INVESTIGATION REPORT

BANK OF CYPRUS – MARFIN POPULAR BANK GROUP – REVIEW OF CROSS-BORDER MERGER

PREPARED FOR THE CENTRAL BANK OF CYPRUS

26 MARCH 2013

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1. Instructions

1.1 Instructions

1.1.1. Alvarez & Marsal ("A&M") was instructed by the Central Bank of Cyprus ("CBC") on 21 August 2012 to conduct an Investigation as independent persons, appointed in accordance with Section 24 of the Central Bank of Cyprus Laws of 2002 to 2007, to assist the CBC in accordance with the Mandate (the "Investigation").

1.1.2. Specifically, the Investigation was tasked with assisting "the Governor to take all necessary legal and regulatory remedies, whether they concern the conduct of supervision by the Bank, the procedures followed by some systemically important local banks (hereinafter referred to as "the Cypriot banks") to acquire Greek Government Bonds and / or investing abroad in the form of a branch network and/or subsidiaries banks, having regard to the requirements specified by the provisions of the Banking Laws of 1997 to (No. 2) 2011 and the Central Bank of Cyprus Laws of 2002 to 2007 and the Regulations / Directives/ Guidelines issued under these Laws, or otherwise at the discretion of the Governor".

1.1.3. This report sets out findings, conclusions and recommendations based on our work conducted up to 26 February 2013 in relation to the cross-border merger of Marfin Popular Bank ("MPB") and Marfin Egnatia Bank S.A. ("MEB") and the CBC's regulation of this merger.

1.1.4. This report has been prepared for the CBC solely for use in relation to the Investigation and must be read in conjunction with our Statement of Protocol of 26 March 2013. It may not be used for any other purpose, reproduced or disclosed to any other party in whole or in part without our prior notice. In no event, regardless of whether notice has been provided, will we assume any liability or responsibility to any third party to which this report is disclosed or otherwise made available.

2. Executive Summary

2.1.1 On 2 July 2012, Marfin Popular Bank Group received a €1.8 billion bail out from the Cypriot Government which was needed to recapitalise the bank following losses sustained on its holdings of Greek Government Bonds and its loan portfolio. The size of the bail out has led to allegations that the funds required were exacerbated by the conversion of MPB's Greek subsidiary into a branch, thereby transferring liability from Greece to Cyprus.

2.1.2 The initial intention of MPB was to move the head office from Cyprus to Greece, however, following the announcement of this decision on 19 May 2009 there were concerns raised in Cyprus over the reputational damage and economic loss that would result from one of the Republic's systemic banks moving to Greece. As a result MPB decided to merge the banks such that the head office remained in Cyprus and the Greek operations became a branch of the Cypriot bank.

2.1.3 Prior to the conversion of the Greek subsidiary there would have been no legal requirement for MPB to recapitalise MEB following the losses sustained through PSI and its loan portfolio. As a subsidiary it would have been a separate legal entity that was under the supervision, and therefore the fiscal responsibility, of Greece. However, a number of factors suggest that the parent, although not legally responsible, would have been required to recapitalise its subsidiary.

2.1.4 Prior to the finalisation of the cross-border merger in March 2011, the Bank of Greece ("BOG") had conveyed in writing to the CBC its concerns about MEB's concentration and credit risk policies and the control weakness identified during its Supervisory Review and Evaluation Process ("SREP") review on the 31 December 2009 data.

2.1.5 The appropriateness, and financial impact, of the conversion of the subsidiary to a branch needs to be considered in the light of a number of factors:

2.1.6 The reorganisation of the bank was, in part, motivated by reducing the time and costs of dealing with two regulators. The initial plan was to move the headquarters of the merged bank to Greece. However, following apparent political and other pressure from Cypriot stakeholders this was reversed and the merged bank's regulatory control was to rest with Cyprus.

2.1.7 Prior to the conversion to a branch, the CBC regulated the Greek operations on a consolidated basis. When an attempt was made by the CBC to visit MEB in Greece, the CBC was not afforded access on the basis that the bank's regulator was the BOG. As a branch of the Cypriot bank the CBC had full supervisory control of the Greek operations.

