MINISTRY OF FINANCE

POSITION PAPER FOR THE TREATMENT OF THE SECURITIES ISSUED BY CYPRUS POBULAR BANK & BANK OF CYPRUS

1. Government Proposal

(a) Coverage:

The Government proposal aims to cover all the holders (individuals and institutional investors) of the securities (see annex) issued by the two banks (Bank of Cyprus (BOC) and Cyprus Popular Bank (CPB)) during the period 2007-2011 **as well as the holders of such securities of the CPB , who converted their securities into shares at the end of June 2012**. It is noted that the eligibility to the Government's proposal will only be available to the original holders of the securities, i.e. to those who obtained securities from the primary market and not other investors who may have purchased the securities subsequently from the secondary market. The current total amount of securities and shares under consideration is 1.367 billion euros.

The securities are held primarily by individuals and to a lesser extent by institutional investors. The total amount of securities and convertible enhanced capital securities of the two banks is € 1,190 billion, of which € 626 million relate to the CPB and € 564 million to the BOC. **The amount held by holders who converted their securities into shares (at a price of 10 cent) is € 177 million and relates to CPB holders of capital securities who converted them into shares of CPB in June 2012.**

It is noted that since the announcement of the termination on the payment of coupon for the said securities, there is a persistent a public outcry which is damaging for the long term franchise of the two banks, and crucially destabilizing for the wider economy and society. A substantial number of complaints relating to misselling practices, - running in the hundreds of cases-, have been submitted to the supervisory authorities (Central Bank of Cyprus, Cyprus Securities Commission), the banks themselves and the Ministry of Finance. A significant number of investors have also initiated legal proceedings against supervisory authorities, the Ministry of Finance and the banks in the Courts of Cyprus.

(b) Details of Government Proposal

- The Republic will buy all the securities issued by the 2 banks at their nominal value as well as the shares under consideration at the price paid by their holders, provided the investors acquired these at the primary offerings.
- The securities and shares will be allotted to the Republic in exchange for the provision of 5 year government bonds.

- The government bonds that will be issued will have a five year maturity and will be provided to the securities and shares holders at a coupon between 3.5%-4.5% at an issue price that equals the nominal price of their securities or the conversion price for shares (10 cent). Investors will carry the burden of a significantly reduced coupon vs. that paid by the capital securities prior to coupon payment termination in June 2012.
- The securities allotted to the Republic will maintain their current form without their conversion into shares or their redemption.
- The coupons of the various issues of the securities will be paid to the Government, thus effectively the Banks will continue to be burdened by the coupon payments for the benefit of the Government which is contributing the State Aid.
- The holders of the capital securities who opt for the conversion should have completed full tax returns for all years up to 2011. **For holders of capital securities of a nominal value of over Euro 200k, a Cyprus Inland Revenue Department approved full capital statement demonstrating sources of funds and corresponding tax payments, would be a prerequisite.**

(c) Advantages of the Government Proposal

In brief the advantages are:

- Alleviation of the severe socio-economic problems that have been created.
- Issue is conclusively resolved with the positive intervention of the Government.
- Restoring public confidence in the financial system that will lead to a shortening of the recovery period for banks and hence the need for financial support from the State.
- Avoid the submission of massive lawsuits against the banks, the Central Bank, the Cyprus Securities and Stock Exchange Commission and probably the Government which will flood the court system and cause delays in the process of judging the cases which has as a result, the prolongation of the confidence crisis for banks. It should not be excluded, that there is a possibility that the courts could decide in the vast majority of cases in favour of the amounts and thus at the end of the day, the impact on the state will not be different from the proposed arrangement.
- Will cover only the investors who have fulfilled their tax obligations in a demonstrable manner and only those investors who acquired securities from the primary issues .

2. Arguments supporting the Proposal

- The Banks' difficulties primarily and exclusively stem from the Greek sovereign debt crisis and the Greek Government Bonds exchange programme (PSI +) agreed at EU sovereign level. For the Cypriot banking system and mainly for the 2 above named banks the impairment of GGBs was around €4.5 billion (until 30/06/2012). More specifically, for BOC the loss from the PSI+ was €1.83 billion and for the CPB €2.5 billion. In the absence of such an exogenous event, the Banks would not have resorted to state aid and they would have satisfied the 2011 EBA stress test. Moreover, the Banks would have had the ability to continue to service coupon payments of the securities.

