European Stability Mechanism

24 April 2013

Proposal for a financial assistance facility agreement for the Republic of Cyprus

1. Background

On 25 June 2012, the Republic of Cyprus ('Cyprus') made an official request for financial assistance from the EFSF or ESM to the President of the Eurogroup, as well as from the International Monetary Fund ('IMF'), with a view to supporting the return of the economy to sustainable growth path, ensuring a properly-functioning banking system and safeguarding financial stability in the European Union and in the euro zone. In its statement on 27 June 2012, the Eurogroup subsequently welcomed the request by the Cypriot authorities for financial assistance from euro area Member States in view of the several challenges Cyprus is facing. The Eurogroup also mentioned that the financial assistance package would be provided by the EFSF or the ESM.

The Eurogroup furthermore requested the European Commission ('Commission'), together with the ECB and the IMF, to negotiate with the Cypriot authorities the macroeconomic adjustment programme and the Memorandum of Understanding and to undertake the required assessments in line with Article 13(1) TESM.[1] The Commission, in liaison with the ECB and the IMF, conducted such eligibility assessments to ascertain:

- whether the economic and financial situation in Cyprus poses risks to the financial stability of the euro area as a whole or of its Member States;
- whether the public debt of Cyprus is sustainable; and
- what the actual or potential financing needs are.

These assessments confirmed that Cyprus fulfils the eligibility criteria for receiving financial assistance from the ESM and on this basis the Board of Governors may decide to grant, in principle, stability support to Cyprus in the form of a financial assistance facility according to Article 13(2) TESM.

2. Memorandum of Understanding

According to Article 13(3) TESM, the financial assistance facility is subject to detailed policy conditionality drafted in a Memorandum of Understanding ('MoU'). The MoU shall reflect the severity of the weaknesses to be addressed and the fact that the financial assistance instrument chosen is a loan facility. The MoU prepared by the Commission, in liaison with the ECB and the IMF, provides for such conditions.

[1] Pursuant to Article 13(1) TESM, the procedure for granting stability support is initiated by a request of an ESM Member "to the Chairperson of the Board of Governors". It is however noted that in conjunction with Article 13(1) TESM, the fact that the request of Cyprus was addressed to the President of the Eurogroup is not incompatible with this provision. The same rationale applies to the entrusting of the Commission and the ECB under Article 13(1) TESM to make the necessary assessments. Reference is made to the ESM *Note on the legal procedure under Article 13 of the ESM Treaty* distributed to the ESM Board of Directors on Friday 22 March 2013.

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At the beginning of April 2013, the staff level agreement was reached with the Cypriot authorities on the policy conditionality underlying the future macroeconomic adjustment programme for the period 2013-2016. It is envisaged that the MoU will be formally signed by all parties on 26 April 2013. The policy package aims to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence; to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit as soon as possible and maintain fiscal consolidation in the medium-term; and to implement structural reforms to support competitiveness and sustainable and balanced growth .

To achieve these goals, the macroeconomic adjustment programme builds on three pillars. First, the financial sector strategy is based on a significant restructuring, downsizing, and de-risking of the Cypriot banking sector to reorient the provision of credit to the real economy. At the end of the process, the domestic banking sector will be half of its current size and below the EU average. The necessary downsizing and restructuring of the banking sector is already under way – the carve-out of the Greek operations of the largest Cypriot banks is completed. The resolution of Cyprus Popular Bank and the absorption of selected assets and liabilities by the Bank of Cyprus, and the recapitalisation of the Bank of Cyprus through a debt to equity conversion, without use of public money has downsized the banking sector immediately and significantly to 350% of GDP. The Bank of Cyprus has been fully recapitalised. Supervision will be reinforced and anti-money laundering (AML) framework will be strengthened in line with best practice and the implementation of AML standards ensured. As bank liquidity was under pressure, exceptional measures were necessary to prevent massive large deposit outflows and to preserve the solvency and liquidity of the credit institutions.

