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**Subject: State aid SA.42080 (2015/N) – Cyprus
Sixth Prolongation of Cypriot guarantee scheme for banks H2 2015**

Sir,

1. PROCEDURE

- (1) On 6 November 2012 the Commission approved until 31 December 2012 the Cypriot Guarantee Scheme for banks (hereinafter "the scheme") by its decision in State aid case SA.35499 (2012/N) (hereinafter "the original decision")¹.
- (2) On 22 January 2013, the Commission approved the first prolongation of the scheme until 30 June 2013². On 25 July 2013, the Commission approved the second prolongation of the scheme until 31 December 2013³. On 18 December 2013, the Commission approved the third prolongation of the scheme until 30 June 2014⁴. On 25 June 2014, the Commission approved the fourth prolongation of the

¹ See Commission decision of 6 November 2012 in State Aid SA.35499 (2012/N) "State guarantee scheme for Cypriot banks", OJ C 173, 19.06.2013, p. 6.

² See Commission decision of 22 January 2013 in State Aid SA.35852 (2012/N) "Prolongation of Cypriot guarantee scheme for banks H1 2013", OJ C 77, 15.03.2013, p. 10.

³ See Commission decision of 25 July 2013 in State Aid SA.36930 (2013/N) "Second prolongation of Cypriot guarantee scheme for banks H2 2013", OJ C 261, 10.09.2013, p. 3.

⁴ See Commission decision of 18 December 2013 in State Aid SA.37870 (2013/N) "Third Prolongation of Cypriot guarantee scheme for banks H1 2014", OJ C 280, 22.08.2014, p. 17.

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scheme until 31 December 2014⁵. On 14 January 2015, the Commission approved the fifth prolongation of the scheme until 30 June 2015⁶.

- (3) On 8 June 2015, Cyprus notified a sixth prolongation of the scheme until 31 December 2015.
- (4) By electronic emails dated 11 June 2015 and 30 June 2015 the Cypriot authorities submitted further information.
- (5) By letter dated 30 June 2015, Cyprus agreed exceptionally to waive its rights deriving from Article 342 TFEU in conjunction with Article 3 of Regulation 1/1958⁷ and to have the present decision adopted and notified in English.

2. FACTS

Description of the scheme and eligibility

- (6) A detailed description of the scheme is provided in the original decision, in particular recitals 5 and 6 concerning the objective of the scheme, recital 7 concerning the legal basis and recitals 8 to 19 on the general description of the scheme.
- (7) The terms and conditions of the scheme remain the same. Eligible beneficiaries are banks and cooperative credit institutions that are incorporated in the Republic of Cyprus and have been licensed by the Central Bank of Cyprus ("beneficiaries").
- (8) The remuneration for the guarantees will be calculated in accordance with the formula set out in the 2011 Prolongation Communication⁸ and described in the original decision⁹. Since credit default swap ("CDS") data are unavailable for any of the domestic credit institutions, the Cypriot authorities will continue to determine the guarantee fee on the basis of the CDS of a sample of banks in the lowest rating buckets ("BBB and below")¹⁰.

Operation of the scheme up to 12 May 2015

- (9) According to the report of Cyprus on the operation of the scheme submitted with the present notification, as of 12 May 2015 the guarantees granted under the scheme amount to EUR 1 billion¹¹ and no new guarantees have been granted since November 2012.

⁵ See Commission decision of 25 June 2014 in State Aid SA.38867 (2014/N) "Fourth Prolongation of Cypriot guarantee scheme for banks H2 2014", OJ C 280, 22.08.2014, p. 29.

⁶ See Commission decision of 14 January 2015 in State Aid SA.40027(2014/N) "Fifth prolongation of Cypriot guarantee scheme for banks H1 2015", OJ C 79, 06.03.2015, p. 13.

⁷ EEC Council: Regulation No 1 determining the languages to be used by the European Economic Community, OJ 17, 6.10.1958, p. 385.

⁸ 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, OJ C 356, 06.12.2011, p. 7.

⁹ See recitals 15 to 17 of the original decision State Aid SA.35499 (2012/N).

¹⁰ That sample of selected European banks has been reviewed and updated for the second half of 2015 in the current version of the DG Competition Staff Working Document "Updated Practical Guidelines for the Pricing of State Guarantees" of 15 May 2015.

