the impact of the crisis on the economy of Cyprus. While the economy continued growing at a high rate for the whole of 2008, in 2009 significant lagged shocks caused a dramatic downturn of economic activity[4]. According to Cyprus, delayed effects of the global

4 Cypriot economy continued growing at a high rate for the whole of 2008 (3,6% annual rate of growth), including the second half of the year (increase of 3,4% and 2,8% respectively in the 3rd and 4th quarters of 2008). However, the

crisis have led to tight lending conditions and an increased dependence of credit institutions on funding from the ECB. Although the Cypriot credit institutions have no solvency problems at this time, these conditions strain the resilience of the Cypriot banking system and create potential for adverse implications for the financial system.

25. Cyprus indicates that the recession in which the economy has entered in 2009 has already had a negative impact in almost all sectors and will, if not addressed promptly, inevitably affect the financial sector as well, endangering the financial stability in Cyprus.

26. In the view of the Cypriot authorities the Scheme represents a necessary, appropriate and proportionate measure to maintain financial stability and confidence in the Cypriot economy.

27. The Cypriot authorities claim that the Scheme is compatible with the common market because it is necessary to remedy a serious disturbance in the Cypriot economy pursuant to Article 87(3)(b) of the EC Treaty.

28. A letter sent by the Central Bank of Cyprus dated 9 September 2009 confirms that the Scheme is necessary to remedy the serious disturbance in the Cyprus economy resulting from the international financial crisis.

29. The Cypriot authorities consider that the Scheme does not involve undue distortions of competition because the measure is non-discriminatory and open to any bank authorised to operate in Cyprus. The Cypriot authorities note that the Scheme will not allow the credit institutions to expand their business in a disproportionate manner or undertake aggressive business strategies.

IV. ASSESSMENT

1. State aid character of the Scheme

30. As set out in Article 87(1) of the EC Treaty, 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 common market.

31. The Commission agrees with the position of Cyprus that the Scheme constitutes aid to the credit institutions concerned, pursuant to Article 87 (1) of the EC Treaty.

32. The Scheme allows the beneficiaries to access liquidity at preferential terms which would not otherwise be possible in the light of the prevailing conditions in the financial markets. This gives an economic advantage to the beneficiaries and strengthens their position compared to that of their competitors in Cyprus and other

situation changed dramatically in 2009 (following a subdued growth rate of 0,9% (year-on-year). In the first quarter of 2009, the Cypriot economy experienced a negative growth rate of -1,1% in the second quarter, while -0,5%, with a significant downside risk, is forecasted for 2009, compared with 3,6% in 2008. According to Cyprus, this is the first time since 1974-1975 that the Cypriot economy is set to register a negative growth rate. From a quarter-on-quarter perspective, the growth rates registered in the first and second quarter of 2009 were -0,6% and -0,4%, respectively. The outlook still remains negative, as evidenced by economic sentiment indicators which, in contrast to developments in other euro area countries, continue to decline with all the sectoral indicators also displaying a similar pattern.

Member States and must therefore be regarded as liable to distort competition and affect trade between Member States. The advantage, which is provided through State resources, is selective since it only benefits the beneficiaries of the Scheme.

2. Compatibility of the Scheme

a) Application of Article 87(3)(b) of the EC Treaty

33. Cyprus intends to provide aid to assist credit institutions which have problems to access liquidity. Given the present circumstances in the financial markets, the Commission considers that it is acceptable to examine this State aid directly under the Treaty rules and in particular under Article 87(3)(b) of the EC Treaty.

34. Article 87(3)(b) of the EC Treaty enables the Commission to declare aid compatible with the common market if it is necessary "to remedy a serious disturbance in the economy of a Member State". The Commission recalls that the Court of First Instance has stressed that Article 87(3)(b) needs to be applied restrictively and must tackle a disturbance in the entire economy of a Member State.[5]

35. The Commission considers that the Scheme concerns the entire Cypriot banking industry. The Commission does not dispute the analysis of the Cypriot authorities that the current global financial crisis has made access to liquidity more difficult for credit institutions across the board. It has also eroded confidence in the creditworthiness of counterparties. In these circumstances, even sound credit institutions can be found to be under pressure. The Commission considers that if the issues of lack of liquidity and lack of confidence are not addressed, it may result not only in difficulties for the banking sector but, due to that sector's pivotal role in providing financing and directing liquidity to the rest of the economy, may also have a systemic effect on the economy as a whole. The Commission does not dispute that the present Scheme is designed to address the problems of liquidity and possible drop in confidence that have also reached banks in Cyprus. The Commission consequently finds that the Scheme aims at remedying a serious disturbance in the Cypriot economy.

