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CYPRUS

TECHNICAL ASSISTANCE REPORT—DEBT AND CASH MANAGEMENT

January 2022

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Debt and Cash Management

APRIL 2021

Prepared By

Thordur Jonasson (Mission Chief), Shirin Nikaein (MCM), Michael Papaioannou, and Jim Siracusa (External Experts)

Authoring Department:

Monetary and Capital Markets Department

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GLOSSARY

AFP	Annual Financing Program/Annual Borrowing or Funding Plan
CBC	Central Bank of Cyprus
CET1	Common Equity Tier 1 (Tier 1 Capital)
DMO/PDMO	Debt Management Office/Public Debt Management Office
DvP	Delivery-versus-Payment
ECB	European Central Bank
EMTN	European Medium-Term Note
EZ	Eurozone
FC, FX	Foreign Currency
GDP	Gross Domestic Product
GMRA	Global Master Repurchase Agreement
HQLA	The stock of high-quality liquid assets; that is, the numerator of the Liquidity Coverage Ratio (LCR) of banks
IMF	International Monetary Fund
LMO	Liability Management Operations
MCM	Monetary and Capital Markets Department
MoF	Ministry of Finance
MTDS	Medium-term Debt Management Strategy
PDML	Public Debt Management Law
T-bill	Treasury Bill

PREFACE

In response to a request from the Ministry of Finance of Cyprus, a mission from the International Monetary Fund's Monetary and Capital Markets Department (MCM) conducted a virtual visit to Nicosia from December 7–18, 2020.[1] The objective of the mission was to provide technical assistance to the authorities on further strengthening their debt and cash management framework.

In carrying out its work, the mission met with Phaedon Kalozois, Director of the Public Debt Management Office and his staff, Yiola Georgiou, Stelios Leonidou, and Irene Theocharous. Meetings were also held with George Panteli, the Permanent Secretary of the Ministry of Finance, and officials from the Treasury Department of Cyprus. The mission also held extensive discussions with domestic and foreign banks.

The mission team expresses its appreciation to all officials for the warm welcome extended and for being available repeatedly, often at short notice, for discussions. Special thanks are owed to Yiola Georgiou for aptly managing the mission's agenda and information requirements.

[1] The mission consisted of Thor Jonasson (Mission Chief), Shirin Nikaein (both IMF), Michael Papaioannou, and Jim Siracusa (both IMF external experts).

EXECUTIVE SUMMARY

In tandem with Eurozone financial market developments and the prevalence of negative interest rates in 2020, Cypriot banks passed through the costs of their liquidity to their customers, reducing the attractiveness of placing PDMO cash surpluses in domestic bank deposits. Suitable investment alternatives to central bank deposits for the PDMO's liquidity buffer are scarce, given negative yields on other Eurozone sovereign and agency issues. This situation is shared by the PDMO with almost all of its Eurozone peers. While this is likely to persist in the short term, it should not preclude establishing a framework governing the PDMO's investment policy or a suitable set of guidelines.

The PDMO predominantly builds its liquidity buffer via pre-funding in the international capital markets through its EMTN program. Size and structural limitations in the domestic Treasury bill (T-bill) market preclude the use of the market to both manage liquidity and finance the Republic. Consideration should be given to addressing these operational limitations in order to develop further the domestic T-bill market, to facilitate the necessary T-bill issuance volumes to attract higher domestic and international investor participation.

Other options to manage upcoming maturities include the use of Liability Management Operations (LMOs) and the establishment of a contingent credit line. While LMOs could be pursued, investors may be reluctant to exchange higher coupon debt with lower coupons in the current environment if the exchange is not cash neutral.

The mission found that Cyprus' current liquidity buffer is appropriately sized given current uncertainties.[2] Going forward, determining the appropriate buffer size is important. As per the PDMO's current strategy, the cash buffer is determined using the following main quantitative variables: (i) the refinancing needs, at the end of every month, for the next 9 and 12 months, (ii) the projected budget deficit/surplus, and (iii) other contingent liabilities not included in the budget balance, with a reasonable provision for contingent liabilities being included in the annual budget. Additional idiosyncratic factors are also taken into account.

