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The Economic Adjustment Programme for Cyprus Second Review - Autumn 2013

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EXECUTIVE SUMMARY

Staff teams from the European Commission (EC), European Central Bank (ECB) and the International Monetary Fund (IMF) visited Nicosia on 29 October – 7 November 2013 for the second quarterly review of Cyprus' economic adjustment programme, which is supported by financial assistance from the European Stability Mechanism (ESM) and the IMF. The programme's objectives are to restore financial sector stability, strengthen public finance sustainability and implement structural reforms so as to support sustainable and balanced long-run growth.

Cyprus' programme is on track. All fiscal targets have been met with considerable margins, reflecting the ambitious fiscal consolidation underway, prudent budget execution, and a less severe deterioration of economic activity than originally projected. Structural reforms are also advancing. Furthermore, since the last review, the on-going recapitalisation and restructuring of the financial sector has significantly progressed. This has allowed further relaxation of payment restrictions since July, in line with the government's milestone-based roadmap. New foreign direct investment in the banking sector has been a positive sign. The authorities' strong programme implementation so far is welcome. Nevertheless, given prevailing significant risks ahead, continued full and timely policy implementation remains essential for the success of the programme.

The economic situation remains difficult, although so far the recession has been less pronounced than expected. Based on recent indicators, output in 2013 is projected to contract less than originally envisaged. The households and some sectors such as tourism and professional services have proven relatively resilient, and confidence has improved somewhat since April 2013. Looking forward, output in 2014 is expected to contract more than initially foreseen, and to recover gradually starting in 2015. The uncertainty surrounding the outlook remains substantial.

The authorities have made important strides with the recapitalisation and restructuring of the financial sector. Hellenic Bank has been successfully recapitalised with private funds, including foreign investment, and without state support. The restructuring of Bank of Cyprus (BoC) and cooperative credit sector is advancing. New Boards of Directors for BoC and the Cooperative Central Bank have been appointed and funds for the recapitalisation of the cooperative credit sector have been secured, without involving depositors. Deposit outflows abated, pointing to some return of depositors' confidence, but further improvement of bank's balance sheets is needed to resume credit to the private sector and support economic recovery. Diligent implementation of banks' restructuring plans will be critical, including tackling the still rising level of non-performing loans and making efforts to protect troubled borrowers, while discouraging strategic defaults. The published milestone-based roadmap remains the guiding principle for gradual relaxation of payment restrictions while safeguarding financial stability. Finally, the authorities need to further strengthen the supervisory and regulatory frameworks and implement the anti-money laundering action plan as a priority.

Fiscal performance has remained strong. The authorities have maintained a primary surplus of about 0.7% of GDP through end-September, meeting the programme targets comfortably and placing end-of year targets well within reach. Given the outturns to date, both the 2013 and 2014 fiscal deficits are expected to be up to 1% of GDP lower than anticipated during the last review.

Structural reforms are advancing, although delays and partial compliance were observed in a number of cases. A governance structure has been put in place to carry out an ambitious revenue administration reform aimed at improving efficiency of collections. Progress has also been made on the reform of the social welfare system, aimed at introducing a guaranteed minimum income scheme providing financial assistance to those in need. These efforts need to be complemented by a credible and detailed privatisation agenda, backed-up by strong political will.

This review is expected to be concluded with all necessary decisions by the Eurogroup, the ESM Board of Directors and the Executive Board of the IMF taken in December. Its approval would pave the way for the disbursement of EUR 100m by the ESM, and about EUR 86m by the IMF.

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1. INTRODUCTION

The report assesses compliance with the terms and conditions set out in the MoU, which was updated following the first review mission during the summer of 2013, between the Cypriot authorities and the programme partners, i.e. the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF). On 24 April 2013, the European Stability Mechanism (ESM) Board of Governors approved the MoU. Vice-President Olli Rehn signed the first MoU on 26 April 2013 and the revised MoU 13 September 2013.

The 3-year programme entails an external financing by the ESM and the IMF of some EUR 10bn, for possible fiscal financing needs and support to the banking system. Around 90% of the programme envelope will be financed by the ESM while the remainder will be financed by the IMF under an Extended Fund Facility.

A joint EC/ECB/IMF staff mission visited Nicosia from 29 October – 7 November for the second quarterly mission and concluded that the economic adjustment programme is on track.

In the updated MoU, nine policy provisions were set as prior actions for the granting of the third disbursement. By the time of publication, all prior actions have been met. In the financial sector, the Central Bank of Cyprus should approve Bank of Cyprus' proposed set of quarterly targets for the next 12 months and the legal obstacles to the CBC's ability to retain and employ the necessary qualified staff should be removed. Moreover, a relationship framework between the State and the Central Cooperative Bank should be established to ensure sound policies and restructuring measures. In the area of AML, it should be verified that all directives and circulars issued by supervisory authorities are in line with relevant legislation. On fiscal policies, the 2014 draft Budget Law should be aligned with the programme's macroeconomic and budgetary projections. Regarding structural reforms, the authorities are required to adopt legislation for capping the pension benefits for members of the House of Representatives, adopt a privatisation plan with asset-specific timelines and intermediate steps, legislate key elements of the Service Directive, and ensure access to the registers of title deeds.

A successful completion of the second review should pave the way for the disbursement of EUR 100m by the ESM, and about EUR 86m by the IMF. This will bring the total amount authorised for disbursement under the programme to around 50% of the overall international assistance of EUR 10bn.

The report is organised as follows. Section 2 examines recent macroeconomic, fiscal and financial developments. A detailed assessment of compliance of programme conditionality is reported in Section 3. Section 4 looks at programme financing and debt sustainability, while Section 5 discusses risks to the programme. Annex 1 contains a comprehensive monitoring table with an assessment of programme conditionality. Background tables are presented in Annex 2 and 3. Programme documents are in Annex 4.

2. ECONOMIC DEVELOPMENTS AND OUTLOOK

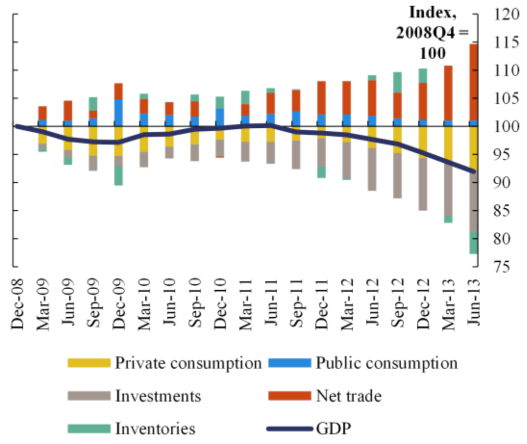
2.1. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

The unwinding of macroeconomic imbalances continued to act as a drag on the economy. Domestic demand remained weak, reflecting the confluence of several factors, notably disruptions to credit intermediation, private sector deleveraging, fiscal consolidation measures, salary cuts in the private sector and deteriorating labour market conditions. Amid high economic uncertainty, some sectors, such as tourism and professional services, proved more resilient than anticipated, while Hellenic Bank succeeded in attracting private capital including foreign investment.

Economic activity continued its decline in the second quarter of 2013, although to a lesser extent than foreseen in the first review's macroeconomic projections. While further revisions to GDP growth rates are possible (see Box 2.1), the data available so far show that the better performance was largely due to private consumption, which proved less weak than anticipated despite deteriorating labour market conditions. The resilience of households may be attributed to efforts by households to use their precautionary savings in order to smooth their consumption and sustain past living standards. Uncertainty about future business prospects led firms to accelerate their destocking, weighing further on growth. Gross fixed capital formation continued to display a sharp contraction, reflecting the need to unwind earlier excessive expansion in the housing market and liquidity shortages. A sharp contraction in imports led to a positive growth contribution from net trade.

The current account recorded a significant improvement. In the first half of 2013 the current account deficit narrowed to 1.8% from 7.4% of GDP in the same period of 2012. This mostly reflects an improvement in the balance of trade in goods, following a sharp decline in imports. This was partially compensated by an improvement in the income and current transfer balances (see Box 2.2 for a discussion of the net international investment position and the current account adjustment).

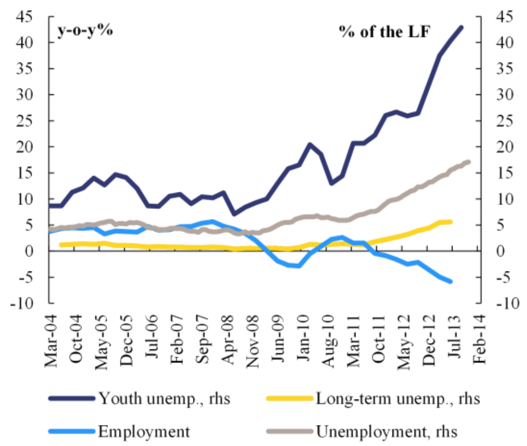
Graph 2.1: **Real GDP and contributions to growth**



Source: CYSTAT and Commission services.

Unemployment continued to adjust to the deteriorating economic environment. Unemployment increased to unprecedented levels, with youth unemployment approaching almost 40% of the youth labour force (Graph 2.2), one of the highest levels in the EU. The increase in total unemployment was, however, smaller than the decline in employment as the labour force continued to shrink in size.

Graph 2.2: **Labour market developments**

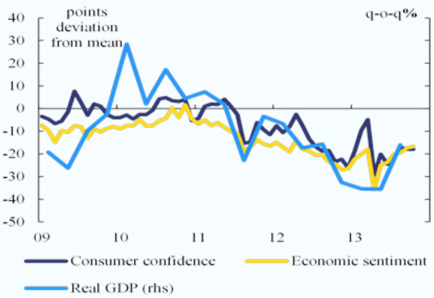


Source: Labour Force Survey and Eurostat.

Box 2.1: GDP releases in an uncertain macroeconomic environment

In the context of the surveillance of economic adjustment programmes, quarterly GDP figures constitute one of the main indicators in the monitoring process. Recent releases of quarterly GDP growth rates have surprised on the upside. For instance, quarterly GDP growth in the second quarter remained broadly identical to the first quarter, while monthly consumer confidence and business confidence indicators fell below the levels observed in the first quarter as a response to pronounced financial market instability (Graph 1). At the same time, recent historical data have been subject to larger than usual downward revisions. This calls for a better understanding of the statistical models underlying GDP estimates and the reasons for the recent revisions.

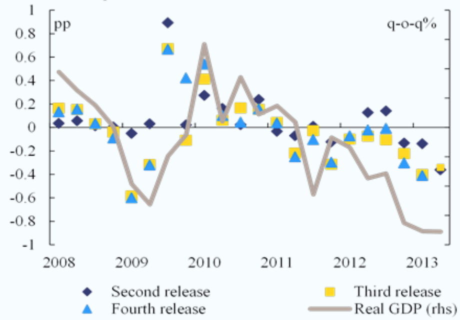
Graph 1: **GDP and confidence indicators**



The flash estimates of headline GDP is released one and a half months after the end of the reference quarter. Quarterly GDP figures are derived from statistical models that use short term indicators to estimate economic activity, as it is done in many other EU Member States. All models used to produce GDP estimates by the statistical service of the Cypriot Ministry of Finance, CYSTAT, are in line with ESA 95 standards and continuously validated by EUROSTAT. These models are based on 'hard' data, while 'soft' data, such as opinion surveys, are not incorporated in the models. Demand and supply components are published with the second release, roughly 2½ months after the end of the reference period. GDP estimates are derived from the production approach, as more numerous and reliable indicators are available for this approach.

GDP estimates are not final until the annual survey data are taken into account close to 2 years after the end of the reference year. Until then quarterly GDP figures are revised as new data reach CYSTAT. Revisions are therefore an intrinsic and unavoidable part of the statistical process. Since new information mostly relates to the two latest quarterly data points, revisions usually affect those estimates. Some revisions also take place in March, when CYSTAT produces the first estimate of annual GDP of the previous year. Similarly to the practice followed when incorporating annual survey data, any new information that might affect provisional figures are taken into account when producing the first annual GDP estimate.

Graph 2: **GDP and revisions to the flash estimate**



Markers show pps revision vis-a-vis the q-o-q flash estimate

The large revisions in some quarterly GDP estimates in 2013 were mostly due to the exceptional events that occurred during that period. The bank holiday in March-April led to late transmission of some data (and in particular information on social security contributions) used by CYSTAT to compile the flash estimate for the first quarter of 2013. This led to sizeable revisions of GDP estimates for the first quarter of 2013 (Graph 2). Also, GDP estimates are more likely to be subject to large revisions in periods of high uncertainty, as it was the case in 2009, or in early 2013 at the initiation of the restructuring of the financial sector and the introduction of capital controls.

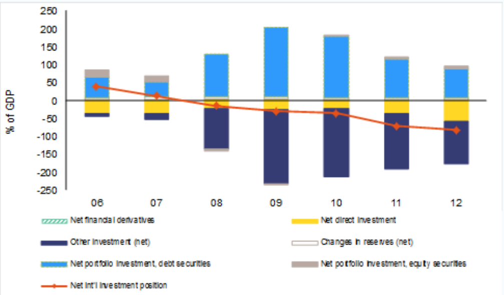
Currently, elevated levels of uncertainty in the macroeconomic environment call for a cautious interpretation of GDP estimates. Further revisions of GDP estimates cannot be excluded, as the complete information set is not yet available to CYSTAT. In particular, the compilation of the first annual GDP estimate for 2013 and the incorporation of annual survey data in spring and autumn of next year respectively, might lead to further revisions of activity, also given the amplitude of the economic shock.

Box 2.2: Net international investment position and current account adjustment

For more than a decade the Cypriot economy has been recording persistent current account deficits. From the beginning of 2000s, Cyprus' current account deficit deteriorated gradually and in 2008 reached a record level of 15.6% of GDP. The current account deficits were financed by high external capital inflows in the financial account, mostly in the form of foreign deposits which are recorded in other investments and monetary flows in the form of retained profits of firms with foreign shareholding based in Cyprus, which is recorded as foreign direct investments (FDI).

These unsustainable developments fuelled a strong deterioration in the Net International Investment Position (NIIP). ([1]) The NIIP turned negative in 2008 and rapidly declined from -15% of GDP in 2008 to -82% of GDP in 2012, reflecting continuous, albeit smaller, current account deficits. The deterioration can be attributed to the decrease in net holding of foreign debt securities and an increase in foreign deposit and in net liabilities from FDI (Graph 1). ([2]) The former relates partly to the losses on holding of Greek government bonds. In the first quarter of 2013, the NIIP deteriorated further and amounted to a record level of more 100% of the GDP as a result of the liquidation of debt securities (e.g. bonds) held by residents.

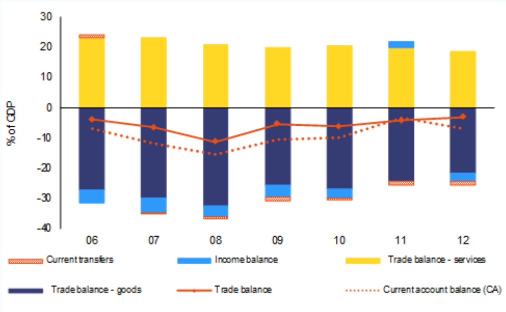
Graph 1: Decomposition of the Net International Investment Position



Source: Central Bank of Cyprus and Eurostat

Since 2008, the current account balance has significantly improved, mainly reflecting import contraction. Between 2008 and 2012, the current account deficit narrowed by approx. 8.5 pps of GDP, which is almost exclusively attributed to the improvement in the trade balance of goods and services (Graph 2). The domestic demand contraction led to a sharp decline in imports. This trend is evident in the first half of 2013 and is expected to continue in the remaining of 2013.

Graph 2: Decomposition of the current account balance



Source: Central Bank of Cyprus and Eurostat

Despite some improvement, the income account has remained a drag to the current account. The income account deficit narrowed from 3.9% in 2008 to 2.6% of GDP in 2012, while a surplus of 2.0% was exceptionally recorded in 2011. Re-invested earnings and dividends constitute a major element of the income account. They are usually unrelated to the domestic economic activity, as they reflect the presence of foreign companies that choose to channel their operations via Cyprus and could also be driven by factors that are considered exogenous to the economy such as the distribution of dividends from foreign to parent companies. Table 1 indicates that re-invested earnings and dividends contributed to the current account deficit by 3.2% of GDP on average since 2008.

Table 1: Current account balance: The impact of re-invested earnings and dividends

as a % of GDP	2008	2009	2010	2011	2012
Current account balance	-15.6	-10.7	-9.8	-3.4	-6.9
Current account excl. re-invested earnings	-15.6	-4.7	-11.3	-4.4	-5.0
Current account excl. re-invested earnings and dividends	-12.1	-5.5	-5.6	-4.1	-3.1

Source: Central Bank of Cyprus.

The income account is expected to temporarily improve on the back of the financial sector restructuring measures. The so-called "bail-in" and equity conversion of some of the uninsured

(Continued on the next page)

([1]) The international investment position depicts the financial assets and liabilities of residents of an economy vis-à-vis the rest of the world. The difference between an economy's external financial assets and liabilities is the economy's net IIP.

([2]) Changes in the NIIP also reflect revaluation effects. It is estimated that more than half of the deterioration in the NIIP in the period 2008-2012 can be attributed to revaluation effects.

Box (continued)

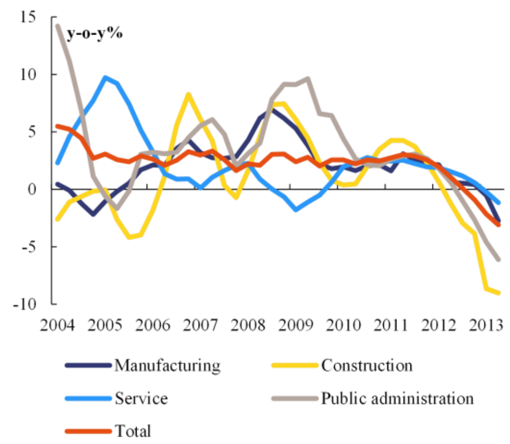
deposits in the Cypriot banking system will negatively impact the interest and dividend payments to non-residents as equity participations in the banking system are not expected to generate outflows (i.e. dividends) until the profitability in the banking sector is restored. However, the income account deficit is likely to gradually increase again in the following years, in line with improvement of banks' profitability and the restoration of the foreign investors' confidence to the Cypriot economy.

As a result, the income account will continue to weigh negatively on the current account balance improvement. The trade balance will be the driving force behind the expected improvement of the current account balance and will lead to a marginally positive current account from 2014. The income account deficit is estimated to return to levels close to 4.0% of GDP towards the end of the programme period. The adjustment of the NIIP towards a level close to the indicative threshold of the Macroeconomic Imbalance Procedure scoreboard (-35% of GDP) would therefore require current account surpluses in excess of these currently forecasted, and hence higher trade balance surpluses. For instance, it is estimated that current account surpluses close to 2.5% of GDP per annum are required in order to half the NIIP in the next 10 years.

The adjustment in the labour market has also been reflected in wage moderation. The annual change in nominal compensation per employee has been moderating gradually since 2011 (Graph 2.3). Driven by wage cuts in large parts of the economy, the rate of change turned negative in mid-2012 and the adjustment has continued throughout 2013. Combined with a milder decline in real gross value added, unit labour costs have been falling, supporting the price competiveness of the Cypriot economy. Compensation per employee has diminished in both the construction sector and the public administration, reflecting the weakness in the property market and the related subdued residential investment activity, and the cuts in public wages, respectively. The annual change in compensation per employee in the manufacturing sector has proved relatively resilient and just recently moved into negative territory.

The annual decline in nominal house prices accelerated somewhat in second quarter, alongside a further decline in loans for house purchases. According to the Bank Lending Survey, the fall in housing loans reflected both a tightening of credit standards and a declining demand for housing loans. The demand for residential properties remained weak from non-domestic and particularly domestic residents. For the latter group, this reflected the worsened economic situation and a need for balance sheet adjustment, which continued to weigh on house prices.

Graph 2.3: **Compensation per employee**



(1) 4-quarter moving averages.
Source: Eurostat.

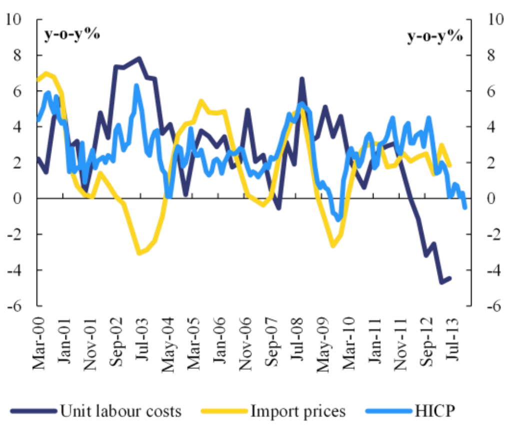
HICP inflation has been moderating since last year, reflecting the sizeable spare capacity and weak domestic cost pressures in the economy (Graph 2.4). At the same time, stable inflation in import prices, driven also by higher excise duties, has curbed the fall so far. Underlying inflation has also remained subdued reflecting a weakening in the service component of the HICP index.

Table 2.1: **Main features of macroeconomic forecast**

	2012 Curr. prices (EUR m)	2012 % of GDP	2010	2011	2012	Updated forecast 2013	Updated forecast 2014	July forecast 2013	July forecast 2014
			Annual percentage change						
GDP	17,720	100	1.3	0.4	-2.4	-7.7	-4.8	-8.7	-3.9
Private consumption	12,087	68.2	1.5	1.3	-2.5	-10.7	-6.7	-12.3	-5.5
Public consumption	3,438	19.4	1.0	-0.2	-3.1	-4.1	-5.2	-8.9	-3.6
Gross fixed capital formation	2,430	13.7	-4.9	-8.7	-19.6	-28.5	-14.0	-29.5	-12.0
Exports (goods and services)	7,710	43.5	3.9	4.5	-2.7	-5.8	-2.9	-5.0	-2.5
Imports (goods and services)	8,180	46.2	4.8	-0.1	-6.4	-16.0	-8.0	-16.0	-6.5
GNI (GDP deflator)	17,185	97.0	2.4	4.8	-6.3	-6.6	-7.1	-5.5	-4.4
Contribution to growth:	Domestic demand		0.2	-0.8	-5.6	-12.0	-7.0	-13.7	-5.5
	Inventories		1.8	-0.7	1.3	-0.6	0.0	0.0	0.0
	Net exports		-0.6	1.9	1.9	4.9	2.1	5.0	1.6
Employment			-0.2	0.5	-4.1	-6.3	-4.4	-6.6	-3.1
Unemployment (1)			6.3	7.9	11.9	16.7	19.8	17.0	19.5
Compensation per employee			2.6	2.5	-1.0	-5.3	-5.6	-7.5	-5.0
Unit labour costs, whole economy			1.1	2.5	-2.7	-3.9	-5.2	-5.4	-4.2
Real unit labour costs			-0.9	0.2	-4.3	-4.3	-6.2	-6.0	-5.3
GDP deflator			1.9	2.3	1.6	0.4	1.0	0.6	1.1
Harmonised index of consumer prices			2.6	3.5	3.1	0.7	1.0	1.0	1.2
Terms of trade			0.0	-0.2	-0.3	-0.5	-0.5	-1.6	-1.0
Merchandise trade balance (2)			-26.8	-24.3	-21.8	-17.2	-15.4	-18.1	-16.8
Current account balance			-9.0	-4.7	-6.8	-1.4	0.3	-1.9	-0.6

(1) Eurostat definition, % of labour force. (2) as a percentage of GDP.
Source: Commission services.

Graph 2.4: **HICP inflation, unit labour cost and import prices**



Source: Eurostat.

GDP was down by 5.7% y-o-y in the third quarter of 2013 according the flash estimate, slightly less than the fall of 5.8% y-o-y in the second quarter. [1] The moderation of the annual fall in GDP is in line with the improvement in indicators for consumer confidence since the trough in April. Nevertheless, given the volatility in the monthly data observed in recent months, the underlying trend appears weak. Since April, business sentiment indicators have also improved somewhat, with the exception of confidence in the construction sector. However, indicators for new car registrations and retail sales continue their downward trend, confirming the underlying weakness in private consumption. In addition, in view of falling capacity utilisation, rapidly shrinking lending and tight credit supply conditions, together with the lack of liquidity and the on-going balance sheet adjustment in the private sector, gross fixed capital formation is expected to contract further (Graph 2.5). Short-term trade statistics suggest a continuation of positive growth contributions from net trade.

All in all, the Cypriot economy will continue to face several headwinds. Real GDP in 2013 and 2014 is expected to contract sharply. Uncertainty about economic activity in 2013 remains unusually high, partly due to the amplitude of the economic shock, but also due to recent revisions of national accounts figures (see Box 2.1). The cumulative fall in GDP over 2013 and 2014 is still expected to reach around 13%, i.e. broadly in line with expectations in the first-review forecast, implying a larger contraction in 2014 following a milder than anticipated adjustment in 2013 (Table 2.1).

(1) The Q3 flash estimate was released on 14 November 2013, after the finalisation of the macroeconomic forecast at end-mission, and has therefore not been taken into consideration for the revised programme forecast.

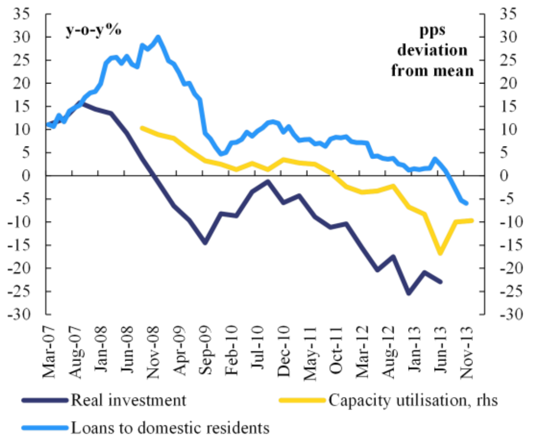
Table 2.2: **Key macroeconomic and budgetary developments, 2011-2016**

	2011	2012	2013	2014	2015	2016
Real GDP (1)	0.5	-2.4	-7.7	-4.8	0.9	1.9
Output gap (2)	1.0	-0.2	-5.3	-7.5	-4.3	-1.2
General government balance (3)	-6.4	-6.4	-7.8	-7.1	-6.1	-2.8
Primary balance (3)	-4.0	-3.3	-3.6	-3.1	-2.1	1.2
Cyclical-adjusted balance (4)	-6.9	-6.3	-5.5	-3.9	-4.2	-2.3
Structural balance (4)	-6.6	-6.7	-5.3	-4.6	-4.2	-2.3

(1) Percentage change, (2) % of potential output, (3) incl. compensation of pension funds, estimated to amount to 1.8% of GDP in 2013, (4) % of GDP.
Source: Commission services.

The projected fall in GDP in 2014 is driven by an anticipated further contraction in domestic demand. The significant though more gradual deleveraging process in the private sector, together with further worsening of labour market conditions, relatively stronger-than-expected decline in wages and the fiscal adjustment planned and already underway, will put a drag on domestic demand. A further shrinking of imports in 2013-14 is expected to more than offset declining exports, leading to a positive contribution to growth from net trade, and a significant improvement in the current account balance.

Graph 2.5: **Investment, capacity utilisation and credit to domestic residents**



Source: CYSTAT, Central Bank of Cyprus and DG ECFIN.

The deep contraction in economic activity in 2013 and 2014 is expected to weigh on employment and to push unemployment to unprecedented levels, although some of the labour market adjustment is expected to take place on the wage side as well. Subdued domestic cost pressures and sizeable spare capacity are projected to contain inflation in 2013 and 2014, despite higher indirect taxes, implying some downward revisions to HICP inflation and the GDP deflator.

In 2015, the recession is expected to come to an end and growth is foreseen to resume gradually, as private domestic demand regains strength. The on-going deleveraging of both households and corporates will remove impediments to a more balanced growth over time. At the same time, the restoration of confidence in the banking sector is expected to gradually loosen the tight credit conditions, thus supporting domestic demand. The projected rise in imports will reduce the positive contribution of net export to GDP and have an adverse effect on the current account balance. Reflecting the expected pick-up in domestic demand in 2015, HICP inflation is projected to accelerate, albeit remaining below 2%.

For 2014-2016, risks remain tilted to the downside. A more protracted period of disruptions to efficient credit intermediation together with tighter credit supply conditions and a further deterioration in the confidence in the banking sector could pose considerable risks to the real side of the economy. Moreover, further worsening of labour market conditions may lead to more prolonged weakness of business and consumer confidence. On the upside, the underlying dynamics in the economy, which are very difficult to assess amid the current high uncertainty, could be slightly better than envisaged now for 2013. Additional upside risks for the Cypriot economy relate to possible improvements in the external outlook and, in the outer years, investments in the energy sector and a more competitive tourist sector.

2.2. FISCAL DEVELOPMENTS AND OUTLOOK

The 2013 budget execution remains on track. This reflects the significant fiscal consolidation measures undertaken, the strict expenditure control, and the better-than-projected revenue performance given the less severe economic contraction than initially expected. Despite weakening trends in the collection of certain taxes, recent developments suggest an end-year budgetary outcome for 2013, around ½ pp better than projected during the first review, when taking into account the agreed compensation of pension funds.

Q1-Q3 2013 budget execution data for the general government (in ESA95) suggests that budgetary developments remain on track vis-à-vis the annual target set in the July MoU and the quarterly targets established by the authorities.([2]) Over this period, the budget balance showed a better-than-targeted outcome by 2.2% of GDP, resulting in a deficit of 1.9% of GDP. In the same vein, the primary balance ended up 1.3% of GDP above the target, showing a surplus of 0.8% of GDP. This suggests that the IMF's Q3 Quantitative Performance Criterion (QPC) of a primary deficit of EUR 402m (specified in cash terms ([3])) has been met with a significant margin. ([4])

The authorities continue to be very cautious in their expenditure policy. All main expenditure categories decreased year-on-year, despite the negative impact of the adverse labour market developments. High lump-sum payments due to the still on-going rush to early retirement in the public sector exerted an additional pressure to expenditure performance, although the retirement wave also contributed to a decrease in the public sector wage bill. Capital expenditure decreased by 80% y-o-y, mainly due to signing fees for gas exploration (1% of GDP) being statistically treated as disposal of non-produced assets. This effect was further strengthened by a significant amount of investment projects having been put on hold or cancelled and administrative delays for the payment of land annexation compensations during the first half of 2013.

Total revenue is holding up better than foreseen in the projections underpinning the MoU's annual target. The sharp fall in private consumption and imports led to a significant year-on-year decrease in the collection of taxes on production and imports. Weak labour market conditions and the decline in corporate profits, resident deposits and interest rates negatively affected taxes on income and wealth and social contributions received. However, the fall in revenues was lower than projected, reflecting the milder than expected recession in 2013 and success in implementing some important revenue side measures, e.g. the increase in immovable property taxes. The significant measures undertaken have helped dampening the decline in revenues and their full effect is expected to be reached in 2014.

Compared to August 2013, public debt in September increased by EUR 1.5bn to 112% of GDP, reflecting the recapitalisation of the financial sector. The general government's gross debt stock remained broadly stable over the months January-April 2013, due to favourable fiscal developments. The first disbursement of programme money by the ESM and the IMF took place in May and June 2013, amounting to EUR 2.1bn and EUR 1.0bn respectively. The debt-to-GDP ratio at the end of 2013 is expected to reach 114%, compared to 87% in 2012, peak around 126% of GDP in 2015 and gradually decline towards 105% of GDP in 2020.([5])

During the second review, programme partners and the authorities agreed on an updated fiscal forecast, based on the latest macroeconomic and budgetary developments. Against the background of the significant consolidation effort undertaken in line with the MoU requirements, the

([2]) Quarterly targets are in line with the IMF's Quantitative Performance Criteria and the annual targets set in the MoU. The targets are not budgeted, but derived from previous years' profiles and are therefore indicative.

([3]) Differences between ESA95- and cash terms for Q3 2013 amounted to EUR 29m.

([4]) The IMF's Q3 and Q4 QPCs have been adjusted to account for the compensation of provident and retirement funds in Cyprus Popular Bank. The 2013 headline deficit target set in the MoU has been revised by EUR 299m (1.8% of GDP) to incorporate this compensation and now amounts to 8.3% of GDP.

([5]) The upward revision of the 2012 debt-to-GDP ratio by 0.8% of GDP is due to the downward revision of the 2012 nominal GDP level. This does, however, not significantly affect the debt trajectory and the long term sustainability of public finances.

Table 2.3: **General government budget, ESA95 Q1-Q3 2013**

in million euros unless otherwise stated

	2012 data (cumulative)	2013 data (cumulative)			Current programme forecast
	Q1-Q3	Q1	Q2	Q3*	2013
Total revenue	**5,113**	**1,420**	**3,038**	**4,719**	**6,595**
Taxes on production and imports	1,898	452	1,156	1,789	2,420
Current taxes on income and wealth	1,423	412	782	1,308	1,919
Social contributions	1,214	346	744	1,106	1,433
Other current resources	574	211	356	515	821
of which					
Other current resources	208	115	156	204	
Sales	366	96	199	311	
Capital transfers received	4	1	1	2	2
Total expenditure	**5,701**	**1,398**	**3,241**	**5,037**	**7,882**
Total current expenditure	5,340	1,494	3,273	4,964	7,509
of which					
Intermediate consumption	620	156	359	548	857
Compensation of employees	1,983	610	1,190	1,812	2,630
Social transfers	1,924	450	1,206	1,820	2,573
of which					
Social transfers other than in kind	1,916	449	1,204	1,816	
Social transfers in kind	8	0	2	4	
Interest	471	165	276	456	689
Subsidies	68	31	50	66	95
Other current expenditure	275	83	191	262	665
Total capital expenditure	361	-96	-32	73	373
of which					
Gross fixed capital formation	306	52	111	188	
Other capital expenditure	55	-149	-142	-116	
General government balance (ESA95)	**-589**	**23**	**-203**	**-318**	**-1,287**
% GDP	*-3.3*	*0.1*	*-1.2*	*-1.9*	***-7.8***
General government primary balance	**-118**	**188**	**73**	**139**	**-598**
% GDP	*-0.7*	*1.1*	*0.4*	*0.8*	*-3.6*

(*) Subsequently approved by EUROSTAT.
Source: CYSTAT and Ministry of Finance.

general government deficit is expected to reach 7.8% of GDP in 2013 due to the agreed one-off compensation of provident and retirement funds in Cyprus Popular Bank (1.8% of GDP). The 2014 deficit is projected to decline to 7.1% of GDP in 2014, i.e. more than 1 pp less than projected in July, while it remains largely unchanged for 2015 and 2016 (at 6.1% of GDP and 2.8% of GDP respectively).

