



## RATING ACTION COMMENTARY

# Fitch Upgrades Bank of Cyprus to 'B+'; Outlook Positive

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Fitch Ratings - Paris - 06 Dec 2022: Fitch Ratings has upgraded Bank of Cyprus Public Company Limited's (BoC) Long-Term Issuer Default Rating (IDR) to 'B+' from 'B-' and Viability Rating (VR) to 'b+' from 'b-'. The Outlook on the Long-Term IDR is Positive. A full list of rating actions is below.

The two-notch upgrade reflects the execution of the sale of EURO.6 billion non-performing exposures (NPEs, as defined by the European Banking Authority) and EURO.1 billion foreclosed real-estate assets. The sale (project Helix 3) together with the organic reduction of impaired assets, has improved BoC's asset quality, resulting in a significant decline in the level of capital encumbered by legacy problem assets (NPEs and net foreclosed assets). The upgrade is also underpinned by Fitch's view of the resilience of the Cypriot's economy, even in light of growing economic uncertainties.

The Positive Outlook reflects improved recurring earnings prospects for BoC from a less-risky balance sheet and strong benefits from rising interest rates. We also expect capital encumbrance by net problem assets to decline further in the short to medium term.

## KEY RATING DRIVERS

**Asset Quality, Capital Underpin Ratings:** BoC's ratings reflect improving asset quality from weak levels, due to the completion of Helix 3. However, a large portfolio of remaining foreclosed assets results in still high but decreasing capital encumbrance by

unreserved problem assets. Ratings are also supported by a leading franchise in Cyprus, improved profitability prospects due to higher interest rates and cost savings from workforce reduction as well as a stable deposit base.

**Strengthened Operating Environment:** The Cypriot banking sector has made significant and continued progress since end-2019, improving its resilience to shocks. Despite the coronavirus crisis, banks' continued cleaning up their balance sheets while capitalisation and profitability have further strengthened. We expect Cypriot banks to benefit from a strong economic recovery and interest rate increases in 2022 before entering a tougher environment in 2023. However, this should remain supportive of the banks' performance and risk profiles. Nevertheless, Cypriot's economy remains small and open, which makes it sensitive to shocks.

**Leading Franchise in Cyprus:** BoC is the largest bank in Cyprus, albeit a small and narrow market. BoC's business model is centred on traditional retail and commercial banking with some diversification in insurance and payment. The reduction of stock of legacy problem assets and improved profitability supports long-term stability of the business profile.

**Average NPEs Ratios, High Problem Assets:** BoC's asset quality has improved significantly due to organic reduction of legacy impaired loans and execution of Helix 3. Nevertheless, the problem assets ratio remains higher than peers, at about 16% at end-September 2022. We expect new impaired loan formation to increase slightly in 2023, but for the NPEs ratio to remain below 5% and BoC's asset quality to continue to improve, mostly through organic reduction of real estate foreclosed assets. Our assessment of asset quality is supported by good quality of other earning assets (large cash buffer and securities portfolio), but reflects still weaker asset quality than higher-rated Southern European peers.

**Interest-Driven Profitability, Reduced Costs:** BoC's profitability has been below global industry averages in recent years, although de-leveraging has improved its ability to generate recurring earnings. We expect the bank to reach an operating profit/risk-weighted assets (RWAs) of close to 2% in 2022. BoC's earnings will strongly benefit from higher interest rates and improved operational efficiency thanks to a reduction of the branch network and the voluntary staff exit plan, which will reduce staff costs by about 20% from 2023.

**Decreasing but Still High Capital Encumbrance:** The bank's phased-in common equity Tier 1 (CET1) ratio was 14.7% at end-September 2022. We expect the CET1 ratio to be above 15% by end-2023 driven by better earnings generation and retention. Capitalisation benefits from improvement of asset quality. The encumbrance of fully-

loaded CET1 capital by unreserved problem assets fell slightly below 100% at end-September 2022, but remains higher than most Southern European peers. Nevertheless, this makes capital sensitive to shocks and still not fully commensurate with its business and financial risks.

**Stable Deposit Base:** BoC's funding is supported by a strong deposit franchise in Cyprus, which is growing. As deposits exceed loans, liquidity buffers are consistently strong. About 80% of BoC's deposits are domestic and deposit preference in Cyprus contributes to funding stability. BoC has restored its access to unsecured wholesale funding. However, we believe that funding remains sensitive to investor-confidence shocks, although it proved fairly stable recently.