¹¹ Granted in November 2012.

3. POSITION OF CYPRUS

- (10) Cyprus requests a prolongation of the scheme for a further period of six months until 31 December 2015.
- (11) Cyprus submits that the scheme constitutes State aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union (“TFEU”), but is of the view that the proposed prolongation is compatible with the internal market on the basis of Article 107(3)(b) TFEU as it is necessary to remedy a serious disturbance in the economy of Cyprus.
- (12) Cyprus submitted a letter by the Central Bank of Cyprus¹² confirming the need for the proposed prolongation. The Central Bank of Cyprus considers the prolongation of the scheme for Cypriot banks for another six months necessary in order to enable those credit institutions to raise medium-term funding through the scheme if the need arises.
- (13) According to the Central Bank of Cyprus, the prolongation is necessary under the prevailing market conditions and in light of the recent abolition of capital restrictions which may adversely affect the liquidity of Cypriot credit institutions. The prolongation of the scheme is expected to cater for the funding needs of credit institutions and support the economy in general, as well as reinforce overall financial stability.
- (14) Cyprus submitted the following commitments relating to the scheme:
- i. to grant the guarantees under the support scheme only for new issuance of credit institutions' (banks') senior debt (subordinated debt is excluded);
 - ii. to provide guarantees only on debt instruments with maturities from three months to five years;
 - iii. to limit the guarantees with a maturity of more than three years to one-third of the total outstanding amount of guarantees granted to the individual credit institution;
 - iv. to determine the minimum level of State guarantee remuneration in line with the formula set out in the Commission's Communication on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis¹³;
 - v. to submit a restructuring plan, within two months of the granting of the guarantees, for every credit institution that is granted guarantees on new liabilities or renewed liabilities for which, at the time of the granting of new guarantee, the total outstanding guaranteed liabilities (including guarantees accorded before the date of this decision) exceed both a ratio of 5% of total liabilities and the total amount of EUR 500 million;
 - vi. to submit individual restructuring or wind-down plans¹⁴ within two months after the guarantee has been activated for credit institutions which cause the guarantee to be called upon;

¹² Notification letter of the Governor of the Central Bank of Cyprus of 28 May 2015.

¹³ OJ C 356, 06.12.2011, p. 7.

¹⁴ The plan must be prepared on the basis of the parameters established in the Commission Communication on the return to viability and the assessment of the restructuring measures in the financial sector in the current crisis under the State aid rules (Restructuring Communication) (OJ C 195, 19.08.2009, p. 9).

- vii. to impose a ban on advertising referring to the State support on the beneficiaries of the scheme and to prevent them from employing any aggressive commercial strategies which would not take place without the State support;
 - viii. to grant aid measures under the support scheme only to credit institutions which have no capital shortfall¹⁵ and, where a credit institution with a capital shortfall is in urgent need of liquidity, to submit an individual notification to the Commission;
 - ix. to report to the Commission on i) the operation of the scheme, ii) the guaranteed debt issues, and iii) the actual fees charged, on a three-monthly basis, meaning by 15 October 2015 (for the period 1 July 2015 to 30 September 2015) and by 15 January 2016 (for the period 1 October 2015 to 31 December 2015) at the latest; and
 - x. to supplement its reports on the operation of the scheme with available updated data on the cost of comparable non-guaranteed debt issuances (as regards nature, volume, rating, currency).
- (15) In line with the requirements of the 2011 Prolongation Communication, Cyprus provided an indicative fee (estimation) for each financial institution eligible to benefit from those guarantees. The estimation was based on an application of the scheme's remuneration formula and recent market data.

4. ASSESSMENT

4.1. Existence of State Aid

- (16) According to 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.
- (17) For the reasons indicated in the original decision, the Commission considers that the scheme constitutes State aid within the meaning of Article 107(1) TFEU because it concerns the provision of State resources to a certain sector, i.e. the financial sector, which is open to intense international competition. Under the scheme, participating banks obtain liquidity support under conditions which would not be available to them under market conditions, and so receive an advantage. Given the characteristics of the financial sector, any advantage from State resources to a bank affects intra-Union trade and therefore threatens to distort competition. The measure therefore constitutes State aid within the meaning of Article 107(1) TFEU.

