ΚΕΝΤΡΙΚΗ ΤΡΑΠΕΖΑ ΤΗΣ ΚΥΠΡΟΥ

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25 Οκτωβρίου 2012

Κύριο Χρίστο Πατσαλίδη
Γενικό Διευθυντή
Υπουργείου Οικονομικών
Γωνία Μιχαήλ Καραολή & Γρηγόρη Αυξεντίου
1439 Λευκωσία

ΜΕ ΤΟ ΧΕΡΙ

Αξιότιμε κύριε Πατσαλίδη,

Θέμα: Αίτηση της Τράπεζας Κύπρου Δημόσιας Εταιρίας Λτδ για κρατική στήριξη

Στα πλαίσια χειρισμού από το Υπουργείο σας της πιο πάνω αίτησης, η Κεντρική Τράπεζα της Κύπρου φρονεί ότι θα πρέπει να διευκρινιστεί, το συντομότερο δυνατό, με τη Διεύθυνση Ανταγωνισμού της Ευρωπαϊκής Επιτροπής κατά πόσον η κρατική στήριξη με τη μορφή ενός Ενδεχομένως Μετατρέψιμου Υβριδικού Αξιόγραφου (Contingent Convertible Hybrid Instrument) είναι, κατ' αρχήν, αποδεκτή.

Η πιο πάνω μορφή στήριξης εμπεριέχει χαρακτηριστικά που δημιουργούν ισχυρά κίνητρα προς την Τράπεζα Κύπρου για έξοδο από την κρατική στήριξη το συντομότερο δυνατό, εξέλιξη που είναι προς όφελος της κυβέρνησης, του συνόλου του τραπεζικού συστήματος και της χρηματοπιστωτικής σταθερότητας.

Συναφώς, επισυνάπτονται σχετικά σημειώματα στην Ελληνική και Αγγλική.

Με εκτίμηση,

Κοιν. Πρόεδρο ΔΣ

Σπύρος Γ. Σταυρινάκης
Ανώτερος Διευθυντής

Επισυν.: 2

Κοιν.: κ. Γιάννη Κυπρή, Διευθύνων Σύμβουλος Συγκροτήματος Τράπεζας Κύπρου

[ENGLISH TRANSLATION OF PRECEDING GREEK DOCUMENT]

[LOGO]
CENTRAL BANK OF CYPRUS
EUROSYSTEM

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October 25, 2012

Mr. Christos Patsalides
General Manager
Ministry of Finance
Corner of Mihail Karaole & Gregory Afxentiou
1439 Lefkosia

BY HAND

The Honorable Mr. Patsalides,

Issue: Bank of Cyprus Public Company Ltd. Application for State Financial Support:

Within the framework of the Ministries handling of the aforementioned application, the Central Bank of Cyprus is of the opinion that a clarification should be made as soon as possible with the Directorate General for Competition of the European Commission regarding to what extent a Contingent Convertible Hybrid Instrument would be acceptable.

The above method of support contains elements that creates strong incentives for the Bank of Cyprus to exit state support as quickly as possible, a development which is beneficial not only to the government but to the entire banking system and towards financial stability.

As such, attached, please find relevant notes in Greek and English.

Respectfully,

[Signature]

Spiros G. Stavrinakis
Senior Director

Distributed to the President
Of the Board of Directors

Attachments: 2

Distributed to Mr. Yiannis Kypri Managing Director of the Bank of Cyprus Group.

MEMO

Application for state support in the form of a contingent convertible hybrid instrument

Bank of Cyprus (also referred to in this letter as the "Bank") implemented a Capital Strengthening Plan in order to address capital shortfalls which it has incurred as a result of sovereign debt exposures, and primarily the Greek Government Bonds ("GGBs") exchange programme. Despite its efforts, the Bank was unable to meet by 30 June 2012 the relevant Core Tier 1 capital ratios set by the European Banking Authority ("EBA") in December 2011 and on 29th June 2012 has therefore applied to the Ministry of Finance and Central Bank of Cyprus for the provision of state support in the form of a non-equity capital injection.

1 Introduction

The EBA approved in December 2011 a recommendation that main European banks should create a temporary capital buffer enabling them to attain a Core Tier 1 capital ratio of 9% plus a temporary sovereign buffer by 30 June 2012.