2.1.8 The powers of the CBC in respect of the conversion to a branch did not enable it to force the status quo, instead the CBC faced the option of accepting the conversion or ultimately forcing MPB to terminate its operations in Greece.

3. Timeline of Events

3.1 Background

3.1.1 Cyprus Popular Bank Co (formerly known as Marfin Popular Bank) is one of the largest banking groups in Cyprus and the Hellenic region. In 2006 the mergers in Greece of Egnatia, Laiki and Marfin formed Marfin Egnatia Bank which was 95% owned by Marfin Popular Bank.

3.1.2 Following the merger, the structure of the Group was such that the parent company, MPB, was located in Cyprus, with its subsidiary, MEB, based in Greece.

3.1.3 On 15 May 2009 the Board of Directors ("BOD") of the MPB Group approved a decision to undertake a cross-border merger of MPB and MEB, with the original intention being to move the head office of the merged bank from Cyprus to Greece.

3.1.4 The decision to undertake the merger was motivated by a number of factors, one of which was the desire to reduce the regulatory and financial burden on the MPB Group of dealing with two regulators. The decision to move the head office from Cyprus to Greece was also due to concerns over the regulatory environment in Cyprus and MPB's alleged unfavourable treatment by the Cypriot regulator as compared to its competitors.

3.1.5 Following the announcement on 19 May 2009 of the decision to move the head office, there were concerns raised in Cyprus over the reputational damage and economic loss that would result from one of the Republic's systemic banks moving to Greece.

3.1.6 Following these concerns, Mr Andreas Vgenopoulos ("Mr Vgenopoulos"), as Vice Chairman of MPB, attended a Cypriot Parliamentary session on 13 July 2009.

3.1.7 At this Parliamentary session, Mr Vgenopoulos cited his frustrations with the Cypriot banking regulatory system in general, and raised the following concerns:

3.1.7.1 Alleged unfavourable discrimination of MPB compared to Cypriot competitors;

3.1.7.2 Alleged governance issues within the CBC;

3.1.7.3 The CBC permitting one of its former employees, who had been working on an investigation into MPB, to take up a position with a competitor with immediate effect (and the associated confidentiality issues); and

3.1.7.4 That certain CBC requirements on regulatory capital were too strict compared to European counterparts' requirements.

3.1.8 Subsequent to this parliamentary meeting, on 15 September 2009, the BOD of MPB approved a revision to the cross-border merger under which MEB would be absorbed into MPB, with the head office of the merged entity to be in Cyprus, under the supervision of the CBC.

3.1.9 The minutes of the BOD meeting set out that this change in the cross-border merger was due to political and other pressure from Cypriot stakeholders.