¹⁵ "No capital shortfall" is certified by the competent supervisory authority, as it is established, in line with point 28 of the 2013 Banking Communication, in a capital exercise, stress test, asset-quality review or an equivalent exercise at Union, euro area or national level, which has to be confirmed by the competent supervisory authority.

4.2. Compatibility of the scheme

4.2.1 Legal basis for the compatibility assessment

- (18) Under the scheme Cyprus intends to provide aid in the form of guarantees in favour of banks.
- (19) Given the exacerbation of tensions in sovereign debt markets that has taken place since 2011 and in light of the persisting circumstances and risks, the Commission considers it appropriate, as confirmed by the 2013 Banking Communication¹⁶, to examine the measure under Article 107(3)(b) TFEU.
- (20) Article 107(3)(b) TFEU empowers the Commission to find that aid is compatible with the internal market if it is intended "to remedy a serious disturbance in the economy of a Member State". The Commission has acknowledged that the global financial crisis can create a serious disturbance in the economy of a Member State and that measures supporting banks are apt to remedy that disturbance. That assessment has been confirmed in the Recapitalisation Communication¹⁷ and the Restructuring Communication.¹⁸ The Commission still considers that the conditions for State aid to be approved pursuant to Article 107(3)(b) TFEU are present. The Commission confirmed that view by adopting the 2013 Banking Communication¹⁹.
- (21) The Commission does not dispute the position of the Cypriot authorities concerning the continuing need of Cypriot credit institutions to improve their funding situation and to reinforce the overall financial stability of the Cypriot banking system. The Commission also notes that notwithstanding the return of the State to the market for medium- and long-term debt²⁰, the volume of such issuances remains limited and its cost high. In addition, banks in Cyprus still rely significantly on Central Bank funding. Therefore, the Commission cannot conclude that market access conditions for the Cypriot banking system as a whole have been fully restored given that the adverse effects of the sovereign crisis still persist. Moreover, despite the fact that the scheme has not been used in the last year, the Commission notes that the availability of the scheme enhances the ability of the Cypriot financial institutions to access the capital markets in the future. Hence, the Commission finds that the scheme aims at remedying a serious disturbance in the Cypriot economy.
- (22) Therefore, the Commission continues to base its assessment of State aid measures in the banking sector on Article 107(3)(b) TFEU.
- (23) In order for an aid to be compatible under Article 107(3)(b) TFEU, it must comply with the general principles for compatibility under Article 107(3), viewed in the light of the general objectives of the Treaty. Therefore, according to the

¹⁶ Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis (OJ C 216, 30.7.2013, p. 1).

¹⁷ Commission Communication - Recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition (OJ C 10, 15.1.2009, p. 2).

¹⁸ Commission Communication on the return to viability and the assessment of the restructuring measures in the financial sector in the current crisis under the State aid rules, (OJ C 195, 19.8.2009, p. 9).

¹⁹ See points 4 to 6.

²⁰ For instance, on 28 April 2015, the Republic of Cyprus issued a 7-year government bond of EUR 1 billion amount with a 3.875% coupon rate.

Commission's case practice²¹ any aid or scheme must comply with the following conditions: (i) appropriateness, (ii) necessity and (iii) proportionality.

- (24) The 2013 Banking Communication and the Restructuring Communication formulate assessment criteria which reflect those general principles and their requirements in light of the specific policy context.