The Bank participated, in cooperation with the Central Bank of Cyprus, in the capital exercise proposed by the EBA and agreed by the Council of the EU on 26 October 2011 (**"Capital Exercise"**). The Capital Exercise determined, using 30 September 2011 data, that the Bank had a capital shortfall of €1.56 billion to be covered by 30 June 2012. The Bank prepared a Capital Strengthening Plan in order to cover the capital shortfall and until 30 June 2012 had already implemented, among others, the following steps:

(i) Disposal of Bank of Cyprus Australia Ltd, with a positive impact on capital of €80 million in December 2011.

(ii) Capital increase of €160 million in March 2012 in the form of a rights issue.[1]

(iii) Voluntary conversion of €432 million Convertible Enhanced Capital Securities into ordinary shares in March 2012.[2]

(iv) Amendment of the terms of its Convertible Enhanced Capital Securities in issue amounting to €455 million so as to comply with the EBA guidelines for Core Tier 1 capital.

In addition, the Bank of Cyprus announced on 15 June 2012 the deferral and cancellation of coupon payments on its Tier 1 securities and it has not paid any dividend since the payment of the final dividend for 2010 [3].

However, in light of the GGBs exchange programme in March 2012, the Bank had to reduce the book value of its GGBs by 74% of their nominal value.[4] In addition to the impairment loss arising on initial recognition of the new bonds during the first half of 2012,

[1] The original target under the Capital Strengthening Plan announced in November 2011 was for €400 million but due to deteriorating market conditions and the Eurozone crisis it became unfeasible.

[2] The original target for voluntary conversion under the Capital Strengthening Plan was €600 million.

[3] See announcements at http://www.bankofcyprus.com/Start/Investors-Relations/Announcements/.

[4] See Announcement of 24 April 2012 regarding the Final Audited Group Financial Results for the year ended 31 December 2011.

on 30 August 2012 (on the announcement of the first 6 month results) an additional loss before tax of €109 mn was recognised relating to the impairment of GGBs.

2 The application for support and the proposed instrument

Bank of Cyprus therefore applied for state support in order to meet the EBA capital buffer requirements. The support requested is in the form of non-equity capital via a contingent convertible hybrid instrument expected to be issued by the Bank which will qualify as Core Tier 1 capital. A copy of the proposed draft term sheet for the instrument is enclosed. The main features of the instrument are:

- Total issue size: €730[5] million (approximately 3% of Risk Weighted Assets ("RWA")).
- Investment period: five years with mandatory conversion into ordinary shares if the Bank does not buy back the instrument from Government.
- Coupon: mandatory fixed coupon of 8.5% per annum, payable semi-annually, with a step up of 25 basis points in each of years two and three, and 50 basis points in each of years four and five.
- Alternative coupon payment mechanism: where payment of coupons in cash is not possible, coupons will be satisfied with payment in kind (through issuance of ordinary shares).
- Ban on dividends whilst the instrument is outstanding and requirement to use distributable profits to pay the coupon on the instrument and on buyback of the instrument.

These terms are very similar to those subscribed to by the Portuguese Government in relation to Banco BPI and to Millenium BCP, also to assist in meeting the EBA Core Tier 1 ratios.[6] In addition, pursuant to Article 462(6) of the current draft Capital Requirements Regulation, instruments issued in the context of state support to financial institutions before the application of the Regulation and which qualified as Tier 1 capital under relevant provisions of the Capital Requirements Directive (2006/48/EC) will be eligible for grandfathering until 2017. Accordingly, we consider the instrument will be eligible for grandfathering as Core Tier 1 capital until 2017.

3 Compatibility with State Aid

We are aware that state support will need to be notified and approved in advance by the European Commission ("**Commission**") as rescue aid under State Aid rules enshrined in the Treaty on the Functioning of the European Union ("**TFEU**") ("**State Aid Rules**"). In this regard, we consider that the instrument will meet all the conditions to be temporarily approved under Article 107(3)(b) TFEU (Aid to remedy a serious disturbance in the economy of a Member State) for the following reasons:

[5] The initial amount for state aid that the Bank has applied for amounted to €500 mn and has changed to €730m following the announcement of the Group's financial statements as of 30 June 2012. This amount may change following the assessment by the Central Bank of Cyprus and the relevant European Authorities

[6] See details of the capital injections provided by the Portuguese Government under Law 63-A/2008 of 24 November to Banco BPI on 27 June 2012 at http://bpi.bancobpi.pt/index.asp?riIdArea=AreaAccionistas&riId=SGFMeeting27June.and to Millenium BCP on 25 June 2012 at http://www.millenniumbcp.pt/pubs/en/governance/article.jhtml?articleID=762827.