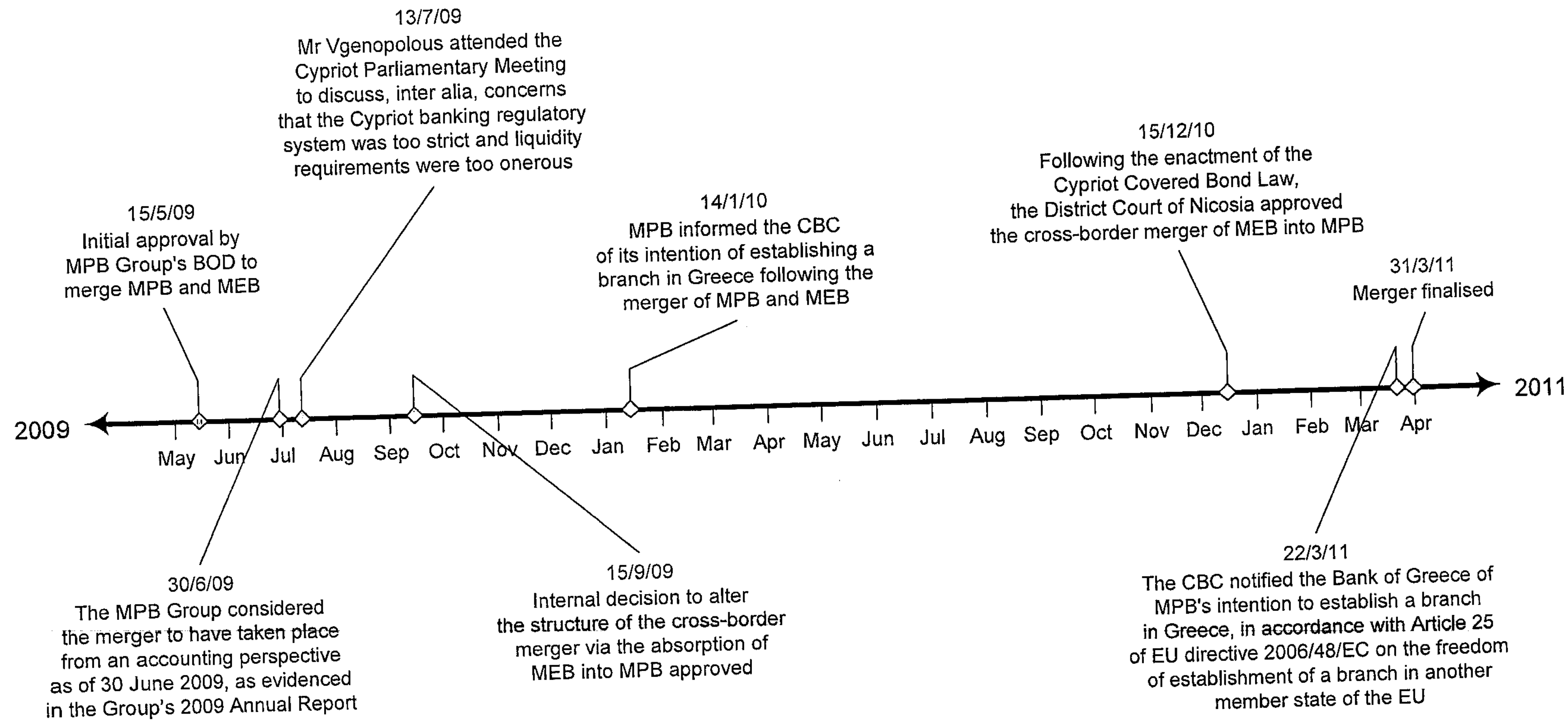
3.1.10 Despite the BOD approval for the merger being given on 15 September 2009, the merger did not proceed at this time on account of legislation on covered bonds not being passed by the parliament in Cyprus. This meant that €1 billion of covered bonds issued by MEB could not be transferred to MPB until this law came into effect on 23 December 2010.

3.1.11 On 15 December 2010, the District Court of Nicosia approved the completion of the cross-border merger of MEB and MPB, in accordance with EU Directive 2005/56, with the merger being finalised on 31 March 2011.

3.1.12 In accordance with the Banking Laws of Cyprus and Article 25 of the EU Directive 2006/48/EC the CBC sent a letter dated 22 March 2011 to the BOG informing them of MPB's intention to establish a branch in Greece.

3.1.13 On 2 July 2012, MPB Group received a €1.8 billion bail out from the Cypriot Government which was needed to recapitalise the bank following losses sustained on its holdings of Greek Government Bonds and the loan portfolio. As a result of the approved merger of MEB into MPB, the bail out required from the Cypriot Government included the liabilities of the Greek operations and prompted questions regarding the approval of the merger.

Timeline of Events



3.2 Principal Concerns

3.2.1 The question underpinning the review of the cross-border merger is whether or not, following the losses sustained from the PSI and the deterioration of the Bank's loan portfolio, Cyprus had to provide materially more funding to bail out MPB than it would have done had the merger not taken place.

3.2.2 This needs to be considered in conjunction with:

3.2.2.1 Whether, given the contemporaneous information, the CBC maintained a desire to prevent the merger;

3.2.2.2 Provided that the CBC had the desire to prevent the merger, it maintained the regulatory and legal authority to do so;

3.2.2.3 The politically sensitive situation in respect of the merger. The initial plans for the merger were to move the banking operations, and therefore the liabilities, to Greece. It was in part due to the political pressure that the Bank decided to remain headquartered in Cyprus and therefore moved the Greek operations so as to be supervised by the same supervision authority as the headquarters; and

3.2.2.4 Even if the status quo had remained, whether the Cypriot parent of MEB would have been pressured to recapitalise its subsidiary even though there is no legal obligation to do so.

