Rating-Agentur Expert RA GmbH confirmed at 'BB' the ratings of Cyprus

Rating-Agentur Expert RA GmbH confirmed the sovereign government credit rating (SGC) of Cyprus at 'BB' (Sufficient level of creditworthiness of the government) in national currency and at 'BB' (Sufficient level of creditworthiness of the government) in foreign currency.

Rating-Agentur Expert RA GmbH confirmed the country credit environment rating (CCE) of Cyprus at 'BB' (Sufficient quality of credit environment of the country) in national currency and at 'BB' (Sufficient quality of credit environment of the country) in foreign currency.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- As of the end of 2016, short-term debt remained as low as 3,25% of GDP and 8,6% of budget revenues and represented only 3% of the total debt. Additionally, 95% is issued in EUR and 66% is in the form of official loans. Nonetheless, the floating interest rate debt accounted for 43% of total debt as of December 2016 (46% in 2015);
- The fiscal deficit narrowed further in 2016 and stood at 0,5% of GDP (1,4% in 2015, excluding the effect of the recapitalization of the cooperatives). The improvement in fiscal stance is due to strong economic growth, favorable tax collection and controlled expenditures. Fiscal performance will depend on the government's determination to finalize the process of privatization and to keep up with the prudent fiscal policy. Possible departure from this path can be caused by lack of political consensus and the upcoming presidential elections in 2018 which could increase the public spending;
- As expected, real GDP grew by 2,8% in 2016 and we can anticipate strong growth rates (above 2%) to remain in the future. The growth was mostly driven by an increase in real consumption due to declining prices and a dynamic tourist sector. GDP per capita at PPP remained solid and increased up to USD 34 400 in 2016;
- The privatization plans have been delayed mostly by the opposition parties and unions but, at the same time, the government has repealed several privatization decrees. However, the government has shown strong determination to conclude this objective in order to further reduce the debt burden;
- High level of institutional development. Cyprus was ranked 45th out of 190 countries in the Doing Business ranking (improvement of two places compared to the previous ranking). Additionally, it has a very high Human Development Index (adjusted for inequality) of 0,762.

Restricting factors:

- The amount of private credit and banks' assets to GDP dropped considerably by the end of 2016 due to continued deleveraging and NPLs restructuring; however, both metrics remained high at 254% and 376% respectively as of December 2016 – the highest among its euro peers[1];
- Government guarantees stood at around 9,8% of GDP as of middle of 2016 due to the cancelation of two government guaranteed bonds from the Bank of Cyprus;

[1] Cyprus peers include the "peripheral Eurozone" countries such as Portugal, Italy, Spain and Greece.

- The harmonized consumer price index (y-o-y % change) turned positive in December 2016 and stood at 0,1%; we can expect inflation to keep increasing moderately in 2017;
- The economy is diversified in different sub-sectors where the main three are retail, financial and real-estate. Still, the services sector represents around 87% of the economy;
- The economy is moderately competitive. Cyprus ranked 83rd out of 138 countries in the Global Competitiveness Index report (2016-2017) prepared by the World Economic Forum (65th in previous ranking). Additionally, the country recorded a very narrow trade surplus of 0,002% of GDP in 2016.

Negative factors:

- Despite a minor improvement, government debt remained high at around 106% of GDP and 282% of budget revenues; however, it stands below the average level of debt among peer countries. Moreover, strong real GDP growth and improvement in the budget position are expected to support a continued decline of debt metrics in the following years;
- The banking system continued to recover during 2016 but remains a key risk to the sovereign's creditworthiness. NPLs have declined further as a share of total loans (47% by December 2016) but remain substantially high and ROA was once again negative at -0,34% by end-2016. Nevertheless, the banking sector remains well capitalized with capital to assets ratio of 10% and capital adequacy ratio of almost 17% as of December 2016;
- FX reserves stood at 4,5% of gross government debt as of March 2017, which is a small improvement compared to end-2015 (3,8%);
- The unemployment rate declined slightly as of end-2016 compared to the previous year and it is below its euro peers' average; despite this decline, it remains high at 13%;
- Stock market remains underdeveloped with 81 listed companies as of March 2017 (85 in 2015) and a market capitalization of 13,4% of GDP by December 2016.