- The Bank of Cyprus is the leading bank in Cyprus and is systemically important to the economy of Cyprus.

- The need for the instrument is a result of Bank of Cyprus' exposure to GGBs and the write off of over €1.8 billion of those GGBs (74% of their nominal value plus related hedging and the additional loss recognised in the financial statements for the period ending 30 June 2012) following the GGB impairment losses. Bank of Cyprus is a viable and sound financial institution that would have met its profitability targets for 2011 absent the GGB exchange programme. Profits before provisions and the impairment of GGBs reached €805 million, a significant increase of 11% compared to €725 million for 2010. Failure to meet the EBA capital buffer ratios is not as a result of risky commercial strategies but rather a consequence of the sovereign debt crisis. Bank of Cyprus' capital base remains healthy and the Bank of Cyprus Group's Tier 1 capital as at 30 June 2012 is estimated to €1,75 billion and its Tier 1 ratio at around 7,9%.

- Support in the form of non-equity capital qualifying as Core Tier 1 has been used in other Member States of the EU to assist banks in meeting the EBA's recommendations. In particular, the Portuguese Government has recently announced capital injections into Banco BPI and into Millenium BCP through instruments presenting similar features to the one proposed by Bank of Cyprus.[7] Similarly, Banco Monte dei Paschi di Siena has recently applied for support from the Italian Government in the form of non-equity instruments to meet EBA requirements.[8] Likewise, all Irish banks participating in the bank recapitalisation scheme received state aid in 2011 through non-equity capital.

- The remuneration is fixed and is in line with levels used for other Core Tier 1 instruments, for example in Portugal, and other instruments approved by the European Commission in the past.[9]

- The investment period of the instrument is limited in time (five years) and coupon payments are mandatory and step up over the five years. Whilst the instrument is outstanding, the Bank may not distribute dividends and if it has distributable profits must use these for remuneration of the coupon on the instrument and buyback of the instrument. At expiry of the five years, if no redemption takes place then it will convert into ordinary shares thus diluting existing shareholders (consistent with the Commission's requirement that hybrid instruments should in principle contain an "alternative coupon satisfaction mechanism" whereby coupons which cannot be paid out in cash would be paid to the State in the form of newly issued shares).[10] This combination of features creates strong incentives for the Bank to exit State support as soon as possible and ensure that the support is temporary in nature in accordance with State Aid Rules.

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[7] Idem.

[8] See http://english.mps.it/Investor+Relations/Comunicati/Archivio/Business+Plan+2012+2015+approved.htm.

[9] See for example recapitalisation of Österreichische Volksbanken AG in April 2009, in which the Austrian Government subscribed participation certificates amounting to a total of €1 billion. The instrument, which qualified as Tier 1 capital, did not give the State voting rights but gave it a preferential dividend (at 9.3%) subject to profits and a conversion option (SA.31883)..

[10] See paragraph 13 of the Communication from the Commission on the application, from 1 January 2012, of State Aid rules to support measures in favour of banks in the context of the financial crisis published on 6 December 2011 ("Second Prolongation Communication").

- The proposed method for State Aid would have minimal impact on the taxpayer, since remuneration is fixed and ensures regular and timely payments to the State.
- The Government's injection will amount to around 3% of Bank of Cyprus' RWA (€730 million[11]), being the amount of Tier 1 capital required to meet the EBA capital buffer requirements, and will therefore be limited in amount (notably at levels where the Commission has previously considered that a bank would be fundamentally sound).[12]
- The Bank currently has around 85,000 shareholders and share price dilution (and consequently the further drop of the share price) may have an adverse impact on the economy. That said, coupons on the Bank's Tier 1 instruments have already been cancelled or deferred by the Bank as of 15 June 2012 and dividends have not been declared since 2010. In addition, shareholders will forego future profitability and dividends in order to repay the State Aid at an adequate remuneration consistent with the principle of burden sharing under State Aid Rules.