4. The CBC's Supervision of MEB

4.1.1 Prior to the conversion of MEB to a branch of MPB, the CBC was the primary regulator in respect of MPB and regulated MEB on a consolidated basis. The principal supervision in respect of MEB was conducted by BOG and the CBC was entitled to conduct supervision reviews of MEB in co-operation and conjunction with the BOG.

4.1.2 Whilst MEB was regulated in Greece, the CBC sometimes found it difficult to properly supervise the bank as they were not afforded access on the basis that the BOG has supervisory responsibility for the bank. As a result, one of the arguments in favour of the merger is that it provided the CBC with stronger regulatory powers in respect of the Greek operations on the basis that primary supervisory responsibility for the newly established branch rested with CBC.

4.1.3 Post finalisation of the merger, the CBC undertook a SREP review, following which it required MPB to hold €1.56 billion of additional capital against its sovereign bond portfolio and €2.1 billion against its loan portfolio (51% of which was concentrated in Greece).

4.1.4 The table below summarise the main interaction of the CBC with BOG and MEB between October 2008 and March 2011:

Onsite examination October 2008 Joint onsite examination visit with BOG in March 2009	The CBC was not afforded access to MEB on account of BOG being its primary regulator • €800 million of loans granted to various entities for the purpose of investing in MIG, structured as bullet loans • Loans granted to the MIG Group on favourable terms (e.g. low interest rates, long term repayment etc) • Deterioration of profits by 68% due to low margin and an increase in provisions for NPLs • Concerns over conflicts of interest on the BOD • Overall assessment of MEB as a high risk entity	The CBC undertook a joint onsite examination with the BOG CBC required MPB to hold additional capital to cover the risks identified in its subsidiary, and to increase provisions for NPLs
On 27 January 2011 CBC wrote to BOG asking if, in light of the cross-border merger of MPB and MEB, the BOG had any supervisory concerns over MEB	The BOG set out that, following its SREP review of MEB (based on 31.12.09 data) it had rated MEB at 3.25 under the Bank Risk Assessment System, which was lower than the average of the Greek banking system. The BOG set out that improvements were required to: • Internal control systems (specifically relating to provisions for avoiding conflicts of interest and observance of sound risk management policies) • Concentration risk management policies • Sustainability of funds • Credit risk provisioning policy The BOG also stated that MEB's credit risk was higher than assessed under its ICAAP, and additional capital should be held to mitigate this risk	Following CBC's own SREP review on data for the 15 months to 31 March 2011, the CBC required MPB to hold additional capital of €2.1 billion against its consolidated loan portfolio
The CBC instigated quarterly and then monthly sovereign bond reporting from June 2009	The MPB Group held c€3 billion of GGBs, with approximately €2 billion booked in MEB and €1 billion in MPB	CBC required additional capital of €1.5 billion to be held against the sovereign bond portfolio

5. Relevant Legislation and Powers

5.1 Relevant Legislation

5.1.1 External legal advice in respect of the conversion of MEB from a subsidiary into a branch of MPB has highlighted three key areas of legislation that are relevant in considering the requirements of the regulators and the bank wishing to convert its subsidiary into a branch.

5.1.1.1 Law 66(I)/1997 on Banking Activities (the "Banking Law");

5.1.1.2 EU Directive 2005/56/EC on cross-border mergers of limited liability companies (the "Mergers Directive"); and

5.1.1.3 EU Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (the "Credit Institutions Directive").

5.1.2 The Mergers Directive has been integrated into Cypriot company law and sets out the requirements in respect of a cross-border merger of two or more limited liability companies within the EU. Although this is relevant to the merger of MPB in respect of the transfer of assets and liabilities and registering and consolidating the existence of the merged entity, it does not relate to the transferring of a subsidiary's banking licence into a licence for the parent company to operate a branch in another member state.

5.1.3 The Credit Institutions Directive, which has been incorporated into the Banking Law, is the relevant EU legislation in respect of the transfer of MEB into a branch of MPB.

