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Ratings

Sovereign Government Credit (LC)	BB-
Sovereign Government Credit (FC)	BB-
Country Credit Environment (LC)	BB-
Country Credit Environment (FC)	BB-

* These ratings are unsolicited

Main Economic Indicators of Cyprus

Macro indicators	2013	2014	2015
Gross gov. debt, EUR bn	18,5	18,8	18,6
Nominal GDP, EUR bn	18,1	17,5	17,4
Real GDP growth, %	-5,9	-2,5	1,6
Gross gov. debt/GDP, %	102,2	107,5	107,0
Deficit (surplus)/GDP, %	-4,4	-0,2	-0,5
Inflation rate, %	-1,3	-1,0	-0,4
Current Account Balance/GDP, %	-4,5	-4,6	-5,1
External debt, USD bn	-	-	-

Development indicators 2015

Inequality adj. HDI	0,76
GDP per capita, USD th	31,2

Default indicator 22.04.2016

10Y Gov Bond Yield, %	3,9
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Source: RAEX (Europe) calculations based on data from the IMF, WB, UN, Deutsche Bank, Ministry of Finance of Cyprus, Central Bank of Cyprus

Summary

Cyprus 'BB-' ratings are mainly supported by its outstanding fiscal and economic turnaround since the IMF and the European Stability Mechanism (ESM) program was introduced in 2013. Public finances have substantially improved showing stabilized government debt levels as well as a narrow budget deficit. In addition, real GDP growth exceeded expectations in 2015 and banks' capitalization and liquidity metrics improved vastly. These factors allowed the country to exit the adjustment program earlier than expected.

However, factors such as the steep levels of NPLs in the banking system, the significant amount of government debt, high domestic and external private debt and a negative net external investment position, had a negative impact on the rating.

Government debt, while still high, has stabilized and is expected to decrease further. Since the aftermath of the 2008 financial crisis gross government debt metrics have been constantly increasing. Even though debt figures remain high, these levels have finally stabilized in 2015 thanks to the country's successful execution of the IMF-ESM program. Government debt to GDP was 107% in 2015, a reduction of 0,5p.p. from 2014, and debt to budget revenues was reported at 274,1% in the same period, an increase of 6,4p.p. from a year ago. We expect debt ratios to remain stable and continue their downward trend propelled by fiscal consolidation and continued economic growth.

The overall structure of the debt is satisfactory. Short-term debt was at acceptable levels in 2015 with figures as low as 3% of GDP and 7% of budget revenues. These obligations only represented 2% of total government debt while in 2014 they accounted for 4%. This reduction contributes to soften the debt repayment burden on the government. Furthermore, 65% of the debt is concessional, which means that interest rates are below-market and restructuring or prolongations are easier to carry out (see graphs 1 & 2).

The only downside of the debt structure is the amount of issues with floating interest rates. Floating interest rate debt amounted to 44% of total debt in 2015 (an increase of 3p.p. from 2014). Even though interest rates are currently low overall, an increase could hurt the debt service