The above factors mean that the aid will be limited to the minimum necessary and, given the circumstances giving rise to this application and the EBA requirements, it is appropriate and proportionate to remedy the difficulties faced by Bank of Cyprus.

4 Extent of restructuring

Since January 2011 any financial institution receiving a recapitalisation is subject to the obligation to submit a restructuring plan if temporary aid has not been redeemed within six months. Given the duration of the proposed instrument (five years), we acknowledge that the Government may need to submit a restructuring plan for the Bank to the Commission.

The Commission has indicated in its Second Prolongation Communication that it will undertake a proportionate assessment taking full account of elements indicating that a bank may need limited restructuring in particular where (i) the capital shortage is essentially linked to a confidence crisis on sovereign debt, (ii) the public capital injection is limited to the amount necessary to offset losses stemming from marking sovereign bonds of the Contracting Parties to the EEA Agreement to market in banks which are otherwise viable and (iii) the analysis shows that the banks in question did not take excessive risk in acquiring sovereign debt. Commissioner Almunia has also indicated that the Commission will not request a radical restructuring of banks that face difficulties due to the sovereign debt crisis.[13]

As set out above, although it is a fundamentally sound bank, Bank of Cyprus finds itself in need of a State non-equity capital injection due to its exposure to Eurozone sovereign bonds, including the Greek, Irish and Cypriot sovereign bonds, in order to meet the EBA

[11] The initial amount for state aid that the Bank has applied for amounted to €500 mn and has changed to €730m following the announcement of the Group's financial statements as of 30 June 2012. This amount may change following the assessment by the Central Bank of Cyprus and the relevant European Authorities

[12] See Commission Communication published on 15 January 2009 on Recapitalisation of financial institutions in the current financial crisis – limitation of aid to the minimum necessary and safeguards against undue distortions of competition, Annex 1, and Communication published on 7 December 2010 on the application of the State Aid rules, from 1 January 2011, to support measures in favour of banks in the context of the financial crisis, paragraph 12.

[13] See paragraph 14 of the Second Prolongation Communication and Commissioner Almunia's speech of January 24 2012 in which with regard to element (ii) the Commission would consider whether the public capital put into the bank is limited to the amount necessary to reach the temporary capital ratio of 9% set by EBA. Speech available at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/29&format=HTML&aged=0&language=EN&guiLanguage=en.

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recommendations on capital ratios. Accordingly, the Bank would qualify for limited restructuring and compensatory measures.

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INDICATIVE TERM SHEET OF THE PROPOSED INSTRUMENT

GOVERNMENT SUBSCRIBED CORE TIER 1 CAPITAL INSTRUMENTS

Issuer	Bank of Cyprus Public Company Limited ("Bank", "Issuer")
Instruments	Government Subscribed Core Tier 1 Capital Instruments (GSI)
Total issue size	€730m *(approx. 3% of its Risk Weighted Assets)*
Nominal Value	€1,00
Issue and Subscription Price	At par and multiples thereof
Subscription Date	Not later than xxxxx2012.
Issue/Settlement Date	Not later than xxxxx 2012.
Investment Period	5 years from the Issue Date.
Governing Law	The laws of the Republic of Cyprus.
Conditions Precedent	The State shall be provided by the Bank with the following documents, in form and substance satisfactory to the State: (a) corporate resolutions from the Bank's corporate bodies, including its board of directors and its shareholders' meeting, required for the State to exercise any of its rights under the GSI, including waiving of any pre-emption rights, and allowing shares to be issued in the event that any payments, purchases or redemptions of or under the GSI are to be made through the issuance of ordinary shares, (b) agreement of the terms and conditions of the GSI and the signing of the subscription agreement between the Bank and the State, including customary and appropriate representations, warranties, covenants, closing conditions and indemnities to the benefit of the State; and (c) such other approvals or consents as are required to effect the issue of the GSI.
Status and Subordination	The GSI constitute direct, unsecured, undated and subordinated securities of the Bank and rank *pari passu* without any preference among themselves. They are fully issued and paid-in. The GSI can only be held by the State or acquired by the Bank as a consequence of exercising the Bank's Buyback Option *(as such Term is defined below)*. The rights and claims, in respect of interest, principal or otherwise, of the State: - are subordinated to the claims of the creditors of the Bank, who are: • depositors or other unsubordinated creditors of the Bank • subordinated creditors, except those creditors whose claims rank or are expressed to rank *pari passu* with the claims of