Despite the overperformance until end-Q3 2013, the 2013 projections remain cautious and account for some possible deterioration in the rest of the year. Trends in the year-on-year comparisons of major revenue items show some weakening, including in the taxes on production and imports, social security contributions and taxes on income and wealth.(6) On the expenditure side, higher than expected lump-sum retirement payments could trigger a less positive expenditure performance with regard to the end-year target.

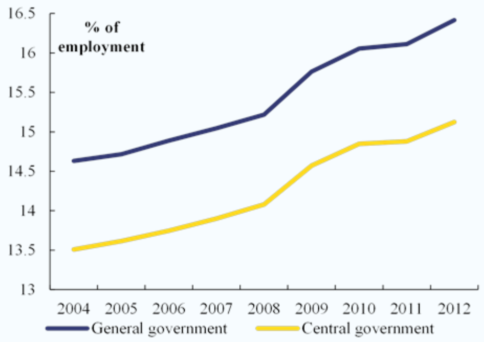
For 2014, the already adopted consolidation measures with effect from 1 January 2014 and additional measures included in the draft 2014

(6) Interpreting the year-on-year developments in direct taxes is, however, complicated by the fact that there has been a change in collection dates for advancements on income taxes and significant tax increases were implemented over the course of the year.

Box 2.3: Compensation of employees in the public sector

General government employment in Cyprus has been on an increasing path over the last decade. Between 2004 and 2012, the share of the employed population in the general government increased by about 2 pps to reach 16.4% in 2012. This largely reflects developments in the central government sector (see Graph 1), while the small share of the employed population in local governments and SOE's remained broadly stable over these years (1% and 3% on average, respectively).

Graph 1: **Employment in the public sector**

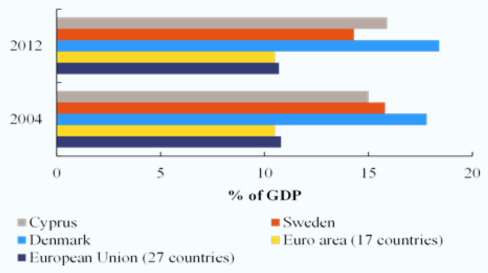


Source: CYSTAT.

The rise in public employment, combined with public sector wage developments, contributed to a significant increase in compensation of employees in the general government, which is the highest in the euro area and the second highest in the EU (see Graph 2). The compensation of employees rose on average by 5% per year over 2004-2012, roughly double the one in the EU27. As a result, it accounted in 2012 for a much larger share of public expenditure and GDP in Cyprus than in other EU27 countries (35% of total expenditure and 15% of GDP in Cyprus versus 23% and 11% respectively for EU27). Data from the national accounts suggests that wage developments played significant a role in this regard. Over 2004-2012, the average annual wage per employee in Cyprus amounted to EUR 35000, roughly EUR 6000 above the EU27 average.

The composition of compensation of employees remained broadly stable. The largest part was borne by the educational sector, which made up for an average of 30% of the total amount, broadly in line with the EU27 value. However, the share of the health sector was around 8 pps lower than the overall share for the EU27, while it was around 9 pps higher in the general public services sector.

Graph 2: **Compensation of employees, general government**



Source: Eurostat.

In 2012, increased uncertainty about possible plans to reform the generous public pension system contributed to a significant retirement wave.([1]) This, combined with measures undertaken in 2011 and 2012, decreased the compensation of employees by 2 pps, compared to 2011, through the reduction of the public sector wage bill. This effect was, however, partly dampened by the increase in pension annuities and lump-sum retirement payments, which are also recorded in the compensation of employees.

The adjustment programme foresees several further measures to address the size of the public sector. The authorities have committed to reduce public sector employment by at least 4500 positions over the period 2012-2016, inter alia by freezing the hiring of new personnel on first entry posts in the broader public sector, implementing a policy of recruiting one person for every four retirees and implementing a four year plan aimed at the abolition of at least 1880 permanent posts. With 1040 early retirements until September 2013, the retirement wave will continue to have a large impact on the achievement of these goals. The programme also foresees wage reductions, including a flat rate reduction of 3% on all wages in 2014, and freezes of general wage increases for the public and broader public sector. As a result, the compensation of employees is projected to decline by an average of 4% per year (2 pps of GDP) over 2013-2016, thereby contributing significantly to the long-term consolidation of public finances.

([1]) Early retirements in 2012 are estimated at 1080, i.e. 130% higher than in 2011. This number captures only the amount of early retirements for which the gratuity was paid in 2012. Overall retirements (including age-related retirements) amounted to 2022, but the payment of the lump-sum for 495 retirements was shifted to 2013.

Table 2.4: **Fiscal accounts, projections for 2013-2016**

in million euros unless otherwise stated	November projection				July projection	
	2013	2014	2015	2016	2013	2014
Total revenue	**6,595**	**6,415**	**6,453**	**6,791**	**6,674**	**6,270**
Taxes on production and imports	2,420	2,346	2,415	2,564	2,315	2,269
Current taxes on income and wealth	1,919	1,795	1,810	1,899	1,847	1,711
Social contributions	1,433	1,439	1,424	1,455	1,385	1,394
Sales and other current resources (1)	821	833	802	870	1,116	886
Capital transfers received	2	2	2	2	11	10
Total expenditure	**7,882**	**7,541**	**7,434**	**7,263**	**8,037**	**7,594**
Total current expenditure	7,508	7,051	6,937	6,753	7,472	7,089
of which		0	0	0		
Intermediate consumption	857	868	861	839	857	831
Compensation of employees	2,630	2,450	2,402	2,373	2,613	2,544
Social transfers	2,573	2,658	2,620	2,508	2,573	2,665
Interest	689	643	641	673	669	645
Subsidies	95	85	85	85	100	102
Other current expenditure (2)	665	347	327	275	660	302
Total capital expenditure	373	490	497	510	565	505
General government balance	**-1,287**	**-1,126**	**-980**	**-472**	**-1,363**	**-1,324**
% GDP	*-7.8*	*-7.1*	*-6.1*	*-2.8*	*-8.3*	*-8.3*
General government primary surplus	**-598**	**-483**	**-339**	**201**	**-694**	**-679**
% GDP	*-3.6*	*-3.1*	*-2.1*	*1.2*	*-4.2*	*-4.3*

(1) The November projection for 2013 incorporates the revised statistical treatment of signing fees for gas exploration as disposal of non-produced assets. Consequently, compared to the July projection, those fees are shifted from sales and other current resources and treated as negative capital expenditure. (2) For 2013, this includes compensation of pension funds amounting to 1.8% of GDP.
Source: Commission services.

Budget Law will help to improve further the fiscal balance despite the negative impact of the recession. On the revenue side, reflecting the worsening economic conditions, most taxes are projected to decline despite the implementation of significant consolidation measures. Social contributions are expected to broadly stabilise due to an increase in the contribution rate. On the expenditure side, further measures to cut the public sector wage bill and reduce public investment, intermediate consumption and other current expenditure are projected to outweigh the increase in social transfers connected to the adverse labour market developments.

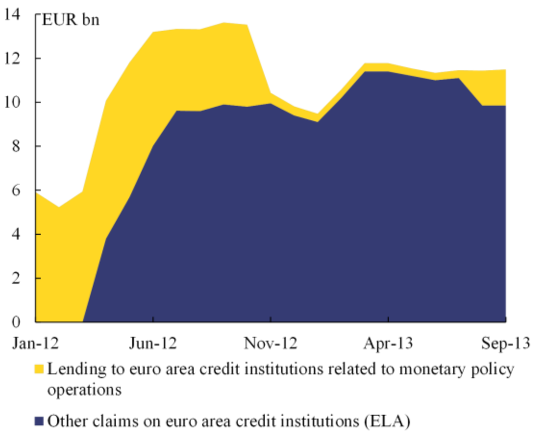
The 2014 primary deficit is forecast to be more than 1% of GDP lower than projected in July, despite the downward revision of the 2014 GDP growth projection. This is mainly due to: a carry-over effect from the better-than-expected outcome for 2013; higher number of retirements in 2013, which will reduce the 2014 wage bill; and additional consolidation measures of 0.3% of GDP to be implemented in the 2014 budget.

In 2015 and 2016, the projections remain largely unchanged compared to the first review, with a forecasted further improvement in the headline balance. Total revenue is expected to recover in line with the improving macroeconomic situation, with the 2014 VAT increase also providing some support. Total primary expenditure is projected to continue to decrease in outer years, due in part to lower lump-sum payments following the end of the retirement wave. This will drive a further fall in total expenditure in 2016 despite a higher interest bill reflecting a more expensive re-entry into the capital market and the stepwise increase in the ESM interest rate.

2.3. FINANCIAL MARKETS AND FINANCIAL SECTOR DEVELOPMENTS

The financial sector has stabilised, even though the return to long-term viability is still to be achieved. Differences at the level of individual banks, however, persist. Bank of Cyprus was successfully brought out of resolution, Hellenic Bank reached its goal to fund its three-year forward-looking capital shortage with private contributions, and the cooperative credit institutions have made good progress with the preparation of their recapitalisation plan. Nevertheless, confidence in the financial sector remains weak and non-performing loans have continued their increasing trend. The new definition of non-performing loans, introduced on 1 July, offers a more realistic picture of the credit quality.

Graph 2.6: **Eurosystem lending to credit institutions in Cyprus**

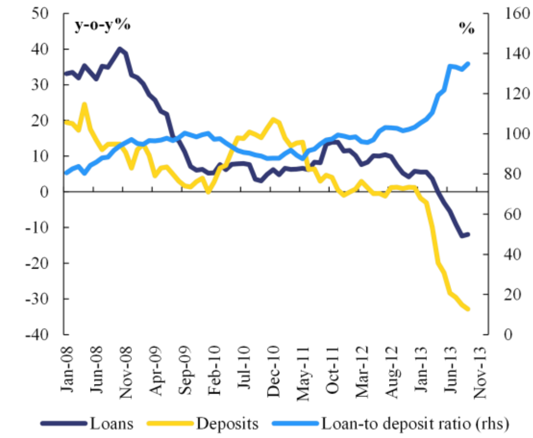


Source: Central Bank of Cyprus.

Deposits outflows have not materially affected banks' liquidity. Banks continued to experience deposit outflows, even though at a lower daily intensity. However, the sector's overall reliance on borrowing from the Eurosystem has remained broadly constant at EUR 11.5bn during this period (Graph 2.6). The composition changed, though, because the exit from resolution permitted Bank of Cyprus to replace some of its ELA by regular funding from the ECB. The fact that the deposit contraction did not result into a net liquidity outflow was due to asset disposals by banks and, primarily, loan book amortisation. The latter also explains the net bank credit contraction, which accelerated noticeably from 4% y-o-y in June to 12% y-o-y in September (see Graph 2.7). The loan-to-deposit ratio peaked at 134% in June 2013 following the bail-in of deposits, and has stabilized at that level.

The decline of bank loans suggests that the correction of the excessive household and corporate indebtedness is underway. Banks' aggressive credit granting policy (Graph 2.8) led to a sharp increase in overall net financial indebtedness which culminated at 72% of GDP in 2011. Very recently, a genuine nominal deleveraging has started in Cyprus, more noticeably with respect to lending to households.

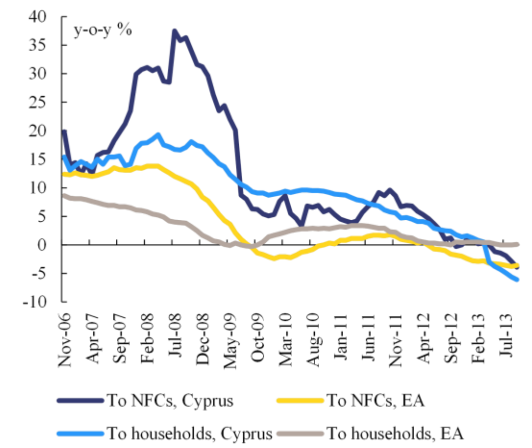
Graph 2.7: **Loans and deposits**



Source: Central Bank of Cyprus.

Loans to resident households contracted by more than 6% y-o-y in September, while corporate credit shrank by less than 4% y-o-y. In relative terms, the contraction affected mostly credit for consumption and lending for house purchases, which decreased by 10.3% and 6.6% y-o-y, respectively.

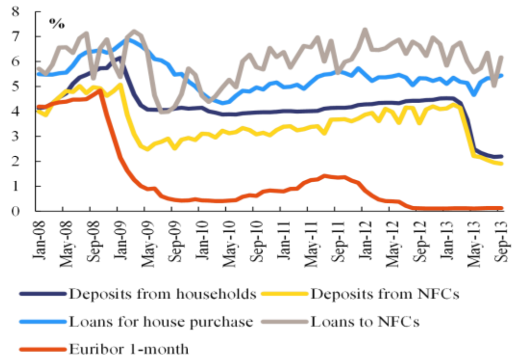
Graph 2.8: **Bank loans in Cyprus and the euro area**



(1) Domestic entities only.
Source: Central Bank of Cyprus and ECB.

The cost of new credit remains high. After an initial decline in the lending rate for house purchases, associated with the Central Bank of Cyprus' regulatory efforts to bring deposit rates down, the average cost for a residential mortgage have returned to levels observed before the regulative initiative (Graph 2.9). In contrast, the average corporate lending rate has been trending somewhat down, although some caution is warranted when interpreting these numbers since the turnover of new lending is limited.

Graph 2.9: **Interest rates on new loans and deposits**



Source: Central Bank of Cyprus.

3. PROGRAMME IMPLEMENTATION

The second review mission by staff of the European Commission (EC), European Central Bank (ECB) and International Monetary Fund, (IMF) concluded that the economic adjustment programme is on track.

The Cypriot authorities have made further progress in implementing the programme. Financial sector reforms are progressing well, although with a few delays. The fiscal policy measures remain on track to achieving the end-year targets with a considerable margin on the back of a cautious expenditure control. Structural reforms are also progressing in all key areas, although some delays and partial compliance are observed.

Minimising the impact of consolidation on vulnerable groups is explicitly stated as programme objectives and enshrined in the MoU. To this end, several steps have been taken in designing the programme. Reforms in the areas of pensions, health and social welfare are being undertaken. The latter is explicitly aimed at providing better protection of vulnerable groups with the introduction of a guaranteed minimum income (GMI) scheme and better targeting of benefits to ensure public support for those most in need. Pension reform steps are largely progressive, including by necessary adjustments to the relatively favourable government employee pension scheme. Health reform steps aim at strengthening the sustainability of the funding structure and will contribute, together with the implementation of a National Health System, to more equal access to public health services for all parts of the population. The programme also comprises a range of actions with regard to activating the unemployed and combatting youth unemployment as well as an explicit commitment to preserve the good implementation of structural and other EU funds and to target EU funds to those areas that deliver the most important economic and social impact.

Ambitious reforms of the tax revenue and public administration are envisaged in the programme and aim at improving tax compliance, fight tax invasion and making the public sector more effective in performing its tasks, including by making it easier to reallocate public sector resources to areas most affected by the economic crisis.

The design of fiscal consolidation measures aim at a more progressive system in several respects, by combining an increased taxation of capital (interest income, dividends, immovable property) with a higher corporate tax rate, increased excises for certain products with adverse health effects (tobacco and alcohol) and "greening" elements of the tax system (e.g. higher excises on petroleum products and an environmentally friendly vehicle taxation). Due to the severity of Cyprus' fiscal situation, it has been necessary, however, to also increase the VAT rate. Where reductions in public sector emoluments have been necessary, they are predominantly progressive and targeting also certain benefits and privileges for senior officials. The objectives behind the necessary fiscal and fiscal-structural measures are clearly outlined in the introduction to these chapters of policy conditionality. Addressing these challenges is instrumental to ensure that the disposable income of Cypriot households can start growing again over the medium-term and to bring public finances back to a sounder position.

A summary assessment of compliance with the programme conditionality is provided in Table 3.1, while the specific assessment on the implementation of the individual elements of conditionality with an end-Q3 deadline is found in Annex 1.

The authorities should continue to pursue their ambitious reform agenda and maintain its momentum. It is of primary importance to ensure timely implementation of the necessary reforms in line with the programme conditionality. To this end, political consensus and administrative capacity need further strengthening.

3.1. FINANCIAL SECTOR

3.1.1. Maintaining liquidity in the banking sector

The roadmap for exiting capital restrictions remains unchanged, with the first stage being successfully completed. The authorities, in consultation with the programme partners,

Table 3.1: **Summary of compliance with policy conditionality for the second review (end-Q3 2013)**

	Status
Financial sector policy	**Partially compliant.** While work is progressing well, due to the sheer number of work-streams, a few deadlines were not met. The submission of the restructuring plan of the cooperative sector takes more time than initially foreseen, while for BoC only a small delay is noted and, related to this, also their funding and capital plans are late as well as the determination of the disclosure requirements for the markets to assess progress. However, the merger process of the cooperative banks started already. Concerning the capital-raising of Hellenic Bank, it was successfully completed through a liability management exercise and a rights issue. Several regulatory initiatives with Q3 as deadline (implementation of the roadmap for gradual liberalisation of administrative measures, new NPL definition, review of accounting standards, strengthening governance, external auditor for the coops, arrears management, establishment of a management unit for the government's stake in the coops) were successfully met, while for other measures the work was not finalised in time (action plan for the effective integration of the coop supervisor, relationship framework for the management of the government's stake in the coops, staff issues at the CBC) or is still ongoing and deadlines have been shifted to the future (credit register, impediments review to debt restructuring, financial ombudsman). On AML, the authorities have largely complied with their commitments regarding the transparency of beneficial ownership, while the CBC provided on 19 November 2013 an analysis of the adequacy of relevant CBC directives for review by the programme partners. The analysis confirmed that the CBC Directive is in its current form in line with relevant legislation. In addition, the CBC has not finalised the follow-up on all the cases revealed by Deloitte and thus an extension until January 2014 was provided.
Fiscal policy	**Compliant.** Budgetary execution remains on track and end-year budgetary targets are well within reach. Primary expenditure and deficit ceilings in Q3 have been respected with considerable margins. The fiscal consolidation measures agreed in the context of the programme for 2013 and 2014 have been enacted and are being implemented. For 2014, the authorities have proposed additional measures amounting to 0.3% of GDP in the draft 2014 Budget which, prior to its adoption by the House of Representatives, will be aligned with the programme's revised macroeconomic and budgetary projections. For 2015-2016, the revised projections imply a fiscal gap of 2% of GDP, slightly below the additional fiscal effort anticipated at the beginning of the programme.
Fiscal-structural measures	**Partially compliant.** The authorities are continuing their work in these areas , including public financial management, budgetary framework, social welfare reform, PPPs and tax administration reform. Most fiscal structural reforms deadlines have been observed by the time of the review mission. However, in the area of privatisation compliance cannot be considered achieved. The adoption of a privatisation plan by the government was set as a prior action. A draft plan was prepared and modified, but still needed additional detailing in order to ensure that the programme targets are met. Political ownership of the technical work had not yet been ensured. Other areas are partially compliant, including: (a) the screening of State-Owned Enterprises' (SOEs) viability and the steps to improve their governance; (c) a deadline for end-year was introduced for the application of GEPS reforms in the broader public sector; and (d) insufficient progress to pursue the implementation of a NHS. The setting up the project governance structure in tax administration, although somehow delayed, has been delivered and some progress made.
Labour market	**Compliant.** While there were no explicit Q3-deadlines, progress has been registered with respect to the definition of measures to tackle youth unemployment and to address the shortcomings of the current system of activation policies. Also, tripartite negotiations to extend the reform of wage indexation to the private sector are on-going.
Goods and services market	**Partially compliant.** The authorities have complied in the housing market with regard to the legislation for the mandatory registration of sales contracts for immovable property, as well as with the publication of their quarterly progress review; the complete draft legislation for the elimination of the legal interest requirement was pending and had been targeted as a prior action. A number of sector-specific laws related to the Services Directive had not been adopted, implementation of the Services Directive therefore not being satisfactory. Existing bans on advertising in specific regulated professions were not eliminated in due time. Therefore, the former was set as a prior action. In the area of tourism, the authorities delivered an updated action plan with quantified targets during the review mission, and in the area of energy, the first version of the roll-out plan was delivered with minor delay.
Data reporting	**Compliant.** The authorities comply with the regular data reporting requirements, set in the MoU. However, some responses to clarifying questions on the 2014 budget data and on the additional measures were somehow delayed. Moreover, information regarding on-going TA by the World Bank, the IMF and others could flow more smoothly.

Source: Commission services.

confirmed during the second review the milestone-based strategy for exiting capital restrictions as adopted on 8 August 2013. ([7]) Limits above which authorisation ex ante is required for payments related to goods and services within Cyprus have been fully relaxed, while for transfers abroad the threshold has been increased to EUR 1m. The first stage of the roadmap has also allowed for the opening of fixed term deposits under certain conditions, and for establishing current accounts in other credit institutions if related to new credit facilities. The former relaxation aimed at attracting cash in circulation, while for the latter, the intention was to stimulate banks to revive the supply of loans to the Cypriot economy. Opening term deposits with cash proved to have some favourable impact, but the other measure was less effective. In order to become operational, a new decree permits working capital to be channelled to the newly opened current accounts, which would allow banks to better monitor the credit risk of clients.

Further relaxation of capital restrictions will depend on progress made with restructuring plans subject to an assessment of bank liquidity or other financial stability considerations. Stage two of the roadmap will unlock the restrictions on fixed-term deposits and free the transfers between domestic banks, also those which are not linked to execution of payments for normal business operations, i.e. financial transactions. In order to move to the next stage, three important milestones need to be accomplished: i) Hellenic Bank needs to be recapitalised; ii) the restructuring plan of the Bank of Cyprus (BoC) has to be approved by the CBC; and iii) the restructuring plan of the cooperative credit sector has to be submitted to the European Commission. While Hellenic Bank was successfully recapitalised by private means in October 2013 and the Central Bank of Cyprus approved BoC's restructuring plan in November 2013, moving to stage two is pending on the official submission to the European Commission of the restructuring plan for the cooperative sector and the assessment of the liquidity situation of banks. The former is possible after the authorities submit the official and final version of the restructuring plan endorsed by the CEO of the Central Cooperative Bank, who was not appointed yet in late November 2013. While every next step of the roadmap is clearly defined by progress made in bank restructuring, financial stability also matters. In this respect, the Monitoring Board, established by the EC and the Cypriot authorities, with the ECB, the IMF, ESM and the EBA participating as observers, follows closely financial flows and thoroughly assesses whether bank liquidity conditions permit further relaxations.

3.1.2. Regulation and supervision of banks and cooperatives credit institutions

Compliance with the implementation of the regulatory and supervisory changes has been satisfactory. The authorities have created a much needed framework for dealing with troubled borrowers and have established a Code of Conduct for banks in that respect (Box 3.1). Related to the maximisation of loan recovery values, the legislation on the loan mediation functions of the Financial Ombudsman is undergoing a lengthy consultation process leading to the proposal to restrict mediation functions to restructuring loans collateralised by a first residency and maybe in a second step to widen the scope. In this context, technical assistance is being provided by the programme partners. Major progress has been achieved also in the area of unifying the supervision and regulation of commercial banks and cooperative credit institutions. The supervision of the credit cooperatives passed to the CBC on 5 September 2013 and it has been staffed throughout October.

The intensive involvement of the authorities in a large number of parallel work-streams has necessitated the postponement of a few deadlines. Despite the considerable work invested in the setting up of the single credit register, the legal framework could not be created by end-September 2013. The updated MoU allows until December 2013 for achieving this goal. Similarly, the October deadline for establishing mandatory disclosure requirements on banks' progress with their restructuring plans was replaced by November 2013. Other important work-streams, such as the directive on loan origination and provisioning and the directive on restricting lending to board members, were achieved on time. A detailed presentation of progress with

([7]) http://www.mof.gov.cy/mof/mof.nsf/All/3766C4D62B9EDE71C2257BC2002E22E9/$file/Roadmap%20PresentationLHM07%2008%202012ENG%20[Compatibility%20Mode].pdf

Box 3.1: **Policy initiatives addressing arrears management**

Policy initiatives in Cyprus to improve management of arrears are part of a comprehensive framework for dealing with troubled borrowers. This framework was established by a Directive on Arrears Management, which aims at the implementation of a uniform policy across the commercial and cooperative credit institutions. The main objective is to perform restructurings that are feasible and viable through an appropriate policy of managing arrears. Institutions are required to:

i) provide a strategy for implementing the framework, accompanied by a diagnostic check of the arrears that need strengthening, by end-September 2013;

ii) establish an internal independent appeals process with respect to loan restructuring, by end-September 2013;

iii) submit an action plan for the full implementation of the framework, as well as a highly descriptive progress report of restructurings, by end-October 2013.

The Framework on Arrears Management, which is Appendix 1 to the above-mentioned Directive, establishes a minimum set of uniform requirements for all banks with respect to their practical management of arrears. Banks are instructed to implement efficient and effective processes and tools in order to execute fair, adequate and sustainable debt restructurings. The strategy adopted by each institution should address the three very different situations of i) pre-arrears credit facilities, ii) facilities in arrears and iii) restructuring and modification of facilities, within a fair, collaborative and case-by-case approach. In addition to proper portfolio segmentation, each sub-portfolio is to be broken down into discrete cohorts according to the duration of the arrears. Key Performance Indicators (KPI) shall allow the institution to monitor the successful implementation of the strategy.

In dealing with viable and cooperative borrowers, banks should offer a range of fair and sustainable restructuring options, tailored to the specific situation. Emphasis should be put on the repayment of the principal. A reasonable standard of living is to be determined, so that a luxury lifestyle is avoided, while borrowers are able to maintain active their involvement in society. The restructuring "shall not lead to undue hardship but, whilst striking the right balance, shall be based on respect of the physical, psychological and social needs of the troubled borrowers." In particular, the financial assessment by the creditor shall take into account the individual situation of the borrower, including the essential need for car, the variable costs encountered, and any discretionary expenses specific to the individual situation. Each bank must set up an internal appeals process, independent from credit origination, which would ensure the impartial application of these principles. In addition, the expertise related to these principles and to the implementation of the overall strategy shall be gathered within an independent centralised Arrears Management Unit, distinct from the Debt Recovery Unit, and independent from the credit origination department of the bank. Finally, the Framework on Arrears Management advises a cooperative approach to the cases of multiple creditors to a troubled borrower and lists a menu of short- and long-term restructuring options.

The Code of Conduct on the Handling of Borrowers in Financial Difficulties, which forms Appendix 2 to the Directive, sets up guidelines for interacting with troubled borrowers. It identifies six crucial stages of the general approach to restructuring. The first stage, i.e. effective communication with the borrower, appears crucial, as it determines whether the borrower is cooperative or not. Different degrees of active communication by means of personal meetings, phone calls, and written letters are advised for the different stages of arrears. The further steps of the restructuring process, namely the processing of financial information from the borrower, the assessment of its financial position and the consideration of suitable restructuring options, are reserved for borrowers who have cooperated during the communication stage. In the event a viable restructuring is deemed possible, the credit institution shall present the borrower with a transparent and understandable description of the financial implications. An Appeals Committee within the institution will handle all cases of disagreement. Credit Institutions are liable for demonstrating their compliance with this Code, namely by keeping written records of their

(Continued on the next page)

Box (continued)

communication and decision processes for at least 6 years.

Three other on-going policy initiatives are related to the general policy of improving banks' risk management with respect to NPLs. First, there is the legal initiative to set up Financial Ombudsman that will handle cases of litigation between banks and their borrowers, under the ultimate authority of the Supreme Court. The legal proposal is currently in a standstill, due to banks' fears that the right balance between the roles of facilitating debt restructurings and arbitraging litigation cases has not been reached and that the new institutions would confer an undue privileged position to the borrowers. Second, a unified credit register, with common access for both banks and credit cooperative institutions, is in the process of being set up. This will allow credit providers to better know their risk exposure and the central bank to acquire a new information-rich tool for carrying out its offsite inspections. Third, an independent external review of banks' loan origination and provisioning policies has provided a number of suggestions for improving practices in areas such as assessment of customers' capacity to repay, thresholds on LTVs and interest serviceability, real estate values, forex lending, etc. A directive has been prepared by the Central Bank of Cyprus and is in the process of being enacted.

implementing the MoU conditionality in the area of regulation and supervision can be found in the annexed compliance table.

3.1.3. Recapitalisation, resolution and restructuring

Bank of Cyprus

In accordance with the MoU, a new Board of Directors of the Bank of Cyprus (BoC) has been established and a restructuring plan has been submitted to the Central Bank of Cyprus. Furthermore, a CEO has been appointed by the new Board of Directors on 22 October 2013. The restructuring plan of the BoC has been submitted to the Central Bank of Cyprus, which approved it in early November 2013. Restructuring of BoC is now progressing: all branches of the former Cyprus Popular Bank (CPB) have been renamed into BoC branches, 50 branches have been closed, and the plan is to finalise this process by end-2013.

Restoring depositors' confidence remains the key priority. To that end, BoC will take steps to continue to strengthen its balance sheet, reduce ELA, and manage NPLs more effectively. Since 15 October 2013, a crash hands-on programme for the active handling of NPLs has been launched. In the medium-term two separate units will be created, one for "normal" NPLs, and one "Special Projects Division" for the top 22 corporates and real estate developers. With a focused approach, it will be attempted that the NPLs of the top 22 corporates will either start performing again or that action may be taken to seize the collateral. If necessary for maintaining a sufficient level of liquidity, BoC will take steps to issue government guaranteed bonds, for a value of up to EUR 3bn. The Cypriot authorities stand ready to consider these additional government guarantees, in line with State aid rules, if and as needed to safeguard financial stability. The instrument is a backstop and at present the liquidity position does not require further guarantees to be issued.

BoC has front-loaded the PIMCO losses compared to the distribution in the KPMG report. This resulted in a core Tier 1 ratio of about 10.5%, below the 12% indicated in the KPMG report. Because the PIMCO losses are only front-loaded, the core Tier 1 ratio is expected to remain above 9% throughout the programme period, in accordance with the MoU. The shift in the timing of the losses allocation has also the advantage that profitability will be higher at the end of the programme.

There are concerns regarding the subsidiaries of the BoC and the Cyprus Popular Bank in Ukraine. The resolution of the CPB and the restructuring of BoC involve the sale of subsidiaries abroad. Related to specific judicial procedures, the sale process is difficult in this country, as compensation is sought through a claim on the assets of the subsidiaries. More broadly, it will be attempted to speed up the disposal of the assets of Legacy Laiki, the run-down vehicle of Cyprus Popular Bank. To that end, the Resolution Authority will present an action plan. In the meantime, in order to ensure proper management of Laiki's shares in BoC, the voting rights attached to these shares will be entrusted to an independent external party.

Hellenic Bank

In accordance with the MoU, Hellenic Bank has successfully completed its capital raising plan. Hellenic Bank, for which PIMCO had identified a capital shortfall of close to EUR 300m, has closed its capital hole without relying on State aid. Together with a new rights issue, its plan included an offer for exchanging existing Tier 1 and Tier 2 capital instruments into CoCos that will be automatically converted into equity when the core Tier 1 capital ratio falls below 9%.

The Tier 1 and Tier 2 capital instruments have been exchanged into CoCos. First, the total of EUR 126m of Tier 1 instruments with write down or conversion features have been converted into CoCos 1. Second, the total of EUR 17m of Tier 1 instruments without mandatory conversion features and EUR 111m from the total of EUR 164m of Tier 2 instruments have been exchange for CoCos 2. The CoCos have the same trigger point for conversion into core Tier 1 capital, but the prospectus specifies that CoCo 1 will be converted before CoCo 2.

The rights issue of EUR 103m has attracted foreign investors, which is a sign of confidence in the banking sector going forward. Not only the capital gap left by the incomplete exchange of the Tier 2 instruments into CoCos could be filled, but the equity provision by the external parties also resulted in a capital buffer of about EUR 64m above the identified shortfall. This has raised the core Tier 1 capital ratio of Hellenic Bank to 9.5%.

The Cooperative Credit Institutions

The Cooperative Credit Institutions (CCIs) will engage in an in-depth restructuring. First, the capital structure will be entirely modified (Box 3.2) with the Central Cooperative Bank (CCB) becoming the main shareholder of the CCI. The shares that old members held in the CCIs will be heavily diluted. Second, the current 93 CCIs will progressively merge into at most 18 institutions. The consolidation process has already started with the merger of 28 cooperative banks into four larger CCIs and is expected to be finalized by March 2014. This will greatly enhance the efficiency of the sector. Third, the enhancement of internal policies and guidelines will be achieved through the establishment of dedicated committees at the level of the CCB in order to strengthen governance and accountability. Credit policy, risk management, and management of troubled and connected borrowers will be under the responsibility of the CCB. CCIs will strictly follow the guidelines enacted by these committees and will be closely monitored. Fourth, the management of non-performing loans will be transferred to five newly created specialized units. The latter will report directly to the CCB.