- The main reason for the problems of the two Cypriot banks was in effect sovereign losses that resulted from a number of wrong actions / decisions. More specifically:

  - ✓ **The decision of the EU leaders on the PSI+ without considering the consequential losses on all banks and sovereigns;**
  - ✓ **Our Government's agreement to the PSI+ without imposing any conditions so as to avoid such detrimental effects on the Cypriot Banks;**
  - ✓ **The bank management's decisions acquiring such volumes of GGBs and not following prudent risk management and banking guidelines;**
  - ✓ **The bank boards for not controlling their greedy managements and / or taking steps to put their house in order (when they realized what happened);**
  - ✓ **The bank regulator not taking active steps to stop the Cyprus Banks from investing so heavily in these Bonds and by not sending a written note to the President how to handle the PSI+ decision process.**

  Thus, it is not fair that the securities holders should now suffer a haircut because of the wrong decisions or actions of all the above.

- The perceptions of the buyers of these instruments were based on the audited financial statements, indicating that the two banks were in very good shape. The financial statements of the 2 banks were audited over the past decades by 2 of the big four audit companies. According to the audits, the financial statements were prepared on a going concern basis giving a true and fair picture.

  Moreover the results of the European Banking Authority stress tests (2010) in relation to the two participating Cypriot banks (Bank of Cyprus, Marfin Popular Bank) were positive, showing the resilience of the Cypriot banking system to withstand possible negative shocks.

- Moreover, it is noted that in the case of the CPB, the additional capital needs emanate from losses from the Greek operations of the bank. The Greek operations had the status of a subsidiary till April 2011. Had the Greek operations remained as a subsidiary and not turned into a branch, then the recapitalisation of the Greek operations of the group would have been covered by the Hellenic Financial Stability Fund, whilst also the Greek subsidiary would most likely have been able to access the Greek Emergency Liquidity Assistance of the Central Bank of Greece

- A potential bail in of creditors will increase the credit risk of bank securities. This would make it more difficult and costly for banks to reaccess capital markets. In the case of Cyprus, a large percentage of the holders of these securities are at the same time depositors. A decision of full burden sharing at the level of the capital invested would lead to the complete loss of confidence in the specific banks with the potential risk of withdrawal of significant deposits, endangering the financial stability of the system.

- Should a bail in take place, the social interest would be enormous as many of the holders had converted their life long savings in deposits into these instruments. A large percentage is retired persons, who, were using the interest income to supplement their pension and are now faced with serious economic problems. Another significant percentage, of the holders, was saving this money to use them for financing the studies of their children.. The above information is derived from the hundreds of complaints filed with the Supervisors, the Ministry of Finance and the two Banks.

- The avoidance of bail in will restore the confidence of the investors to the banks and this will facilitate the exit strategy of the government at a subsequent stage.

- Finally, the turmoil resulting from the bail in would have devastating reputational effects on the Cypriot banking sector and its use by foreign investors and depositors.

Cyprus Popular Bank

Year	Type of Instrument	Initial Amount	Amount Converted into shares	Amount as of 16 July 2012
2008	Capital Securities	€ 200.000.000	€ 45.717.000	€ 154.283.000
2009	Capital Securities	€ 242.229.000	€ 74.027.000	€ 168.202.000
2010	Capital Securities	€ 295.524.000	€ 57.240.000	€ 238.284.000
2011	Convertible Enhanced Capital Securities	€ 65.439.624	€ 0	€ 65.439.624
Total		**€ 803.192.624**	**€ 176.984.000**	**€ 626.208.624**

Bank of Cyprus

Year	Type of Instrument	Initial Amount	Amount Converted into shares	Amount as of 30 June 2012
2007	Capital Securities	€ 126.436.506	€ 104.266.946	€ 22.169.560
2009	Convertible Capital Securities	€ 645.327.822	€ 572.239.677	€ 73.088.145
2011	Convertible Enhanced Capital Securities	€ 915.000.000	€ 446.766.364	€ 468.233.636
Total		**€ 1.686.764.328**	**€ 1.123.272.987**	**€ 563.491.341**