Some features of the current approach can lead to overfunding. The funding plan is on an annual basis, but the cash buffer size is determined monthly. This means that formulating the AFP requires taking into account the forecasts of all factors determining the required cash buffer for the next 2 years and not just for the next 12 months. In addition, the rather long reference period of forecasts, combined with increased cashflow uncertainty, can lead to serious discrepancies between the targeted and required cash liquidity. This holds true since

[2] The numerical figures, information, and recommendations cited in this report reflect projections, knowledge, and assessments during the time of the mission (December 7-18, 2020).

cash-flow projections rely heavily on fiscal and macro forecasts that tend to be very volatile under conditions of increased instability.

The mission recommended that the level of cash buffer be closely monitored and managed. This necessitates a cash-management policy framework, and the necessary infrastructure. A key consideration in the PDMO's investment decisions pertains to the determination of investment options for the excess liquidity stock.

The mission proposed a number of high-level recommendations (see Table 1):

- **As COVID-19 conditions ease and forecast uncertainty declines, the PDMO may consider reducing the size of the cash buffer in a gradual manner, to the range provisioned in the PDML.** The mission provided a broad quantitative framework for determining the range of the liquidity cash buffer needed during the period of the pandemic and during normal times, along with an indication of the excess cash balances that may be invested in other euro-zone countries' higher-yielding instruments or used for buybacks.
- **The reliance on predominantly long-term (greater than one-year maturity) debt instruments to fund the cash buffer should be revisited, with a view to shift to shorter-term financing sources, especially T-bills, for part of this funding, in order to give flexibility to vary the buffer in-year.**[3] Based on the mission's discussions with domestic and foreign banks, this would necessitate advancing the T-bill market through mainly liquidity-enhancing measures for the money market and other institutional changes, relating to custodian and settlement systems, in particular if foreign investors are targeted to participate in the T-bill market. Since this would represent a change in issuing policy that could affect investor perceptions, the PDMO should appropriately communicate its plans with the public.
- **The authorities should consider a more proactive approach to managing the redemption profile with LMOs.** LMOs could be considered in the context of launching new debt. Smaller near-term redemptions would reduce the target size of the cash buffer.
- **Investment options of the cash surplus are rather limited at present but should improve as market conditions change.** In the prevailing negative interest rate environment, the PDMO can either deposit funds with the Central Bank of Cyprus (CBC), at a rate of -0.50 percent, or with commercial banks at a similar rate. When the pandemic passes and market conditions normalize, the PDMO may consider investing excess cash surpluses in instruments from other euro-zone governments that may offer higher yields than commercial-bank deposits, possibly by taking some duration risk, or

[3] The use of funding instruments for the buffer with a maturity of greater than one year introduces significant rigidities in the buffer, as it reduces the flexibility to change the buffer during a year, i.e., the buffer's size cannot be adjusted in-year by the proportion of securities that have a maturity in excess of a year.

paying back maturing debt or undertaking some liability management operations, including ad-hoc buybacks and early redemptions. Finally, the mission offered some general considerations for involving external investment managers for investing in other euro-zone countries' instruments or undertaking buyback operations.

Table 1. Cyprus: Main Recommendations

Recommendation	Milestone
Prepare an internal model to calibrate the size of the cash liquidity buffer	Internal model completed
Improve custody and settlement features of Treasury bills to reach international investors	Treasury bills are eligible for settlement with an international central securities depository or a comparable mechanism
Conduct LMOs more actively, targeting upcoming maturities	LMOs are implemented as and when feasible
Invest excess cash surpluses	Investment policy is developed
Constant monitoring for the possible emergence of new contingent risks and/or the possible elimination of economic/financial risks that no longer necessitate liquidity coverage	New contingent risk(s) is(are) identified and/or existing economic/financial risks that no longer necessitate liquidity coverage are eliminated
Consider reducing the size of the cash buffer in a gradual manner and in line with the provisions of the PDML, as the COVID-19 pandemic conditions ease	Size of the cash buffer is gradually reduced