5.2 The Banking Law

5.2.1 The outcome of the cross-border merger of MPB and MEB, was that a branch of a Cypriot registered bank was created in Greece, in place of a separate legal entity with its own Greek banking licence. The operations of that branch were therefore subsumed under the parent's banking licence, i.e. the licence granted to MPB by the CBC. Consequently the newly merged entity was governed by the Banking Law.

5.2.2 Sections 7 and 10 of the Banking Law set out the requirements in respect of a Cypriot bank that wishes to establish a branch in another EU member-state. Based on the legal advice received these procedures also apply in the case of a bank wishing to convert a subsidiary it holds in another member-state into a branch.

5.2.3 Under the legislation, in order for a bank to convert a subsidiary into a branch it must inform the CBC and provide them with all the relevant details of the branch, such as the business envisaged, structure of the branch, names of the responsible management and the capital base and capital adequacy ratios of the bank.

5.2.4 Once the CBC has received this notification it has three months to communicate the information to the supervisory authority of the host nation, which the CBC did in this instance. Alternatively, the CBC could refuse to do this, in which case it must notify the bank of the reasons for its refusal.

5.2.5 In addition to the approval process, the CBC retains the right at any time to impose new conditions in respect of any foreign branch that has been previously approved. This could include cancellation of the approval to have a foreign branch.

5.2.6 Furthermore, Section 30 of the Banking Law, provides a wide range of powers that include the ability of the CBC to restrict the scope of a bank's activities or set limits to a bank's network. These powers can be used where the CBC considers these actions necessary for the safeguarding of the interests of depositors or creditors.

5.3 CBC Relevant Powers

5.3.1 Other than the ability to refuse a notification/request to establish a branch in a member-state, the CBC has other discretionary powers available to it in respect of banking entities that fall under its remit.

5.3.2 Section 7(3) of the Banking Law provides that the CBC may, by giving notice in writing, revoke an approval granted in respect of the operation of a branch, and that the termination may be within such time limits as the CBC specifies in its notice.

5.3.3 Section 41(2) of the Banking Law states that in respect of the ability to revoke an approval, such a decision must, amongst other matters, take into account international best practice, the protection of deposits and the smooth running of the banking system. Furthermore, in all cases the CBC must provide reasons and directions in relation to any decision.

5.3.4 The revocation of the approval for MPB's branch in Greece could have had a significant impact on the Cypriot banking system as the CBC would have needed to set out the reasons for its refusal, such as the need to safeguard the interests of the depositors. Mr Costas Poullis, former head of Supervision at CBC, stated in his interview that revoking the approval for MPB to operate a branch in Greece, and therefore essentially terminating the Bank's operations in Greece, was not an option as it would have had a significant impact on the confidence of the banking sector. Mr Poullis stated that post the conversion to a branch, the CBC enforced stricter capital requirements on the bank.

6. Consequences of the Proposed Merger

6.1 Consequences of Changing MEB from a Subsidiary to a Branch

6.1.1 As a result of the conversion of the Greek subsidiary into a branch of MPB a number of advantages and disadvantages have been cited, some of these relate to the banking operations of MPB and others to the regulatory regimes, and are set out below.

- The CBC became the main regulator allowing access to MEB's books and records for supervision. This also allowed greater authority to be exercised over MEB when enforcing change (i.e. the CBC's regulatory control over a significant proportion of the Group's activities was enhanced).
- Post merger there was no requirement for separate capital to be held against operations at MEB (i.e. the branch), where there had been as a subsidiary.
- On an individual entity basis, MPB's regulatory capital increased following the absorption of MEB which had the potential to free up more capital to employ elsewhere in the business (on the assumption that pre merger MPB held sufficient capital to cover regulatory requirements).
- Liability was transferred from the Greek deposit protection scheme to the Cypriot deposit protection scheme.
- As a subsidiary, and therefore a separate legal entity, there was no legal requirement for MPB to cover losses realised in MEB, or to recapitalise MEB should the need arise. (However, consideration should be given to the fact that there may have been political and /or other pressure on MPB to recapitalise MEB. Therefore in real terms the liability to recapitalise the bank may not have changed).
- Post the merger restructuring options available in the case of insolvency were reduced; whilst this would not necessarily be a primary consideration for a business when deciding on whether to operate a branch or subsidiary, a regulator should always consider the full implications of any actions taken by the institutions it regulates, in relation to all eventualities (including the possibility of that institution becoming insolvent).