4.2.2 Compatibility assessment of the scheme

Appropriateness

- (25) The scheme should be appropriate to remedy a serious disturbance in the Cypriot economy. The objective of the guarantee scheme is to temporarily offer appropriate measures to establish backstops for the financial system in a timely and efficient manner, where banks face difficulties in obtaining sufficient funding. The Commission observes that the crisis has eroded confidence in the creditworthiness of the banks, which results in difficulties in obtaining necessary funding on the financial markets. Hence, a backstop mechanism by the Member State, which in case of urgency ensures that banks would have access to funding, is an appropriate means to strengthen banks and thus to restore market confidence.
- (26) Points 23 and 60(a) of the 2013 Banking Communication explain that guarantee schemes will continue to be available in order to provide liquidity to banks but that such schemes should be limited to banks without a capital shortfall. The Commission observes that Cyprus has committed to restrict the scheme only to banks without a capital shortfall as certified by the competent supervisory authority.
- (27) Moreover, the Commission notes that Cyprus has committed to grant guarantees only for new issues of banks' senior debt, as prescribed in point 59(a) of the 2013 Banking Communication.
- (28) In addition, the Commission notes that, although Cyprus has not yet adopted the legislation transposing Directive 2014/59/EU on bank recovery and resolution²² into national law, the aid measure by means of the guarantee scheme does not violate intrinsically linked provisions of Directive 2014/59/EU, which in this specific case relate to Article 32(4)(d)(ii). The scheme's criteria ensure that the institutions benefitting from the scheme would not be deemed failing or likely to fail on the sole basis of their participation in the scheme. If the scheme's criteria did not ensure that outcome, the scheme could not be deemed appropriate since it would not be apt to remedy the serious disturbance in the Cypriot economy.

²¹ See Commission decision of 06.09.2013 in State Aid Case SA.37314 "Rescue aid in favour of Probanka" (OJ C 314, 29.10.2013, p. 1) and Commission decision of 06.09.2013 in State Aid Case SA.37315 "Rescue aid in favour to Factor Banka" (OJ C 314, 29.10.2013, p. 2).

²² Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and EU No 648/2012, of the European Parliament and of the Council, OJ L 173, 12.06.2014, p. 190.

- (29) The first subparagraph of Article 32(4) of Directive 2014/59 establishes that an institution shall be deemed to be failing or likely to fail and placed into resolution, (if all the other pre-conditions for resolution are met), where, inter alia, extraordinary public financial support is required, except when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support takes the form, inter alia, of a State guarantee of newly issued liabilities (Article 32(4)(d)(ii) of Directive 2014/59).
- (30) The second subparagraph of Article 32(4) of Directive 2014/59 provides that in order not to trigger resolution such State guarantees on newly issued liabilities must be confined to solvent institutions and must be conditional on final approval under the Union State aid framework. Those measures must be of a precautionary and temporary nature and must be proportionate to remedy the consequences of the serious disturbance and must not be used to offset losses that the institution has incurred or is likely to incur in the near future.
- (31) The Commission notes that the scheme is limited to solvent institutions. The guarantees granted under the scheme are of a temporary nature since the window of their issuance is limited to six months and their maturity is limited to five years and are of a precautionary nature since they only cover newly issued liabilities. The guarantees granted under the scheme are also proportionate to remedy the consequences of the serious disturbance as explained in recital 25. Therefore, at the present stage, the Commission concludes that the aid measure does not violate the intrinsically linked provisions of Directive 2014/59 in the context of the State aid rules.

Necessity

- (32) With regard to the scope of the measure, the Commission notes positively that Cyprus has limited the size of the guarantee scheme by setting its maximum budget at EUR 6 billion and that the scheme applies until 31 December 2015.
- (33) The Commission notes that Cyprus has committed to grant guarantees only on debt instruments with maturities from three months to five years and limit guarantees with a maturity of more than three years to one-third of the outstanding guarantees granted to the individual bank, which complies with the requirements in points 59(b) and 60(b) of the 2013 Banking Communication.
- (34) Regarding the remuneration level, the Commission observes that Cyprus, in line with point 59(c) of the 2013 Banking Communication, has committed to follow the pricing and other conditions for State guarantees laid down in the 2011 Prolongation Communication which requires, in particular, the application of a pricing method based largely on market data.
- (35) Since the beginning of the sovereign debt crisis the CDS of Member States in difficulty have increased to high levels. The CDS of the large banks located in those Member States have increased in line with those of their sovereign. The very high CDS of large banks in programme countries do not seem to primarily reflect their intrinsic risk profile, but are mainly driven by the sovereign risk. That link can lead to a situation in which the application of the guarantee pricing formula based on the individual CDS spread of the bank results in an excessively expensive guarantee, which is not justified by the risk profile of the bank. Therefore, it seems

appropriate to consider the CDS spreads of individual banks located in the countries subject to a financial assistance programme as temporarily non-representative of the intrinsic risk of those banks.

- (36) On that basis, the Commission does not object to Cyprus's intention to determine the guarantee fee for banks which still have a traded CDS on the basis of the CDS of the sample of Union banks in the "BBB- and lower" rating category. The Commission will review its assessment of the macro-economic situation and appropriateness of that exceptional pricing mechanism if a further prolongation of the scheme is notified.