A unit has been created in the Ministry of Finance for controlling the stake of the government in the cooperative credit institutions. This follows the voting of the law on the new governance framework for the relationship between the government and the cooperative sector on 5 September 2013. The unit is responsible for ensuring that the cooperative credit institutions have the appropriate corporate governance structure, implement the restructuring plan, and protect the value of the investment of the state. To that end, a detailed relationship agreement is being drafted describing the responsibilities of the Board of the Central Cooperative Bank and of the management unit acting on behalf of the state with a view to avoid political influence in the daily management decisions including lending decisions. In application of its mandate, the unit prepared the Terms of Reference for the valuation by an external adviser of the entry price of the State's shares in the Central Cooperative Bank, which in the meantime started the work.

Furthermore, the liquidity buffer of the Central Cooperative Bank has been mobilised to recapitalise the cooperative credit institutions up to 4% core Tier 1, as set by the MoU. This accounting operation affects in no way the availability of the liquidity of the Central Cooperative Bank. The operation reflects the new ownership structure between the central body and the affiliated institutions where the former is 99% shareholder of the latter, while previously the affiliated banks dominated the central body. The new structure will allow proceeding swiftly with the appointment of the appropriate management in the affiliated cooperative banks.

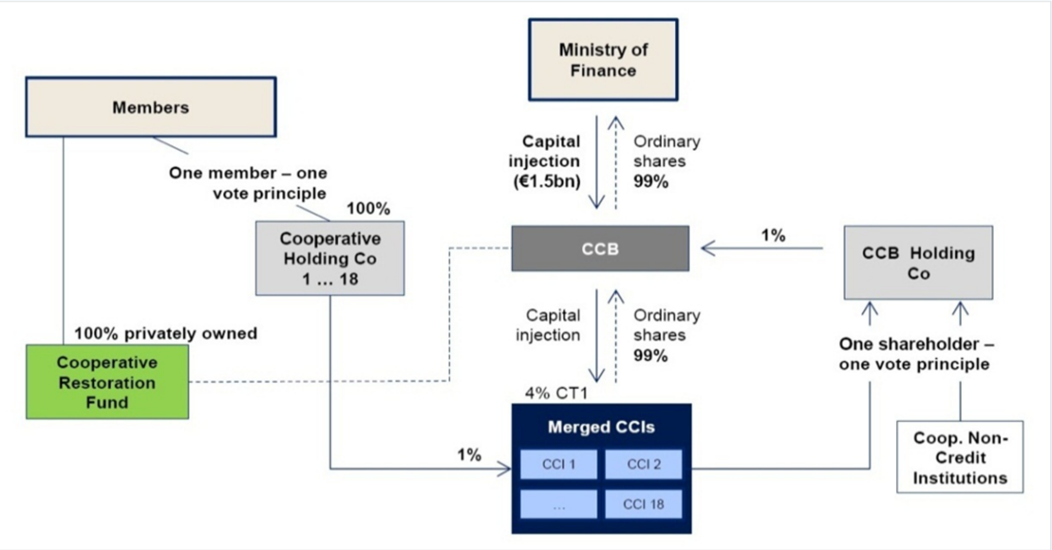
Box 3.2: Restructuring of the cooperative credit institutions

The programme reserved funds for the State recapitalisation of the cooperative credit institutions with a total capital need of EUR 1.5bn. This amount will be injected in the central body of the cooperatives, the Central Cooperative Bank (CCB), in exchange for common shares. As a consequence, due to the low value of CCB, the State will become the majority shareholder of CCB and control it. The State support has to be in line with EU State aid rules, which means that it can only take place following the approval of a detailed restructuring plan by the European Commission

The restructuring plan is based on an underlying strategy which was outlined by the Central Bank of Cyprus in July 2013. This strategy envisages a much stronger coordination and centralisation of the group with the CCB owning the majority of the shares of the individual cooperative credit institutions (CCIs) and de jure and de facto controlling these. In addition, the initially over 90 CCIs will be merged to a maximum of 18 institutions. The merger process has already started and should be completed by the end of March 2014. A better and central control of a significantly reduced number of CCIs was a prerequisite for the enhancement of efficiencies and an improved risk management. Clear levels of accountability will help to avoid moral hazard. The new company and governance structure (see picture below) will nevertheless allow for a minority participation of the CCIs in the CCB and, indirectly, of the individual CCI members to emphasise the continuing local focus of the cooperatives.

To make these structural changes possible, the legislative framework was adjusted. Existing banking legislation was amended and new legislation adopted (the Decree for the recapitalization of the Cooperative Central Bank, the Directive governing the affiliation of CCIs with CCB and the Law relating to the establishment and operation of a Management Unit for Cyprus' shareholding in the cooperative sector) in September and October.

The submission of the restructuring plan to the European Commission by the end of September 2013 has been shifted in the new MoU to end-January 2014, due to some delays in the appointment of CCB's new executive managers who need to endorse the plan. The Commission cannot approve the restructuring plan under State aid rules before this submission. In its decision the Commission will assess the submitted diagnosis of the groups' problems and the proposed strategies to restore its viability (including a stress tested business plan) as well as the suggested burden sharing and measures to limit the distortions of competition. A monitoring trustee will monitor the implementation of the plan.



3.1.4. Anti-Money Laundering

The Cypriot authorities have initiated implementation of the Anti-Money Laundering (AML) Action Plan. The amendments to the Trust and Company Services Provider and the Anti-Money Laundering laws were adopted on 5 September 2013. The revised laws will facilitate the provision of beneficial ownership information in response to requests related to money laundering and tax matters, and will enable the provision of the widest possible range of cooperation to foreign counterparts.

Access to and availability of beneficial ownership information has improved. The supervisory authorities (Cyprus Securities and Exchange Commission – CySec, Cyprus Bar Association – CBA and Institute of Certified Public Accountants of Cyprus – ICPAC) have appropriately revised their directives and circulars, in line with the relevant amended legislation and with international standards. On the basis of an analysis of the adequacy of relevant CBC directives, which was reviewed by the programme partners, the CBC was required to review the adequacy of the current directive. To this end, the CBC provided on 19 November 2013 an analysis of the adequacy of relevant CBC directives which was reviewed by the programme partners. The analysis confirmed that the CBC Directive is in its current form in line with relevant legislation. The updated Directive now includes a reference to obtaining a copy of the registration of a trust, which has been introduced to ensure full alignment with the law on "Regulating Companies Providing Administrative Services and Related Matters". The full compliance to the MoU has been accomplished, though with a slight delay, as the amendment of the CBC Directive took place in Q4 2013.

Further steps were made in enhancing the transparency of trusts in line with international standards and best practices. The supervisory authorities (CySec, CBA and ICPAC) have established trust registers. In addition, all nominee directors and nominee shareholders (Administrative Services Providers) are regulated by the relevant supervisory authority and they are required to maintain information on the identity of their nominator.

The CBC has made some progress in following-up on the cases revealed by the Deloitte report, and is considering corrective actions. However, this procedure has not been finalised, notably due to capacity constraints in the AML supervisory unit of the CBC. The CBC has committed to finalise the appropriate follow-up of the remaining cases by the end of January 2014. In addition, the CBC has committed to ensuring that its AML supervisory unit will be appropriately staffed by the same date.

Some delay was noted in the formal establishment of co-operation mechanisms between the CBC and the supervisory authorities for exchanging information and ensuring supervisory coordination. The formal system was, however, finally in place by October 2013. Before that, the coordination of the supervisory authorities was facilitated - on an informal basis - through meetings organised by the Unit for Combating Money Laundering (MOKAS).

MOKAS has taken the initiative to provide the programme partners with statistical data on the breakdown of requests made and received, including spontaneous disseminations in an orderly manner. This information will be published on MOKAS website on an annual basis.

Finally, the Cypriot authorities have committed to maintain efforts to ensure that the widest possible exchange of information with other FIUs is achieved, either spontaneously or in response to requests. To assess progress in this area, the Cypriot authorities have taken initiative to monitor the number of requests made and received and to make this information public.

3.2. FISCAL POLICY

For 2013, the assessment of the second review mission has confirmed that Cyprus is on track with regard to achieving the primary balance target for 2013. This is largely due to prudent budget execution and better than projected macroeconomic performance leading to higher than foreseen revenues. The revised primary balance target accounted for the compensation of

Box 3.3: The excessive deficit procedure

Cyprus is subject to both fiscal policy conditionality under its adjustment programme and to the Excessive Deficit Procedure (EDP). Both procedures aim at bringing an end to the excessive government deficit and strengthening the sustainability of public finances. In line with the Two-Pack Regulation, consistency should be ensured by integrating the programme's budgetary targets into the EDP adjustment path and streamlining EDP reporting and monitoring under the regular programme surveillance.

While mutually supportive, the EDP and programme set different operational targets. The EDP sets annual headline balance targets while the programme works on the basis of the primary balance, recognising that interest expenditure is largely outside the control of the government (Table 1).

Table 1:
Headline and primary government balance

	2012	2013	2014	2015	2016
Primary balance, % of GDP					
April PF/EDP May	-3.3	-2.4	-4.3	-2.1	1.2
July PF/EDP September	-3.3	-4.2	-4.3	-2.1	1.2
November PF	-3.3	-3.6	-3.1	-2.1	1.2
Headline balance, % of GDP					
April PF/EDP May	-6.3	-6.5	-8.4	-6.3	-2.9
July PF/EDP September	-6.3	-8.3	-8.3	-6.3	-2.9
November PF	-6.4	-7.8	-7.1	-6.1	-2.8

Note: PF: programme forecast
Source: Commission staff estimates

Furthermore, both under the EDP and the programme, Cyprus has been required to take a specific amount of additional permanent measures in 2013 and to fully implement the measures adopted in 2012 with effect in 2014 (Table 2).

Table 2:
Required amount of measures

	2013	2014
EUR m		
April PF/EDP May	>351	>270
July PF/EDP September	~400	~300
November PF	~425	~300

Note: PF: programme forecast
Source: Commission staff estimates

EDP procedures traditionally target both the headline and the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures). However, the large economic shock experienced by Cyprus made the estimation of the structural balance particularly uncertain, especially due to significant shifts in forecasted output and estimated potential growth. It was therefore decided, that the required fiscal adjustment in the EDP recommendation for Cyprus would not be stipulated in structural terms,

Despite this uncertainty, the structural effort remains an important element in the assessment of the fiscal stance. The fiscal forecast of the second review points to a significant structural improvement over 2013-2016. Particularly, the forecast for 2014 suggests a structural improvement of 0.7%, which is better than the 0.3% implicitly underlying the EDP recommendation (Table 3).

Table 3:
Structural balance

	2012	2013	2014	2015	2016
% of potential GDP					
April PF/EDP May	-6.7	-5.4	-5.1	-4.4	-2.5
July PF/EDP September	-6.7	-5.6	-5.4	-4.8	-3.1
November PF	-6.7	-5.3	-4.6	-4.2	-2.3

Note: PF: programme forecast
Source: Commission staff estimates

The primary balance target included in the programme can be revised to reflect budgetary performance and new information. During the first review, the 2013 primary balance was revised to include the one-off compensation of provident and retirement funds in Cyprus Popular Bank, amounting to 1.8% of GDP (Table 1). Providing the necessary budgetary funds for this compensation was agreed in the April MoU with an explicit reference to a possible revision of the target. However, at the time of adopting the EDP recommendation, the budgetary impact of this compensation could not be established with precision, since the conversion rate of the deposits was still to be determined. Due to the one-off nature of this compensation, the EDP deadline remains unaffected.

Following the second review mission, the 2014 primary balance target was revised up, mainly to account for better-than-anticipated fiscal performance in 2013, additional measures of 0.3% of GDP and a larger than originally foreseen reduction in the public sector wage bill on the back of the on-going early retirement wave. This does not alter the 2014 EDP headline deficit target, but implies a certain safety margin, should unexpected events impact on the 2014 budget execution.

(Continued on the next page)

Box (continued)

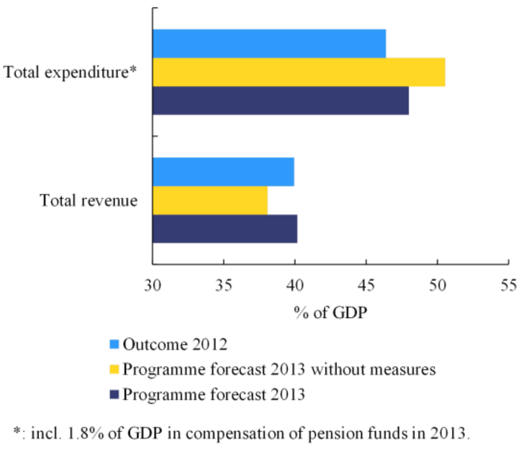
All in all, under the current forecast, Cyprus remains on track both regarding the programme conditionality and the EDP adjustment path. The programme targets are within reach with a fiscal gap of around 2% of GDP for 2015-16 to be covered by measures that will be specified as part of the programme implementation. Similarly, Cyprus remains on track towards correcting the excessive deficit by 2016 as recommended by the Council. The EDP procedure is in abeyance on the basis of the Commission's assessment of effective action in September 2013 ([1]).

([1]) Communication from the Commission to the Council on action taken by Cyprus to bring an end to the situation of excessive government deficit, COM(2013) 626 final 6.9.2013 and the associated Staff Working Document, SWD(2013) 327 final.

provident and retirement funds in Cyprus Popular Bank. Overall, Cyprus has implemented the fiscal policy measures under the adjustment programme with determination (Graph 3.1). Notably, the MoU targets for the yields from the increase in the immovable property tax and cuts in social transfers are expected to be achieved (see Box 3.3 for a discussion of the consistency of programme and EDP targets).

The updated fiscal projection, agreed among programme partners and the authorities, shows that Cyprus is also on track vis-à-vis the primary balance target for 2014. The significant fiscal consolidation measures under the adjustment programme are projected to be sufficient to compensate the negative effect from the macroeconomic developments, including the downward revision of GDP growth for 2014.

Graph 3.1: **General government revenue and expenditure**



Source: Commission services.

On 25 September 2013, the Cypriot authorities submitted the draft 2014 Budget Law to the programme partners. According to the revised MoU, the 2014 Budget Law will be adopted by December 2013, "after review by and consultation with the programme partners by mid-September 2013". It has been agreed that the draft budget will be aligned to the updated programme forecast. To advance some of the fiscal effort needed for the outer years, the draft budget foresees the introduction of fiscal measures amounting to ⅓% of GDP as of January 2014, additional to the ones already adopted under the programme. The following additional measures are included in the draft 2014 Budget Law: i) further cuts to public sector allowances; ii) abolition of the income tax exemption for certain pension schemes; iii) introduction of a contribution to pensions of temporary workers, and police and army personnel; iv) further targeting of social pensions; and v) a reduction in the tax-free threshold for lottery gains.

Projections for 2015 and 2016 show a fiscal gap of around 2% of GDP, slightly lower than anticipated at the onset of the programme in April 2013. Discussions on additional measures necessary to close the fiscal gap will take place in due course, notably in context of preparing the 2015 draft budget. Currently, the overall consolidation effort in 2013 and 2014 is slightly tilted to the revenue side, primarily as a consequence of the March Eurogroup political agreement, which implied additional revenue side measures. It is therefore foreseen that any further consolidation should primarily focus on reducing spending.

Fiscal developments remain subject to careful monitoring to ensure that fiscal risks can be detected and addressed up-front. Risks to fiscal performance remain tilted to the downside, although to a milder extent as far as 2013 is concerned. In particular, in view of the better-than-expected quarterly GDP figures, the forecast agreed among programme partners and authorities for 2013 suggests that tax collection will weather the downside risks in 2013. At the same time, developments in both direct and indirect tax collection continue to point to a weakening future performance of key revenue items. For 2014-2016, macroeconomic developments continue to pose risks of lower-than-projected real and nominal GDP growth and might therefore impact negatively on the fiscal performance. Furthermore, weaknesses in the tax administration constitute a risk for the performance of revenues.

3.3. FISCAL-STRUCTURAL REFORMS

3.3.1. Pension and healthcare systems

Some effort is still needed to fully implement all aspect of the pension reform agreed in the MoU. Measures aimed at increasing retirement ages, introducing penalties for early retirement and reducing the generosity of pension benefits were largely implemented in both the general social insurance system (GSIS) and the government employees' pension state system (GEPS). However, Cyprus has not yet ensured that total annual public pension benefits for members of the House of Representatives do not exceed 50% of their annual pensionable salary. Approval of the related amendment by the House of Representatives has been set as a prior action. The MoU also required that, to the extent possible, all measures aimed at the GEPS should be made applicable to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees. This was largely done, but there are a number of cases concerning individual retirement funds, which still need to be further examined.

The actuarial study for the pension system shows that the reforms implemented as of January 2013 have considerably improved the viability of the pension system. The actuarial study was peer reviewed by the Ageing Working Group of the Economic Policy Committee (AWG/EPC) on 25 September 2013 and endorsed by the EPC on 22 October 2013. According to the study, the pension system remains in balance over the years 2013-2060. It also shows that the reforms have reduced the projected increase in pension expenditures by more than 5% of GDP in the long-run, making it one of the lowest in the EU. The financing of the growing GSIS pension expenditures due to an ageing population would, however, require running down the real reserve fund (i.e. the reserve fund excluding the notional reserves deposited to the general government). This makes the system vulnerable to negative shocks. The authorities agreed to continue monitoring the long-term financial sustainability of the system and consider further reform steps, if needed.

Regarding the healthcare system, further progress has been achieved towards strengthening the funding structure and the efficiency of the public healthcare system. Q3 deadlines were broadly met. The fiscal measures related to compulsory healthcare contributions for public servants and public servant pensioners and to co-payments for using public healthcare services have been fully implemented. The transposition of the framework for pricing and reimbursement of goods and services according to Directive 201/24/EU will be accomplished by end November, and has yet to be assessed by the European Commission. Adequate progress is registered for the coding of all hospital inpatient cases based on an activity-based payment systems (diagnosis related groups), with 100% coding expected by January 2014. Finally, regular working times have been adjusted to reduce overtime and the related wage costs.

The government reaffirmed its commitment to the implementation of a NHS system, but is considering adapting the initial strategy. The government therefore agreed to present its new detailed plan by January 2014 and closely work with the programme partners on the design of an alternative plan, if one is needed. In parallel, the IT requirements for NHS are being redefined within a technical assistance project financed by the European Commission. The aim is to reduce IT costs and provide for a timely IT implementation in line with the deadline set for a NHS. A postponement of the deadline by one quarter was accepted by programme partners in order to adapt, if needed, the IT needs to the new strategy.

The results of the working groups on improving the efficiency of healthcare delivery in public hospitals were broadly satisfactory and will be monitored continuously. These measures include seven work streams and aim at improving processes in wards, implementing clinical pathways, installing a bed management system, improving the performance of hospital laboratories, defining admission criteria for emergency departments, streamlining access to outpatient departments and restructuring hospital pharmacies. No progress was made on the path towards achieving hospital autonomy (both managerial and financial). The World Bank is preparing recommendations in this regard and preliminary results are expected before the end of 2013.

Results on the remaining work-streams were broadly satisfactory and are expected to proceed in line with the agreed deadlines. These measures include: i) the production of clinical guidelines, prescription protocols for pharmaceuticals and laboratory tests; ii) improving the framework of health technology assessments to increase the cost-effectiveness of the basket of publicly reimbursed products; iii) the set-up of a system of family doctors acting as gate-keepers for access to further levels of care; and iv) the review of income thresholds for free access to public health care.

3.3.2. Public Financial Management and Budgetary Framework

Steps towards strengthening the public financial management (PFM) are progressing at a satisfactory pace. Following consultations with programme partners, including a third IMF technical assistance mission in early August 2013, a first draft of an umbrella law, the Fiscal Responsibility and Budget Systems Law (FRBSL), was finalised and went through inter-service consultation with line ministries and other government departments.

The FRBSL is intended to provide a legal basis for sound PFM principles throughout the annual budgetary cycle. It will put together a number of provisions currently scattered in different legal documents, in particular the MTBF law adopted in December 2012. The draft FRBSL introduces improvements to some of the existing practices such as: i) a more strategic approach at budget preparation stage; ii) project evaluation and selection process procedures that are integrated in the budget cycle; iii) procedures enabling a better monitoring of fiscal risks from different sources such as macroeconomic developments, government exposure to contingent liabilities, including guarantees, municipalities, and communities, public private partnerships (PPPs), and semi-governmental entities and state-owned enterprises (SOEs). New aspects include the creation of a structurally-independent Fiscal Council and basic principles applicable to the management of revenues derived from natural resources.

The FRBSL is intended to ensure compliance with EU requirements stemming from the Directive on budgetary frameworks (Dir. 2011/85/EU), the Two-Pack Regulation (Reg. (EU) 473/2013), and the Fiscal Compact. Provisions have been included in order to take into account the latest developments in EU legislation regarding fiscal rules, namely including the budget balanced rule foreseen in the Fiscal Compact, the adjustment path to the Medium-Term Objective, a debt rule, and a correction mechanism associated to the budget-balance rule involving the preparation and implementation of corrective plans. The scope of the FRBSL goes beyond the central government and includes provisions applicable to local governments and SOEs, which are expected to provide better monitoring tools to the Ministry of Finance. As for the Fiscal Council, it will be an independent entity in structural terms. The FRBSL is expected to be adopted by December 2013 and to enter into force by 1 January 2014.

To address the need of closer monitoring of potential risks stemming from government guarantees, a draft bill amending the Public Debt Management (PDM) Law was submitted for legal vetting in mid-October. The PDM law is enhanced with provisions dictating regular assessment of the said risks, while it secures the right for the Public Debt Management Office to acquire necessary information on outstanding guarantees from their recipients. Submission of the amended Bill to the House of Representatives is foreseen on 14 November and its enactment is expected by end-December 2013.

Progress has been made in addressing the gaps identified in the commitment control systems of the government. Following a technical assistance mission, a circular specifying the procedures for the authorisation and proper recording of commitments was issued by the end of October. The underlying aim is to help minimise the risk of spending commitments being above available appropriations, and thus accumulating arrears. Initially, the new procedures are to be applied to the central government (by December 2013) and to the general government thereafter (March 2014).

3.3.3. Public Private Partnerships

The two inventories on Public Private Partnerships (PPPs), both the inventory of current and planned PPPs and the inventory of contingent liabilities, were duly submitted within the deadline. There were nonetheless some missing elements that were adjusted after discussion with programme partners, including a three-year projection of the baseline revenue and expenditure impact of each PPP on the budget. On the contingent liabilities analysis, the authorities argued that only one PPP amounts to a contingent liability, namely the Larnaca Port and Marina. As stated in the original MoU, both inventories will be regularly updated as of 1 January 2014.

3.3.4. State-Owned Enterprises and Privatisation

Some progress has been made on the completion of the inventories of State-Owned Enterprises (SOEs) and real estate/land, whilst SOEs that could be subject to restructuring or liquidation have not yet been confirmed. The inventory of SOEs with the highest commercial value was completed and submitted within the deadline, as well as the inventory of real estate and land, albeit the latter with some adjustments to be reflected in the full version by late-2013. Contrary to what was agreed for the Q3-deadline, the Cypriot authorities have not indicated which SOEs could be restructured or liquidated. SOEs to be divested are expected to be included (a priori) in the still-to-be-agreed draft privatisation plan. Programme partners have encouraged the authorities to have the Council of Ministers examine a list of SOEs that need to be restructured or liquidated by end-2013.

The action plan strengthening SOEs' corporate governance has been addressed through the creation of a SOEs unit at the Ministry of Finance, though its mandate is still to be defined and agreed. As a means to ensure that SOEs adhere to the high standards of the Code of Conduct (i.e. full transparency and ethics in management), the Ministry of Finance has taken the initiative to build a unit in charge of the fiscal surveillance and monitoring of the implementation of corporate governance principles of almost 35 (out of 60) SOEs. However, this unit lacks clear incentive structure to ensure a sound financial management of SOEs, which makes this Q3-commitment only partially compliant. The report reviewing the operations and finances of SOEs was submitted within the deadline and has served as a tool for the privatisation plan. However, it is not forward-looking enough and does not include all the details agreed in the MoU on the SOEs' business prospects or the potential exposure of the government to the SOEs. Main lines of the draft SOEs Law (to be adopted by end-2013) were also discussed.

A first draft privatisation plan was prepared and modified throughout the review mission, but by the time of the cut-off date of the report the plan had not been presented to the Council of Ministers for political decision and further detailing is necessary before its finalisation. The privatisation plan is going in the right direction and contains concrete asset-specific timelines with intermediate steps which, however, will require further detailing. Importantly, the draft plan would benefit from a more ambitious timeline, aiming at speeding up preparatory steps, while giving priority to the assets with the highest estimated proceeds during the programme period. As the draft plan stands, it may not realistically fulfil the requirement of raising at least EUR 1bn by the end of the programme and an additional EUR 400m by 2018. The draft plan would therefore require further work, by including land and real estate assets that can raise the credibility of meeting the financing needs' targets. The privatisation law and the unit within the Ministry of Finance formed by a mixed team of civil servants and representatives from the business world, are both work-in-progress and are expected

Box 3.4: Cyprus' privatisation plan: first steps

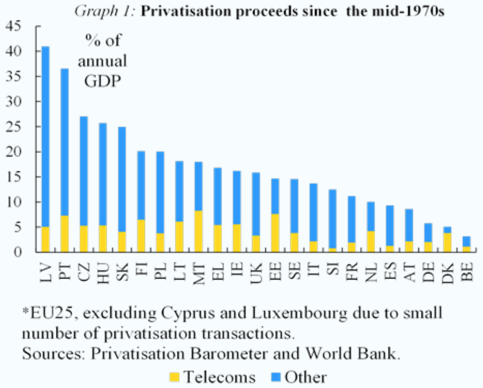
The political agreement reached between Cyprus and the Eurogroup in March 2013 on programme conditionality included a commitment by Cyprus to step up efforts in the area of privatisation. Following this, the authorities have agreed to include a privatisation plan containing asset-specific timelines and concrete intermediate steps, ensuring both ambition and transparency. Compliance with EU law on unbundling of assets, state aid and public procurement, while establishing solid regulatory frameworks, are intrinsic to the success of the privatisation process. Structural reforms to ensure appropriate competition in privatised sectors are also essential. The MoU is explicit that an appropriate regulatory framework is a prerequisite for the privatisation of natural monopolies. Completing all these elements should help maximise benefits of privatisation for Cyprus.

Cyprus has a total of 60 State-Owned Enterprises (SOEs), all established by law, most operating in a market environment. These include Cyprus Telecommunication Authority (CyTA), Electricity Authority of Cyprus (EAC), and Cyprus Ports Authority (CPA). Other SOEs fulfil a specific purpose, e.g. Home Finance Organisation; Precious Metals Engraving Organisation; and Health Insurance Organisation. The rest are providing non-commercial activities, e.g., Cyprus Theatre Organisation; Cyprus Tourism Organisation; and Investment Promotion Agency. The State also owns a large amount of land and real estate that may be attractive for privatisation.

There are a number of privatisation methods. Some of the SOEs could be sold directly to single investors or consortia, or through public share offerings. The sale of licences can also be a way of privatising an asset, primarily in the gaming industry. Additional casino licences could be considered. Concession agreements are a typical process followed in the privatisation of parts of ports, marinas, motorways, airports and infrastructure in general. This option guarantees the state part of the revenues generated by the asset and avoids potential abuse by private investors, as they are subject to a framework established and monitored by the competent regulatory authority. It also ensures a clear separation between regulatory and operational functions. Transmission networks of a natural monopoly can be privatised by a concession agreement.

Experience from other countries suggests that a successful large first sale can generate support for further privatisations. Telecoms is often one of the first sectors to face privatisation. A telecoms sector with a solid regulatory framework can succeed in the private sector without compromising its public service aspect, while generating significant revenues and economic growth. Cyprus' telecoms regulatory framework is well structured and follows best European practice. It is a sector that does not require excessive preparation and should not be too difficult to privatise, as shown in countries that have undergone privatisation.

Graph 1: **Privatisation proceeds since the mid-1970s**



*EU25, excluding Cyprus and Luxembourg due to small number of privatisation transactions.
Sources: Privatisation Barometer and World Bank.

Privatisation of SOEs can bolster the growth potential in the medium and long-term and help support fiscal sustainability. Successful privatisations as part of a wider structural reform agenda can lead to improvements in economic efficiency and overall productivity through enhanced competition and stronger incentives for risk management and innovation. This can help restore investor confidence and attract foreign capital. The proceeds from privatisation reduce public debt and can help improve the government's funding conditions, with positive effects on the debt-to-GDP ratio.

International experience shows that a clear and strong institutional structure with political backing increases the chances for success in privatisation. Cyprus has agreed to assemble a dedicated team to run the privatisation process. The team will be composed of a mix of civil servants and private sector specialists. It will be responsible for preparing SOEs for privatisation and delivering sales and concession contracts. The team will report directly to the Minister of Finance.

to be adopted and created, respectively, by January 2014 (see Box 3.4).

3.3.5. Revenue Administration

With a delay of about a month, a governance structure has been put in place to carry out an ambitious revenue administration reform. The reform aims at improving efficiency and effectiveness of collections, inter alia by establishing a new function-based tax agency (integrating IRD and VAT Services). In lateOctober 2013, the Council of Ministers decided on the composition of a high-level steering committee chaired by the Minister of Finance and an executive technical committee chaired by the Permanent Secretary of the Ministry of Finance. In addition, a project team was installed consisting of nine full-time staff.

For the remainder of the year, the project members will focus on drawing up a detailed reform plan. Given the delayed set-up of the project management, achieving the end-year deadline for developing the related reform plan and securing government and programme partners' approval is ambitious. Experts from the IMF and the Commission are providing technical assistance to develop the plan, giving some reassurance that process can be made before the end-year deadline.

Progress with short-term compliance, efficiency enhancing measures and analysis of compliance risks is mixed. All these measures have a Q4-2013 deadline. Good progress is being observed on the legislative changes to strengthen the administration's power to collect taxes, to hold taxpayers responsible for not paying taxes and to enable full self-assessment. Inter alia, the authorities have drafted legislation to empower the administration to seize bank accounts, securities and other property. Progress can also be reported on the development of joint IRD-VAT Services audit programmes, where a number of large and high-risk taxpayers were selected for auditing. Similarly, work is advancing in optimising the use of IT-systems, particularly for the purpose of exchanging information between different tax administration entities. However, no or little progress was made in ensuring that tax fraud is prosecuted, on the independent review of discretionary powers and on initiating analytical work to identify compliance risks. Programme partners will follow up closely on all these measures to make progress towards the end-year targets (see Box 3.5).

3.3.6. Public Administration Reforms

Working time in the public service has been adjusted in compliance with the MoU in order to advance the regular starting time and extend the flexibility period. The implementation has been effective in all ministries, except at the Ministry of Health, due to time-shifts. The Cypriot authorities have proactively pushed for moving the flexibility period back to one hour (and not just half an hour) within the logic of overtime cost reduction.

The public administration (PA) review was launched in early-September 2013 and is expected to result in preliminary deliverables by December 2013. Technical assistance (TA) has been provided by the World Bank and UK public administration, collecting significant data as part of the review of a first set of public institutions covering the Ministries of Agriculture, Education and Health, as well as cross-cutting elements of Human Resource Management. The exercise is fully financed by the Cypriot national budget. Final deliverables for this first batch of the review are expected by Q2-2014 for the sectoral part, while the final results for the horizontal part are expected by Q4-2014. A second batch will immediately follow, covering the rest of the ministries and all those SOEs excluded from the privatisation plan. TA interim reports will be submitted to programme partners, in parallel with the Cypriot authorities.

3.3.7. Reform of the Welfare System

Work on the steps foreseen for the adoption of a welfare reform plan has progressed, although the compliance has been partial and delays have occurred. The Cypriot authorities have provided with some delay a definition of the Minimum Consumption Basket (MCB) in terms of coverage and weight, with technical assistance by the International Labour Organisation (ILO). The MCB is based on actual expenditure patterns of low and mid-low income households (first four deciles of income distribution), as established by the latest Household Budget Survey of 2009. During the second review mission, it was agreed

Box 3.5: Revenue administration – the need for a comprehensive approach to manage compliance risks

Key institutional arrangements of Cyprus' revenue administration are deemed conducive to low compliance levels. Pinpointing the exact set of determinants of compliance behaviour is difficult. However, a combination of low tax morale and the ability to misreport or not report at all is generally considered an important catalyser for tax evasion. Arguably, a number of features and more recent developments in the tax administration in Cyprus have contributed to both these factors.

Certain bottlenecks in the tax administration and the repeated application of tax amnesties have likely hampered tax morale. It can take the administration very long to finalise original assessments. Issuing refunds is also slow, whereas taxpayers are required to pay timely, which contributes to a perception of unfair treatment. In addition, there appears to be little confidence in the dispute resolution process, which is fragmented and may take excessively long times. Repeated tax amnesties (or extensions of existing ones) have likely further hampered tax morale in Cyprus. Furthermore, it is generally acknowledged that tax morale and compliance rates are negatively affected in times of recession.

In addition, enforcement of tax discipline has weakened and taxpayers face a decreasing risk of being detected for misreporting or non-reporting. Auditing activities have considerably declined in recent years and the amount of recovered back duty (i.e. tax unpaid due to withheld information) has dropped sharply this year (Table 1). So far audit selections are not risk-based in the Inland Revenue Department (IRD) and joint audits by IRD and VAT Services have not taken place. The two tax administration bodies exchange little information, which does not allow them to form a holistic view on taxpayers' activities, further reducing the likelihood of being detected. In addition, there is little prosecution activity for direct taxes when it comes to tax fraud or wilful non-payment of taxes. Both the number of VAT debtors and outstanding debt have increased considerably, pointing to increasing difficulties to collect tax debt. The share of undisputed tax debt in net revenue collections in Cyprus is one of the highest in the EU. This can be partly explained by Cyprus not writing-off any tax debts, but could also be fuelled by its relatively weak powers to enforce tax payments.

