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Press Release

Cyprus Ratings Lowered To 'BB+/B'; Outlook Negative

- Standard & Poor's is lowering its long-term sovereign credit ratings on the Republic of Cyprus to 'BB+' from 'BBB', and its short-term rating to 'B' from 'A-3'.
- The downgrade reflects our opinion of the effect on Cyprus of deepening political, financial, and monetary problems within the European Economic and Monetary Union (eurozone), with which Cyprus is closely integrated.
- The downgrade also reflects our view of Cypriot financial institutions' significant exposure to Greece, which we believe further exacerbates Cyprus' existing external vulnerabilities.
- The outlook on the long-term rating is negative.

LONDON Jan. 13, 2012--Standard & Poor's Ratings Services today lowered its long-term and short-term sovereign credit ratings on Cyprus by two notches to 'BB+/B' from 'BBB/A-3'. The outlook is negative. We have removed the long- and short-term sovereign credit ratings on Cyprus from CreditWatch, where they were first placed with negative implications on Aug. 12, 2011. We have assigned a recovery rating of '4'.

Our transfer and convertibility (T&C) assessment for Cyprus, as for all eurozone members, is 'AAA', reflecting Standard & Poor's view that the likelihood of the European Central Bank restricting nonsovereign access to foreign currency needed for debt service is extremely low. This reflects the full and open access to foreign currency that holders of euro currently enjoy and which we expect to remain the case in the foreseeable future.

The outcomes from the EU summit on Dec. 9, 2011, and subsequent statements from policymakers lead us to believe that the agreement reached has not produced a breakthrough of sufficient size and scope to fully address the eurozone's financial problems. In our opinion, the political agreement does not supply sufficient additional resources or operational flexibility to bolster European rescue operations, or extend enough support for those eurozone sovereigns subjected to heightened market pressures.

We also believe that the agreement is predicated on only a partial recognition of the source of the crisis: that the current financial turmoil stems primarily from fiscal profligacy at the periphery of the eurozone. In our view, however, the financial problems facing the eurozone are as much a consequence of rising external imbalances and divergences in competitiveness between the eurozone's core and the so-called "periphery". As such, we believe that a reform process based on a pillar of fiscal austerity alone risks becoming self-defeating, as domestic demand falls in line with consumers' rising concerns about job security and disposable incomes, eroding national tax revenues.

The downgrade reflects our view of the systemic stresses--emanating from the eurozone--we see on the large Cypriot financial sector and Cyprus' external asset position, which in our view remains susceptible to a write-down on its high lending exposure to Greece. Cyprus is in a net external liability position that has averaged nearly 10% of GDP between 2007 and 2011, noting that this excludes "brass plate" holding companies and financial institutions that do not have meaningful local operations. It has run a current account deficit averaging 11% of GDP over the same period. Besides increasing funding costs, we expect losses on Cypriot banks' loan books to Greek customers--along with the banks' holdings of Greek government and bank paper--will further worsen its net external liability position and increase narrow net external debt to levels above 100% of current account receipts. In our view, Cyprus' external financing costs may remain elevated for some time due to high gross external financing requirements and reduced financial market integration in the eurozone.

The ratings on Cyprus are constrained by what we view as a politically obstructive environment, a relatively concentrated economy, and very high contingent liabilities emanating mostly from its large financial sector. The ratings are supported by relatively high levels of prosperity and strong official institutions.

We have assigned a recovery rating of '4', indicating an expected recovery rate of 30% to 50% in the event of a default, however unlikely.

The negative outlook reflects our view that there is at least a one-in-three probability that we could lower Cyprus' long-term rating again in the next 12 months. This could occur in a context of losses from a Greek restructuring that turn out to be higher than we currently anticipate. This could lead to lower economic growth and larger external vulnerabilities, which could give us cause to adjust our economic and external scores in accordance with our criteria. Additionally, we could reduce our fiscal score if the government significantly misses its revised fiscal deficit targets, for example due to a sustained decline in growth or if domestic banks were to require additional significant fiscal support from the state.

Cyprus' long-term rating could stabilize at the current level if private creditors were to provide any needed capital to domestic banks. If public-sector access to market funding improves and government financing is assured, amid stabilizing growth prospects, the ratings could also stabilize.

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