b) Conditions for compatibility under Article 87(3)(b) of the EC Treaty

36. In line with the Commission Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis[6], in order for an aid scheme to be compatible, any aid or aid scheme must comply with general criteria for compatibility under Article 87(3) EC, viewed in the light of the general objectives of the Treaty and in particular Articles 3(1)(g) and 4(2) EC, which imply compliance with the following conditions:[7]

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[5] Cf. in principle Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG Commission* [1999] ECR II-3663, para. 167. Applied in Commission Decision in case C 47/1996, *Crédit Lyonnais*, OJ L 221, 8.8.1998, p.28, point 10.1, Commission Decision in Case C28/2002 *Bankgesellschaft Berlin*, OJ 2005 L 116, p. 1, points 153 *et seq* and Commission Decision in Case C50/2006 *BAWAG*, OJ L 83, 26.3.2008, p. 7, point 166. See also Commission Decision of 5 December 2007 in case NN 70/2007, *Northern Rock*, OJ C 43 of 16.2.2008, p. 1, Commission Decision of 30 April 2008 in case NN 25/2008, *Rescue aid to WestLB*, OJ C 189 of 26.7.2008, p. 3, Commission Decision of 4 June 2008 in Case C9/2008 *SachsenLB*, not yet published.

[6] OJ C 270, 25.10.2008, p. 8.

[7] Cf. Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, OJ C 273, 28.10.2009, p.2, at point 41.

a. *Appropriateness*: The aid has to be well targeted to its objective, i.e. in this case to remedy a serious disturbance in the entire economy. This would not be the case if the measure is not appropriate to remedy the disturbance.

b. *Necessity*: The aid measure must, in its amount and form, be necessary to achieve the objective. That implies that it must be of the minimum amount necessary to reach the objective, and take the form most appropriate to remedy the disturbance. In other words, if a lesser amount of aid or a measure in a less distortive form (e.g. a temporary and limited guarantee instead of a capital injection) were sufficient to remedy a serious disturbance in the entire economy, the measures in question would not be necessary. This is confirmed by settled case law of the Court of Justice.[8]

c. *Proportionality*: The positive effects of the measures must be properly balanced against the distortions of competition, in order for the distortions to be limited to the minimum necessary to reach the measures' objectives. This follows from Article 3(1)(g) EC and Article 4(1) and (2) EC, which provide that the Community shall ensure the proper functioning of an internal market with free competition. Therefore, Article 87(1) EC prohibits all selective public measures that are capable of distorting trade between Member States. Any derogation under Article 87(3)(b) EC which authorises State aid must ensure that such aid is limited to that necessary to achieve its stated objective.

c) Assessment of the Scheme

37. As regards appropriateness, the Commission acknowledges that the objective of the Scheme is to ensure that the participating credit institutions have sufficient access to liquidity. The temporary acquisition of bonds to be used as collateral should enable banks to use illiquid assets (loans) to access liquidity from the Eurosystem and the interbank market. In the current financial situation, other banks may not be willing to accept these types of assets as collateral for loans. The Commission would in general consider that the existence of such a scheme contributes to the stability of the financial markets because it provides a safety net for the financial sector by ensuring speedy access to liquidity in case of urgency.

38. Therefore, as the Commission has previously found concerning a very similar State aid scheme[9], measures such as the Scheme can also be considered as an effective means of overcoming the current difficulties by preventing harmful spill-over effects on the Cypriot financial system and the economy as a whole and is thus appropriate.

39. The Scheme is also targeted at the appropriate beneficiaries as the measures are limited in principle to solvent companies that must comply with the minimum prudential liquidity ratios required by the Central Bank of Cyprus. Moreover, the maintenance of an appropriate capital adequacy ratio of over 8% is one of the eligibility criterion for the allocation of the bonds.

40. The Commission therefore considers the Scheme is appropriate to resolve the liquidity problem currently facing Cypriot credit institutions.

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[8] Cf. Case 730/79, *Philip Morris* [1980] ECR 2671. This line of authority has more recently been reaffirmed by the Court of Justice in Case C-390/06 *Nuova Agricast* [2008] ECR I-2577, where the Court held that, "As is clear from Case 730/79 […], aid which improves the financial situation of the recipient undertaking without being necessary for the attainment of the objectives specified in Article 87(3) EC cannot be considered compatible with the common market […]."