## **RATING SENSITIVITIES**

### **Factors that could, individually or collectively, lead to negative rating action/downgrade:**

We could revise the Outlook to Stable if we no longer expect asset quality to improve, specifically if there was a lower reduction in foreclosed assets than currently anticipated.

Rating downside could also arise from strong economic shocks to the Cypriot economy leading to a material deterioration of asset quality, large credit losses and ultimately capital erosion. The ratings could also come under pressure if BoC's profitability remains weak, despite improvement of asset quality, illustrating structural weaknesses of the business model.

### **Factors that could, individually or collectively, lead to positive rating action/upgrade:**

The Positive Outlook on BoC's Long-Term IDR indicates that an upgrade is likely in the next two years, notably if asset quality and profitability continue to improve.

An improvement in capital encumbrance by net problem assets significantly below 100% of fully-loaded CET1, driven by a sustained reduction in the problem assets ratio below 10%, while maintaining a CET1 ratio of about 14% would be a likely trigger for an upgrade.

Improving operating profit/RWAs sustainably above 1.25% would also be positive for the bank's ratings.

An upgrade of our assessment of operating environment in the 'bbb' category would also benefit the ratings, and would require evidence of continued economic growth in

Cyprus supporting banks' business opportunities, reduced private-sector indebtedness (including from system-wide NPEs), or an upgrade of the sovereign rating.

## **OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS**

### **SHORT-TERM IDR**

BoC's Short-Term IDR of 'B' is in line with the 'B+' Long-Term IDR under Fitch's rating correspondence table.

### **DEPOSIT RATINGS**

Fitch has upgraded the long-term deposits ratings to 'BB-' from 'B' and affirmed the short-term deposit ratings at 'B'. The long-term deposit rating is one notch above the Long-Term IDR because of full depositor preference in Cyprus, our expectation that BoC will comply with its minimum requirement for own funds and eligible liabilities (MREL) requirements over the medium term, and that deposits will therefore benefit from the protection offered by more junior bank resolution debt and equity, resulting in a lower probability of default.

### **GOVERNMENT SUPPORT RATING (GSR)**

BoC's Government Support Rating of 'no support' (ns), reflects Fitch's view that although extraordinary sovereign support is possible, it cannot be relied upon. The EU's Bank Recovery and Resolution Directive and the Single Resolution Mechanism for eurozone banks provide a framework for resolving banks that requires senior creditors participating in losses, if necessary, instead of or ahead of a bank receiving sovereign support. In our view, senior creditors can therefore no longer expect to receive full extraordinary support from the government in the event that the bank becomes non-viable.

## **OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES**

BoC's deposit ratings are primarily sensitive to changes in its IDRs. The long-term deposit rating could be downgraded if we deemed BoC unable to increase the size of its senior and junior debt buffers and comply with its final MREL.

An upgrade of the GSR would be contingent on a positive change in the sovereign's propensity to support the bank. In Fitch's view, this is highly unlikely, although not impossible.

## **VR ADJUSTMENTS**

The operating environment score of 'bb' has been assigned below the 'bbb' category implied score, due to the following adjustment reasons: size and structure of economy (negative), level and growth of credit (negative).

The capitalisation & leverage score of 'b+' has been assigned below the 'bb' category implied score, due to the following adjustment reason: reserve coverage and asset valuation (negative).

## BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years.

The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit

<https://www.fitchratings.com/site/re/10111579>

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on our ESG relevance scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY / DEBT ⇄	RATING ⇄	PRIOR ⇄
Bank of Cyprus Public Company Limited	LT IDR B+ Rating Outlook Positive Upgrade	B- Rating Outlook Positive

	ST IDR	B	Affirmed		B
	Viability	b+	Upgrade		b-
	Government Support	ns	Affirmed		ns
long-term deposits	LT	BB-	Upgrade		B
short-term deposits	ST	B	Affirmed		B

[VIEW ADDITIONAL RATING DETAILS](#)

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[Bank Rating Criteria \(pub. 07 Sep 2022\) \(including rating assumption sensitivity\)](#)

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Bank of Cyprus Public Company Limited

EU Issued, UK Endorsed

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