Proportionality

- (37) As regards proportionality, the Commission notes, first, that Cyprus, in line with point 59(d) of the 2013 Banking Communication, has committed to submit a restructuring plan within two months for any bank granted guarantees on new liabilities or on renewed liabilities for which, at the time of the granting of the new guarantee, the total outstanding guaranteed liabilities (including guarantees accorded before the date of the decision) exceed both a ratio of 5% of the bank's total liabilities and a total amount of EUR 500 million. That commitment ensures that the use of guarantee scheme will not enable banks with structural weaknesses in their business models to postpone or avoid the necessary adjustments.
- (38) Second, the Commission notes that Cyprus has committed, in line with point 59(f) of the 2013 Banking Communication, to a number of behavioural safeguards such as a ban on advertisements referring to the State support and a ban on any aggressive commercial strategies which would not take place without the State support. Such safeguards help ensure that the participating institutions do not misuse the received State support to expand their activities.
- (39) Finally, the Commission welcomes that Cyprus undertakes to submit individual restructuring or liquidation plans, within two months, for banks which cause the guarantee to be called upon, in line with point 59(e) of the 2013 Banking Communication.
- (40) As regards the combination of the scheme with other aid measures, the Commission recalls that, as indicated in the Annex to the Restructuring Communication, the restructuring plans to be submitted should contain all State aid received as individual aid or under a scheme during the restructuring period.
- (41) Furthermore, based on point 16 of the Restructuring Communication, the Commission recalls that, should further aid not initially foreseen in a notified restructuring plan be necessary for the restoration of viability, such additional aid cannot be granted under an approved scheme but needs to be subject to individual ex ante notification. All State aid measures received by a bank as individual aid or under the scheme during the restructuring period will be taken into account in the Commission's final decision on that bank.

Monitoring

- (42) The Commission welcomes, in line with point 60(c) and (d) of the 2013 Banking Communication, that Cyprus undertakes to present every three months a report on the operation of the scheme, on guaranteed issuances and on the actual fees charged

and to supplement it with updated available data on the cost of comparable non-guaranteed debt issuances (nature, volume, rating and currency).

Conclusions on the compatibility of the aid measure

- (43) On the basis of the above, the Commission finds the notified prolongation to be in line with the 2013 Banking Communication and the Restructuring Communication. The amended scheme remains an appropriate, necessary and proportionate measure to remedy a serious disturbance of the Cypriot economy and does not alter the Commission's previous assessment in the original decision of 6 November 2012²³ and the prolongation decisions of 22 January 2013 in State aid case SA. 35852 (2012/N)²⁴, 25 July 2013 in State aid case SA. 36930 (2013/N)²⁵, 18 December 2013 in State aid case SA. 37870 (2013/N)²⁶, 25 June 2014 in State aid case SA. 38867 (2014/N)²⁷ and of 14 January 2015 in State aid case SA. 40027 (2014/N)²⁸.
- (44) In line with the Commission's decisional practice, the scheme can therefore be prolonged until 31 December 2015. Any further prolongation will require the Commission's approval and will have to be based on a review of the developments in financial markets and the scheme's effectiveness.
- (45) Finally, the Commission notes that Cyprus agreed to have the present decision adopted and notified in English due to the urgent need for a decision relating to the scheme.

5. CONCLUSION

The Commission has accordingly decided to consider the aid to be compatible with the internal market pursuant to Article 107(3)(b) TFEU and not to raise objections to the scheme.

Cyprus exceptionally accepts that the present decision be adopted in the English language, for reasons of urgency.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site: <http://ec.europa.eu/competition/elojade/isef/index.cfm>.

²³ OJ C 173, 19.06.2013, p.6.

²⁴ OJ C 77, 15.3.2013, p. 10.

²⁵ OJ C 261, 10.9.2013, p. 3.

²⁶ OJ C 280, 22.08.2014, p. 17.

²⁷ OJ C 280, 22.08.2014, p. 29.

²⁸ OJ C 79, 06.03.2015, p. 13.

Your request should be sent electronically to the following address:

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Yours faithfully
For the Commission

Margrethe VESTAGER
Member of the Commission

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