Table 1:
Audits by the IRD of legal and self-employed persons

	2008	2009	2010	2011	2012	2013 Q1-Q3
Back duty (in EUR m)	82	100	135	127	142	57
Number (in thousands)	52	52	29	13	14	9

Source : IRD

Compliance costs are another factor often associated with non-compliance, but seem to play a lesser role in the case of Cyprus. The 'paying taxes' indicator shows that the estimated administrative burden for a medium-sized company is below both the EU and EA-average. However, the use of e-filing is one of the lowest in the EU for both income taxes and VAT and Cyprus is considered to face a particular challenge in this area.

Given these evident weaknesses and as a first step, it is essential to conduct a systematic analysis of taxpayer compliance in Cyprus. The existing studies use rough indicators, which produce mixed evidence for Cyprus and do not allow judging where the key risks lie. ([1]) Estimates of the size of the shadow economy in Cyprus go up to 25.2% of GDP, putting Cyprus in the upper quartile in the EU-27. There is also evidence of a high share of informal workers and low compliance rates among self-employed, a taxpayer segment for which income tax revenues have plummeted recently. At the same time, the estimated VAT revenue ratio (i.e. the ratio of actual VAT revenues over theoretical ones that would arise if the standard VAT rate were applied to total final consumption) is one of the highest in the EU.

As every modern revenue administration, Cyprus should develop a comprehensive compliance management strategy, firmly grounded in analyses of key risks, reasons for non-compliant behaviour and the most cost-effective mitigation strategies. The MoU prescribes a series of short-term measures to mitigate upfront some

([1]) The Council considered that Cyprus faces a particular challenge in this area and recommended in May 2012 that Cyprus takes measures to improve tax compliance and fight tax evasion.

(Continued on the next page)

Box (continued)

key problems, such as weak collection powers, limited information exchange within the tax administration and with other government entities, and uncoordinated audit activities. However, an effective treatment of the (potentially large) compliance problems can only happen once the risks are well-understood.

that the authorities would fully integrate in their work a normative approach for the calculation of the MCB. This normative approach would help defining the level of basic needs which will be used to cross check and possibly recalculate the level of the MCB, on which the Guaranteed Minimum Income (GMI) will be based.

In line with the MoU deadline, the Cypriot authorities have also explained the methodology they will use for the design and costing of the GMI. Six possible alternative GMI design options have been proposed and are being assessed in terms of their fiscal costs and their social and economic impacts. It has been agreed that some fine-tuning on the final design of the GMI may be possible by Q4-2013, taking into account the refinement of the means-testing mechanisms of benefit schemes. Technical assistance on the refinement of the means-testing is currently being provided by the ILO.

To achieve progress with the installation of a comprehensive database and the necessary IT requirements supporting the administration of the welfare system, the authorities have requested technical assistance from the Support Group for Cyprus (SGCY) (see Box 3.6)**.** Work is on-going to meet this request. As regards the transfer of all relevant competencies and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour and Social Insurance, work on the Terms of Reference of a study aimed at assessing the current structure and developing proposals for the a new administrative structure was initiated.

3.3.8. Other Fiscal-Structural Reforms

Progress in the area of international tax cooperation appears adequate. Cyprus has largely abided by deadlines on information exchange established in Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax. In relation to Council Directive 2011/16/EU on administrative cooperation, the Commission's conformity assessment is still pending.

Efforts are undertaken to improve the follow-up on information received from other Member States under the Savings Directive (2003/48/EC). A new web-based search tool will make information on savings income received under the Directive available to all tax officers. The authorities outlined their difficulties with identifying taxpayers manually due to the poor quality of information received. For those taxpayers that could be identified the authorities have launched a large-scale examination. Overall, further work is needed to ensure the systematic follow-up on information that Cyprus receives from other countries. In the long-term, the new integrated administration of direct taxes and VAT is expected to further enhance the ability to properly assess the information received.

The legal framework on international tax cooperation has been improved, but its implementation will likely need further improvement. Cyprus has followed the majority of recommendations to improve its legislative framework issued in the Phase 1 report of the OECD Global Forum on Tax Cooperation and Transparency. Phase 2 of the review focussed on implementation issues over the period 07/2009-06/2012, but was not yet released at the time of the review mission. The authorities flagged that the review identified serious shortcomings, which the authorities commit to address in the MoU.

The immovable property tax (IPT) reform is progressing, although with significant challenges ahead. In compliance with the MoU requirements, the study on refining the parameters of the imputed market value index was initiated and the Department of Lands and Surveys (DLS) has formed a task group in charge of preparing the Terms of Reference and following-up on the deliverables. The study is expected to be carried out within the context of IMF and SGCY technical assistance (TA) framework and within the agreed

Box 3.6: **The Support Group for Cyprus**

Following the political agreement on the key elements of an economic adjustment programme for Cyprus at the Eurogroup meeting of 24-25 March 2013, President Barroso decided to set up a Support Group for Cyprus (SGCY) to provide technical assistance to the Cypriot authorities. The creation of the SGCY was confirmed at the College meeting of 27 March 2013. Administratively, the Support Group is an organisational entity attached to the Directorate-General for Economic and Financial Affairs and its general coordination is ensured by Vice-President Rehn. The Support Group, which is based in Brussels with a team of resident experts in Nicosia, is composed of Commission officials placed at its disposal on a full-time basis, seconded national experts and temporary agents, according to the identified needs for expertise. The tasks of the Support Group are fulfilled by drawing on contributions from all relevant European Commission services, EU Member States and international organisations.

The SGCY has the joint aims of: 1) assisting to alleviate the social consequences of the economic shock by mobilising funds from European Union instruments and by supporting the Cypriot authorities' efforts to restore financial, economic and social stability; and 2) bringing in further expertise to facilitate the emergence of new sources of economic activity.

To achieve these aims the SGCY works closely with the Cypriot authorities by providing technical expertise in Cyprus to support the achievement of the economic adjustment programme. The SGCY also assists the Cypriot authorities in effectively utilising the funding available through various EU programmes, including through the Structural Funds, to cater for the needs that arise on the ground on the basis of the authorities' reform agenda. Under the Memorandum of Understanding (MoU), it is acknowledged that given the nature of the structural challenges Cyprus is facing, including a lack of specific skills in some areas and scarcity of resources, the targeting of a small number of areas for mobilisation of technical assistance is warranted. The MoU also confirms that all technical assistance provided by the European Commission, other than technical assistance provided directly under the Structural and other EU funds, will be coordinated by the Support Group.

In accordance with its mandate, the SGCY is engaging in discussions with the Cypriot authorities to agree on the priority areas for technical assistance for the remainder of this year and for 2014. On the 30th of September 2013, the Cypriot authorities transmitted their official request for technical assistance to Vice-President Rehn. The following areas were identified as in need of technical assistance: health care, the budgetary framework, revenue administration, tax compliance and international tax cooperation, immovable property tax reform, public administration reform, the welfare system and renewable energy sources. A scoping mission on the provision of technical assistance in the area of healthcare took place in October 2013. In the autumn, there were further scoping missions on immovable property tax reform and the development of renewable energy in Cyprus The first resident expert, who will work in the Ministry of Finance in the area of public financial management, is in the process of being recruited.

deadlines. Nonetheless, the second study, relating to the scope of simplifying the collection and administration of the property taxes collected at the municipal level, was initiated with delay. The Terms of Reference were concluded in early September 2013 and the tender procedure was initiated in early October 2013. Due to tender procedure modalities, the study is expected to be awarded to an external expert by end-December.

The Cypriot authorities have requested technical assistance from the Support Group for Cyprus and of the IMF. A scoping mission took place in mid-October and the final report is expected in early December 2013. On the basis of the findings and recommendations, there may be a need to re-evaluate the strategy and the milestones of the currently agreed IPT reform. The preliminary conclusion of the TA indicated that the general valuation project as initiated by DLS is consistent with best international practices. However, some concerns were raised about the human resource allocation during critical periods of the project.

3.4. STRUCTURAL REFORMS

3.4.1. Labour Market

Tripartite negotiations to extend the reform of wage indexation to the private sector are on-going. The granting of the Cost of Living Allowance (COLA) in the private sector is currently suspended until end-2014. The most controversial element of the reformed system appears to be the change from full indexation to partial indexation (at 50% of inflation). The authorities will keep programme partners informed on the progress of negotiations both at technical and political level, which are bound to be concluded by end-2013.

The authorities do not foresee any change to the minimum wage applicable to certain professions until the end of the programme. Statutory minimum wages covering specific professions (shop assistants, clerks, child-care workers, personal care workers, security guards, cleaners) are frozen at EUR 870, increasing to EUR 924 after 6 months on the job.

Progress has been registered with respect to the definition of measures to tackle youth unemployment and to address the shortcomings of the current system of activation policies. A youth action plan is being drafted with the assistance of the ILO, which includes measures envisaged for support under the Youth Employment Initiative. The plan - fully specifying all the measures - is to be finalised by the end of the year, with implementation foreseen in the course of 2014. In addition, a uniform monitoring and evaluation framework will apply to all active labour market measures, and a common database is being established, to be shared by all the different implementing bodies. This is envisaged as a transitional solution, until a common data warehouse becomes fully operational in 2015. Measures to strengthen the capacity of public employment services within the constraints of the current freeze on hiring are being devised, relying primarily on a revision of tasks, increased staff mobility and outsourcing. The cooperation, coordination and exchange of information between public employment services and the social welfare administration is being strengthened.

3.4.2. Energy

The assessment of the implementation of the Third Energy Package is an on-going process. In particular, the transformation of the energy sector in the context of the foreseen introduction of natural gas (first through imports and later from the exploitation of the domestic off-shore gas reservoirs) will require close attention to the correct implementation of the provisions of the Third Package. A new tendering procedure is about to be launched on the possible import of natural gas for domestic use. Different options may have different implications for the 'isolated market' and 'emergent market' derogations available to Cyprus.

The government appears to work intensely on formulating a comprehensive strategy for the rearrangement of the energy sector. In particular, the government has shown awareness of the major risks in their planning and the gaps in their information base. In response, they have commissioned a number of studies and have been requesting technical assistance ([8]), which will provide critical input to the strategy.

A first version of the roll-out plan for infrastructure was submitted with a small delay. After appraisal drilling in Block 12, on 3 October 2013 the energy company with the exploitation and exploration license revised downwards the estimated mean size of the gas reservoir it had discovered in 2011. As a consequence, the authorities saw the need to re-examine the roll-out plan. Programme partners assessed the plan to be a satisfactory first version, which however should focus more on physical infrastructure needs and assess more fully the major underlying uncertainties and related alternatives and mitigating measures, and less on the on-going chain of operational implementation decisions. In particular, the plan needs to take better account of the uncertainty concerning the

([8]) Namely on the institutional framework for the management of hydrocarbon revenues, on the market organisation and regulatory regime in the energy sector, and on the consequences of the increasing share of renewable energy sources in total power supply for the island's electricity network.

actual size of the domestic commercially-viable natural gas fields and the time at which they will become available as well as the developments in the international gas markets. In this context, the government should make use of "alternative world energy scenarios" from an internationally-reputed organisation.

The authorities agreed to provide a financial and budgetary impact analysis prior to finalising the Government Agreement (GA) and its supplementary agreements on the Liquefied Natural Gas (LNG) project. The agreements between the Republic of Cyprus and the upstream energy companies that have already signed a Production Sharing Contract with the Republic will specify the terms and conditions applying to the development, financing, construction and operation of LNG facilities as well as to the storage, export and sale of LNG. Depending on the decision whether the state will take an equity share in the plant, this may imply a financial commitment from the state. Finalisation of the agreements is expected for early 2014. According to the revised MoU, the GA and its supplementary agreements need to be consistent with the MoU fiscal targets until 2016 and beyond.

The MoU deadline for completing the intermediate comprehensive outline for the regulatory regime and market organisation of the energy sector and gas exports by end-2013 now appears ambitious in light of the expected delivery of some preparatory studies only by the end of this year**.** Regarding the market organisation, the draft intermediate report of the consultants' study did not address the issue of competition in the energy sector. Consequently, further important areas were identified as requiring clarification, namely: the potential for market entry, for setting up wholesale markets and opening up to non-producing traders; the freedom of customers to choose their supplier; the unbundling of network and commercial functions; and the sales framework for the gas exports.

As regards the management of the public gas revenues, the key provisions to be embedded in the Fiscal Responsibility and Budget Systems Law (see 3.3.2) are currently being discussed with the authorities. A separate law on the Resource Fund and its governance structure will be elaborated under technical assistance from the IMF.

3.4.3. Services and Regulated Professions

The alignment of the legislation with the requirements of the Services Directive is taking longer than foreseen and amendments had not been adopted by the time of the cut-off date of the report. Considerable progress was achieved at the technical level between the Cypriot authorities and the European Commission in a number of remaining sectors, e.g. building contractors and construction services, tourism, car rental services or employment agencies. Nonetheless, by the time of the cut0off date of the report this progress was not reflected in the legislation, as a considerable number of draft amendments were still pending for adoption by the House of Representatives.

The access and exercise of specific regulated professions have been reviewed with the view of alleviating the bans that are still in place. Regulated professions, such as the veterinarians, maintained, by the time of the cut-off date of the report, bans on their advertising system, despite having agreed to their elimination by Q3-2013. The Cypriot authorities have agreed with the European Commission on the list of priority professions and have exchanged views on the requirements affecting their access and exercise of activity. As reflected in the MoU, the complete list of all professions will be finalised later this year.

3.4.4. Housing Market and Immovable Property Regulation

The reform of the housing market and immovable property regulation has regained some momentum. In accordance with the MoU requirements, the legislation on the mandatory registration of the sales contracts for immovable property was enacted in early September 2013. However, the abolition of the requirements on the proof of legal interest for access to the Department of Land Surveys data by monetary financial institutions was not adopted by end-October, as envisaged in the MoU. The Cypriot authorities have continued to publish data on building and planning permits, as well as on title deeds, deed transfers and related mortgage operations. As regards private auctions, the Cypriot authorities have made progress in the drafting of the required legislation amendment, due by end-2013. An IMF technical assistance mission on the Insolvency and Bankruptcy procedures was initiated in early November 2013. The recommendations deriving from this mission could benefit the private auction legislation.

3.4.5. Tourism

An action plan for the implementation of the Tourism Strategy 2011-2015 was submitted within the deadline. Following comments and recommendations by the programme partners, an updated comprehensive action plan including quantified targets on the basis of the revised Tourism Strategy was submitted during the review mission.

The Council of Ministers has approved the mixed-use developments framework already by mid-October 2013, ahead of the Q4 deadline. The Cypriot authorities have also initiated the analysis of the country's needs on air services and the assessment of the existing agreements. The report on the findings is expected to be finalised by end-2013, as envisaged in the MoU.

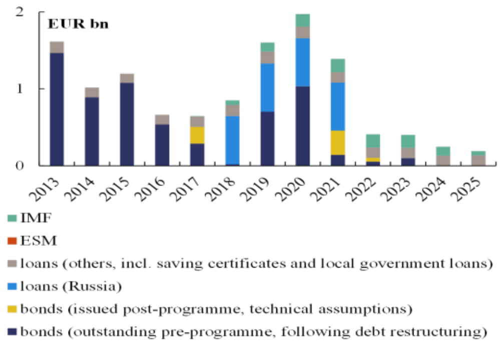
4. PROGRAMME FINANCING AND DEBT SUSTAINABILITY

The Eurogroup of 25 March agreed on external assistance for the Republic of Cyprus of up to EUR 10bn. This envelope was considered adequate to finance debt redemption, fiscal deficits and the recapitalisation of the financial sector – excluding Cyprus Popular Bank and Bank of Cyprus – until the end of the first quarter of 2016. Since the approval of the adjustment programme by the ESM Board of Governors and the IMF executive board, the first tranche of EUR 3.1bn (EUR 3bn from the ESM paid in two instalments and EUR 86m from the IMF) and the second tranche of EUR 1.6bn (EUR 1.5bn from the ESM and again EUR 86m from the IMF) were released. The disbursement of the ESM's second tranche of EUR 1.5bn for the recapitalisation of the cooperative banking sector was a cashless transaction and took place in the form of ESM notes.

The first programme disbursement intended to provide Cypriot authorities with sufficient liquidity to cover debt service and deficit financing until the next cash disbursement planned for the end of the fourth quarter 2013. The first ESM and IMF tranches were used in particular to reimburse the foreign-law bond worth EUR 1.4bn, which matured on 7 June and to cover fiscal needs of about EUR 0.4bn for the second and third quarter. In addition, the first disbursement included a buffer in case of lower than expected participation of domestic investors in the exchange of the EUR 0.7bn domestic-law bond maturing on 4 July. However, investors holding almost the entire outstanding amount agreed to the exchange, thus significantly exceeding the authorities' expectations. Hence, the government was able to bolster its cash buffer, which stood at almost EUR 1.5bn at the end of September.

The average maturity of Cyprus' outstanding debt has improved. In line with the Eurogroup statements of 16 and 25 March, the Cypriot authorities exchanged some EUR 1bn of domestically-held bonds, with new bonds maturing in 6-10 years. Moreover, the repayment pattern of the EUR 2.5bn bilateral loan granted by the Russian Federation in 2012 was changed from a bullet repayment in 2016 into eight equal semi-annual instalments taking place between 2018 and 2021. The interest rate was also lowered to 2.5%.

Graph 4.1: **Debt amortisations and sovereign maturing debt**



(1) The above amortisation pattern excludes the repayment of the CPB recapitalisation bond. For the time being, the programme partners assume continuous roll-over beyond the final maturity date in June 2017
Source: European Commission

The successful second programme review would unlock the disbursement of the ESM's third tranche to meet debt service and fiscal needs arising until the end of the first quarter of 2014. Over the remainder of this year, no significant debt redemptions are scheduled (total of EUR 33m). Around EUR 250m will become due in the course of the first quarter 2014, of which two bonds worth a total of EUR 240m maturing in early and mid-January. Based on the current macro-fiscal projections, total fiscal needs for the fourth quarter of 2013 and the first quarter of 2014 are estimated at about EUR 400m, leading to total financing needs until end-March 2014 of somewhat less than EUR 700m. In light of the government's comfortable cash position, the third ESM disbursement, which would come on top of the IMF's disbursement of EUR 86m, will therefore be minimal (EUR 100m).

Taking into account the third ESM and IMF disbursements, around EUR 5bn of programme funds remain available. Following the first three disbursements including the cash-less second tranche for the recapitalisation of the financial sector, the ESM has disbursed more than half of its share of the agreed programme envelope of EUR 9bn. The IMF, spreading disbursements equally over the programme horizon and not participating in the recapitalisation of the financial sector, has disbursed a total of EUR 0.3bn, i.e. a quarter of the funds allocated for the Cypriot adjustment programme.

Box 4.1: **Debt sustainability assessment**

On 12 April 2013, the European Commission, in liaison with the ECB, presented to the ESM an assessment of the public debt sustainability of Cyprus. This box updates the key calculations of debt sustainability, with a baseline scenario assuming that Cyprus will fully use the financing envelope of EUR 10bn that was politically approved in March 2013.

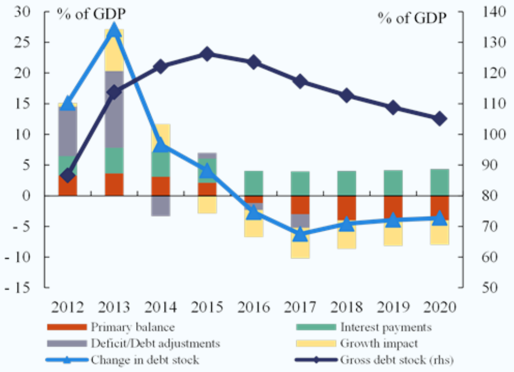
During the second review, updated macro- and fiscal projections were agreed, with some impact on the projected debt trajectory. First, the general government primary deficit is revised upwards to 3.6% of GDP in 2013, largely driven by the one-off compensation of provident and retirement funds in Cyprus Popular Bank, while it has been lowered in 2014 by more than 1 pp and remained largely unchanged in 2015-2016. Second, the updated macro scenario assumes a change to the path of the recession, projecting a milder contraction of real GDP in 2013, which comes however at the cost of a sharper decline in 2014.

The interest bill is revised slightly downward due to lower interest rates on outstanding pre-programme loans. Over the period 2013-2016, the average annual interest payments are estimated to amount to about EUR 660m. Following the adjustment programme, the interest bill is expected to rise gradually on the back of higher market interest rates compared to those charged on ESM and IMF loans and slightly increasing interest rates on the ESM loan in line with projections derived from 10-year German government bond futures.

There are no critical changes to the composition of the stock-flow adjustment. Bank recapitalisations continue to be the biggest component in this regard, amounting to EUR 2.5bn until 2015. Due to a delay in the valuation of the assets, the CBC loan-asset swap, originally foreseen for 2013, has been shifted to mid-2014. Together with the gold sale, this will have a debt-reducing impact amounting to EUR 1.4bn. Privatisation proceeds are projected to materialise over a three-year horizon from 2015 onwards, amounting to a total of EUR 1.4bn.

As a result, the baseline public debt projections remain broadly unchanged. In light of the changes to the macro- and fiscal scenarios, the debt trajectory is shifted slightly upwards, compared to the debt trajectory suggested by the April 2013 DSA. Notably, debt in 2013 is revised upwards to 114% of GDP, from 109% of GDP, also due to the postponement of the CBC loan-asset swap. However, debt is still projected to peak in 2015 and to decline to 105% of GDP in 2020, driven by the economic recovery and the impact of primary surpluses in outer years (see Graph 1).

Graph 1: **Composition of debt developments**



Source: Commisssion services.

The debt trajectory continues to be highly sensitive to the macroeconomic and fiscal environment. Graph 2 shows that a reduction (increase) in real GDP growth by one standard deviation (observed over the period 2008-2012, equivalent to a shock of 2.45% of GDP) over the programme period would result in a sharp upward (downward) revision of the debt-to-GDP ratio until 2020. Taking into account the impact of the change in real GDP growth on primary balance would further aggravate the impact of the shock.([1]) An isolated fiscal shock leading to an annual

([1]) The scenario draws on a semi-elasticity of the budget balance to changes in the output gap of 0.4. In doing so, it is assumed that potential GDP stays constant.

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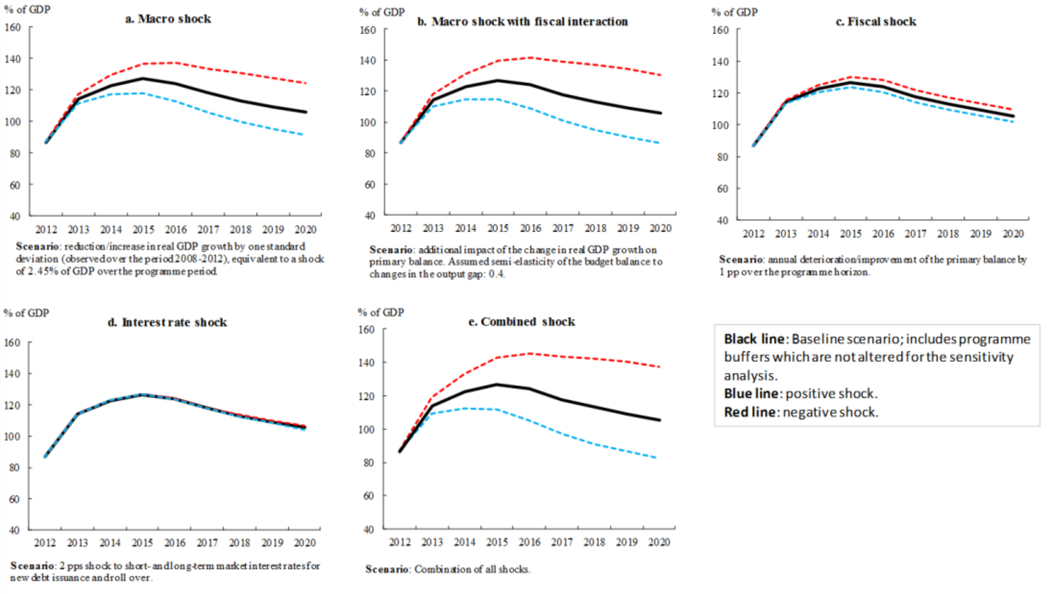
Box (continued)

Graph 2: Programme scenario sensitivity analyses



improvement (deterioration) of the primary balance by 1 pp over the programme horizon would have a more limited effect on the debt-to-GDP ratio until 2020. The sensitivity of the debt trajectory to changes in higher (lower) short- and long-term market interest rates (by 2 pps, respectively, until 2020) is not large.

5. RISKS TO THE PROGRAMME

Despite the strong implementation so far, continued full and timely policy implementation remains essential for the success of the programme. Overall and specific targets are conditioned by the following downside risks:

- protracted period of low confidence in the banking sector resulting from the restructuring and downsizing of the banking sector;
- further tightening of credit supply conditions due to the relatively large and increasing amount of NPLs in the domestic banking system, thereby delaying the recovery of economic growth;
- potentially stronger or more protracted contraction of the economy, particularly in the medium term, with further worsening of the labour market outlook and a steeper drop in real estate prices;
- worsening economic situation in trade-partner economies;
- inability to reach the agreed primary surplus targets established in the programme, due to insufficient policy measures, implementation shortcomings or adverse macroeconomic and financial developments;
- insufficient implementation of structural reforms, including privatisation and risk of lower-than-expected privatisation proceeds; and
- lack of success in regaining market access at a reasonable borrowing cost, once the programme is coming towards its conclusion.

ANNEX 1
Compliance Table

Table A1.1: **Assessment of compliance: monitoring table**

	Actions for the second review (to be completed by end Q3-2013)	**Assessment** - Comment
	FINANCIAL SECTOR	
	Maintaining liquidity in the banking sector	
1.1	The Government has introduced and implemented the restrictions in line with the rules on the free movement of capital set out in the Treaty on the Functioning of the European Union. The impact of the restrictions has since been monitored on a daily basis by the Cypriot authorities with full information sharing with the European Commission (EC), the European Central Bank (ECB), the European Stability Mechanism (ESM) and the International Monetary Fund (IMF). A Monitoring Board has been established by the EC and the Cypriot authorities, with the ECB, the IMF, ESM and the EBA participating as observers, in order to ensure monitoring, assessment and timely relaxation of the implemented temporary restrictive measures. A number of restrictions have already been relaxed or lifted, following a gradual approach, after consultation with the Monitoring Board. The remaining restrictive measures will remain in place no longer than is strictly necessary to mitigate serious risks for the stability of the domestic financial system.	**Compliant** - Continuous monitoring, information sharing and functioning Monitoring Board. Gradual relaxations.
1.2	The Cypriot authorities have developed a roadmap which identifies a series of milestones for the gradual relaxation of the remaining measures, also taking into account indicators of investor confidence in the banking system and financial stability indicators, including the liquidity situation of credit institutions. To enhance transparency and predictability of policies, the roadmap was published **on 8 August 2013**. The roadmap foresees two major stages of relaxation: the first pertains to measures within the Republic and the second relates to cross-border movements of capital.	**Compliant -** The roadmap was published.
1.3	The CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector. The CBC will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules. In this respect, the Cypriot authorities stand ready to consider the issuance of additional government guarantees, if needed.	**Compliant**
1.4	The authorities will request domestic banks relying on central bank funding or that are to receive State aid to establish and submit, quarterly, medium-term funding and capital plans, to be communicated at the end of each quarter to the CBC, which will be transmitted to the ECB, the EC, the ESM and the IMF. The Cooperative Central Bank and the Bank of Cyprus will submit their first plan **by end-September 2013 and mid-October 2013 respectively**. The plans should realistically reflect the anticipated deleveraging in the banking sector and reduce dependency on borrowing from the central bank, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario will be provided by the CBC, in coordination with the ECB.	**Partially compliant -** The relevant template and the macroeconomic assumptions have been circulated to the banks concerned, who are working on these along with their restructuring plans.
	Regulation and supervision for banks and cooperative credit institutions	
1.7	Non-performing loans are threatening bank profitability and need to be properly monitored and managed in order to safeguard the banks' capital buffers. A new definition of non-performing loanshas entered into force on 1 July 2013. The time series for non-performing loans will be published including historical observations reaching as far back as possible.	**Compliant** (new NPL definition). The publication of the series is ongoing.
1.8	The CBC will also create a central credit register listing all borrowers and beneficial owners, from both commercial banks and cooperative credit institutions, to enable these institutions to check new loan applications against the register. The credit register will identify the borrowers who are or were in arrears and will help monitor credit risk and large exposures. The legal framework for the credit register will be set up **by end-September 2013** and the central credit register will be operational **by end-September 2014**.	**Partially compliant** - Considerable work is ongoing, but the deadline was missed. <u>In the new MoU the deadline is shifted to mid-December 2013 for setting up the legal framework</u>.
1.9	After analysis of the results from the due diligence exercise and taking into account best practices in the implementation of the International Financial Reporting Standards, the CBC will review, **by end-October 2013**, its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Without prejudice to the conclusions of this review and to the existing regulatory and accounting framework in the EU, regulatory amendments will be introduced, drawing on technical assistance, with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will enter into force **by end-March 2014**.	**Compliant** - An independent audit firm (Deloitte Italy) submitted its review on the asset impairment and provisioning on 16 September to the CBC which is in the process of preparing the relevant directive.
1.10	Legislation will be passed **by end-September 2013** to strengthen banks' governance by prohibiting commercial banks and cooperative credit institutions from lending to independent board members, including their connected parties, and removing any board members whose existing debts to their banks are non-performing in accordance with the new definition adopted by the CBC, while lending to other board members will be prohibited above a certain threshold, which will be calibrated by the CBC. Loans and other credit facilities to each board member will be disclosed to the public. A majority of directors in banks' boards will be independent.	**Compliant** - The relevant amendments have been incorporated in the Banking Law which was passed on 5 September 2013.
1.12	The CBC will issue **by end-October 2013** mandatory disclosure requirements to ensure that banks regularly communicate to markets progress in restructuring their operations. Starting **end-December 2013**, banks under restructuring plans will be required to publish quarterly reports describing main developments. To enhance their credibility, the reports will be accompanied by independent assessments made by the banks' external auditors on the basis of agreed procedure with the CBC.	**Partially compliant** - Work is ongoing, based on the draft restructuring plans, but the deadline was missed. <u>In the updated MoU the deadline is shifted to end-November 2013.</u>

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Table (continued)

1.13	Stress-testing will be integrated into regular off-site bank supervision and will serve as an input into Pillar 2 assessments. Supervisory stress-tests will be carried out at an annual frequency, with the first exercise completed in accordance with the timeline to be set in the framework of the Single Supervisory Mechanism.	**Compliant** (ongoing) - To be steered by the SSM. The Credit Register, in preparation, will facilitate calculating probabilities of default. For other banks, the CBC is steering the process which will be aligned with that for the directly supervised banks.
1.14	Cooperative credit institutions have played a significant role in the domestic economy and an important objective of the programme is to strengthen the regulation and supervision of the cooperative sector. To complete the alignment of the regulation and supervision of cooperative credit institutions to that of commercial banks, the Cypriot authorities will integrate the supervision of cooperative credit institutions into the CBC, for which legislation will be passed as a **prior action**. Subsequently, the CBC will finalise **by end-September 2013** a detailed action plan to effectively exercise the supervision of the cooperative sector. This action plan should include steps to recruit experienced staff, and to apply the CBC supervisory and regulatory model for the effective monitoring of the entire cooperative credit sector, to be fully operational **by end-March 2014**.	**Compliant** - The relevant legislation was enacted on 5 September 2013. **Compliant with delay** concerning the action plan for the effective exercise of its supervision of the cooperative sector.
1.15	The accounts of cooperative credit institutions, above a size to be decided by the CBC after consultation with the EC, the ECB and the IMF while informing the ESM will be subject to an independent annual audit by an external, recognised and independent auditing firm. The CBC will have the right to overturn the selection of an auditor by any cooperative credit institution. The pro forma consolidated accounts of the cooperative credit institutions will be published beginning from 2013 annual accounts.	**Compliant**
1.16	The CBC should have sufficient staff to fulfill its responsibilities and tasks. Legal obstacles to the CBC's ability to employ and retain the necessary and qualified staff should be removed without delay. To further strengthen the regulatory and supervisory framework in line with international best practices, the authorities will also request a stand alone assessment against the "Basel Core Principles for Effective Banking Supervision", to be completed **by end-2015**.	**Partially Compliant** - The relevant amendments to the laws were approved by the Council of Ministers and were expected to be adopted by the House of Representatives in early-December - this was set as a prior action in the updated MoU.
	Monitoring of corporate and household indebtedness	
1.18	Measures will be taken to deal with troubled borrowers following the implementation of the resolution and recapitalisation of banks. A framework for targeted private-sector-debt restructuring will be established to facilitate new lending, and diminish credit constraints. Ways will be explored to improve the funding constraints of SMEs.	
	· Several steps have already been taken and the Cypriot authorities need now to finalise the banks' Code of Conduct for dealing with troubled borrowers and framework for the management of arrears **by end-August 2013**. In this regard, in addition to the central credit registry, a framework for seizure and sale of loan collateral will be implemented	**Compliant**
	· **By end-September 2013** banks will be asked to submit to the CBC a strategy to implement the framework for the management of arrears. Banks will need to include in the strategy a diagnostic of areas that require strengthening and an action plan to ensure full implementation.	**Compliant**
	· **By end-October 2013**, banks will submit to the CBC their plan to implement the restructuring framework within their organization. They will also be required to report on restructuring progress along specific performance indicators (e.g. number of loans restructured, cash collections, etc.).	**Partially compliant** - The CBC gave appropriate instructions to the banks of which not all have submitted their framework.
	· Building on recent work to identify and address impediments for private debt restructuring, **by end-October 2013** the authorities will perform a legal review of the relevant legislation with technical assistance as needed.	**Partially compliant** - The insolvency framework is being reviewed by the CBC and subject to a technical assistance mission which started on 11 November in view of examing whether there are impedements to the restructuring of loans.
	On this basis, legislation will be passed to expand the role of the mediation service between banks and their clients to achieve fair debt restructuring **by end-November 2013,** while ensuring adequate resources for the service given the expected case load.	**Partially compliant** - Considerable work is ongoing, but the deadline was missed. In the new MoU the deadline is shifted to end-January 2014.
	Increasing financial transparency	
1.19	The anti-money laundering (AML) framework will be further strengthened in line with best practice. While Cyprus' AML regime received an overall positive evaluation in the 2011 MONEYVAL report, the April 2013 audit undertaken by MONEYVAL and an independent auditor identified specific shortcomings. The Cypriot authorities are committed to further enhancing the AML framework and to ensuring its implementation, under the timetable set out in the agreed AML Action Plan (see Annex 2) and in particular by taking the following measures:	
	· Strengthen preventive measures of obliged entities with regard to customer due diligence, use of introduced business and reporting of suspicious transactions (Action Plan – sections 1, 2 and 3).	**Compliant -** Three out of five Action Plan commitments due to be completed in Q3 2013 (2.3, 4.1.2 and 4.3.1) have been complied with.
	· Ensure transparency and timely access to information on beneficial ownership of trusts (Action Plan – section 4). The programme partners take note of the Cypriot authorities' commitment to establish trust registers with the supervisory authorities (Action Plan – section 4.3.1)	**Compliant with delay / Partially compliant** - Some progress on the two other commitments occurred**.** (a) 4.1.1: The CBC provided on 19 November 2013 an