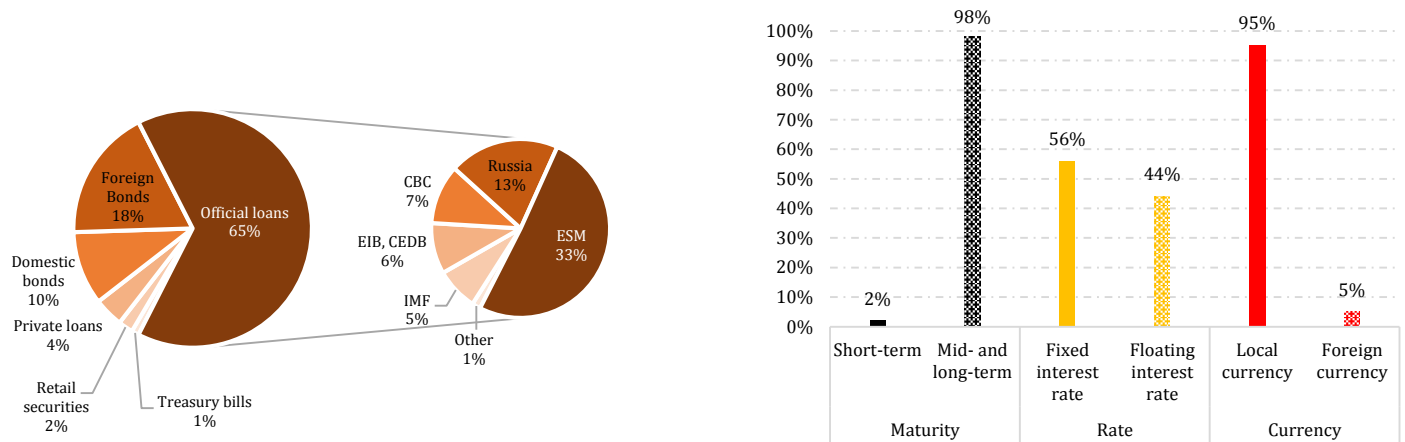
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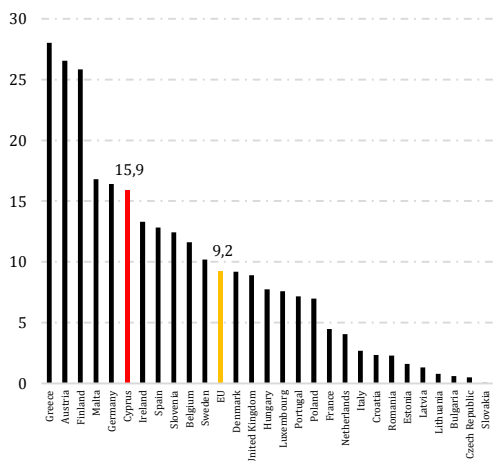
capacity of the government. Finally, FX-denominated debt is almost negligible at 5% of total debt (see graph 2).

Graphs 1 and 2: Government debt structure



Source: RAEX (Europe) calculations based on data from the Ministry of Finance of Cyprus

Graph 3: EU's government guarantees, % of GDP



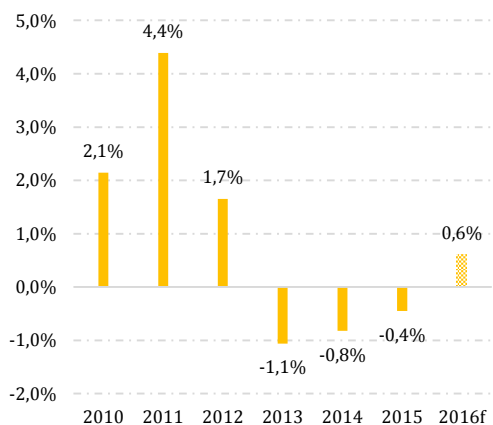
Source: RAEX (Europe) calculations based on data from Eurostat

Regarding contingent liabilities, Cyprus' government guarantees stood at 15,9% in 2014, among the highest in the EU (see graph 3).

Satisfactory real economic growth in 2015. Also as a result of a well-executed adjustment program, the economy reached an inflection point in 2015 when the economy expanded at a 1,5% rate in real terms, its first positive growth since 2011.

The increase in GDP was mainly driven by private consumption caused by higher real wages due to negative inflation rates. The recovery appears to be broad-based with almost all sectors of the economy showing positive signs. Supported by EUR depreciation, tourist arrivals reached 2,6 m in 2015 and is set to continue this trend in 2016. In fact, the service sector in general had an important contribution to GDP growth. On the other hand, manufacturing, mining and agriculture grew on average by 2,1%. Low world-energy price levels have also contributed to economic growth as it encourages private consumption. However, the high concentration of the services sector in the economy prevails (87% of GDP).