Support factors:

- Participation in a strong currency and political union. Cyprus is part of the European Economic and Monetary Union (EMU) since 2004 (strong support factor);
- The country has a very strong and important reserve currency (EUR) (weak support factor).

Stress factors:

- Dependence on partner-countries for provision of financial support in crisis situations has decreased since Cyprus left the three-year economic adjustment program European Stability Mechanism (ESM) and the International Monetary Fund (IMF) earlier this year. (weak stress factor).

ADDITIONAL FACTORS THAT INFLUENCED CCE RATINGS:

Negative factors:

- Marginal quality and quantity of instruments offered in the financial market of the country;
- Private sector debt (domestic and external), despite declining, remains extremely high estimated at 741% of GDP in 2016.

Restricting factors:

- The Cyprus Stock Exchange General Index (CYSMMAPA) was stable in 2016 starting the year at 65 points and standing at 66 points as of April 2017. Over the year the index was varying from 63 to 70 points.

Positive factors:

- Narrow spread between interest rates on loans and deposits at 3,12% in 2016 (3,52% in 2015).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Persistent and robust real GDP growth which will propel an improvement of the overall debt metrics and budget stance;
- Decline in the level of NPLs ratio which will signal banking sector stabilization and improve its metrics in terms of profitably and adequacy.

The following developments could lead to a downgrade:

- Deterioration of the banking system metrics driven by a rebound on the trend of the NPLs' dynamics;
- Destabilization of public finances due to increased expenditure and lower than planned revenues, causing higher debt and wider budget deficits.

"Better than expected economic growth resulting in positive inflation, further stabilization of the banking sector and better fiscal metrics support our confirmation of Cyprus' ratings at "BB". On the other hand, high levels of government and private debt, large share of NPLs and elevated external exposure continue to restrain the rating; nonetheless, these factors' dynamics have been positive.

A sustained consolidation of the positive factors and continued improvement of the current negative variables, could lead to a rating upgrade in our next revision." - Clarified Marko Denic, Rating Analyst of Rating-Agentur Expert RA GmbH.

Responsible expert: Marko Denic, Rating Analyst of Rating-Agentur Expert RA GmbH

Reviewer: Hector Alvarez, Rating Associate of Rating-Agentur Expert RA GmbH

Research report on Cyprus is available at:

http://raexpert.eu/reports/Research_report_Cyprus_07.04.2017.pdf

Next scheduled rating publication: 6 October 2017

http://raexpert.eu/sovereign/#conf-tab-5

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RATING HISTORY:

Date	Review reason	SGC		CCE	
		National currency	Foreign currency	National currency	Foreign currency
14.10.2016	Scheduled review of both types of ratings for the country	BB	BB	BB	BB
22.04.2016	First assignment of both types of ratings for the country	BB-	BB-	BB-	BB-

Minute's summary

The rating committee for Cyprus was held on 5 April 2017. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: Methodology for Assigning Sovereign Government Credit Ratings and Country Credit Environment Ratings. Short Public Version (from April 2015) can be found under the following link: http://raexpert.eu/files/methodology/Methodology-Short-Sovereign.pdf. Descriptions and definitions of all rating categories can be found under the following link: http://raexpert.eu/sovereign.php under the "Rating scale" section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information International Monetary Fund, World Bank, World Federation of Exchanges, World Economic Forum, Doing Business, United Nations, Central Bank of Cyprus, European Central Bank, Ministry of Finance of Cyprus, Cyprus Stock Exchange (CSE).

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Despite similar methodologies, credit ratings of Cyprus from RAEX (Moscow) (both SGC and CCE) may be different from those assigned by Rating-Agentur Expert RA GmbH due to:

- Possible differences in expert assessments of individual factors;
- Some differences in methodologies (methodologies are similar but not identical);
- Differences in the date/period of assessment for individual factors.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies of the RAEX group.

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Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

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The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.