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Table (continued)

	· The supervisory competent authorities will review their off-site and on-site supervisory procedures and further implement a risk-based approach to AML supervision for financial and non-financial (lawyers, accountants and TCSPs) institutions (Action Plan – sections 5 and 6).	analysis of the adequacy of relevant CBC directives for review by the programme partners. The analysis confirmed that the CBC Directive is in its current form in line with relevant legislation. Full compliance with the MoU has thereby been accomplished, though with a slight delay; (b) 5.5.1: The CBC has reviewed all 88 cases identified by Deloitte as requiring further examination, but has not drawn full conclussions from this exercise or completed enforcement action. This, in turn, gives rise to concerns about resources and capacity available for AML supervision at the CBC.
	Moreover, to address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have committed to revise the legal framework so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts in response to requests related to money laundering and tax matters:	
	To this end, the Cypriot authorities will promptly, **by 11 September 2013** and in any event prior to the release of the second tranche of financial assistance, adopt revisions to the Trust and Company Services Provider law.	**Compliant -** Amendments were adopted on 5 September 2013
	In addition, **by 11 September 2013** and in any event prior to the release of the second tranche of financial assistance, the authorities will amend the Anti-Money Law in order to enable the provision of the widest possible range of cooperation to foreign counterparts (including with regard to the laundering of the proceeds of tax crimes involving fraudulent activity), and by giving precision to the scope of cooperation by the financial intelligence unit.	**Compliant** - Amendments were adopted on 5 September 2013
	In addition, the authorities will ensure that directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) are revised to lay down clear implementing procedures, in line with relevant legislation and international standards **by Q3 2013**.	**Compliant with delay -** CySec, CBA and ICPAC have issued, where necessary, the relevant directives and circulars. For CBC please see above regarding point 4.1.1 of the AML action plan.
	Restructuring and resolution of Cyprus Popular Bank and Bank of Cyprus	
1.21	A transitory Board of Directors of Bank of Cyprus, appointed on 26 April 2013, has been mandated by the CBC to ensure the bank's stability once it has exited resolution The transitory Board of Directos has called a General Meeting of the shareholders to be held, no later than **12 September 2013** to appoint a new Board of Directors. The CBC will require the Board to prepare a restructuring plan defining the bank's business objectives and credit policies, including measures to enhance viability and profitability, **by mid-October 2013**. The plan, to be reviewed and approved by the CBC, should specify quarterly goals.	**Compliant** - After the appointment of the CEO on 22 October, the bank submitted its restructuring plan which was reviewed and approved by the CBC.
	Restructuring and recapitalisation of other commercial banks	
1.22	Commercial banks with a capital shortfall, which are deemed viable, can, if other measures do not suffice, ask for recapitalisation aid from the State. Capital should, to the largest extent possible, be raised from private sources including asset disposals and liability management exercises. To this end, **by end-September 2013**, the necessary steps will have been launched. In case, **by end-October 2013**, private sector participation was not successful, State aid can be granted. Any public support granted, must be in line with State aid rules. The banks need to be fully capitalised **by end-December 2013** without burdening depositors.	**Compliant -** The bank successfully completed by end October 2013 the liability managment exercise and the rights issue.
	Restructuring and recapitalisation of cooperative credit institutions	
1.23	The CBC assessed the capital needs of individual cooperative credit institutions, indicating a total capital shortfall of EUR 1.5 billion. The CBC has finalised by **July 2013** a strategy for restructuring and recapitalising the sector, including a plan to merge individual cooperative credit institutions into a maximum of 18 entities **by March 2014**. These mergers are designed to achieve viability, efficiency and profitability.	**Compliant -** The merger process is ongoing.
1.24	The CBC assessed the capital needs of individual cooperative credit institutions, indicating a total capital shortfall of EUR 1.5 billion. The CBC has finalised by **July 2013** a strategy for restructuring and recapitalising the sector, including a plan to merge individual cooperative credit institutions into a maximum of 18 entities **by March 2014**. These mergers are designed to achieve viability, efficiency and profitability.	**Compliant** - The 4% CT1 regulation has been included in the affiliation directive of the individual CCIs .
1.25	The restructuring plan for the cooperative sector will be submitted to the EC **by September 2013**. Cooperative credit institutions in need of aid from the State will not be recapitalised before the restructuring plan has been formally approved under state-aid rules. The terms and remuneration of the public support will comply with the EU State-aid rules with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process, which will be scrutinised by an external monitoring trustee. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones.	**Partially compliant** - A draft restructuring plan was received by end-October. The new Board and CEO of the CCB needs to endorse the plan before its final submission of which the deadline in the updated MoU is shifted to end-January 2014.

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Table (continued)

1.26	The legal framework for a new governance structure to manage the stake of the State in the cooperative credit sector will be established, as a **prior action** for the review. The framework will allocate clear levels of continued accountability and will define the role of the State as the main Central Cooperative Bank shareholder. On this basis, a relationship framework between the State and the Central Cooperative Bank will be established and fully operationalized **by end-October 2013**, to ensure that the Central Cooperative Bank adopts sound policies and restructuring measures to enhance the viability of the cooperative sector, but without interfering in commercial business decisions. Sufficient funds for the recapitalisation of the cooperative credit institutions will be made available from the programme following the fulfilment of the prior action, as mentioned above, and will be deposited in a securities account with the CBC to boost confidence in the system. EUR 1.5 billion of state funds will be injected in the Central Cooperative Bank in exchange for common shares on the basis of capital needs identified in the PIMCO exercise and in line with state aid rules, **by end-O**	**Compliant** (with respect to the management unit) - Following the voting of the law on 5 September, the special unit was set-up in the Ministry of Finance. **Partially compliant** (with respect to the relationship framework) - The end-October deadline was missed and this became a prior action in the updated MoU.
	Fiscal policy in 2013	
2.2	A reform of the tax system for motor vehicles with effect from budget year 2014, based on environmentally-friendly principles, with a view to raising additional revenues in the medium-term, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.	**Compliant** - The relevant amendments were approved by the HoR on 5 September 2013.
2.3	A compensation scheme for provident and retirement funds in Cyprus Popular Bank. The scheme should meet the following criteria: i) ensure comparable treatment with such funds in Bank of Cyprus, ii) take into account the cash-flow and actuarial position of each fund in determining timing by which the compensation will take place, iii) minimise the impact on the general government deficit and ensuring its one-off nature. Given the social welfare nature of provident and retirement funds, the Cypriot authorities will earmark an amount of up to EUR 299 million out of the state budget, for such compensation, of which up to a maximum of EUR 154 million can be released, before the second review of the adjustment programme.	**Compliant** - The HoR adopted the supplementary Budget on 5 September 2013, authorising an additional amount of up to EUR 299 million. The supplementary Budget was accompanied by a circular outlining the way the compensation scheme will be implemented.
	Fiscal Policy in 2014	
	Cyprus should fully implement permanent measures for 2014, amounting to at least EUR 270 million in 2014. The total amount of fiscal policy measures to underpin the 2014 budgetary targets, will be agreed in the context of the 2014 Budget Law consultation. After review by and consultation with the programme partners by mid-September 2013, the 2014 Budget Law will be adopted **by December 2013.**	**Compliant -** The draft 2014 Budget is in line with the programme budgetary targets and, after review by and consultation with the programme partners, is planned to be adopted by the House of Representatives in December 2013. The macroeconomic and revenue forecast in 2014 budget was aligned to the programme assumptions and this was set as a prior action.
	Pension Reforms	
3.1	Measures have been adopted to ensure that total annual public pension benefits do not exceed 50% of the annual pensionable salary earned at the time of retirement from the post with the highest pensionable salary of the official's career in the public sector and broader public sector (except for pension benefits for Members of the House of Representatives, for whom the measures will be adopted **by mid-October 2013 and enter into force by 1 January 2014**); and	**Compliant with delay** - The relevant amendment was not yet submitted to the HoR at the time of the 2nd review mission. Given the insufficient progress with the simple amendment, approval of it was set as a prior action in the revised MoU.
3.1	Ensure that all of the measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees.	**Partially compliant** - The GEPS reforms apply automatically to most schemes in the broader public sector, but the authorities have not yet delivered the information necessary to evaluate whether they apply to all schemes. The revised MoU therefore introduced a Q4-2013 deadline for this measure.
3.1	An actuarial study for the GSIS will be submitted **by end-August 2013**, for peer review in the Ageing Working Group of the Economic Policy Committee. The objective of the actuarial study is to provide additional reform options to ensure the long-run viability of the national pension system.	**Compliant** - The study was submitted and subsequently reviewed and endorsed by the EPC. No reform options were provided as the study shows the long-run viability of the pension system.
	Health care expenditure	
3.2	g) continue to publish clinical and prescription guidelines and to audit their implementation; continue to establish the system for health-technology assessment. Periodic reviews of the basket of publicly-reimbursable medical services will be conducted, based on objective, verifiable, criteria, including cost-effectiveness criteria (health technology assessment will contribute when feasible); prepare quarterly reports on the results of the respective workstreams;	**Compliant -** Progress achieved according to deadlines set initially
3.2	h) introduce a coherent regulatory framework for pricing and reimbursement of goods and services based on the actual level of costs incurred in accordance with Article 7 of Directive 2011/24/EU of the European Parliament and of the Council of 9 March 2011. An interim report will be ready **by Q3-2013**;	**Partially compliant** - A delay for voting the bill is foreseen. Measure will be reviewed in Q4-2013.
3.2	i) continue to code inpatient cases by the system of diagnosis-related groups (DRGs) with the aim of replacing the current hospital payment system by payments based on DRGs **by Q3-2013**; and,	**Compliant** - adequate progress is registered for the coding of all hospital inpatient cases based on an activity-based payment systems, with 100% coding expected by January 2014.

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Table (continued)

3.2	j) adjust back by half an hour the regular starting and ending working times in the Health Service and further reduce overtime and related costs to the wage bill, by making working time more flexible so as to cover - as a minimum - service hours from 7:00 until 17:00 in the entire public sector and service hours from 7:00 to 19:00 for public sector services with extended operating hours (including, but not limited to, healthcare and security), under regular working time. Working hours outside regular working time shall be limited by enforcing strict controls, including requiring pre-approval of any non-emergency work outside regular working time. Following a review, in a second step, revise the regular working hours and stand-by shifts of healthcare staff, including rules to increase the mobility of staff; revise current regulations on overtime pay and fully implement existing laws on recording/monitoring overtime payments (see 3.10) **by Q1-2014**.	**Compliant** - The discussion wth the MoH has revealed that the Ministry of Health was not aware of the horizontal agreement included in the MoU to make working time more flexible and avoid any overtime payment between 7.00 and 19.00 in the healthcare sector. Working times have been accordingly adjusted to comply with the provision.
3.3	**Budgetary Framework and Public Financial Management**	
	Public private partnerships (PPPs)	
3.4	The Cypriot authorities will:	
3.4	create an inventory of PPPs including information on the objectives of current and planned PPPs and more detailed information on signed contracts, including their nature, the private partner, capital value, future service payments, size and nature of contingent liabilities, amount and terms of financing. In addition, an inventory of contingent liabilities including information on the nature, intended purpose, beneficiaries, expected duration, payments made, reimbursements, recoveries, financial claims established against beneficiaries, waivers of such claims, guarantee fees or other revenues received, indication of amount and form of allowance made in the budget for expected calls, and forecast and explanation of new contingent liabilities entered into in the budget year will be compiled. The inventories will be shared **by Q3-2013** with the programme partners. **As of 2014,** the inventories will be updated annually and included as “Statement of PPPs” and “Statement of Contingent Liabilities” in appendices to the annual budget law and to the annual financial report;	**Compliant** - Both the inventory of PPPs on the objectives of current and planned PPPs and the inventory of contingent liabilities were submitted within the deadline. Adjustments on the baseline revenue and expenditure impact of each PPP on the budget were added during the review mission.
3.4	Put in place an adequate legal and institutional framework for public investment projects, including PPPs, to assess fiscal risks and to monitor their execution through: (i) establishing an effective gateway process that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Minister of Finance and his services (i.e. the Ministry, Planning Bureau and Treasury) in reviewing and approving public investment projects and in particular PPPs at critical points in the gateway process; and (iii) developing financial reporting and accounting rules that ensure timely and transparent communication of public investment project and PPP related obligations. The legal basis for managing public investment and specifically PPPs will be included in the FRBSL, which will be drafted **by Q3-2013 and implemented by Q4-2013**; and	**Compliant** - The legal basis for managing public investment and specifically PPPs is being included in the FRBSL, which will enter into force on 1 Januray 2014, after adoption by the House of Representatives.
3.4	Commit not to enter into any new tendering process and not to sign any new PPP contract before the implementation of the legal and institutional PPP framework, excluding any project having reached commercial close **by end-October 2012**.	**Compliant**
	State-owned enterprises and privatisation	
3.5	As regards extra-budgetary funds and entities, in particular the State-Owned Enterprises (SOEs) and other state-owned assets, the Cypriot authorities will: Establish an inventory of assets, owned by central government and local authorities, including real estate and land. The inventory shall include all SOEs, reflecting up-to-date valuations of those with the highest commercial value by Q3-2013. The inventory will indicate which SOEs could be subject to divestment or restructuring or liquidation. The inventory of the largest and most valuable real estate and land assets (those of market value exceeding EUR 1 million) will be ready by Q3-2013. The full inventory of all assets (SOEs, real estate and land) will be completed by Q4-2013. The inventory will be gradually submitted to the programme partners;	**Partially compliant** - Progress has been made on the completion of the inventories of SOEs and real estate/land, whilst SOEs that could be subject to restructuring or liquidation have not yet been confirmed.
3.5	prepare a plan to strengthen the governance of SOEs in accordance with international best practices and draft a report reviewing the operations and finances of SOEs (see 3.10) by Q3 2013. The report will assess these companies' business prospects, the potential exposure of the government to the SOEs and the scope for orderly privatisation.	**Partially compliant** - The action plan strengthening SOEs' corporate governance has been addressed through the creation of a SOEs unit at the Ministry of Finance, though its mandate is still to be defined and agreed.
3.6	The privatisation plan will be based on the report reviewing and assessing the operations and finances of SOEs (3.5), as well as the inventory of assets. The privatisation plan will be finalised after consultation with programme partners, including asset-specific timelines and intermediate steps **by November-2013;**	**Non Compliant** - Although a first draft privatisation plan was prepared and modified throughout the review mission, additional adjustments and political ownership are still needed to ensure that the EUR 1 bn target within the duration of the programme will be delivered. <u>In the updated MoU, adoption of the privatisation plan by the Council of Ministers was set as a prior action.</u>
	Revenue administration, tax compliance and international tax cooperation	
3.7	(11) 1. establish the project management, including a high-level governmental steering committee chaired by the Minister of Finance and an executive technical committee, which manages the development and implementation of the reform plan and which will be chaired by the Permanent Secretary of the Ministry of Finance **by Q3-2013**;	**Compliant with delay** - The Council of Ministers decided on the compositions of the steering committee and the executive technical committee at the end of October. A head of the project team was appointed and nine full-time staff were assigned to the team.
3.8	The authorities will:	

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Table (continued)

	(1) fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation[2] and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other. The Cypriot authorities have submitted Law N. 205(I)/2012 (enacted on 28 December 2012), transposing the Directive, to the European Commission.	**Compliant** - The detailed evaluation of the implementation of Directive 2011/16/EU is still pending. Regarding Regulation 904/2010, Cyprus has been within the three months deadline in 2/3 of the cases, which is above the average of the EU28.
	(2) ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States; and	**Compliant** - This is an on-going effort and progress is satisfactory so far. The authorities have taken a number of steps to improve the follow-up procedure, which is difficult due to cumbersome procedures to identify taxpayers. Further work in the area will be required.
	(3) improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer.	**Compliant** - This is an on-going effort and progress is satisfactory so far. The legislative barriers on data protection have been overcome and data from various other government entities have been added to the IRD database.
	Immovable Property Tax Reform	
3.9	In addition, the following studies should be initiated **by Q3-2013**, and their recommendations implemented at the latest by 1 January 2015:	
3.9	• a study on refining the parameters of the imputed property market value index within the bounds of administrative and legal simplicity. In particular, the study shall assess the feasibility of a unit tax base for individual dwellings. Moreover, the study shall report on a mechanism to dampen cyclical variations in the index; and	**Compliant** - Following the agreed Terms of Reference in early September, the Cypriot authorities initiated the procedure for requesting Technical Assistance (TA) for the study by mid-September. A TA scoping mission, organised by IMF and SGCY, took place in October 2013.
3.9	• a study on the scope of consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope of shifting revenues from transaction fees and taxes to recurrent taxation.	**Compliant with delay** - Following the agreed Terms of Reference in early September, the Cypriot authorities initiated the tendering procedure with delay in early October.
	Public Administration Reform	
3.10	The public sector represents a large share of public expenditures in Cyprus. To ensure an efficient use of government resources, while delivering a quality service to the population; the Cypriot authorities will :	
3.10	as a first step, starting on **1 September 2013**, establish working time in the Public Service, in conjunction with moving the starting time by half an hour (from 7:30 to 8:00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00);	**Compliant** - The new working time arrangements have been implemented in all ministries, including the Ministry of Health, which has nonetheless voiced concerns on its enforcement in hospitals.
3.10	In addition, the Cypriot authorities are commissioning an independent external review of possible further reforms of the public administration. The review will include a horizontal and a sectoral element.	**Compliant** - The external review is currently being undertaken by the World Bank and the UK public administration, namely for the first batch of studies (horizontal review on remuneration, working conditions and apparaisal system; sectoral review on Ministries of Agiculture, Education and Health, local govenrments, and the Department of Registrar of Companies and Official Receiver).
	Welfare System *(Reforms must be consistent with the fiscal targets defined in this MoU)*	
3.11	To this end, the Cypriot authorities will take the following steps:	
3.11	first, define the minimum consumption basket in terms of composition and weights **(Q3-2013)**;	**Compliant** - The CY authorities provided information on the definition of minimum consumption basket in terms of weights and coverage.
3.11	thereafter, refine the costing and the coverage of the new guaranteed minimum income scheme (GMI) which will replace the existing public assistance scheme (**end-October 2013**);	**Partially Compliant** - The CY authorities provided a note on the methodology used for the design and costing of the GMI. To date, work on the actual design of the GMI and its costing is not finalised while the level of the minimum consumption basket covering basic needs, which is to be intergrated in the GMI, still needs to be defined. Moreover, further refinement of the methology used for the calculation of the minimum consumption basket was requested, notably relating to the use of a normative approach for the construction of the minimum consumption basket as an intergrated part of the methodology.
	Services Directive: Sector-specific legislation	

(Continued on the next page)

Table (continued)

5.1	5.1. The Cypriot authorities will adopt any remaining necessary amendments to the sector-specific legislation (e.g. construction, tourism, car rental services, employment agencies), in order to fully implement the Services Directive, easing the requirements related to provision of services and establishment. Amendments will be adopted **by Q3-2013**. Rules that refer to the calculation of fees for professional services (including those adopted by professional bodies) need to be assessed before adoption for compliance with internal market and competition principles, except as otherwise agreed with programme partners. To this end, the opinion of the Cypriot Commission for the Protection of the Competition (CPC) and of programme partners is required.	**Non compliant** - None of the key amendments in accordance to the Services Directive were adopted and a number of amending laws are still pending for adoption at the House of Representatives. In the updated MoU, adoption of relevant sector-specific legislation was set as a prior action.
	Reform of Regulated professsions	
	The authorities will:	
5.2	• eliminate any existing total bans on the use of a form of commercial communication (advertising) in specific regulated professions, such as veterinarians, as required by the Services Directive **by Q3-2013**; and	**Non compliant** - The elimination of the bans in the commercial communication of veterinarians was not adopted within the deadline and is still pending at the House of Representatives.
5.2	• further improve the functioning of the regulated professions sector (such as lawyers, engineers, architects) by carrying out a comprehensive review of requirements affecting the access and exercise of activity. This review will be completed **by Q3-2013** for a list of priority professions, to be agreed with programme partners before mid-August 2013, and by Q4-2013 for the rest of regulated professions. Following completion of the review, the requirements that are not justified or proportional will be eliminated by Q1-2014.	**Compliant** - The Cypriot authorities have agreed with the Commission the list of priority professions and have exchanged views on the requirements affecting their access and exercise of activity.
5.3	**Competition and sectoral regulatory authorities**	
	Housing market and immovable property regulation	
	The Cypriot authorities will:	
5.4	• enact legislation for mandatory registration of sales contracts for immovable property **by Q3-2013**	**Compliant** - The legislation was adopted on 5 September 2013 (Law 99(I)/2013)
5.4	• every three months, publish quarterly progress reviews, including executive commentaries on developments related to the issuance of building and planning permits, certificates, title deeds, title deed transfers and related mortgage operations, starting **end-July 2013**;	**Compliant** - The Cypriot authorities are publishing on a regular basis statistical data.
5.4	Any requirements on the proof of legal interest for access to these data by these bodies shall be abolished **by October 2013;**	**Non compliant** - The authorities have not adopted the required legislative amendments that alleviate the requirement on the proof of legal interest for the monetary financial institutions in accessing the registries of property title deeds (cadastre). In the updated MoU, this requirement was set as a prior action.
	Tourism	
5.5	Since tourism is one of Cyprus' largest economic sectors and a potential driver of future growth and employment, a reinvigoration of its competitiveness is necessary. To that end, the Cypriot authorities will:	
5.5	• provide a concrete action plan leading to the implementation of the quantified targets identified, inter alia in the recently revised Tourism Strategy 2011-2015 **by Q3-2013**;	**Compliant with delay** - The Cypriot authorities submitted an action plan and quantified targets end-September 2013. A revised concrete action plan, along with the quantified targets, were delivered during the mission.
	Energy	
	The Cypriot authorities will:	
5.6	1. a roll-out plan for the infrastructure required for the exploitation of natural gas, taking into account possible technical and commercial uncertainties and risks. The plan should cover: the required investments, associated costs, financing sources and methods, related ownership structure; related major planning risks and bottlenecks; and a projection of the revenue streams over time; first version **by Q3-2013**;	**Compliant with delay** - The plan, submitted with delay, is a satisfactory first version, however, it should focus more on the physical infrastructure needs and planning and the related uncertainties and risks. An updated version is foreseen for Q4-2013.
	Technical Assistance	
6.1	Given the nature of the structural challenges Cyprus is facing, including a lack of specific skills in some areas and scarcity of resources, the Cypriot authorities will provide a request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-September 2013**. This request will identify and specify the areas of technical assistance or advisory services, which the Cypriot authorities consider essential for the implementation of the MoU and where they intend to seek such technical assistance services, in coordination with the programme partners. All technical assistance provided by the European Commission, other than technical assistance provided directly under the Structural and other EU funds, will be coordinated by the Support Group for Cyprus.	**Compliant** – The Cypriot authorities delivered a request for technical assistance on 30 September 2013

Source: Commission services.

ANNEX 2
Macroeconomic Projections

Table A2.1: **Use and supply of goods and services (volume)**

percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	1.5	1.3	-2.5	-10.7	-6.7	1.3	2.8
2. Government consumption expenditure	1.0	-0.2	-3.1	-4.1	-5.2	-3.2	-3.1
3. Gross fixed capital formation	-4.9	-8.7	-19.6	-28.5	-14.0	1.2	3.1
4. Domestic demand excl. inventories	0.2	-0.8	-5.4	-11.8	-7.2	0.4	1.7
5. Changes in inventories (contr. to growth)	1.8	-0.7	1.3	-0.6	0.0	0.0	0.0
6. Domestic demand incl. inventories	1.9	-1.4	-4.1	-12.3	-7.1	0.4	1.6
7. Exports of goods and services	3.9	4.5	-2.7	-5.8	-2.9	1.7	2.7
7a. - of which goods	12.2	22.6	1.0	0.1	1.1	1.6	2.3
7b. - of which services	2.4	1.1	-3.5	-7.1	-3.8	1.7	2.8
8. Final demand	2.5	0.2	-3.7	-10.3	-5.8	0.8	2.0
9. Imports of goods and services	4.8	-0.1	-6.4	-16.0	-8.0	0.8	2.3
9a. - of which goods	7.3	-3.6	-10.0	-20.6	-9.8	0.5	2.3
9b. - of which services	-0.4	7.7	0.9	-7.6	-5.2	1.2	2.3
10. GDP at market prices	1.3	0.4	-2.4	-7.7	-4.8	0.8	1.9
(Contribution to change in GDP)							
11. Final domestic demand	0.2	-0.8	-5.6	-12.0	-7.0	0.4	1.6
12. Changes in inventories	1.8	-0.7	1.3	-0.6	0.0	0.0	0.0
13. Net exports	-0.6	1.9	1.9	4.9	2.1	0.5	0.3

Source: Commission services.

Table A2.2: **Use and supply of goods and services (value)**

percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	3.7	4.7	-0.2	-10.0	-5.5	2.9	4.6
2. Government consumption expenditure	2.6	3.0	-4.1	-4.4	-4.5	-1.9	-1.7
3. Gross fixed capital formation	-3.7	-10.7	-18.3	-27.6	-12.8	5.4	6.0
4. Domestic demand excl. inventories	2.0	1.6	-3.8	-11.3	-6.1	2.1	3.5
5. Changes in inventories (contr. to growth)	0.1	0.0	0.2	0.1	0.1	0.1	0.1
6. Domestic demand incl. inventories	3.8	0.9	-2.5	-11.7	-6.0	2.1	3.5
7. Exports of goods and services	6.1	6.6	-0.9	-4.7	-1.6	3.0	4.3
7a. - of which goods	13.6	24.1	2.0	1.2	2.4	2.9	3.8
7b. - of which services	4.8	3.4	-1.6	-6.0	-2.6	3.1	4.5
8. Final demand	4.5	2.5	-2.0	-9.6	-4.6	2.4	3.8
9. Imports of goods and services	7.0	2.1	-4.5	-14.6	-6.4	2.6	4.0
9a. - of which goods	9.6	-0.7	-8.1	-19.2	-8.2	2.5	4.1
9b. - of which services	1.6	8.4	3.1	-6.0	-3.4	2.9	3.8
10. Gross national income at market prices	5.4	6.5	-4.5	-6.2	-6.1	0.2	2.4
11. Gross value added at basis prices	3.8	3.2	-0.7	-10.2	-4.2	2.5	3.2
12. Gross domestic product at market prices	3.3	2.7	-0.9	-7.3	-3.9	2.3	3.7

Source: Commission services.

Table A2.3: **Implicit deflators**

percent change	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	2.1	3.3	2.4	0.8	1.3	1.5	1.7
2. Government consumption expenditure	1.6	3.2	-1.1	-0.3	0.7	1.3	1.4
3. Gross fixed capital formation	1.2	-2.2	1.7	1.2	1.4	4.2	2.8
4. Domestic demand incl. inventories	1.9	2.4	1.7	0.6	1.2	1.7	1.8
5. Exports of goods amd services	2.2	2.0	1.8	1.2	1.3	1.3	1.5
6. Final demand	2.2	2.0	1.8	1.2	1.3	1.3	1.5
7. Imports of goods and services	2.1	2.2	2.1	1.7	1.8	1.9	1.7
8. Gross domestic product at market prices	1.9	2.3	1.6	0.4	1.0	1.5	1.8
HICP	2.6	3.5	3.1	0.7	1.0	1.4	1.7

Source: Commission services.

Table A2.4: **Labour market and costs**

Percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Labour productivity	1.5	0.0	1.7	-1.4	-0.4	0.1	0.2
2. Compensation per employee	2.6	2.5	-1.0	-5.3	-5.6	-1.8	1.3
3. Unit labour costs	1.1	2.5	-2.7	-3.9	-5.2	-1.9	1.0
4. Total population	2.6	2.6	1.5	1.0	1.0	1.0	0.8
5. Population of working age (15-64 years)	2.9	2.9	1.7	1.0	1.0	0.2	0.2
6. Total employment	-0.2	0.4	-4.2	-6.3	-4.4	0.8	1.7
7. Unemployment rate (1)	6.3	7.9	11.9	16.7	19.8	19.0	17.7

Source: Commission services.

Table A2.5: **External balance**

EUR bn unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Exports of goods (fob)	1.1	1.4	1.4	1.5	1.5	1.5	1.6
2. Imports of goods (fob)	5.8	5.8	5.3	4.3	3.9	4.0	4.2
3. Trade balance (goods, fob/fob) (1-2)	-4.7	-4.3	-3.9	-2.8	-2.4	-2.5	-2.6
3.1 p.m. (3) as % of GDP	-26.8	-24.3	-21.7	-17.2	-15.4	-15.4	-15.5
4. Exports of services	6.2	6.4	6.3	5.9	5.7	5.9	6.2
5. Imports of services	2.6	2.8	2.9	2.7	2.6	2.7	2.8
6. Service balance (4-5)	3.6	3.6	3.4	3.2	3.1	3.2	3.4
6.1 p.m. 6 as % of GDP	20.6	20.0	19.1	19.4	19.8	19.9	20.2
7. External balance of goods and services (3+6)	-1.1	-0.8	-0.5	0.4	0.7	0.7	0.8
7.1 p.m. 7 as % of GDP	-6.2	-4.4	-2.7	2.2	4.4	4.6	4.7
8. Balance of primary incomes and current transfer	-0.5	-0.1	-0.7	-0.6	-0.6	-0.7	-0.8
8.1. - of of which, balance of primary income	-0.5	0.1	-0.6	-0.3	-0.7	-1.0	-1.2
8.2 - of which, net current transfers	0.0	-0.2	-0.2	-0.3	0.0	0.3	0.4
8.3 p.m. 8 as % of GDP	-2.8	-0.4	-4.1	-3.6	-4.1	-4.4	-4.7
9. Current external balance (7+8)	-1.6	-0.8	-1.2	-0.2	0.0	0.0	0.0
9.1 p.m. 9 as % of GDP	-9.0	-4.7	-6.8	-1.4	0.3	0.2	0.0
10. Net capital transactions	0.0	0.0	0.0	0.2	0.0	0.0	0.0
11. Net lending (+)/net borrowing (-) (9+10)	-1.5	-0.8	-1.2	-0.1	0.0	0.0	0.0
11.1 p.m. 11 as % of GDP	-8.9	-4.5	-6.9	-0.5	0.1	0.1	-0.1

Source: Commission services.

Table A2.6: **Fiscal accounts**

	2010	2011	2012	2013	2014	2015	2016
	levels, EUR m						
Taxes on production and imports	2,679	2,612	2,633	2,420	2,346	2,415	2,564
Taxes on income and wealth	1,926	2,098	1,962	1,919	1,795	1,810	1,899
Social contributions	1,552	1,566	1,620	1,433	1,439	1,424	1,455
Other current resources	948	851	854	821	833	802	870
Total current revenue	7,106	7,127	7,069	6,593	6,413	6,451	6,789
Capital transfers received	10	12	11	2	2	2	2
Total government revenue	7,116	7,139	7,080	6,595	6,415	6,453	6,791
Compensation of employees	2,758	2,875	2,819	2,630	2,450	2,402	2,373
Intermediate consumption	978	945	866	857	868	861	839
Social transfers	2,500	2,630	2,687	2,573	2,658	2,620	2,508
Interest payments	391	426	563	689	643	641	673
Subsidies	62	85	95	95	85	85	85
Other current expenditure (1)	436	500	514	665	347	327	275
Total current expenditure	7,124	7,460	7,543	7,508	7,051	6,937	6,753
Total capital expenditure	911	811	675	373	490	497	510
Total expenditure	8,036	8,272	8,218	7,882	7,541	7,434	7,263
General government balance, EDP	-920	-1,132	-1,139	-1,287	-1,126	-980	-472
	% of GDP						
Taxes on production and imports	15.4	14.6	14.9	14.7	14.9	14.9	15.3
Taxes on income and wealth	11.1	11.7	11.1	11.7	11.4	11.2	11.3
Social contributions	8.9	8.8	9.1	8.7	9.1	8.8	8.7
Other current resources	5.4	4.8	4.8	5.0	5.3	5.0	5.2
Total current revenue	40.8	39.9	39.9	40.1	40.6	39.9	40.5
Capital transfers received	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Total government revenue	40.9	39.9	40.0	40.2	40.6	39.9	40.5
Compensation of employees	15.8	16.1	15.9	16.0	15.5	14.9	14.1
Intermediate consumption	5.6	5.3	4.9	5.2	5.5	5.3	5.0
Social transfers	14.4	14.7	15.2	15.7	16.8	16.2	14.9
Interest payments	2.2	2.4	3.2	4.2	4.1	4.0	4.0
Subsidies	0.4	0.5	0.5	0.6	0.5	0.5	0.5
Other current expenditure (1)	2.5	2.8	2.9	4.0	2.2	2.0	1.6
Total current expenditure	40.9	41.7	42.6	45.7	44.7	42.9	40.3
Total capital expenditure	5.2	4.5	3.8	2.3	3.1	3.1	3.0
Total expenditure	46.2	46.3	46.4	48.0	47.8	46.0	43.3
General government balance, EDP	-5.3	-6.3	-6.4	-7.8	-7.1	-6.1	-2.8
Nominal GDP	17.4	17.9	17.7	16.4	15.8	16.2	16.8

(1) Including compensation of pension funds, estimated to amount to 1.8% of GDP in 2013.
Source: Commission services.