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	the holders of the GSI. • holders of subordinated Bonds of the Bank. - rank *pari passu* with the rights and claims of holders of other junior capital subordinated issues hybrid instruments qualifying as Tier 1 capital and particularly the issues of Capital Securities, Convertible Capital Securities and Convertible Enhanced Capital Securities. - have priority over the ordinary shareholders of the Bank and other holders of instruments ranking *pari passu* with ordinary shares. In the event of a winding-up of the Bank the State shall claim, on the subordinated basis mentioned above, an amount equal to the principal amount plus accrued interest. In the event of conversion of the GSI to ordinary shares the State will be a shareholder of the Bank and its claim will rank *pari passu* with the rights and claims attaching to the other shares of the relevant class.
Maturity Date	Unless previously redeemed or converted, the GSI are perpetual without a maturity date.
Coupon	Such rate as provides for an effective annual interest rate of 8,5% per annum, when paid on a semi-annual basis.
Coupon Step-up	The coupon payable on the GSI will increase in accordance with the time elapsed since the issue date, in the following manner: - Second year: Coupon rate of the first year + 25 basis points; - Third year: Coupon rate of the second year + 25 basis points; - Fourth year: Coupon rate of the third year + 50 basis points; - Fifth year: Coupon rate of the fourth year + 50 basis points.
Coupon Payment Date	Semi-annually, with the first payment to be made on 29 December 2012.
Distributable Profits	While the GSI are outstanding: (a) The Bank shall not distribute dividends (b) Any distributable profits which would otherwise be available to distribute as dividends to shareholders shall be used to pay any GSI coupon, and the buyback of any GSI Items (a) and (b) above apply to any other distributions to shareholders, including share repurchases and distribution of assets.
Conversion Rate	The Conversion Rate will be determined by the Minister of Finance, subject to any State Aid requirements, applying a 20% discount to the ordinary share price reflecting the traded market value of the shares at the time conversion is announced, taking into account the effect of dilution.
Bank's Buyback Option	The Bank may, at its own initiative at any time or in accordance with the disinvestment plan (forming part of the Recapitalization Plan to be prepared) approved by the State, elect to, partially or fully, buyback the GSI, at their principal amount together with accrued interest, subject to the prior written approval of the Central Bank of Cyprus and provided that: (a) the GSI have been or will be replaced by regulatory capital of equal or better quality; or

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	(b) the Bank has demonstrated to the satisfaction of the Central Bank of Cyprus that its own funds would, following the buy back, exceed, by a margin that the Central Bank of Cyprus considers to be adequate, the minimum Core Tier 1 ratio or other prudential requirements associated with the amount of own funds in force at that date, taking into consideration any specific determinations that the Central Bank of Cyprus might have put in place for the Bank. Any GSI bought-back by the Bank will be redeemed and cancelled by the Bank in accordance with the prior written approval of the Central Bank of Cyprus and in accordance with the Central Bank of Cyprus regulations.
Alternative Coupon Payment Mechanism	Where payment in cash would result in non-compliance with or in the opinion of the Central Bank of Cyprus may put at risk the fulfilment of the minimum capital requirements, the referred payment may, at the Bank's option, be replaced, to the extent necessary, with payment in kind through new ordinary shares of the Bank. In such a case, if the coupon is paid in ordinary shares, the discount to the share price for this purpose is 5% to the ordinary share price reflecting the traded market value of the shares at the time coupon payment is to be paid.
Mandatory Conversion	(a) If the Bank is in Material Breach of the Recapitalization Plan, the principal due under the GSI not bought back and cancelled by the Bank shall be mandatorily fully converted at the Conversion Rate into ordinary shares. (b) If the Bank does not buyback the GSI fully by the end of the Investment Period, the principal amount due under the GSI held by the State at that date shall be mandatorily fully converted into ordinary shares of the Bank at the Conversion Rate.
Material Breach	A Material Breach will always be deemed to have automatically taken place, without the need of any decision of the Minister of Finance or opinion from the Central Bank of Cyprus , if any coupon payment has been fully or partially cancelled or suspended by the Bank. Additionally, a Material Breach is (a) a material failure to execute structural targets which are essential in the Recapitalization Plan that will be prepared, or (b) a breach of obligations by the Bank which may put at serious risk the objectives of the transaction described in this Term Sheet, in each case as determined by the Minister of Finance, following a prior opinion from the Central Bank of Cyprus , provided that if such a failure or breach is capable of remedy, it shall not be a Material Breach if it is remedied to the satisfaction of the State within such reasonable period as may be required by the Minister of Finance, such period not to exceed in any event 30 days. A penalty may apply during this remedy period.
State's right to conversion	(i) If at any point there is a Viability Event, the State will have the right to convert the GSI into ordinary shares of the Bank at the Conversion Rate. "Viability Event" shall mean the earlier of: (a) a decision that a conversion, without which the Bank would become non viable, is necessary, as the term "non viable" is determined by the Central Bank of Cyprus; and (b) the decision for the State to grant the Bank any additional capital, or for the State to take any other capital equivalent measure, without