Second, ambitious fiscal consolidation strategy, designed to reduce the current primary expenditure and enhance revenue collection will improve the functioning of the public sector and will maintain the fiscal consolidation in the medium-term. The aim is to put the gross public debt-to-GDP ratio on a firm downward path in the medium term. Cyprus' general government debt is expected to peak at around 126% in 2015, reaching around 122% of GDP at the end of the programme in 2016 and decline to around 105% by 2020.

Finally, the macro-economic adjustment programme foresees an ambitious structural reform agenda, including privatisation of state owned enterprises, public sector reform and removing obstacles to the smooth functioning of markets, with a view to supporting competitiveness and sustainable and balanced growth.

3. Financing needs

The European Commission, in liaison with the ECB, has estimated that Cyprus's net financing needs amount to EUR 10 billion over the three-year programme horizon, i.e. 2Q2013-1Q2016, after taking into account the extensive burden sharing measures adopted by the Cypriot authorities. This includes needs for the recapitalisation of the banking sector (around EUR 2.5 billion), the redemption of maturing medium- and long-term debt including loans (around EUR 4.1 billion), and fiscal needs (up to EUR 3.4 billion). This programme envelope, which rests on plausible growth and fiscal assumptions, includes buffers in case of worse than expected macroeconomic and financial sector outcomes.

Given the above, the Eurogroup considered at its meeting of 16 March 2013 that – in principle – financial assistance to Cyprus is warranted to safeguard financial stability in Cyprus and the euro area as a whole by providing a financial envelope of up to EUR 10 billion (including a contribution of the IMF to the financing of the programme). The financial envelope has been reconfirmed in the Eurogroup meeting of 25 March 2013.

As mentioned, the necessary programme amount will be covered by ESM and IMF. IMF has publically announced it considers contributing EUR 1 billion to the programme subject to IMF Board approval which is scheduled at the beginning of May. The ESM's contribution is currently envisaged to be EUR 9 billion. ESM will confirm the final amount after the IMF Board approval. The use of the ESM financing in the context of the programme will be decided.

4. Proposal for a financial assistance facility agreement

According to Article 13(3) TESM, the Managing Director of the ESM shall prepare a proposal for a financial assistance facility agreement, including the financial terms and conditions and the choice of instruments, to be adopted by the Board of Governors.

In view of the above, it is proposed to provide a financial assistance facility agreement to Cyprus on the following terms:

1. The support is granted in the form of a loan facility based on the '*Loan Facility: Facility Specific Terms*' in Section 1 of the Standard Facility Specific Terms for ESM Financial Assistance Facility Agreements.

2. The total financial assistance and loan facility amount will be up to EUR 10 billion, subject to IMF's contribution as stated above, and can be used for general financing needs of the public sector and bank recapitalisation. The definitive and final financial assistance and loan facility amount by the ESM will be separately documented between the contracting parties, once IMF's contribution is known.

3. The loans provided to Cyprus will have a maximum average maturity of 15 years and a maximum maturity of 20 years.

4. The latest date by which the financial assistance is available to Cyprus is 31 March 2016.

5. The Margin charged to Cyprus for the loans disbursed will be 10 basis points as stipulated in the ESM Pricing Policy.

6. The Up-front Service Fee of 50 bps will have to be paid upfront by Cyprus for every disbursement following the reception of an invoice sent by ESM in accordance with the ESM Pricing Policy, or directly deducted from a cash disbursement.

7. The Annual Service Fee of 0.5 bps which will accrue day to day with effect from the first interest payment date of such tranche, as part of the ESM Cost of Funding. It will follow the interest payment schedule.

8. The Commitment Fee allocated to Cyprus, in accordance with the Diversified Funding Strategy and applied in line with the applicable guidelines, will be payable each year following the reception of an invoice at the beginning of each calendar year, as part of the ESM Cost of Funding.

9. Repayment profile for the Tranche: bullet or amortising, as may be defined in the relevant Confirmation Notice.

10. For the duration of the ESM programme, the Cypriot authorities are committed to take all the necessary measures to ensure compliance with the conditionality specified in the MoU. Disbursements under the financial assistance facility agreement will be contingent on such compliance.

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