Table A2.7: **Debt developments**

	2010	2011	2012	2013	2014	2015	2016*
EDP deficit (% of GDP)	-5.3	-6.3	-6.4	-7.8	-7.1	-6.1	-2.8
EDP gross debt (% of GDP)	61.3	71.5	86.6	113.7	122.1	126.2	123.5
			levels, EUR bn				
EDP deficit	-0.9	-1.1	-1.1	-1.3	-1.1	-1.0	-0.5
Gross debt	10.7	12.8	15.3	18.7	19.3	20.4	20.7
Change in gross debt	-0.8	-2.1	2.6	3.3	0.6	1.1	0.3
Nominal GDP	17.4	17.9	17.7	16.4	15.8	16.2	16.8
Real GDP	15.1	15.2	14.8	13.7	13.0	13.1	13.4
Real GDP growth (% change)	1.3	0.4	-2.4	-7.7	-4.8	0.9	1.9
			% of GDP				
Gross debt ratio	61.3	71.5	86.6	113.7	122.1	126.2	123.5
Change in gross debt ratio	2.8	10.1	15.1	27.1	8.3	4.1	-2.7
			Contribution to change in gross debt				
Primary balance	3.0	3.9	3.3	3.6	3.1	2.1	-1.2
Snow-ball effect	0.4	0.8	3.8	11.0	8.6	1.1	-0.4
of which							
Interest expenditure	2.2	2.4	3.2	4.2	4.1	4.0	4.1
Real growth effect	-0.7	-0.2	1.7	7.2	5.7	-1.0	-2.3
Inflation effect	-1.1	-1.4	-1.1	-0.3	-1.2	-1.8	-2.2
Stock-flow adjustments	-0.6	5.4	8.0	12.5	-3.3	0.9	-1.1

*: projected privatisation proceeds of EUR 500m are spread evenly over the four quarters of 2016.
Source: Commission services.

Table A3.1: **Estimated financing needs for the period 2013-2020**

cash data unless states otherwise	2013				2014				2015				2016	Programme period (2013Q2-2016Q1)	2013	2014	2015	2016	2017	2018	2019	2020
million euros, negative = surplus / revenue	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1									
Amortisation of existing market debt excl. short-term	8.5	1,440.9	132.0	32.6	251.4	107.9	556.0	96.9	146.6	60.4	72.4	914.0	337.8	4,149.0	1,614.0	1,012.3	1,193.4	660.533	415.4	779.2	1,473.4	1,795.5
of which:																						
domestic- (GRDS) & foreign-law (EMTN) bonds	0.0	1,416.9	47.6	1.0	244.0	90.0	500.0	55.3	141.3	44.3	17.6	873.8	332.4	3,764.0	1,465.4	889.3	1,076.9	535.7	287.4	19.6	703.1	1,032.5
loans	0.0	17.9	76.1	24.2	0.0	10.5	48.6	34.2	0.0	10.7	49.4	34.8	0.0	306.6	118.3	93.4	95.0	103.3	106.5	738.1	748.7	741.6
Amortisation of new market debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	192.8	0.0	0.0	0.0
Amortisation of offical lenders	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.2	57.4	114.8	165.0
ESM	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.2	57.4	114.8
Financial sector recapitalisation	0.0	0.0	1,500.0	0.0	0.0	0.0	0.0	300.0	0.0	200.0	0.0	200.0	300.0	2,500.0	1,500.0	300.0	400.0	0.0	0.0	0.0	0.0	0.0
of which contingency buffer	0.0	0.0	0.0	0.0	0.0	0.0	0.0	300.0	0.0	200.0	0.0	200.0	300.0	1,000.0	0.0	300.0	400.0	0.0	0.0	0.0	0.0	0.0
Fiscal financing needs	10.9	257.4	126.3	536.4	-137.8	658.3	298.5	656.7	84.4	494.1	49.1	385.4	-97.2	3,311.7	931.0	1,475.8	1,012.9	-34.2	-361.2	-137.0	-118.0	-87.5
of which:																						
primary balance	-171.0	114.6	-54.3	708.6	-34.2	271.7	-127.1	373.0	-77.8	331.0	-168.7	254.7	-208.7	1,382.7	597.9	483.3	339.2	-200.7	-524.2	-727.5	-755.2	-783.9
interest (in ESA terms)	176.3	218.2	200.2	94.1	151.9	74.1	311.3	106.2	157.9	84.3	278.6	120.6	173.3	1,970.7	688.8	643.4	641.4	679.6	690.1	723.2	776.1	840.2
programme financing needs	19.4	1,698.3	1,758.3	569.0	113.6	766.3	854.5	1,053.6	231.0	754.4	121.5	1,499.4	540.7	9,960.7	4,025.6	2,788.0	2,606.3	540.7	-	-	-	-
memo: total annual financing needs															4,045.1	2,788.0	2,606.3	926.3	254.2	699.6	1,470.2	1,873.1

Source: Commission services.

ANNEX 4

Programme Documents

Memorandum of Understanding on Specific Economic Policy Conditionality

The economic adjustment programme will address short- and medium-term financial, fiscal and structural challenges facing Cyprus. The key programme objectives are:

- to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions and strengthening supervision;

- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit by 2016, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and

- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

1. Financial sector reform

Key Objectives

The banking sector has been severely affected by the broader European economic and sovereign crisis, in particular through its exposure to Greece. However, many of the sector's problems are home-grown and relate to overexpansion in the property market as a consequence of the poor risk management practices of banks. Furthermore, the financial sector was vulnerable because of its size relative to that of the domestic economy. The handling of problems in the sector has been complicated by the sensitivity of collateral valuations to property prices, and banks have used certain gaps in the supervisory framework to delay the recognition of loan losses, thus leading to significant under-provisioning. The banking sector would benefit from a considerable restructuring in order to restore its solvency and viability, reinforce its resilience and regain public confidence.

Progress since July

Work continued to address the challenges, in particular the downsizing and the restructuring of the banking sector, as well as the related regulatory reforms. First, BoC's new Board of Directors was elected by the AGM that took place on 10 September 2013 and on 22 October the BoD appointed a new CEO. Second, the authorities have started implementing the strategy to restructure the cooperative credit institutions and first mergers have been completed according to the agreed timetable. Third, Hellenic Bank attracted significant private capital, including from foreign investors, and raised the required capital. Fourth, the gradual relaxation of the administrative restrictions and the capital controls continued in line with the milestones-based approach presented by the authorities on 8 August.

Considerable progress has also been achieved with respect to the supervisory and regulatory reforms. The working plan for the integration of the supervison of the cooperative credit institutions into the CBC was finalised. The CBC issued a Directive on arrears management and a Code of Conduct for dealing with troubled borrowers. The legislation for establishing a financial mediation service is being finalised. The review of banks' asset impairment, provisioning and accounting practices by the external consultant was finalised, and the Directive on the regulatory framework on loan origination was issued, though with a slight delay. The authorities have also finalised the legal framework for setting up a single credit register which has been submitted to the House of Representatives. Finally, an amendment to the Banking Law was passed on 5 September 2013, which limits and regulates bank lending to members of the Board of Directors. The amendments to anti-money laundering legislation have been enacted and the trust registers to improve the availability of information on beneficial ownership have been set up.

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. The Cypriot authorities commit to continue implementing the roadmap for the gradual relaxation of restrictive measures which was published on 8 August 2013. This roadmap identifies a series of milestones for the gradual liberalisation of the restrictions also taking into account indicators of investor confidence in the banking system and financial stability indicators, including the liquidity situation of credit institutions. A number of restrictions have already been relaxed or lifted according to the roadmap. By **end-January 2014** the CBC will study current market conditions, including through well-targeted surveys and focus groups, in order to ensure that further relaxations during the second stage of the roadmap remain consistent with financial stability.

1.2. Furthermore, the CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector. The CBC will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules. In this respect, the Cypriot authorities stand ready to consider to issue additional government guarantees in line with State aid rules, if and as needed to safeguard financial stability.

1.3. The authorities will request domestic banks relying on central bank funding or receiving State aid to submit medium-term funding and capital plans to the CBC at the end of each quarter. These plans will be transmitted to the ECB, the EC, the ESM and the IMF. The Cooperative Central Bank and the Bank of Cyprus will submit their first plans together with their final restructuring plans. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector and reduction of borrowing from the central bank, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario are provided by the CBC, in coordination with the ECB.

1.4. The lack of concentration limits in the liquidity framework for euro-denominated assets allowed a concentrated exposure of Cypriot banks to Greek sovereign debt. To avoid similar outcomes in the future, the CBC will update the liquidity requirements **by December 2014**, after consultation with the ECB, the EC and the IMF and informing the ESM.

Regulation and supervision of banks and cooperative credit institutions

1.5. Strong efforts should be made to maximise bank recovery rates for non-performing loans, while minimising the incentives for strategic defaults by borrowers. The administrative hurdles and the legislative framework currently constraining the seizure and sale of loan collateral will be amended such that the property pledged as collateral can be seized within a maximum time-span of 1.5 years from the initiation of legal or administrative proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. Based on technical assistance, the necessary legislative changes will be submitted to the House of Representatives **by end-February 2014** and implemented **by end- 2014**, macroeconomic conditions permitting. The authorities commit not to introduce any further impediments to the seizure of assets pledged as collateral.

1.6. A new definition of non-performing loans has entered into force on 1 July 2013. The time series for non-performing loans will be published **by end-December 2013**, including historical observations reaching as far back as possible.

1.7. The CBC will also create a central credit register listing all borrowers and beneficial owners, from both commercial banks and cooperative credit institutions, to enable these institutions to check new loan applications against the register. The credit register will identify the borrowers who are or were in arrears and will help monitor credit risk and large exposures. Following the establishment of the legal framework for the credit register **by mid-December 2013**, the central credit register will be operational **by end-September 2014**.

1.8. After analysis of the results from the due diligence exercise and taking into account best practices in the implementation of the International Financial Reporting Standards, the

CBC reviewed its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Taking into account the conclusions of this review, the CBC will introduce regulatory amendments, with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will be finalised **by 31 December 2013** and will become effective for the publication of the 2013 financial statement concerning disclosure requirements. The CBC will require banks to submit **by end-February 2014** an action plan for the full implementation of these guidelines starting from their 2014 annual accounts.

1.9. The CBC will consider the need for introducing mandatory supervisory action based on capitalisation levels **by 30 June 2014**. The follow-up will take into account the related developments in the Single Supervisory Mechanism. If required, technical assistance will be requested by the CBC.

1.10. The CBC will issue **by end-November 2013** mandatory disclosure requirements to banks submitting restructuring plans. Starting with reference date **end-December 2013**, these banks will be required to publish quarterly reports describing the progress with the implementation of the restructuring plans. These reports will contain a set of key performance indicators to be developed by the CBC and communicated to the banks, in advance of the forthcoming quarterly report.

1.11. The CBC will integrate stress-testing into regular off-site bank supervision, taking into account the entry into force of CRD IV and CRR and the related developments and timelines in the Single Supervisory Mechanism.

1.12. Following the legal integration of the supervision of the cooperative credit institutions into the CBC, the operational integration will be completed **by end-March 2014** in line with the action plan of September 2013. This action plan includes steps to recruit experienced staff and to apply the CBC supervisory and regulatory model for the effective monitoring of the entire cooperative credit sector.

1.13. **By end-January 2014**, the CBC will complete its annual supervisory program detailing its main objectives and activities for 2014, including a tentative timeframe to gradually resume regular on-site inspection of commercial and cooperative banks (which will also include review and implementation of provisioning requirements), staffing, cost and budget assigned to each activity, and main training programs. The CBC will clarify the allocation of tasks and responsibilities in the governance structure of the CBC to effectively carry out the supervisory tasks of the central bank in line with SSM requirements. Also **by end-January 2014**, the CBC will require banks to submit the 2014 work program of their internal audit departments.

1.14. The accounts of cooperative credit institutions will be subject to an independent annual audit by an external, recognised and independent auditing firm. The CBC will have the right to overturn the selection of an auditor by any cooperative credit institution. The consolidated accounts of the cooperative credit institutions will be published beginning from 2013 annual accounts.

1.15. The CBC will have sufficient staff to carry out its functions in full independence as stipulated by the Treaties. Legal obstacles to the CBC's ability to retain and employ the necessary qualified staff should be removed, **prior to the granting of the third disbursement of financial assistance**.

1.16. The authorities will, in consultation with EC, ECB and IMF and informing the ESM, review the effectiveness of the Resolution Authority, including its composition and governance, with a view to adopting legislative and operational changes **by end-January 2014**.

Monitoring of corporate and household indebtedness

1.17. The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. Data from surveys will be used until the credit register becomes fully operational. The Financial Stability Report, to be published on a yearly basis **as of December 2013**, will include an extended analysis on corporate and household indebtedness. The first quarterly monitoring report has been received in the beginning of July 2013 and its scope and content will be further enhanced.

1.18. Measures will be taken to deal with troubled borrowers following the implementation of the resolution and recapitalisation of banks. A framework for targeted private-sector-debt restructuring will be established to facilitate new lending, and diminish credit constraints. Ways will be explored to improve the funding constraints of SMEs.

- In line with the framework for the management of arrears, and in accordance with the strategies they are required to develop, banks will submit to the CBC their revised strategies (including pre-packaged programs, and general policies to deal with small and large troubled borrowers, respectively) and plans for their internal implementation **by end-January 2014**. **By end-March 2014**, the CBC, with external technical support, will complete an assessment of the operational capacity of the banks' loan workout units to implement their plans. Banks will also be required to report quarterly on restructuring progress and management of NPLs, beginning **end-March 2014**, using specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.), which will be determined **by end-November 2013** by the CBC in consultation with EC, ECB and IMF and informing ESM.
- **By end-November 2013**, the CBC will publish supplementary information on the Code of Conduct (CoC) in order to further enhance public awareness and facilitate its implementation. **By end-May 2014** the CBC will complete a second round of inspections to verify banks' compliance with the CoC and impose sanctions as needed.
- Building on recent work to identify and address impediments for private debt restructuring, **by end-December 2013** the authorities will perform a legal review of the relevant legislation with technical assistance as needed. On this basis, legislation will be passed to expand the role of the Financial Ombudsman **by end-January 2014** to achieve fair debt restructuring, while ensuring adequate resources for the service given the expected case load.
- The Cypriot authorities, in view of financial stability considerations and on-going bank restructuring, commit not to introduce any new administrative measures which would interfere with the setting of bank lending rates. In particular no ceilings on bank lending rates would be introduced.
- The CBC will with assistance of an external expert review banks' arrears management policies and practices, taking into account international best practices. This review

will be completed **by end-June 2014** and serve as a basis for further policy recommendations on the arrears management processes in credit institutions.

Increasing financial transparency

1.19. The anti-money laundering (AML) framework will be further strengthened in line with best practice. While Cyprus' AML regime received an overall positive evaluation in the 2011 MONEYVAL report, the April 2013 audit undertaken by MONEYVAL and an independent auditor identified specific shortcomings. The Cypriot authorities are committed to further enhancing the AML framework and to ensuring its implementation, under the timetable set out in the agreed AML Action Plan (see Annex 2) and in particular by taking the following measures:

- Strengthen preventive measures of obliged entities with regard to customer due diligence, use of introduced business and reporting of suspicious transactions (Action Plan – sections 1, 2 and 3).
- Ensure transparency and timely access to information on beneficial ownership of trusts (Action Plan – section 4). The programme partners take note of the Cypriot authorities' commitment to establish trust registers with the supervisory authorities (Action Plan – section 4.3.1)
- The supervisory competent authorities will review their off-site and on-site supervisory procedures and further implement a risk-based approach to AML supervision for financial and non-financial (lawyers, accountants and TCSPs) institutions (Action Plan – sections 5 and 6).
- On a quarterly basis, in the context of the programme review starting **Q4 2013**, the supervisory competent authorities will, on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.

To address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have revised the legal framework so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts related to money laundering and tax matters. **Prior to the granting of the third disbursement of financial assistance**, the authorities will ensure that directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) are in line with relevant legislation and international standards**.** To this end, the authorities **by 20 November** provide an analysis of the adequacy of relevant CBC directives for review by the programme partners.

The Cypriot authorities commit to maintain efforts to ensure that the widest possible exchange of information with other FIUs is achieved, either spontaneously or in response to requests. The Cypriot FIU has taken the initiative to provide the programme partners with a breakdown of requests made and received and spontaneous disseminations on a quarterly basis (within 14 days of the end of the quarter), starting with Q4 2013, and publish this information on the FIU website on an annual basis.

B. Recapitalisation and restructuring

Restoring adequate capital buffers

1.20. The CBC will increase the minimum Core Tier 1 capital ratio from the present level of 8% to 9% **by end-December 2013**. By the same date, the CBC will assess the impact of the entry into force of the Common Equity Tier 1 capital definition laid down in the CRDIV and CRR. On the basis of that assessment the CBC will define, by **end-February 2014** and in consultation with the EC, ECB, IMF and informing ESM, the minimum capital requirements taking into account the parameters of the balance sheet assessment and the stress test of the Single Supervisory Mechanism. In no circumstances will this revision lead to a decrease in the minimum amount of capital held by the banks. In the interim period until the revised requirements enter into force, the CBC will prohibit any release of capital by the banks which were found in the PIMCO exercise to face a capital shortfall.

Management of legacy Laiki

1.21. By **end-January 2014**, the Resolution Authority will present a detailed roadmap for the full disposal of legacy Laiki's assets, while maximizing the value for the creditors. Pending disposal of legacy Laiki's shares in BoC and to ensure their adequate management, the Resolution Authority will instruct the Special Administrator to entrust **by end-January 2014,** the voting rights of these shares to a well-recognised and independent consulting or auditing firm(s) or an international institution(s).

Restructuring of Bank of Cyprus

1.22. The CBC will instruct BoC to publish selected features of its restructuring plan before end-2013. On the basis of the plan, **prior to the granting of the third disbursement of financial assistance**, the CBC will approve BoC's proposed set of quarterly targets for the next 12 months for key financial and operational indicators in critical areas and the terms of a quarterly report on progress relative to above-mentioned targets. This report will be submitted to the CBC **by end-March 2014**. A CBC team has been appointed to closely monitor BoC's compliance with the above-mentioned targets, assess any deviations, and define remedial actions if warranted. The report of the team on its main activities will be submitted quarterly to the CBC Board, starting with **end-2013**.

Restructuring and recapitalisation of Hellenic Bank

1.23. Following the successful recapitalisation of Hellenic Bank with privately raised funds, the CBC will require Hellenic Bank to submit **by end-March 2014** a business plan covering the period up to end-2015.

Restructuring and recapitalisation of cooperative credit institutions

1.24. The CBC assessed the capital needs of individual cooperative credit institutions, indicating a total capital shortfall of EUR 1.5 billion for which funds were deposited in a securities account with the CBC to boost confidence in the system. This ensures that there will be no contribution required from depositors to achieve the recapitalisation of the sector.

Following a fair value assessment of the CCB and CCIs' assets and after the approval of the restructuring plan by the EC, these EUR 1.5 billion of state funds will be injected in the Cooperative Central Bank in exchange for common shares.

1.25. To this end the restructuring plan for the cooperative sector will be submitted to the EC **by end-January 2014**. The terms and remuneration of the public support will comply with the EU State aid rules with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process, which will be scrutinised by an external monitoring trustee.

1.26. In line with the strategy for the restructuring and recapitalising of the sector that was published in July 2013, the individual cooperative credit institutions will be merged into a maximum of 18 entities **by end-March 2014**. These mergers are designed to achieve viability, efficiency and profitability. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones.

1.27. Upon completion of each legal merger of affiliated credit cooperative institutions, the Cooperative Central Bank will inject sufficient capital into them to take a 99% stake and ensure compliance with the 4% individual core Tier 1 ratio. These operations will be finalised by end-March 2014, with the view to speed up the appointment of the Board of Directors of each institution and the implementation of the new governance guidelines. At the consolidated level, the sector is still subject to the general minimum core tier 1 capital requirement of 9%.

1.28. Based on the new legal framework for the management of the stake of the State in the cooperative sector, a relationship framework between the State and the Central Cooperative Bank will be established , **prior to the granting of the third disbursement of financial assistance**, to ensure that the Central Cooperative Bank adopts sound policies and restructuring measures to enhance the viability of the cooperative sector, but without interfering in commercial business decisions and undue political interference. Compliance with the relationship framework will be reviewed on a quarterly basis by the monitoring trustee, who will also report any breaches of the framework to the EC. The authorities will inform the ECB, the ESM, and the IMF of the conclusions of that report.

1.29. With the view to decisively restructure the sector, the CBC has required the new board of the CCB to publish, **by end-November 2013**, a roadmap agreed with the CBC specifying key interim actions for the next three months, including: (i) the appointment of the new CEO, (ii) measures to bolster the independence and qualification of CCI Boards, (iii) actions to retain customers, (iv) measures to impede further asset deterioration, and (v) measures to prepare the transfer of NPLs to specialized units within the sector.

1.30. As part of the implementation of the restructuring plan, the Cooperative Central Bank will leverage on external expertise, in particular in the areas of arrears management and corporate restructuring. In addition, it will ensure that the recruitment of executive and senior management of the CCB and CCIs take place in line with international best practices. The selection criteria will be established by the Cooperative Central Bank and consulted by the Ministry of Finance with the EC, ECB, ESM and IMF. Compliance with the requirements of this paragraph will be assessed in the quarterly progress reports of the Cooperative Central Bank on the implementation of the restructuring plan.

2. **Fiscal policy**

Key objectives

Putting public finances on a sustainable path is of overriding importance in order to stabilise the economy and to restore the confidence of companies, citizens and foreign investors in the longer-term economic prospects of Cyprus.

In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation in order to achieve a 3% of GDP primary surplus in 2017, 4% of GDP in 2018 and maintain at least such a level thereafter; (2) to achieve the annual budgetary targets as set out in this Memorandum of Understanding (MoU) through high-quality permanent measures, and additional measures in the outer years, in particular to reduce the growth in expenditure on the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on vulnerable groups; (3) to this end, to fully implement the fiscal consolidation measures for 2013, listed in Annex 1 and below; (4) to correct the excessive general government deficit by 2016; and (5) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see Section 3), including the implementation of a Medium-Term Budgetary Framework designed in accordance with EU specifications.

The Cypriot authorities adopted a number of fiscal measures for 2012-2014 as well as initial steps in relation to fiscal-structural reforms. The authorities commit to the full implementation of these measures (see Annex 1) and to regularly monitor the budgetary effect of the measures taken. Any deviation from the projected budgetary effect of the measures will be evaluated and addressed accordingly in the quarterly programme reviews, taking into account macroeconomic developments. In the event of underperformance of revenues or higher social spending needs, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the programme period, cash revenues above programme projections, including any windfall gains,[9] will be saved or used to reduce debt. To the extent that over-performance is deemed permanent, this can reduce the need for additional measures in the outer years. Measures, such as tax amnesties, that could have an adverse impact on tax compliance and foster tax fraud and evasion, thereby counteracting efforts in line with paragraph 3.7 of this Memorandum, will not be undertaken over the course of the programme period.

Sound fiscal policy and expenditure prioritisation should contribute to preserving the good implementation of Structural and other EU funds, in respect with the programme's budgetary targets. In the light of Cyprus' economic challenges, EU funds will be targeted to those areas that deliver the most important economic and social impact, in accordance with the priorities to be set in the relevant EU regulatory framework. In order to ensure the effective implementation of EU funds, the Government will ensure that the necessary national funds remain available to cover national contributions, including non-eligible expenditure, under the European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD and

[9] Windfall gains associated with hydrocarbons shall mean only the blocks' licencing fees or related signature bonuses for exploration thereof. It is noted that any streams of revenues associated with hydrocarbon exploitation are dealt with under section 5.6, second bullet-point, indent 3

EFF/EMFF) in the framework of the 2007-2013 and 2014-20 programming periods, while taking into account available EIB funding. The authorities will ensure that the institutional capacity to implement current and future programmes is improved and the appropriate human resources of Managing Authorities and implementing bodies are available.

In accordance with Regulation 472/2013, Cyprus shall provide all the information that the programme partners consider to be necessary for the monitoring of the implementation of the economic adjustment programme. The Cypriot authorities will consult ex-ante with the European Commission, the ECB and the IMF on the adoption of policies that are not included in this Memorandum but that could have a material impact on the achievement of programme objectives.

Fiscal policy in 2013

2.1. The Cypriot authorities will achieve a budgetary outcome in line with the Council Recommendation of 16 May 2013, with a view to bringing an end to the situation of an excessive government deficit, taking into account the Commission's assessment of effective action of 6 September 2013. To this end, the Cypriot authorities will rigorously implement the 2013 Budget Law (as amended) and the agreed consolidation measures, amounting to at least EUR 351 million.

In line with State aid rules, the Government shall not implement any measures involving State aid towards Cyprus Airways until the approval of a restructuring plan by the European Commission.

2.1.

Fiscal policy in 2014

Based on programme's current macroeconomic and fiscal projection and reflecting the draft 2014 Budget, the Cypriot authorities will achieve a deficit of the general government primary balance of EUR 483 million (3.1% of GDP) in 2014[10], respecting the EDP recommendation of a headline deficit of no more than 8.4% in 2014. To this end, Cyprus will fully implement permanent measures for 2014, amounting to at least EUR 270 million in 2014 (Annex 1). The total amount of fiscal policy measures to underpin the 2014 budgetary targets, will be included in the 2014 Budget Law.

Notably, the authorities will take the following permanent additional measures, amounting to approximately ⅓% of GDP, as proposed by the Government in the draft 2014 Budget Law, with a view to advance part of the future consolidation effort:

- ensure additional expenditure savings by a further reduction of public sector allowances and streamlining of overtime compensation, including by revising the formula for calculating overtime compensation on weekdays and in weekends for state officers and apply the revision pro rata in the case of hourly paid employees.;
- a further targeting of social pensions;
- an abolition of income tax exemption for certain pension schemes;
- a reduction in the tax-free threshold for lottery gains;

[10] The ESA95 budgetary targets are not comparable to, but remain consistent with the respective cash-based budgetary target set in the context of the economic adjustment programme.

• an introduction of a contribution of 3% on salaries of casual employees servicing on a contract basis, who receive gratuity, including volunteers of 5 years services and police constables.

Prior to the granting of the third disbursement of financial assistance, the Cypriot authorities will submit to the House of Representatives the necessary amendments to the 2014 draft Budget Law in order to align it with the revised macroeconomic and budgetary projections of the economic adjustment programme. Any amendments to the budget that could have a material impact on the achievement of the programme's objectives will be assessed and agreed with the programme partners.

The 2013-2015 expenditure ceilings will be updated for the period 2014-2016 and will accompany the 2014 Budget Law document (see also 5.6.3). The presentation of these ceilings will evolve into a full-fledged Fiscal Strategy Statement in line with the MTBF requirements contained in Directive 2011/85/EU. Any deviation from the budgetary objectives contained in the 2013-2015 framework will be properly documented and reasons for such deviations will be provided to the programme partners.

Fiscal policy in 2015-16

Based on the programme's updated budgetary projection, the Cypriot authorities will achieve a deficit of the general government primary balance of EUR 340 million (2.1% of GDP) in 2015 and a surplus of EUR 201 million (1.2% of GDP) in 2016, respecting the EDP recommendation of a headline deficit of no more than 6.3% in 2015 and 2.9% in 2016.

After review by and consultation with the programme partners the 2015 and 2016 Budget Laws will be adopted, respectively, **by December 2014** and **December 2015**.

The 2014-2016 expenditure ceilings will be updated for the period 2015-2017 and will accompany the 2015 Budget Law document (see also 5.6.3). Any deviation from the budgetary objectives contained in the 2014-2016 framework will be properly documented and reasons for such deviations will be provided to the programme partners. In **Q2-2016**, the Cypriot authorities will present the programme partners with a provisional list of measures to attain a primary surplus of 3% of GDP in 2017 and 4% of GDP in 2018. The measures required will be included in the draft 2017 Budget Law.

3. Fiscal-structural measures

Key objectives

Cyprus enjoyed above euro-area average growth rates for more than a decade and in parallel expanded its public sector employment, support and services considerably. Looking ahead, if the public sector is to provide appropriate support for the sustainable and balanced growth of the Cypriot economy, fiscal-structural reform steps are needed to ensure the long-term sustainability of public finances, to provide the fiscal space necessary to support the diversification of the economy, and to alleviate the adverse impact on jobs and growth arising from Cyprus' exposure to external shocks. In this context, the objectives are: (1) to improve the efficiency of public spending and the budgetary process by means of an effective Medium-Term Budgetary Framework (MTBF) that is fully compliant with the Directive on requirements for budgetary frameworks and the Treaty on Stability, Coordination and Governance (TSCG); (2) implement further reforms of the pension system to address the high projected increase in pension spending; (3) take further steps to control the growth of health expenditure; (4) enhance tax revenues by improving tax compliance and collection; (5) undertake reforms of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services; (6) undertake reforms of the overall benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; and (7) elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatisation programme.

Pension reform

3.1. While acknowledging that the Cypriot authorities have recently introduced substantial reforms (as noted in Annex 1), which, according to the results of the actuarial study which were peer reviewed in the Ageing Working Group of the Economic Policy Committee in September 2013, have adequately addressed the issue of the high projected increase in pension spending and secured the long-term financial viability of the pension system through 2060, it remains important to monitor the long term financial sustainability of the system and consider further reform steps, if needed.

The Cypriot authorities have implemented/agreed to implement the following measures:

- **prior to the granting of the third disbursement of financial assistance**, pass legislation to ensure that total annual public pension benefits do not exceed 50% of the highest pensionable salary of the official's career for Members of the House of Representatives; and
- ensure that all of the measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees **by Q4-2013**, to enter into force **on 1 January 2014.**

Health care reform

3.2. To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following measures will be adopted:

a) preserve and implement all fiscal measures relating to compulsory health-care contribution for public servants and public servant pensioners to be reviewed **by Q2-2014** with the programme partners and all co-payments for using public health care services;

b) restructure public hospitals according to the action plan as approved by the Council of Ministers at end-June 2013 and aim at full implementation **by Q2-2015;**

c) taking into account the results of the updated actuarial study and after consultation with the programme partners, implement without further delay a National Health System (NHS), to be in place **by end-2015**, ensuring its financial sustainability while providing universal coverage and considering the possibility of implementation in stages **by end-2015**. To this end, the government will present its detailed plan by **January 2014**;

d) secure adoption by the Council of Ministers of a binding set of contingency measures (e.g. revision of the basket of publicly reimbursable medical services and products, cuts in tariffs for medical products and providers of medical services, limits to the volume of reimbursable products and services) **by Q4-2014**, in order to ensure that the agreed budget limits of public health expenditure are not exceeded**;**

e) to complete the IT-infrastructure necessary for implementing the NHS, explore all options for improving the IT-infrastructure via the most cost-effective web-based applications as an alternative to the currently-defined IT tender **by Q1-2014**;

f) review income thresholds for free public health care in comparison to the eligibility criteria for social assistance, while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures **by Q4-2013**;

g) continue to publish clinical and prescription guidelines and to audit their implementation; continue to establish the system for health-technology assessment. Periodic reviews of the basket of publicly-reimbursable medical services will be conducted, based on objective, verifiable, criteria, including cost-effectiveness criteria (health technology assessment will contribute when feasible); prepare quarterly reports on the results of the respective workstreams;

h) introduce a coherent regulatory framework for pricing and reimbursement of goods and services based on the actual level of costs incurred in accordance with Article 7 of Directive 2011/24/EU of the European Parliament and of the Council of 9 March 2011. An interim report will be ready **by Q4-2013**;

i) continue to code inpatient cases by the system of diagnosis-related groups (DRGs) achieving full coding of all inpatient cases in public hospitals **by January 2014**; and,

j) adjust back by half an hour the regular starting and ending working times in the Health Service (to 7:30/8:30 – 15:00/16:00) and further reduce overtime and related costs to the wage bill, by making working time more flexible so as to cover - as a minimum - service hours from 7:00 to 19:00 under regular working time (see 3.10.).

Following a review, in a second step, revise the regular working hours and stand-by shifts of healthcare staff, including rules to increase the mobility of staff; revise current regulations on overtime pay and fully implement existing laws on recording/monitoring overtime payments (see 3.10) **by Q1-2014**.

Furthermore, the Cypriot authorities will consider establishing a system of family doctors acting as gate-keepers for access to further levels of care.