	which the Bank would no longer be viable, as the term "non viable" is determined by the Central Bank of Cyprus. (ii) In the event of a change or acquisition of control or a delisting of the Bank, the State will have the right to convert the GSI into ordinary shares of the Bank, provided that the State has given the Bank (with the prior consent of Central Bank of Cyprus) the option to buyback the GSI at their principal amount plus accrued interest and the GSI have not been bought-back. Such conversion shall take place at a conversion rate determined by the Minister of Finance based on an independent appraisal of the volume weighted average price for ordinary shares for the 5 trading days prior to (a) in the case of a change or acquisition of control the announcement (or other disclosure to the market) of the proposed change or acquisition of control (save where such price is not an undisturbed price, in which case such independent appraisal shall use the 5 day period prior to such disturbance) or (b) in the case of a delisting as determined by two independent experts appointed for that purpose by the Minister of Finance. For the purposes of this term " change of control" shall be deemed to occur where at any time after the subscription date any person acquires at least 30% of the ordinary shares of the Bank.
Redemption or Conversion for Regulatory Purposes	In case of proposed changes in the laws or the relevant regulations of the European Union or of Cyprus or in case of proposed changes in specific determinations established by the Central Bank of Cyprus to the Bank, which would lead in particular to the situation where the GSI do not qualify as Core Tier 1 capital in accordance with the final provisions for a Regulation on prudential requirements for credit institutions and investment firms to be adopted by the European Union, the Bank may, with the prior consent of the Central Bank of Cyprus, redeem all (or such part as indicated by the Central Bank of Cyprus as necessary in order to comply with the minimum Core Tier 1 capital requirements) of the GSI together with any accrued interest outstanding. Alternatively, the State and the Bank shall negotiate, subject to the consent of the Central Bank of Cyprus and any applicable State Aid requirements, to agree changes to the terms of the GSI as are necessary to make them qualify as Core Tier 1 capital, provided that an agreement is always reached at least 15 days ahead of the GSI ceasing to qualify as Core Tier 1 capital. In case such an agreement is not reached, the amounts of GSI not redeemed or bought back from the State shall mandatorily convert into ordinary shares at the Conversion Rate.
Redemption or Requirements for Conversion	The Bank shall take all actions as may be required by the State in connection with any conversion of the GSI or the exercise of the State's voting rights upon conversion, including, where necessary, calling shareholder meetings to effect a change of the nominal value of the share capital, or to the extent permitted by law promote the approval of the derogation of the by-laws provision which limits the full exercise of voting rights, so as to allow the State not to be subject to such limitations in respect of the shares acquired pursuant to the conversion of the GSI (such derogation ceasing to apply once the State ceases to hold such shares).
Use of Proceeds	The net proceeds of the GSI issue will be used to maintain a Core Tier 1 ratio in order to comply with the minimum Core Tier 1 ratio or other

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	prudential requirements associated with the amount of own funds in force at any given date during the Investment Period, taking into consideration any specific determinations that the Central Bank of Cyprus might have put in place for the Bank.

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