[9] See Commission Decision of 19.11.2008 in case N560/2008 *Support Measures for the Credit Institutions in Greece*, OJ C 125, 5.6.2009, p. 6.

41. As far as necessity is concerned, the mechanism consisting in the temporary loan of bonds to eligible credit institutions is limited to the minimum necessary in scope and time.

42. As regards temporal scope, the Commission notes positively that the window to enter into the Scheme will be only six months. Moreover, the maturity of the bonds will not exceed three years. The Commission also considers that this is reasonable in the light of earlier decisions.[10]

43. As regards scope, the Commission notes positively that the form of the envisaged measure is one of the least distortive in comparison to, for instance, a recapitalisation. The economic effect of the Scheme is comparable to a guarantee against collateral. The State is providing a bond for a defined period, against collateral that has been subject to a significant haircut, which will allow the banks to access liquidity from interbank markets or the ECB. No financial transaction, other than the fee paid by the borrowing banks, takes place on the transfer of the bonds. Only in the event that the bank is unable to repay the institutions that provided it with liquidity will the State be called upon to pay the bonds that it originally issued. It must however be ensured that the State is properly remunerated for the guarantee.[11]

44. In this regard, the aid amount - and potential competition distortions - is minimised through the provision of collateral and the payment of a market-orientated premium. The participating institutions must provide collateral, assigned in favour of the State, which will be subject to significant haircuts (of up to 50% in some cases), and be monitored throughout the duration of the Scheme. In the event of a bank defaulting on its obligations to its creditors, who would then turn to the State to redeem the bonds that they had accepted as security, this collateral would provide the State with some protection from losses.

45. Furthermore, the credit institutions will pay an adequate premium of 25 bps plus the median of the 5-year CDS spread over the 20 months period ending on 31 August 2008 for the bonds with maturity exceeding one year. This is in line with the Commission's practice on guarantees and the ECB's recommendations on the fee for guarantees where collateral is provided, as outlined above. Moreover, given that the State only provides bonds with a zero coupon, and not liquidity, the State has, contrary to other systems where it accepted assets directly for liquidity, no direct financing costs.[12] As a result, the Commission considers that the Scheme can be considered proportional.

46. Finally, the Scheme is aimed at supporting the granting of residential loans and loans to small and medium-sized enterprises and includes several behavioural safeguards as indicated above, such as the ban on advertisements, which help to ensure that participating credit institutions do not use the received State support to expand their

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[10] See, inter alia, Commission Decision of 25.9.2009 in case N 208/2009, *Support Scheme for Banks' Funding in Poland*, not yet published.

[11] Commission Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current financial crisis, OJ C 270, 25.10.2008, p. 8, point 40.

[12] Cf. Commission decision of 27 October 2008 in case N512/2008, *Guarantee scheme for banks in Germany*, OJ C 293, 15.11.2008, p.2, Commission decision of 22 June 2009 in case N330/2009, *Prolongation of the German bank rescue scheme*, OJ C 160, 14.7.2009, p.4, Commission decision of 20 March 2009 in case N637/2008, *Slovenian liquidity scheme to the financial sector*, OJ C 143, 24.6.2009, p.1.and Commission Decision of 2 November 2008 in case N 548/2008, *Financial Support Measures to the Banking Industry in France,* OJ C123, 3.6.2009, p.1.

activities under the Scheme and thus do not receive more support than is necessary to reinforce financial stability.

47. The Commission acknowledges that Cyprus has committed to provide a restructuring or liquidation plan, within six months, for any institution that is unable to return or repay the bonds.

48. On the basis of the above, the Scheme can be considered compatible with the common market on the basis of Article 87(3)(b) of the EC Treaty.

V. DECISION

The Commission finds that the Scheme constitutes state aid within the meaning of Article 87(1) of the EC Treaty. Since the Scheme satisfies the conditions for aid under Article 87(3)(b) of the EC Treaty, it is compatible with the common market. The Commission has accordingly decided not to raise any objections.

The Commission notes that Cyprus accepts that the decision be adopted in the English language.

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Your request specifying the relevant information should be sent by registered letter or fax to:

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Yours faithfully,

For the Commission

Neelie Kroes
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