<u>Budgetary framework and public financial management</u>

3.3. The Cypriot authorities will:

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in the high-level Fiscal Responsibility and Budget System Law (FRBSL), which will be adopted **by Q4-2013** (including an implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance);
- Enact a FRBSL applicable to the entire general government sector. The umbrella law will encompass, inter alia, macro-fiscal policy-making, and budget formulation, approval and execution. It will take on-board and deepen existing provisions

transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and implementing the Two-Pack EU Regulation 473/2013 and the Fiscal Compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts (on budget documentation and statistics) ensuring that adopted measures are fully effective **by Q4-2013**.

As regards expenditure controls in the state budget, which shall avert the risk of overspending against existing appropriations and/or accumulating arrears, the Cypriot authorities will:

- Remove the risk of overspending by making sure that spending commitments, as these will be defined in the FRBSL,of the central government are subject to pre-commitment validation **by Q4-2013**, and of the general government **by Q1-2014**. All outstanding commitments should be timely and properly recorded and reported in the accounting system.
- Improve the monitoring of government guarantees through a risk assessment analysis. To this end, amend the Public Debt Management Law, **by end-December 2013**, in order to ensure a proper risk assessment of the outstanding stock of government guarantees and ensure appropriate human resources to that end.

Public private partnerships (PPPs)

3.4. The Cypriot authorities will:

- update the inventory of PPPs, including contingent liabilities, **as of 1 January 2014**, and include it both in the annual budget law and in the annual financial report;
- put in place an adequate legal and institutional framework for public investment projects, including PPPs, to assess fiscal risks and to monitor their execution through: (i) establishing an effective gateway process that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Minister of Finance and his services (i.e. the Ministry, Planning Bureau and Treasury) in reviewing and approving public investment projects and in particular PPPs at critical points in the gateway process; and (iii) developing financial reporting and accounting rules that ensure timely and transparent communication of public investment project and PPP related obligations. The legal basis for managing public investment and specifically PPPs will be included in the FRBSL, which will enter into force **on 1 January 2014**; and
- commit not to enter into any new tendering process and not to sign any new PPP contract before the implementation of the legal and institutional PPP framework, excluding any project having reached commercial close by end-October 2012.

State-owned enterprises and privatisation

3.5. As regards extra-budgetary funds and entities, in particular the State-Owned Enterprises (SOEs) and other state-owned assets:

- **by Q4-2013**, the Council of Ministers will examine a list of SOEs to be restructured or liquidated;

- the Cypriot authorities will complete the full inventory of real estate and land assets **by Q4-2013,** specifying which ones are ready for privatisation; and
- submit to the House of Representatives a draft law to regulate the creation and the functioning of SOEs at the central and local levels and enhance the monitoring powers of the central administration, including reporting on SOEs in the context of the annual budgetary procedure **by Q4-2013**. No additional SOEs will be created until the legal framework has been adopted.

3.6. The Cypriot authorities will initiate a privatisation plan to help improving economic efficiency through enhanced competition and encouragement of capital inflows, and to help restoring debt sustainability:

- This plan will include the privatisation prospects of state-owned enterprises (SOEs) and semi-governmental organisations (SGOs), including, inter alia, CyTA (telecom), EAC (electricity), CPA (commercial activities of ports), as well as real estate/land assets and will be based on a prudent estimation of privatisation proceeds. For the privatisation of natural monopolies, an appropriate regulatory framework is a prerequisite. The provision of basic public goods and services by privatised industries will be fully safeguarded, in line with the national policy goals and in compliance with the EU Treaty and appropriate secondary legislation rules;
- The privatisation plan will be adopted by the Council of Ministers **prior to the granting of the third disbursement of financial assistance,** after consultation with programme partners, and will include asset-specific timelines and concrete intermediate steps ;
- In parallel, the specific legal and institutional framework for the privatisation process will be implemented **by January 2014**, after consultation with programme partners; and
- The privatisation plan identified by the Government after consultation with the programme partners will raise at least EUR 1 billion **by the end of the programme period** and an additional EUR 400 million **by 2018 at the latest**.

Revenue administration, tax compliance, and international tax cooperation

3.7. The Cypriot authorities will reform the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection capacity and the fight against tax fraud and evasion, with a view to increasing fiscal revenue. The reform will comprise of a programme of short-term measures to enhance compliance, efficiency and effectiveness as well as a comprehensive long-term reform covering risk management and the establishment of a new integrated function-based tax administration structure, integrating the existing IRD and VAT services. The short-term programme will be implemented **by Q4-2013** and include the following sets of measures:

Enact legislative changes to enhance tax collection and voluntary compliance by

- attributing personal responsibility for payment of company taxes to those, who -in the case of non-listed companies- truly and effectively control a company and to the responsible manager for fraudulent filing of company taxes;

- harmonising the legislation among tax types so that not paying taxes is a criminal offense regardless of the type of tax and ensure tax fraud is prosecuted as a criminal offense; and
- strengthening powers by the tax authorities to ensure payment of outstanding tax obligations, e.g. by having authority to seize corporate assets, prohibiting alienation or use of assets, including property and bank accounts, by the taxpayer.

Improve efficiency and effectiveness of the administration by,

- ensuring staff mobility between different tax administration entities in order to ensure appropriate staffing of entities with high revenue collection capacities;
- optimising the use of IT systems in the tax administration based on: (i) facilitating information exchange between tax administration entities and with other relevant authorities, taking into account legal provisions for data protection; and (ii) enhancing the use of e-filling of tax returns and e-payment (e.g. by allowing payment through bank transfers);
- enacting the necessary legislation to establish self-assessment for all income taxpayers by changing from a pre-assessment verification of income tax returns to post assessment audits selected on the basis of risk;
- deciding on a joint audit programme for large taxpayers, to be conducted **in 2014;**
- developing a joint work programme for conducting targeted audits and enhancing voluntary compliance of known high-risk groups; and
- conduct an independent formal review to recommend changes to legislation to determine the appropriate level of discretion available to the tax administration management and how it is exercised.

The long-term reform will include the following sets of measures:

- A comprehensive compliance strategy that will be put in place **by Q2-2015**. The strategy will be firmly based on analytical work on risk identification and analysis and on an evaluation of different risk treatment strategies. Work for the risk identification and analysis will begin **in Q4-2013**.
- The full integration of the two tax departments will be completed in several phases and will be accompanied by a set of flanking reform measures, such as the development of a common tax procedure code. After having established the project management, which includes a high level steering committee, chaired by the Minister of Finance and an executive technical committee, chaired by the Permanent Secretary the authorities will,
    1. develop a reform plan that reflects the recommendations of the TA received in February 2013 and further recommendations derived from future TA. The reform plan will be agreed with program partners and approved by the government **by Q4-2013**; and
    2. reinforce the tax unit in the Ministry of Finance that is responsible for tax policy formulation and for monitoring the implementation of tax policy and the revenue performance (including by measuring the tax gap) **by Q2-2014**.

3.8. The Cypriot authorities will safeguard the timely and effective exchange of information in regard to tax matters, fully ensuring the applicability of laws and standards governing international exchange of tax information. In this respect, the Cypriot authorities will enhance the practice of timely delivery of relevant and accessible tax information to other EU Member States. The authorities will:

- fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation[11] and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;
- ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States;
- improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer; and
- implement the recommendations put forward in the in-depth review of Cyprus' legal and regulatory framework under the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and commit to address any shortcomings to be identified in the forthcoming evaluation of implementation issues.

In the context of an effective implementation of Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the EUSD), the Cypriot authorities will continue to provide to the EC all necessary and available information/statistics extracted from the data exchanged under the FISC153. In addition, on an annual basis and starting from the tax year ending **on 31 December 2013**, the Cypriot authorities will provide to the EC a breakdown of the information provided under the EUSD by sector of activity of the paying agents, including possible sanctions actually claimed of paying agents for their application of the EUSD. **In 2015**, the Cypriot authorities will provide to the European Commission a report on the results of audits conducted in 2014. The Cypriot authorities (CBC) will provide on an annual basis detailed sectoral deposit statistics with a breakdown of non-resident deposits by country.

Immovable property tax reform

The following measures will be taken to increase revenue and to improve the fairness of the tax burden by levying the recurrent property tax on current market values. An additional objective is to reduce overhead cost in tax base administration.

[11] The Cypriot authorities have submitted Law N. 205(I)/2012 (enacted on 28 December 2012), transposing the Directive, to the European Commission.

3.9. In view of this, the Cypriot authorities have agreed to:

- implement a property price index that establishes the average market valuation in 2013 by square meter of habitable surface and land plot, taking into account recommendations derived from technical assistance. This index shall be operational to provide imputed market valuations for each cadastral plot **by Q2-2014**, in time for the immovable property tax collection in 2014. The index shall vary according to location and zoning as well as other tangible building- and plot-related characteristics. Moreover, the authorities will implement a methodology for annual updates of such imputed market valuations;
- implement the recurrent immovable property tax based on such imputed market valuations **by Q3-2014**. The tax rates shall reflect the progressivity and revenue of the preceding property tax. For co-owned land plots, individual owners shall be taxed according to ownership proportions as provided in the cadastre;
- establish the legal basis for a mandatory annual adjustment of the property unit tax base by a competent authority **by Q3-2014**;

In addition, the recommendations of the following studies should be implemented at the latest **by 1 January 2015**:

- a study on refining the parameters of the imputed property market value index within the bounds of administrative and legal simplicity. In particular, the study shall assess the feasibility of a unit tax base for individual dwellings. Moreover, the study shall report on a mechanism to dampen cyclical variations in the index; and
- a study on the scope of consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope of shifting revenues from transaction fees and taxes to recurrent taxation. The tender procedure and the assignment of the study to the successful bidder shall be concluded **by Q4-2013**.

Public administration reform

3.10. The public sector represents a large share of public expenditures in Cyprus. To ensure an efficient use of government resources, while delivering a quality service to the population, the Cypriot authorities will, **by December 2013,** adjust back by half an hour the regular starting and ending working times, to 7:30 - 8:30 and to 15:00 – 16:00 and further reduce overtime and related costs to the public sector wage bill, by making working time more flexible so as to cover - as a minimum - service hours from 7:00 until 17:00 in the entire public sector and service hours from 7:00 to 19:00 for public sector services with extended operating hours (including, but not limited to, healthcare and security), under regular working time (see 3.2).

In addition, the Cypriot authorities are commissioning an independent external review of possible further reforms of the public administration. The review will include a horizontal and a sectoral element.

The horizontal element will be undertaken by the World Bank and the UK public administration and will include the review of:

- the appropriate system of remuneration and working conditions/conditions of employment in the public sector (e.g. annual vacation leave, sick leave, maternity leave, working time), in relation to the private sector and to other EU countries and based on best practices; and
- the introduction of a new performance based appraisal system in the public sector, for development and promotion purposes, linking performance with the remuneration system/ increments.

The results of the horizontal review will be presented **by Q3-2014.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with the programme partners, submit it to the House of Representatives for approval and implement it **by Q4-2014**.

The sectoral element will cover:

- an examination of the role, the competences, the organisational structure and the size/ staffing of relevant ministries, services and independent authorities;
- an examination of the possibility of abolishing or merging/consolidating non-profit organisations/companies and state-owned enterprises; and
- the re-organisation/re-structuring of local government,

and will comprise two batches:

- the first batch will be undertaken by the World Bank and the UK public administration and will cover the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies and Official Receiver. The results of the first batch will be presented **by Q1-2014.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with programme partners, submit it to the House of Representatives for approval and implement it **by Q2-2014**.
- the second batch will cover all remaining Ministries (Labour and Social Insurance, Communications and Works, Energy, Commerce, Industry and Tourism, Interior, Defense, Justice and Public Order, Foreign Affairs), and the Ministry of Finance, including the Treasury and the Planning Bureau being covered under the PFM. It will also include all SOEs (subject to the decisions taken under the provision of 3.5 regarding privatisation, restructuring or liquidation). Finally, it will cover the President's Office and the Council of Ministers, as well as the Constitutional and Independent Services (see Annex 3 for a detailed list). The results of the second batch will be presented **by Q4-2015.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with the programme partners, submit it to the House of Representatives for approval and implement it **by Q1-2016.**

Welfare system

3.11. The existing welfare system in Cyprus encompasses a broad range of individual benefits provided by different Ministries and Departments. To ensure efficient use of public funds within the welfare system, while at the same time ensuring an appropriate balance between welfare benefits and incentives to take up work (as further specified in section 4.3 below), and enhancing the protection of vulnerable households, the Cypriot authorities will implement the reform plan of the welfare system, **as of 1 July 2014**.

The Cypriot authorities will ensure that the reform will be achieved through:

- consolidating the existing social benefits by streamlining, and, inter alia by merging some benefits and phasing out others, and integrating them under the Ministry of Labour and Social Insurance.
- improving the targeting of benefits; and
- providing work incentives to avoid welfare dependency.

To this end, the Cypriot authorities will take the following steps:

- on the basis of the level of the minimum consumption basket covering basic needs in order to achieve a decent standard of living, define the level, the composition and the eligibility criteria of the new guaranteed minimum income scheme (GMI) which will replace the existing public assistance scheme and estimate its overall costing **(Q4-2013)**;
- refine the means testing mechanism by introducing a common definition of income sources, financial assets and movable and immovable property, so as to ensure the consistency of eligibility criteria across different benefit schemes **(Q4-2013)**;
- adopt the final design of the reformed welfare system by the Council of Ministers **by Q1-2014** after consultation with social partners, followed by consulation and review by programme partners. The adopted reform would define all benefits, their respective level, and eligibility criteria, as well as the overall costing of the system;
- ensure that a comprehensive database and the necessary IT requirements are in place to support the administration of the reformed welfare system **(by May 2014)**; and
- transfer all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour and Social Insurance, which should be appropriately equipped in terms of financial and human resources, the latter being reassigned from other departments of the public administration **by April-2014**, except the benefits to be provided by the Ministry of Education and Culture (education benefits) and the Ministry of Interior (benefits to displaced people), (see 3.10).

The reformed welfare system must be consistent with the fiscal targets defined in this MoU. Draft legislation will be submitted for review to the programme partners before submission to the House of Representatives. The law will be adopted **by end-May 2014**.

4. Labour market

Key objectives

While the Cypriot labour market was characterised by high employment rates and low unemployment in the years leading up to the crisis, the unwinding of unsustainable imbalances and worsening of macroeconomic conditions and prospects have resulted in rapidly rising unemployment and important labour market challenges over the medium-term. Labour market reforms can mitigate the impact of the crisis on employment, limit the occurrence of long-term and youth unemployment, facilitate occupational mobility and contribute to improving the future resilience of the Cypriot economy in the face of adverse economic shocks. In this context, the objectives are: (1) to implement a reform of the system of wage indexation commensurate with ensuring a sustainable improvement in the competitiveness of the economy and allowing wage formation to better reflect productivity developments; (2) to prepare and implement a comprehensive reform of public assistance in order to achieve an appropriate balance between public assistance and incentives to take up work, target income support to the most vulnerable, strengthen activation policies and contain the public finance impact of rising unemployment; and (3) to help attenuate adverse competitiveness and employment effects by linking any change in the minimum wage to economic conditions.

Cost of living adjustment (COLA) of wages and salaries

4.1. To ensure that wage growth better reflects developments in labour productivity and competitiveness, in both expansions and recessions, the Cypriot authorities are reforming the wage-setting framework for the public and private sector in such a way as to improve real wage adjustment. To this end, the effective application of the reform of the wage indexation system (COLA) applicable to the broader public sector, as determined in the budget of 2013 and embedded in the Medium-Term Budget, must be ensured. This reform acts on relevant elements of the indexation system, as follows:

- a lower frequency of adjustment, with the base period for calculating the indexation (COLA) being lengthened from the current period of six months to twelve months. Indexation would take place on 1st January each year;
- a mechanism for automatic suspension of application and derogation procedures during adverse economic conditions, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation would be effected for the following year; and
- a move from full to partial indexation, with the rate of wage indexation being set at 50% of the rate of increase of the underlying price index over the previous year.

As foreseen in section I.2 (Annex 1) of this agreement, the suspension of wage indexation in the wider public sector will remain in place until the end of the programme.

A tripartite agreement will be pursued with social partners for the application of the reformed system in the private sector **by end-2013**. Furthermore, based on the current economic outlook, wage and salary indexation is foreseen not to be applied in the private sector until 2014.

Minimum wage

4.2. With a view to preventing possible adverse competitiveness and employment effects, the Cypriot authorities commit that, over the programme period, any change in the minimum wage covering specific professions and categories of workers should be in line with economic and labour market developments and will take place only after consultation with the programme partners.

Activating the unemployed and combating youth unemployment

4.3. The increase in unemployment underlines the need for an overall assessment of activation policies and available instruments for income support after the expiration of unemployment insurance benefits. The planned reform of public assistance should ensure that social assistance serves as a safety net to ensure a minimum income for those unable to support a basic standard of living, while safeguarding incentives to take up work, ensuring consistency with the reform of the welfare system as described in section 3.11.

4.4. In their assessment of current activation policies, the Cypriot authorities have identified a series of challenges pertaining to the system. These include: the difficulties faced by the Public Employment Services in serving an increased number of unemployed people; the lack of a coherent and homogeneous framework for the continuous monitoring and evaluation of the different schemes, which impedes the proper evaluation of the activation system as a whole; the need for increased coordination across different ministries and departments of the administration and the need to reduce fragmentation; and the absence of a data warehouse, which impedes an automatic and immediate processing and exchange of information.

Therefore, the Cypriot authorities will prepare detailed policy proposals to address the identified shortcomings and weaknesses, to be submitted to the programme partners **by end-2013** for review and consultation. These will include:

- the development of a coherent methodology for the continuous monitoring and evaluation of activation programmes, to be applied consistently across the different schemes, thereby enabling the assessment of their performance and effectiveness;
- the development of the appropriate IT infrastructure so as to automatize better and more comprehensive collection (see 3.11), processing and exchange of data across the various schemes as well as with the administration of social welfare services;
- ensuring an effective integration of the different schemes by centralising the administration of all activation programmes and by enhancing the coordination across the different departments responsible for the various programmes;
- enhancing staff mobility to support the administrative capacity of the public employment services so as to enable them to better respond to the increased demand for their services; and

- reviewing and enhancing the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed.

4.5. With one of the steepest increases in the youth unemployment rate in the EU and with the rapid rise of young people not in employment, education or training (NEETs), Cyprus needs to take swift action to create opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will present **by Q4-2013** a draft action plan for the implementation of measures envisaged for support under the Youth Employment Initiative, in line with the conclusions of the European Council of June 2013. The design, management and implementation of these measures targeted to youth shall be well integrated within the broader system of activation policies (section 4.3) and be coherent with the reform of the social welfare system (section 3.11) and the agreed budgetary targets.

5. Goods and services markets

Key objectives

Addressing issues of a structural nature is critical for rebalancing the Cypriot economy, restoring its growth potential and improving competitiveness. Removing unjustified obstacles in services markets can have a significant impact on growth, in particular for the services-intensive Cypriot economy. In addition, improving the quality and reducing the cost of regulated professional services can play an important role for the business environment and for Cyprus' competitive position. Since tourism is one of Cyprus' largest sectors and an important potential driver of future growth, a reinvigoration of the competitiveness of this sector is warranted. Improving the regulation of administration related to the real estate sector will contribute to the overall functioning of the housing market and help to foster foreign demand at a time when the prospects of this sector are affected by downside risks. Finally, the exploitation of the domestic offshore natural gas potential offers the medium- to long term prospect for reducing Cyprus' energy import dependency and the security and sustainability of energy supply. This would help to address Cyprus' sustained current account deficit and high public debt. However, these positive effects will accrue only after overcoming the challenges of financing and planning the infrastructure investments, designing efficient energy markets and an adequate regulatory regime.

Services directive: Sector-specific legislation

5.1. In accordance with EU law in general and Services Directive in particular, the Cypriot authorities will adopt the necessary amendments to the following sector-specific legislation: Construction services, Travel Agencies, Tourism services on beaches, Car rental services, **prior to the granting of the third disbursement of financial assistance.** The Cypriot authorities stand ready to adopt any further necessary amendments towards the full implementation of the Services Directive. Rules that refer to the calculation of fees for professional services (including those adopted by professional bodies) need to be assessed before adoption for compliance with internal market and competition principles, except as otherwise agreed with programme partners. To this end, the opinion of the Cypriot Commission for the Protection of the Competition (CPC) and of programme partners is required.

Reform of regulated professions

5.2. The Cypriot authorities will:

- complete the comprehensive review of the requirements affecting access and exercise of all regulated professions **by Q4-2013**. Following completion of the review, the requirements that are not justified or proportional will be eliminated **by Q1-2014**; and
- eliminate any existing total bans on the use of a form of commercial communication (advertising) in the veterinarians profession, as required by the Services Directive **by November 2013.**

Competition and sectoral regulatory authorities

5.3. The Cypriot authorities will strengthen the independence and the effectiveness of the Commission for the Protection of Competition (CPC) by:

- guaranteeing sufficient and stable financial means and qualified personnel to ensure its effective and sustained operation **by Q4-2013**;
- enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers and antitrust, including the power to conduct sector enquiries **by Q4-2013**; and
- promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition **by Q4-2013**;

The Cypriot authorities will increase competition by ensuring that powers and independence of the National Regulatory Authorities (NRAs) remain effective, by enabling them to have the necessary resources in line with their duties and in accordance with the EU Regulatory Framework. Any necessary legislative amendments will be adopted **by Q4-2013**.

Housing market and immovable property regulation

5.4. Action is required to ensure property market clearing, efficient seizure of collateral, and restoring demand. A particular risk arises from legal disputes, which may be due to incomplete documentation of ownership and property rights and the slow pace of judicial procedures.

The Cypriot authorities will:

- implement guaranteed timeframes for the issuance of building certificates and title deeds **by Q1-2014**; ensure that the title deed issuance backlog drops to less than 2,000 cases of immovable property units with title deed issuance pending for more than one year **by Q4-2014** (backlog refers to (i) applications, (ii) units that are eligible for the "ex officio" issuance of title deeds, required certificates and permits); take action to accelerate the swift clearing of encumbrances on title deeds to be transferred to purchasers of immovable property **by Q4-2014**;
- every three months, publish quarterly progress reviews, including executive commentaries on developments related to the issuance of building and planning permits, certificates, title deeds, title deed transfers and related mortgage operations, starting end-July 2013;

- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the monetary financial institutions and for all government services **by Q4-2014**. Any requirements on the proof of legal interest for access to these data by these bodies shall be abolished **prior to the granting of the third disbursement of financial assistance**;
- amend the procedure on the forced sale of mortgaged property (see 1.5) to allow for private auctions by amending the relevant legislation and rules in relation to the forced sales of mortgaged property either by adopting similar principles of the rules for immovable property recovery in bankruptcy regulations or by enacting new legislation **by Q4-2013**; and
- improve the pace of court case handling, in order to eliminate court backlogs **by Q1-2016** and provide for specialized judges **by Q4-2013,** with instructions for the expeditious processing of cases under commercial and immovable property laws.

Tourism

5.5. Since tourism is one of Cyprus' largest economic sectors and a potential driver of future growth and employment, a reinvigoration of its competitiveness is necessary. To that end, the Cypriot authorities will:

- present a progress report on the implementation of the action plan twice per year (every March and September until the end of the programme), starting **in Q4-2013,** including an assessment of its implementation based on performance indicators.
- amend the current hotel and other relevant legislation (eg. the immovable property law and town planning policies), in order to facilitate mixed-use developments, **by Q4-2013**;
- provide a report on the analysis and assessment of concrete needs based on the existing and the future air services agreements **by Q4-2013**. This report will provide the basis for an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, taking into account the EU external aviation policy and the EU aviation agreements, while ensuring sufficient air connectivity. This strategy accompanied with a concrete action plan will be launched **by Q1-2014**. The implementation of the action plan will be reviewed annually by the Cypriot authorities, starting **in Q1-2015**.

Energy

5.6. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package is fully and correctly implemented particularly during and after the transformation of the sector; and provide clarity on the intended use of the available 'isolated market' and 'emergent market' derogations and indicate their intended duration of the latter derogations;
- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy, constitutes a living document to be developed under the full authority of the Cypriot Government. It should include at least the following three key elements, which should be presented to the programme partners for consultation according to the timeline specified below:

1. a *roll-out plan* for the infrastructure required for the exploitation of natural gas, taking into account possible technical and commercial uncertainties and risks. The plan should cover: the required investments, associated costs, financing sources and methods, related ownership structure; related major planning risks and bottlenecks; and a projection of the revenue streams over time; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues; updated version **by Q4-2013.**

   Prior to finalisation of the forthcoming energy sector Government Agreement (GA) and its supplementary agreenments between the Republic of Cyprus and the Contracting Parties to a Production Sharing Contract, the Cypriot authorities will undertake a financial and budgetary impact analysis of the GA and its supplementary agreements. The impact assessment will evaluate in detail the potential financial and budgetary impact on the general government position of the various options for a LNG project development plan and financing arrangements, with a particular focus on budgetary commitments that may arise before or at the time of taking the final investment decision. The GA and its supplementary agreements shall be consistent with the fiscal targets until 2016 and thereafter, as defined in this MoU.

2. *a comprehensive outline of the regulatory regime (CERA) and market organisation* for the restructured energy sector and gas exports, with a view to introducing open, transparent, competitive energy markets, and taking explicitly into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, and the EU targets for energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include the following elements: a description of the envisaged institutional framework (the various government and private actors with their respective functions); the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the sequence and envisaged timing of the major actions and changes; the potential for setting-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; and full unbundling of gas suppliers and customers, in particular electricity companies; by **Q4 2013,** with a view to a final outline **by Q2 2014**; and

3. a plan to establish the institutional framework for the management of hydrocarbon resources, including a *resource fund*, which should receive and manage various types of public revenues from offshore gas exploitation and sales (direct revenues, fees, dividends etc). The preparatory phase should include the required legal steps and their adoption. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices. As a first step, clear rules governing inflows and outflows should be established as part of Cyprus' budgetary framework, coupled with clear accounting rules regarding dividend and fees from government entities and stakes in the energy sector. These will be anchored in the FRBSL (see 3.3) which will be adopted **by Q4-2013**.

Since these three key elements are strongly interdependent, they need to be developed in parallel over time. In addition, the strategy should take into account the current uncertainty over the actual size of domestic, offshore, commercially-viable, natural gas fields and possible changes in international gas prices and demand. As regards the later, appropriate data should be firmly based on *alternative world energy scenarios* from an internationally-reputed organisation. The plan will be based on an appropriate level of technical assistance on technical aspects in this context.

6. Technical assistance

6.1. Given the nature of the structural challenges Cyprus is facing, including a lack of specific skills in some areas and scarcity of resources, the Cypriot authorities will provide an updated request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-2013**. This request will identify and specify the areas of technical assistance or advisory services, which the Cypriot authorities consider essential for the implementation of the MoU and where they intend to seek such technical assistance services, in coordination with the programme partners. All technical assistance provided by the European Commission, other than technical assistance provided directly under the Structural and other EU funds, will be coordinated by the Support Group for Cyprus.

Annex 1

Budgetary measures adopted by Cyprus in or after December 2012

Fiscal measures with effect in 2012

Expenditure measures

I.1 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-1000: 0%; EUR 1001-1500: 6.5%; EUR 1501-2000: 8.5%; EUR 2001-3000: 9.5%; EUR 3001-4000: 11.5%; above EUR 4001: 12.5%.

I.2 Extend the suspension of the practice of COLA for the public and broader public sector until the end of the programme (Q1-2016) (see 4.1).

I.3 Extend the freeze of increments and general wage increases in the public and broader public sector and temporary contribution in the public, broader public and private sectors on gross earnings and pensions by three additional years until 31 December 2016.

I.4 Reduce the number of public sector employees by at least four thousand five hundred over the period of 2012-16 by: i) freezing the hiring of new personnel on first entry posts in the broader public sector for three additional years until 31 December 2016; ii) implementing a policy of recruiting one person for every four retirees (horizontal); iii) introducing measures to increase the mobility of civil servants within and across line ministries (see 3.10); and iv) implementing a four-year plan aimed at the abolition of at least 1880 permanent posts (see I.16).

I.5 Freeze the hiring of new hourly paid employees and enforce immediate application of mobility within and across ministries and other government entities. In the case of health and security posts, recruitment of one person for every five retirees will be possible to meet urgent needs.

Revenue measures

I.6 Appropriate a one-off additional dividend income collected from semi-governmental organisations.

I.7 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.095% to 0.11% with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.

I.8 Introduce a mechanism for a regular review of excise taxes to secure the real value of excise tax revenue. Such a mechanism should be non-recurring and should, by no means lead to an automatic indexation mechanism of excise taxes to price developments.

Fiscal measures with effect in 2013

Expenditure measures

I.9 Ensure a reduction in total outlays for social transfers by at least EUR 113 million through: (a) the abolition of a number of redundant and overlapping schemes such as the mothers allowance, other family allowances and educational allowances; and (b) the abolition of supplementary allowances under public assistance, the abolition of the special grant and the streamlining of the Easter allowance for pensioners.

I.10 Ensure a reduction of at least EUR 29 million in the total outlays of allowances for employees in the public and broader public sector by:

i. taxing pensionable allowances provided to senior government officials and employees (secretarial services, representation, and hospitality allowances) in the public and broader public sector;

ii. reducing the allowances provided to broader public sector employees and reducing all other allowances of broader public sector employees, government officials and hourly paid employees by 15%; and

iii. reducing the daily overseas subsistence allowance for business trips by 15%. Ensure a further reduction the subsistence allowance of the current allowance when lunch/dinner is offered by 50% (20% - 45% of overseas subsistence allowance instead of 40% - 90% currently paid).

I.11 Reduce certain benefits and privileges for state officials and senior government officials, in particular by:

i. suspending the right to travel first/business class by state officials, senior government officials and employees with the exception of transatlantic travel. The right to business class travel shall be maintained for the President of the Republic of Cyprus and the President of the House of Representatives;

ii. abolishing the right to duty free vehicles for employed and retired senior public sector officials; and

iii. extending the wage freeze and temporary contribution on gross earnings to cover all state officials and permanent secretaries (129 individuals) for 2013-2016, including members of the House of Representatives. Include pensionable and tax-free allowances of these individuals in the calculation of their taxable income. Introduce a contribution of 6.8% on the pensionable earnings of these individuals.

I.12 Implement the following measures regarding the Government Pension Scheme (GEPS):

i. freeze public sector pensions;

ii. increase the statutory retirement age by 2 years for the various categories of employees; increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral;

iii. reduce preferential treatment of specific groups of employees, like members of the army and police force, in the occupational pension plans, in particular concerning the contribution to the lump-sum benefits;

iv. introduce a permanent contribution of 3% on pensionable earnings to Widows and Orphans Fund by state officials who are entitled to a pension and gratuity. Introduce a contribution of 6.8% on pensionable earnings by officials, who are entitled to a pension and gratuity but are not covered by the government's pension scheme or any other similar plan;

v. amend Article 37 of the Pensions Law to abolish the provision according to which, in the case of death of an employee, if the deceased had a wife/husband at the time of his/her retirement and thereafter he/she remarried, his/her last wife/husband is considered a widow/widower. With the abolition of this provision, the second wife/husband will not be considered a widow/widower and thus she/he will not be entitled to pension;

vi. increase the contribution rate on the pensionable earnings of the members of the Tax Tribunal Council and the Tender Review Authority from 3.4% to 6.8%; and

vii. the contributions to the Widows and Orphans Fund will no longer be reimbursable.

viii. introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018;ix. introduce a change of indexation of all benefits from wages to prices; and

x. pension benefits will be calculated on a pro-rata basis taking into account life-time service as of January 2013 (in place since January 2013).

I.13 Implement further reform steps under the General Social Insurance Scheme by:

i. actuarially reducing pension entitlements from the General Social Insurance Scheme by 0.5% per month for retirements earlier than the statutory retirement age at the latest from January 2013, in line with the planned increase in the minimum age for entitlement to an unreduced pension to reach 65 (by 6 months per year), between 2013 and 2016;

ii. freezing pensions under the Social Security Fund for the period 2013-2016;

iii. abolishing the increase of pensions for a working dependent spouse under the General Social Insurance Scheme at the latest from January 2013 onwards.

iv. increase the minimum age for entitlement to an unreduced pension by 6 months per year to be brought in line with the statutory retirement age;

v. introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral;

vi. introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018;

vii gradually (1 year per year) extend the minimum contributory period in the system from the current 10 years to at least 15 years over the period 2013-17 (in place since December 2012); and

viii. ensure that pension entitlements that will accrue after 1 January 2013 are considered as personal income, thus becoming fully taxable also in the case in which they are received as a lump-sum payment. At the same time, employees will be granted the option of converting all or part of the lump-sum into an actuarially neutral annuity (in place since January 2013).

I.14 Reduce transfers by EUR 25 million from central government to state-owned enterprises and semi-public institutions.

I.15 Ensure a targeted reduction of budgetary appropriations for a series of semi-governmental organisations in the 2013 Budget Law, supported by well-defined activity-reducing measures.

I.16 Implement a four-year plan as prepared by the Public Administration and Personnel Department aimed at the abolition of at least 1880 permanent posts over the period 2013-2016.