Graph 4: Inflation rate dynamics, y-o-y



Source: RAEX (Europe) calculations based on data from IMF

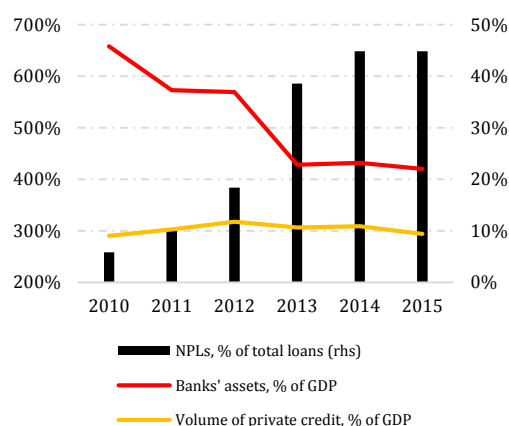
Despite a slight recovery in 2015, unemployment remains high (15,9%) especially among the youth. The inflation rate has increased since 2013 up to -0,44% in 2015 and is expected to post positive figures in 2016 (see graph 4).

The banking system has stabilized but risks regarding NPLs levels still remain. The banking sector was another beneficiary of the IMF-ESM adjustment program. Capitalization and liquidity have vastly improved. Capital adequacy ratio has averaged above 10% for the past two years and

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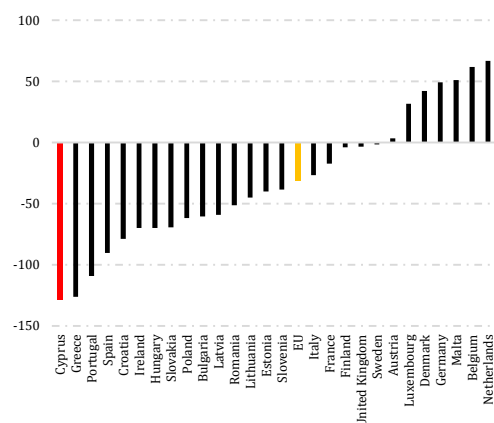
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Graph 5: Banking system dynamics



Source: RAEX (Europe) calculations based on data from IMF and WB

Graph 6: EU's NIIP, % of GDP



Source: RAEX (Europe) calculations based on data from Eurostat

domestic banks' liquidity buffers at end-October 2015 were 10% higher than a year ago.

Nonetheless, levels of NPLs remained extremely high at 44,8% of total loans in 2015. Even though this figure has stabilized (it stayed flat as compared to 2014) the high share of this types of loans has hurt profitability (average ROA was -0,67% in 2015) and the ability of banks to raise capital. Furthermore, such NPLs levels have halted issuance of new credit in the economy. Despite remaining high, the amount of private credit to GDP decreased by 14p.p. from 2014 to 2015 (see graph 5).

Budget balance remains narrow. The fiscal balance has also benefited from the program, especially from the IMF policies which aimed to stabilize public finances and the banking system. The budget balance has constantly narrowed reaching 0,5% of GDP¹ and allowing the country to successfully exit the IMF bailout program in March 2016.

Fiscal policy challenges remain in place especially in respect to the wage bill and public sector inefficiencies. Furthermore, structural reforms aimed at improving the fiscal framework, such as revenue administration and privatization plans, have not been completely implemented.

High external exposure. The economy's overall private debt is extremely high. Domestic and foreign total private sector debt of Cyprus amounted to around 732% of GDP in 2015.

In addition, Cyprus net international investment position (NIIP) as a percentage of GDP was the lowest in the EU in 2015 at -129%, well below the -31% average for the economic block (see graph 6). Even though the current account deficit has stabilized at around 5% due to improvements in investment income, it is still wide. Export growth has been lethargic and imports have grown at a higher pace, thus, impeding the current account deficit to narrow. Nonetheless, increased inflow of foreign deposits is likely to alleviate the current account balance and increase the NIIP.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

http://www.raexpert.eu/reports/Press_release_Cyprus_22.04.2016.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.

¹ Excluding the one-off payment of EUR 174 m to recapitalize the Cooperative Central Bank at end-2015.

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