

## Rating-Agentur Expert RA GmbH upgraded to 'BB' the ratings of Cyprus

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

Rating-Agentur Expert RA GmbH upgraded the country credit environment rating (CCE) of Cyprus from 'BB-' (Sufficient quality of credit environment of the country) to 'BB' (Sufficient quality of credit environment of the country) in national currency and from 'BB-' (Sufficient quality of credit environment of the country) to 'BB' (Sufficient quality of creditworthiness of the government) in foreign currency.

### MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

#### Positive factors:

- As of 2Q 2016 the debt structure remained mostly satisfactory. Short-term debt was as low as 3% of GDP and 7,7% of budget revenues and represented only 2% of the total debt; additionally, 95% of debt is issued in EUR and 65% is in the form of official loans. However, floating interest rate debt accounts for 46% of total debt;
- The fiscal deficit remained narrow in 2015 at 1,4% of GDP (excluding the effect of the cooperatives recapitalization) and is projected to narrow further in the following years due to the continued control on government expenditure and an increase in revenue mainly from tourism;
- Real GDP grew by 1,5% in 2015 and is projected to improve to 2,7% at the end of 2016 boosted by an increase in real consumption due to declining prices. Moreover, GDP per capita at PPP remains solid (USD 31 200);
- Even though some privatization plans have been put on hold, the overall privatization programs are expected to raise EUR 1,4 bn for the budget and, thus, further reduce the debt burden;
- High level of institutional development. Cyprus was ranked 47<sup>th</sup> in the Doing Business ranking. Additionally, it has a Human Development Index (adjusted for inequality) of 0,758 which is considered substantially high.

#### Restricting factors:

- While the deleveraging and NPLs restructuring in Cyprus continues, the amounts of private credit and banks' assets to GDP remain high (314% – the highest among its euro peers<sup>1</sup> – and 420% respectively in 2015);
- Government guarantees were reduced by around 36% to around 9,8% of GDP due to the cancelation of two government guaranteed bonds from the Bank of Cyprus;
- The inflation rate was negative in 2015 and has remained so along 2016 (-0,6% by August 2016). Despite this, prices are less volatile and inflation is starting to pick up; we expect it to return to positive territory in 2017;

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<sup>1</sup> Cyprus peers include the "peripheral Eurozone" countries such as Portugal, Italy, Spain and Greece.

- The economy appears to be diversified in different sub-sectors; however, around 87% of the output is still originated from the services sector;
- The economy is moderately competitive. Cyprus was ranked 72<sup>nd</sup> out of 159 countries in the latest Global Competitiveness Index report prepared by the World Economic Forum. Moreover, the country recorded a trade deficit of 1,4% of GDP in 2015.

#### Negative factors:

- Government debt levels remain high at 108,9% of GDP and 279,5% of budget revenues in 2015 but remain below the average of its euro peers. Despite this, due to an improvement in the fiscal metrics as a result of prudent fiscal policies, both debt metrics are expected to gradually decrease in the following years;
- The banking system, albeit recovering, is still fragile. NPLs have declined in absolute terms, however the decline in the total outstanding loans has been more pronounced, causing an increase in the NPLs to total loans ratio (49,6% by July 2016). Nonetheless, capital to assets ratio has remained stable above 10% and capital adequacy at 16%. Even though ROA was positive in 1H 2016 (0,34%), it has followed the same pace as in 2014 and 2015 indicating a possible negative ratio at year-end;
- FX reserves were as low as 3,8% of gross government debt at end-2015 and have remained stable so far in 2016;
- The unemployment rate was 14,9% in 2015 and, despite declining, remains high. However, it is below its euro peers' average;
- Underdeveloped stock market with 85 listed companies and a market capitalization of just over 9% of GDP by July 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:

- Increased dependence on partner-countries for provision of financial support in crisis situations (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;
- Extremely high level of private sector debt (domestic and external) at 745% of GDP in 2015. Nevertheless, it has been constantly declining.

##### Restricting factors:

- The Cyprus Stock Exchange General Index has been stable in 2016 starting the year at 65 points and currently standing at 66 points.

##### Positive factors:

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

#### SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Consistent reduction of the NPL levels and private domestic and external debt;

- Consolidation of the current account;
- Persistent real GDP growth combined with a reduction in the rate of unemployment.

The following developments could lead to a downgrade:

- Deterioration of the banking system metrics driven by the high level of NPLs;
- Destabilization of public finances causing higher debt and wider budget deficits.

“The upgrade of Cyprus ratings from “BB-“ to “BB” mainly reflects positive dynamics in the factors which we stated in our previous sensitivity assessment as triggers for an upgrade; namely a stabilization in banking system metrics, current and expected improvement of public finances and consistent economic growth. Furthermore, a decrease in contingent liabilities, reduction in price volatility and constant increase of the inflation rate towards positive territory, also influenced our decision to upgrade the ratings.

Despite the upgrade, there are still factors restraining the score. Government debt, despite declining, remains high, NPLs have also declined in absolute terms but the ratio to total loans remains elevated and the external risks, in the form of high debt, negative NIIP and current account deficits, continue to be present.” - Clarified Hector Alvarez, Rating Associate of Rating-Agentur Expert RA GmbH.

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

Reviewer: Gustavo Angel, Rating Associate of Rating-Agentur Expert RA GmbH

Research report on Cyprus is available at:

[http://raexpert.eu/reports/Research\\_report\\_Cyprus\\_14.10.2016.pdf](http://raexpert.eu/reports/Research_report_Cyprus_14.10.2016.pdf)

Next scheduled rating publication: TBD in December 2016

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RATING HISTORY:

Date	Review reason	SGC		CCE	
		National currency	Foreign currency	National currency	Foreign currency
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 13 October 2016. 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).

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## 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.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

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.