6.2 Transfer of Greek Liabilities to Cyprus

6.2.1 One of the key concerns raised in relation to the approval of the cross-border merger was that by converting MEB from a subsidiary to a branch it was no longer a separate legal entity from MPB and therefore all assets and liabilities of the former subsidiary were subsumed into MPB.

6.2.2 Based on company law a subsidiary and parent are two separate legal entities and therefore the parent company does not, unless there are cross-guarantees in place, have the obligation to recapitalise a subsidiary based in another member state.

6.2.3 A branch, as distinct from a subsidiary, is inseparable from the parent and therefore any losses or financial commitments of the branch are the legal obligation of the parent.

6.2.4 The Vienna Initiative, launched in 2009, resulted in a number of large Western European banks pledging to support their foreign subsidiaries in CESEE area. Whilst MPB is a bank based in the CESEE area the fact that there was consideration of parent companies supporting foreign subsidiaries in the event of a crisis demonstrates that more than the legal situation was being considered in relation to potential cross-border banking crises.

6.2.5 An IMF discussion note in 2011 regarding the question of branch or subsidiary states that although there is no legal obligation to support a subsidiary "*there is often an expectation that the parent will support its troubled affiliates*".

6.3 CBC's Knowledge of Potential Liabilities

6.3.1 Following the CBC's joint onsite audit with BOG in March 2009, the CBC was aware of the following issues with MEB's loan portfolio:

6.3.1.1 €1.3 billion of outstanding loans, representing 11% of the portfolio, had been granted for the purpose of investing in shares. These loans were structured such that the repayment of capital was only required at the end of the loan term via balloon payments. As such, MEB was exposed to an increased risk of non payment of capital and deteriorating profitability from the low interest rates.

6.3.1.2 Loans to MIG were granted on favourable terms, for example, at low interest rates and/or with long term repayment plans, further increasing the risks to which MEB was exposed.

6.3.1.3 Insufficient collateral held against loans, either due to incorrect procedures being followed at the time the loans were granted, or due to the deterioration of the value of the collateral without redress.

6.3.2 The above issues resulted in a significant deterioration in profitability of 68%, between 2007 and 2008 and, further, were due to weaknesses in concentration and credit control policies.

6.3.3 Prior to the finalisation of the cross-border merger in March 2011, the BOG conveyed in writing to CBC its own concerns about MEB's concentration and credit risk policies and the control weakness identified during its SREP review on the 31 December 2009 data.

6.3.4 Other than the 2009 onsite audit, CBC did not undertake any additional joint or independent reviews on MEB's data until after the merger was finalised despite the findings from the onsite review in March 2009 and the concerns raised by BOG in March 2011.

7. Conclusions and Recommendations

7.1.1 It is apparent from the Investigation that the CBC did not take any actions to stop the cross-border merger which essentially transferred the liability of the former Greek subsidiary to Cyprus. The lack of action on the part of the CBC is due to the following key factors:

7.1.1.1 The structure of the regulation and legislation is such that under the Mergers Directive the bank did not require any authorisation from the CBC, this resulted in the bank being able to transfer the assets and liabilities to Cyprus without approval from the CBC.

7.1.1.2 The subsequent notification of the conversion of the Greek subsidiary into a branch of the Cypriot bank left the CBC with the option of accepting the conversion, and therefore notifying the BOG, or forcing the bank to cease operations in Greece. Given the desire to maintain the bank's headquarters in Cyprus and the perceived regulatory benefits, the CBC notified the BOG of the creation of MPB's branch in Greece.

7.1.2 Based on the findings of the Investigation it would appear that the current regulation and legislation does not provide sufficient support to the CBC where a Cypriot bank wishes to convert an existing foreign subsidiary into a branch. We recommend the performance of a review of the legislation and consideration of amendments that would enable and require the CBC to consider the impact of such transfers and what powers should be given to the CBC, or other relevant authorities, in respect of the approval or rejection of such transfers.