The additional permanent expenditure measures for 2013, which were adopted by Cyprus **prior to the granting** of the first disbursement of financial assistance:

I.17 Introduce the following measures to control healthcare expenditure:.

a. abolish the category of beneficiaries class "B" and all exemptions for access to free public health care based on all non-income related categories except for persons suffering from certain chronic diseases depending on illness severity. Introduce as a first step towards a system of universal coverage a compulsory health care contribution for public servants and public servant pensioners of 1.5% of gross salaries and pensions. The measure will be reviewed **by Q2-2014** with the programme partners. For families with three or more dependent children, the participation in this health care scheme will be voluntary;

b. increase fees for medical services for non-beneficiaries by 30% to reflect the associated costs of medical services and create a co-payment formula with zero or low admission fees for visiting general practitioners, and increase fees for using higher levels of care for all patients irrespective of age;

c. introduce effective financial disincentives for using emergency care services in non-urgent situations;

d. introduce financial disincentives (co-payment) to minimise the provision of medically unnecessary laboratory test and pharmaceuticals; and

e. adopt a new decision by the Council of Ministers concerning a restructuring plan for public hospitals, improving quality and optimising costs and redesigning the organisational structure of the hospital management, by putting into practice recommendations from the 2009 "Public Hospital Roadmap".

I.18 Reduce the expenditure on various housing schemes by at least EUR 36 million by consolidating and streamlining the schemes for the displaced and the Comprehensive Housing Scheme, discontinuing the special grant for acquiring a first residence and ceasing the provision of loans and loan guarantees related to house construction and acquisition under all government-administered housing schemes.

I.19 Further streamline the Easter allowance to pensioners by limiting the benefit to pensioners with a monthly per household income of at most EUR 500.

I.20 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-2.000: 0.8%; EUR 2.001-3.000: 1%; EUR 3.001-4.000: 1.5%; above EUR 4001: 2.0 %.

Revenue measures

I.21 Increase excise duties on tobacco products, in particular on fine-cut smoking tobacco, from EUR 60/kg to EUR 150/kg. Increase excise duties on cigarettes by EUR 0.20/per packet of 20 cigarettes.

I.22 Increase excise duties on beer by 25% from EUR 4.78 per hl to EUR 6.00 per hl per degree of pure alcohol of final product. Increase excise duties on ethyl alcohol from EUR 598.01 to EUR 956.82 per hl of pure alcohol.

I.23 Increase excise duties on energy, i.e., on oil products, by increasing tax rate on motor fuels (petrol and gasoil) by EUR 0.07.

I.24 Increase the standard VAT rate from 17% to 18%.

I.25 Introduce a tax of 20% on gains distributed to winners of betting by the Greek Organisation of Football Prognostics S.A. (OPAP) and the National Lottery for winnings of EUR 5,000 or more.

I.26 Abolish all exceptions currently in place for paying the annual company levy of EUR 350.

The additional permanent revenue measures for 2013, which were adopted by Cyprus **prior to the granting** of the first disbursement of financial assistance:

I.27 Ensure additional revenues from property taxation of at least EUR 75 million by: (i) updating the 1980 prices through application of the CPI index for the period 1980 to 2012; and/or (ii) amending tax rates and/or (iii) amending value bands.

I.28 Increase the statutory corporate income tax rate to 12.5%.

I.29 Increase the tax rate on interest income to 30%.

I.30 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.11% to 0.15% with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.

I.31 Complete the increase in fees for public services by at least 17% of the current values

Fiscal measures with effect in 2014

Expenditure measures

I.32 Ensure a reduction in total outlays for social transfers by a at least EUR 28.5 million to be achieved through streamlining and better targeting of child benefits and educational grants, and abolition of social cohesion benefits provided by the welfare services.

I.33 Implement a further reduction in emoluments of public and broader public sector employees and pensioners by a flat rate reduction of 3% on all wages.

I.34 Introduce a fee on monthly transportation cards for the use of public transportation services by students and pensioners.

I.35 Introduce as of the budget year 2014 structural reform measures in the educational system, notably, a reduction of the number of teachers seconded to the Ministry of Education and Culture, the removal of 1:1.5 teaching time ratio from evening schools of general and technical and vocational education, the elimination of teaching time concession to teachers for being placed in two or more educational districts, the elimination of mentoring components for pre-service and in-service training for newly appointed teachers and the reduction of the cost of afternoon and evening programmes.

Revenue measures

I.36 Extend the application of the temporary contribution on gross earnings and pensions of public and private sector employees up to 31 December 2016 as follows: EUR 0 – 1,500: 0%; EUR 1,501 – 2,500: 2.5%; EUR 2,501 – 3,500: 3.0%; and > EUR 3,501 - : 3.5%.

I.37 Increase the standard VAT rate from 18% in 2013 to 19% in 2014.

I.38 Increase the reduced VAT rate from 8% to 9%.

I.39 Increase excise duties on energy, i.e., on oil products, by increasing the tax rate on motor fuels (petrol and gasoil) by EUR 0.05.

I.40 Increase the contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point on pensionable earnings, i.e. 0.5 of a percentage point from employees and 0.5 of a percentage point from employers and 1 percentage point in the case of self-employed persons.

I.41 A reform of the tax system for motor vehicles with effect from budget year 2014, based on environmentally-friendly principles, with a view to raising additional revenues in the medium-term, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.

Annex 2

The AML Action Plan by Cyprus on customer due diligence and entity transparency

	Heading/Deficiency	*Action*	*Timeline*
1	**Customer Due Diligence**		
1.1	**Business profile**		
	Business profiles not always properly established.	1.1.1 CBC to provide guidance to ensure that obliged entities engage in adequate training of all staff involved in establishing customer business relationships and opening accounts, so that business profiles are properly determined and assigned.	Q4 - 2013
1.2	**Customer risk profile**		
	Lack of understanding of cumulative risks in complex ownership structures / introduced business.	1.2.1 CBC to provide sufficient guidance to ensure that obliged entities have sound and effective risk management systems in place to identify and understand ML/TF risks within their customers, products and services, geographical locations/areas, and delivery channels. Risk management systems should include an overall policy for identifying and understanding, measuring, controlling, and monitoring ML/TF risks. The risk management policies, procedures and measures should be submitted to the board for approval on an annual basis, or as required by changes in the business model.	Q4 - 2013 Q1-2014
	New legislative measures.	1.2.2 CBC and other supervisory authorities to issue guidance to obliged entities in order to explain the new provisions on the introduction of tax crimes (including tax evasion) as predicate offences.	Q4 - 2013
	Particular issues relating to PEPs.	1.2.3 CBC to issue additional guidance to obliged entities to adequately identify and establish the source of wealth for PEPs or for customers that become PEPs after the business relationship has been accepted.	Q4 – 2013
1.3	**Ongoing CDD**		
	Higher risk customers/changes in risk not dealt with appropriately on an ongoing basis. Particular issues relating to PEPs.	1.3.1 CBC to issue additional guidance to ensure that financial institutions have sound and effective systems and measures in place to demonstrate enhanced ongoing monitoring for higher risk clients, including PEPs. 1.3.2. CBC to ensure that financial institutions have sound and effective systems and measures including updated CDD measures.	Q4-2013 Q2-2014

2	**<u>Reliance/introduced business</u>**		
	Use of introducers allowed by CY legislation and is widespread.	2.1 CBC to review, strengthen, and amend as needed the regulatory framework and the relevant requirements relating to the use of introducers/third parties to ensure compliance by obliged entities establishing business relationships and/or opening accounts through third parties.	Q4 – 2013
	Training/awareness in institutions.	2.2 CBC to reiterate and clarify the obligation under the CBC directive that obliged entities are required to establish adequate AML/CFT training programs for all staff responsible for establishing business relationships and/or opening customer accounts and updating customer information. CBC to ensure that training programs are implemented and include information on current ML and TF techniques, methods and trends, and clear explanations of all aspects of the AML/CFT laws, regulations. In particular, this should include requirements concerning CDD, suspicious transaction reporting and sanctions for non-compliance.	Ongoing
	Mechanisms for coordination with supervisors of introducers	2.3 CBC to establish co-operation mechanisms with CySEC, the Cyprus Bar Association and ICPAC (for accountants) for exchanging information and ensuring supervisory coordination.	Compliant
3	**<u>Suspicious Transaction Reporting</u>**		
	Changes in the legal framework.	3.1 MOKAS to reiterate and clarify through further training the requirements to report STRs, including the new duty to report issues relating to tax crimes as of December 2012, in coordination with relevant supervisory authorities.	Q1 - 2014
4	**<u>Transparency of beneficial ownership</u>**		
4.1	**Access to information**		
	Ensure that transparency and availability of beneficial ownership information is in line with international standards and best practice.	4.1.1 Revision of Trust and Company Services Providers Law as appropriate and AML Law to ensure that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to the domestic competent authorities and their foreign counterparts; and revise the directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, ICPAC).	Partially Compliant CBC Directive prior action Compliant

		4.1.2. In the case of nominees, either a) require nominee directors[4] and nominee shareholders to disclose the identity of their nominator to the company and to the company register; or b) require that all nominee directors and nominee shareholders be authorised or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs).	
4.2	**Company Registry**		
	Efficiency of Companies' Registrar as an important aid to CDD.	4.2.1 Carry out a third party review of the functioning of the Companies' Registrar and communicate results to the programme partners, and ensure the department of the registrar is appropriately resourced.	End 2013
4.3	**Register of Trusts**		
	Enhance the transparency of trusts in line with international standards and best practice.	4.3.1 CY to establish trust registries with the supervisory authorities for all express trusts established under CY law, where the name of the trust and the name and address of the trustee will be contained therein. The trust registers will be accessible by the supervisory authorities in order to facilitate them in their supervisory duties.	Compliant
5	**Supervision of financial institutions**		
5.1	**Revise the AML/CFT supervisory structure within the CBC, ensuring it is adequately resourced**	5.1.1 Revise and/or establish organisation structure and management within the CBC's Banking Supervision and Regulation Department (BSRD) to address AML/CFT matters,[5] in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Q4 – 2013

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[4] Under Cyprus law, there is no legal concept of "nominee director", but it is used with reference to professionals who provide director services.

[5] in accordance with BCP 2 and FATF 26-27

		5.1.2 CBC to ensure adequate human resources and technical capacity to undertake effective AML/CFT supervision. The level of resources should be commensurate with the size, complexity, and risk profiles of the financial institutions operating in the system.[6] To meet this objective, if deemed necessary by the CBC, hire AML/CFT experts with the necessary professional skills and experience (e.g. foreign supervisors retired or on leave) – subject to necessary confidentiality restrictions.[7]	– 31 January 2014
5.2	**Develop risk-based supervisory tool(s) for offsite surveillance/monitoring activities prior to implementation**	5.2.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas,[8] and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - institutional risk profiles; - specific AML/CFT supervisory strategies (adapted to institutional risk profiles).	Q4 - 2013
5.3	**Develop risk-based supervisory tool(s) for onsite inspections prior to implementation**	5.3.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: -Corporate Governance; -Risk Assessment Systems; -Policies & Procedures; -Compliance Function; -Internal & External Audit Functions; -Training Program.	Q1 – 2014
5.4	**Establish Formal AML/CFT Training Program**	5.4.1 Establish a formal AML/CFT training program for CBC staff to ensure adequate implementation of the offsite and onsite tools. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools; - customer acceptance policies;	Q2 – 2014

[6] FATF Immediate Outcome (IO) 3
[7] See BCP 2.6c
[8] The off-site supervisory tool will include monthly reporting by obliged entities on the breakdown by country of origin of the main depositors and the main beneficiaries of loans (and of their beneficial owners).

		- customer due diligence (CDD); - monitoring of transactions; - identification and reporting of STR; - funds transfers; - correspondent banking; - recordkeeping; - compliance function; - internal controls; - audit functions; - corporate governance; - risk assessment systems	
		5.4.2 Provide CBC supervisory staff with ongoing training to ensure adequate knowledge of risks and supervisory techniques.	Ongoing
5.5	**Implement adequate supervision**	5.5.1 CBC to establish corrective actions and follow-up on the cases revealed by Deloitte. Apply appropriate enforcement actions with regard to any breaches of compliance, and apply sanctions if applicable.	– Partially Compliant 31 January 2014
		5.5.2 On a quarterly basis, in the context of the programme review, starting Q4 2013 the CBC will on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Q4- 2013, ongoing
		Subsequent to the successful development of the tools stipulated under 5.2 and 5.3, the CBC will undertake the following: 5.5.3.1 Implement and adjust the new risk-based offsite analytical tool(s) using the results of the pilot reviews, and develop an onsite supervisory program for 2014. 5.5.3.2 Assign institutional ML/TF risk profiles to financial institutions reviewed under the pilot exercise. 5.5.3.3 Develop customised supervisory strategies for financial institutions reviewed under the pilot exercise. 5.5.3.4 Apply the risk-based off-site analytical tools, assign ML/TF risk profiles, and developed customised supervisory strategies to all financial institutions under its responsibility.	Q2 - 2014
		5.5.4.1 CBC to start implementing the new examination/verification procedures in line with the inspection program for 2014, and to adjust/fine-tune the procedures using the results of the pilot inspections. 5.5.4.2 CBC to update the institutional risk profile and supervisory strategy based on the results of the pilot inspection.	Q2 - 2014
6.	**Supervision and**		

	monitoring of lawyers, accountants and TCSPs		
6.1	**Align resources with risks** **Establish an effective monitoring structure for AML/CFT matters**	6.1.1 Ensure adequate human resources and technical capacity to undertake effective AML/CFT monitoring. The level of resources should be commensurate with the size, complexity, and risk profiles of each business and professional. To meet this objective, if deemed necessary by the supervisory authorities, hire AML/CFT experts with the necessary professional skills and experience (e.g. professionals having performed monitoring or supervision of these professions abroad) – subject to necessary confidentiality restrictions.	Q4 - 2013
6.2	**Develop risk-based tool(s) for Offsite surveillance/monitoring activities prior to implementation**	6.2.1 Design, develop, adopt, and pilot a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas, and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - risk profiles; - specific AML/CFT monitoring strategies (adapted to institutional risk profiles).	Q1-2014 (CBA and ICPAC) Q3-2014 (CySEC)
		6.2.2.1 Implement the new offsite analytical tool(s) through pilot reviews of a selected group of business and professionals. Adjust/fine-tune the offsite analytical tool(s) using the results of the pilot reviews. 6.2.2.2 Assign ML/TF risk profiles to businesses and professionals reviewed under the pilot exercise. 6.2.2.3 Apply the risk-based off-site analytical tools, assign ML/TF risk profiles, and developed customized supervisory strategies to all business and professions under monitoring.	Q2-2014 (CBA and ICPAC) Q3-2014 (CySEC)
6.3	**Develop risk-based tool(s) for Onsite inspections prior to implementation**	6.3.1 Design and develop a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: - Risk Assessment Systems - Policies & Procedures - Compliance Function - Training Program	Q2 – 2014 (CBA and ICPAC) Q3-2014 (CySEC)
6.4	**Establish Formal AML/CFT Training Program**	6.4.1 Establish formal AML/CFT training program and develop and deliver customised AML/CFT training courses. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools - customer acceptance policies - customer due diligence (CDD) - monitoring of transactions - identification and reporting of STR	Q2– 2014 (CBA and ICPAC) Q4-2014 (CySEC)

		- recordkeeping - compliance function - risk assessment systems etc.	
6.5	**Implement adequate supervision**	6.5.1. On a quarterly basis, in the context of the programme review, starting Q4-2013, the CySEC, CBA and ICPAC will, on a confidential basis, share anonymised information with the programme partners by granting access, to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Q4 – 2013, ongoing
		Subsequent to the successful development of the tools stipulated under 6.2 and 6.3, the Supervisory authorities will undertake the following: 6.5.2 Implement the new offsite analytical tool(s) through pilot reviews of a selected group of lawyers, accountants and TCSPs. Adjust/fine-tune the offsite analytical tool(s) using the results of the pilot reviews, and come-up with a supervisory program for 2014	Q3 – 2014 (CBA and ICPAC) Q4-2014 (CySEC)
		6.5.3 Implement the new examination/verification procedures through pilot onsite inspections of a selected group of lawyers, accountants and TCSPs. Adjust/fine-tune the procedures using the results of the pilot inspections.	Q3 – 2014 (CBA and ICPAC) Q4-2014 (CySEC)

Annex 3

The Public Administration Review: Second Batch of Studies

The second batch of studies to be carried out in accordance to paragraph 3.10 will cover the following areas:

Ministries and the Departments/Services falling under each Ministry

i. Ministry of Labour and Social Insurance
ii. Ministry of Communications and Works
iii. Ministry of Energy, Commerce, Industry and Tourism (excluding the Companies Registrar and Official Receiver, to be covered in the first batch of studies)
iv. Ministry of Interior
v. Ministry of Defense (excluding the National Guard and Cyprus Army)
vi. Ministry of Justice and Public Order
vii. Ministry of Foreign Affairs

Note: Ministry of Finance, including Treasury and Planning Bureau, will be reviewed under the PFM.

Constitutional Powers /Services

i. President's Office and Council of Ministers
ii. Law Office
iii. Audit Office
iv. Public Service Commission

Independent Services/Authorities

i. Educational Service Commission
ii. Internal Audit Service
iii. Office of the Commissioner for Administration (Ombudsman)
iv. Office for the Commissioner of Personal Character Data Protection
v. Tender Review Body
vi. Refugee's Review Body

Independent Services/Authorities to be excluded from the external review and justified in the Notes below

i. Office for the Commissioner of State Aid Control [12]
ii. Authority for the Supervision of Cooperative Societies [13]
iii. Competition Protection Commission[14]

[12] It functions according to *acquis communautaire* prescriptions and itemploys only a limited number of people (4 persons).
[13] The relevant organisation is dealt within the context of the financial sector part of the MoU.
[14] CPC is currently under review by PAPD and should be finalised by Q4 2013, as part of MoU paragraph 5.3. Once the review is finalised, programme partners will assess whether an independent review for the CPC will be needed.

Cyprus—Letter of Intent

Nicosia, December 4, 2013

Ms. Christine Lagarde:

Managing Director

International Monetary Fund

Washington DC

Dear Ms. Lagarde:

In the attached update of the Memoranda of Economic and Financial Policies (MEFP) of April 29 and August 29, 2013, we describe progress and policy steps towards meeting the objectives of the economic program of the Cypriot government, which is being supported by an arrangement under the Extended Fund Facility (EFF).

Our policy implementation under the program has remained on track:

- Fiscal performance through end-September continued to exceed expectations, while the decline in output has been somewhat less than anticipated. As a result, we have met all program performance criteria (PCs) with comfortable margins, due to revenue over-performance relative to projections and prudent budget execution.

- We are making substantial progress toward stabilizing our financial system. In particular:

    - Bank of Cyprus (BoC) has a new Board of Directors and Chief Executive Officer, and the Central Bank of Cyprus (CBC) has favorably assessed the bank's restructuring plan, in compliance with the program's structural benchmark.

    - The recapitalization of Hellenic Bank with private funds, including foreign investment, was completed ahead of schedule, thus satisfying two structural benchmarks for this and the next review.

    - A new Board of Directors has been elected at the Cooperative Central Bank (CCB) and, on the basis of a draft restructuring plan, we have started the consolidation of the sector by merging 38 cooperative credit institutions (CCIs) into 9 entities.

    - During August-October, we took additional steps to gradually ease payment restrictions in line with our published milestone-based roadmap, meeting the continuous performance criteria on non-intensification of restrictions of payments and transfers for current international transactions or to introduce multiple currency practices.

    - Finally, we have also met the end-September structural benchmark on revision of the anti-money laundering legal framework already in August and have met the requirements of the structural benchmark on the establishment of a central credit register on November 28.

We remain committed to preserve the sustainability of our public finances. To this end, for 2014 we target a somewhat more ambitious fiscal consolidation than assumed in our original program, on the basis of additional streamlining of public spending. The additional effort brings forward part of the adjustment envisaged for the coming years. As a prior action for this review, we will amend the 2014 budget in line with the program's revised targets. Fiscal policy will be complemented by reforms of revenue administration, public financial management, and the welfare system, the latter aiming to better protect vulnerable groups during the downturn.

We will continue to implement financial sector policies aiming to restore confidence in the banking sector. In particular, BoC and the cooperative credit sector will be restructured, while we will continue to strengthen the supervisory, regulatory, and private debt restructuring frameworks to address rising non-performing loans. Also as prior actions for completion of the second review: (i) the CBC will approve BoC's proposed set of quarterly targets for the next 12 months for key financial and operational indicators in critical areas and the terms of a quarterly report on progress relative to above-mentioned targets; and (ii) we will finalize an agreement between the Ministry of Finance and the CCB on the terms of the relationship framework defining the responsibilities and governance boundaries between bank owners and the bank.

Financing of our program remains adequate. The €2.5 billion Russian loan originally set to mature in 2016 was restructured in September at more favorable terms, relieving medium-term government financing needs. We are making efforts to secure additional financing and to reduce our public debt, including through privatization, the allocation of central bank profits, and a debt-to-asset swap.

Based on the above, we request the following:

- Completion of the second review under the EFF and the third purchase under this arrangement in the amount of SDR 74.25 million.

- Modification of the end-December PCs on: (i) the general government primary balance, (ii) the general government primary expenditure; (iii) the stock of general government debt; and (iv) the ceiling on the accumulation of general government guarantees, to reflect the stronger performance through end-September (Table 1).

- Establishment of new quantitative performance criteria for end-March 2014 (Table 1).

- Establishment of new structural benchmarks on the following (Table 3): (i) completion of an independent fair value assessment of the CCB's and CCI’s assets aimed at quantifying the size of the government’s stake in the sector and submission of the final restructuring plan of the CCI sector to the European Commission, by end-January 2014; (ii); transfer of voting rights of legacy Laiki’s shares in BoC to an independent institution, by end-January 2014; (iii) establishment of an effective and adequately resourced AML/CFT supervisory unit by end-February 2014; (iv) completion by the CBC of an in-situ assessment of the degree of operational preparedness of the banks’ loan workout units to implement their arrears management plans, by end-March 2014;and (v) approval by the Council of Ministers of the final design of the reformed social welfare system in line with the 2014 and medium term budget ceilings, by end-March 2014.

We are fully committed to the policies set forth in the attached MEFP, which we believe are adequate to achieve the objectives under the program. We stand ready to take any measures that may become appropriate for this purpose as circumstances change. We will consult with the Fund on the adoption of any such actions in advance of revisions to the policies contained in this letter and the MEFP, in accordance with the Fund’s policies on such consultations.

Sincerely,

/s/ /s/

Minister of Finance Governor of the Central Bank of Cyprus

Cyprus—Memorandum of Economic and Financial Policies

A. Strategy, Recent Developments, and Outlook

1. The economic situation remains difficult, but the outturn so far has been better than anticipated. Economic activity has fallen significantly in the first half of the year, given the severe shock to our banking sector. Our businesses and consumers are seeing their disposable income declining, and unemployment is rising toward unprecedentedly high levels. Nevertheless, the recession has been somewhat less pronounced than expected, and recent indicators point to gradually improving confidence. Indeed, retail sales, tourism arrivals, and professional services have proven to be relatively resilient. New foreign direct investment in our banking sector is also a positive sign. Still, the uncertainty surrounding the outlook remains high.

2. **We have revised our macroeconomic framework to reflect a shallower but more protracted recession this year and next and a somewhat slower recovery thereafter.** In light of the outturn to date, real economic growth is projected at -7.7 percent in 2013, relative to an initial estimate of -8.7 percent. Looking forward, a significant though more gradual deleveraging process expected to take place through the banking sector, which together with the fiscal adjustment already underway, will pose a drag on growth. As a result, we expect growth of about -4.8 percent in 2014, and 0.9 percent in 2015. Other macroeconomic variables underlying our program remain broadly unchanged. As in the past, medium-term growth projections do not incorporate the potential upside from the exploitation of natural gas resources.

3. **We remain committed to full and timely implementation of our adjustment program, so as to pave the way for the resumption of sustainable economic growth.** Our program's main objectives are to restore the health of the financial sector and put public finances on a sustainable path through fiscal consolidation and structural reforms. Building on important steps taken so far, the second review focuses on specific measures to restructure and repair the banking sector, which are key to set the conditions for an eventual resumption of credit and a gradual lifting of capital controls. In the fiscal area, the review concentrates on ensuring that the 2014 budget remains in line with the program targets, and on defining next steps in our structural reform agenda aimed at improving economic efficiency through privatization of state-owned enterprises, modernizing our revenue administration, and strengthening the social welfare safety net so as to provide adequate protection to those most vulnerable given the downturn.

B. Financial sector Policies

4. **Stabilizing the financial sector remains our key priority.** To this end, we have made important strides since end July, when Bank of Cyprus (BoC) was fully recapitalized and exited the resolution process. First, after ensuring their fitness and probity, the Central Bank of Cyprus (CBC) cleared the appointment of BoC's new Board of Directors and its Chief Executive Officer. Second, the CBC completed the assessment of BoC's restructuring plan. Third, the CBC also cleared the appointment of the Board of Directors of the Central Cooperative Bank (CCB), following a fit and proper test. Fourth, on the basis of the finalization of a draft restructuring plan for the sector, all credit cooperative institutions

(CCIs) have agreed to voluntary mergers, and nine such mergers of 38 CCIs have already been completed. Fifth, Hellenic Bank has been successfully recapitalized from private sources. Sixth, the CBC completed the review of banks' practices regarding loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning against best practices. Looking forward, we will build on these steps to ensure that our credit institutions can effectively support the economic recovery. In this regard, we commit to preserve the free functioning of markets in the determination of lending rates to ensure prudent allocation of credit.

Recapitalizing and restructuring financial institutions

5. **We will take steps to ensure that BoC will adequately implement its restructuring plan.** The CBC has finalized the assessment of the plan, which aims at cleaning up the bank's balance sheet, returning the bank to profitability, maintaining adequate capitalization, and ensuring stable funding over the medium term. The plan is broadly consistent with the program assumptions and includes a strategy to deal with troubled borrowers through the creation of specialized units inside the bank. To enhance confidence, the CBC will instruct BoC to publish selected features of the restructuring plan before end-2013. On the basis of the plan, as a **prior action** for the review, the CBC will approve: (i) BoC's proposed set of quarterly targets for the next 12 months for key financial and operational indicators; and (ii) the terms of a quarterly report on progress relative to above-mentioned targets. This report will be submitted to the CBC and its main conclusions made public starting with end-March 2014. A CBC team has been appointed to closely monitor BoC's compliance with the targets, assess any deviations, and define remedial actions if warranted. The team will prepare a quarterly report on its main activities to be discussed by the CBC Board, starting with end-2013.

6. **We will also strengthen the management of legacy Laiki's equity stake in BoC.** Legacy Laiki is the single largest shareholder in BoC, with a shareholding of 18 percent of total shares. It remains under resolution, pending the planned sale of its foreign subsidiaries. By end-January 2014, the Resolution Authority will present a detailed roadmap for the full disposal of legacy Laiki's assets, while maximizing value for creditors. Pending disposal of legacy Laiki's shares in BoC, to ensure their adequate management, the Resolution Authority will instruct the Special Administrator to entrust (by end-January 2014) the voting rights of these shares to a well-recognized and independent consulting or auditing firm(s) or international institution(s) **(structural benchmark)**.

7. **Following the full recapitalization of Hellenic Bank (HB) with private funds, we will ensure that it prepares a business plan in line with the new economic conditions.** On November 1, HB increased its share capital by the issuance of €100 million in shares to three private funds, including a foreign participant, which brought its capitalization level to 9.5 percent CT1. In addition, the bank secured the conversion of €255 million of junior bonds into CT1 eligible instruments, thus exceeding the capital requirements determined by the PIMCO due diligence exercise under the adverse scenario by about €60 million. To ensure that the bank can adapt to the new circumstances, the CBC will require HB to submit by end-March 2014 a business plan through end-2015, including capital, and funding plans.

8. **We are taking steps to complete the restructuring and recapitalization of the cooperative credit sector, while strengthening its governance structure.** The Ministry of Finance has set up a specialized unit to manage the state's future stake in the sector. Already, nine mergers of 38 CCIs have been completed, and a draft restructuring plan for the sector has been finalized. Looking forward:

- As a **prior action**, the Ministry of Finance will agree with the CCB on the terms of the relationship framework that will define, on the basis of international best practices, the responsibilities and governance boundaries between the state as majority owner and the board and senior management of the bank, to ensure that the bank operates on a commercial basis without undue political interference.
- As an initial step toward decisively restructuring the sector, the CBC has required the new board of CCB to publish, by end-November 2013, a roadmap agreed with the CBC specifying key interim actions for the next three months, including: (i) the appointment of the new CEO, (ii) measures to bolster the independence and qualification of the CCI Boards, (iii) actions to retain customers, (iv) measures to impede further asset deterioration, and (v) measures to prepare the transfer of NPLs to specialized units within the sector.
- By end-January 2014, we will: (i) complete an independent fair value assessment of the CCB and CCIs' assets aimed at quantifying the size of the government's stake in the sector; and (ii) submit the final restructuring plan to the European Commission, reflecting the views of the new Board and top management (**structural benchmark)**. The restructuring plan will contain quarterly financial and operational performance targets to be closely monitored by the new unit responsible for the supervision of the CCI sector at the CBC. Immediately following approval of the plan by the European Commission, we will inject €1.5 billion of state funds into the CCB. The CCB will recapitalize the CCIs as the 18 mergers are completed and their new Boards are appointed; the recapitalization process will be completed by end-March 2014 (existing **structural benchmark**). The 18 CCIs will be subject to independent external audits starting with 2013 accounts.

Private sector debt restructuring

9. **We are making efforts to revamp the corporate and household debt restructuring framework to facilitate loan workouts and a cleanup of banks' balance sheets.** We remain committed to support with adequate legislation the restructuring of troubled borrowers on the basis of international experience and best practices, so as to address the large private sector indebtedness and increasing non-performing loans. In this regard, we will strengthen our legal and institutional frameworks to facilitate voluntary workouts between banks and viable debtors in real need while minimizing incentives for non-cooperation and strategic loan defaults by borrowers. Our efforts are concentrated on four critical fronts:

- *Establishment of a framework to facilitate negotiations between borrowers and creditors.* The CBC has completed its first review of banks' compliance with the recently published Code of Conduct (CoC), which sets the framework for voluntary negotiations between banks and their borrowers. On this basis, the CBC provided recommendations for its full implementation by banks. By end-November, the CBC will publish supplementary information on the CoC to further enhance public awareness and facilitate its implementation. By end-May 2014 the CBC will complete a second round of inspections to verify banks' compliance with the CoC and impose sanctions as needed.

- *Adoption by banks of an effective arrears management strategy.* In late October 2013, the CBC completed its review and made recommendations for the banks' strategies to implement the new framework for arrears management providing for minimum standards and procedures to restructure problematic loans. By end-November 2013, the CBC will require banks to submit by end-January 2014 their revised strategies and a detailed implementation plan for arrears management approved by their boards (including pre-packaged programs, and general policies to deal with small and large troubled borrowers, respectively). Also by end-November 2013, the CBC will define the key performance indicators for progress on loan restructuring (e.g. number of loans restructured, cash collections, etc.) and instruct the banks to report quarterly on progress on these indicators beginning end-March 2014. Moreover, by end-March 2014, the CBC, with external technical support, will complete an *in-situ* assessment of the operational capacity of the banks' loan workout units to implement their plans (**structural benchmark**).

- *Review of corporate and personal insolvency framework.* With the help of technical assistance, by end-December 2013 we will carry out a review of the corporate and household debt-restructuring framework and prepare a report identifying impediments to implementation and measures to address them. As needed, by end-February 2014 we will submit legislation to parliament to implement these measures.

- *Creation of mediation services.* By end-January 2014, we will pass legislation to expand the role of the Financial Ombudsman to mediate debt-restructuring negotiations between banks and borrowers.

Ensuring adequate liquidity and normalizing financial flows

10. **We remain committed to preserve sufficient banking system liquidity.** The Central Bank of Cyprus will continue to monitor closely the liquidity situation of the banking system and stands ready to take appropriate measures to maintain sufficient liquidity in the system, following the procedures and rules of the Eurosystem. The government stands ready to consider the issuance of additional government funding guarantees up to € 2.9 billion - in line with state aid rules and in compliance with the provisions of our Public Debt Management Law - if there is a clear need to safeguard financial stability.

11. **We remain fully committed to our published milestone-based roadmap aimed at gradually easing administrative measures and capital controls while safeguarding financial stability**. Building on initial signs of improving confidence in the banking sector and concluding the first stage of the roadmap, during August-October 2013 we relaxed restrictions on wire transfers and opening of new accounts. Looking forward, to ensure that further relaxations remain consistent with financial stability, the Central Bank will fine-tune its technical impact assessment of relaxation measures on banks' liquidity and our methodologies to assess market confidence. On the latter, by end-December 2013, the Central Bank will appoint an independent specialized panel of experts to study current market conditions, including through well-targeted surveys and focus groups. The panel will be tasked with issuing a report (containing main recommendations, a communication strategy and an action plan) by end-January 2014, which will inform actions during the second stage of our roadmap.

Financial sector supervision and regulation

12. **We are taking measures to strengthen banking supervision and regulation.** To this end, following initial delays with finalizing legislation to establish a comprehensive credit register (end-September 2013 structural benchmark), legislation was passed by Parliament on November 28. Moreover, the CBC has issued guidelines on loan origination, requiring banks to base their loan decisions primarily on the borrowers' cash flow as a means of loan repayment as opposed to earlier asset-based lending practices. We will build on these actions as follows:

- By end-December 2013, we will issue guidelines on asset impairment and provisioning and the treatment of collateral in provisioning to bring our current accounting practices up to the most conservative international level. Also by then, the CBC will issue mandatory disclosure requirements to ensure that banks regularly communicate to markets progress in restructuring their loan portfolios and operations. Provisions on disclosure requirements will become effective for the publication of the 2013 financial statements. The CBC will require banks to submit by end-February 2014 an action plan to fully implement these guidelines in the preparation of their 2014 financial statements.
- By end-January 2014, the CBC will complete its annual supervisory program detailing its main objectives and activities for 2014, including a tentative timeframe to gradually resume regular on-site inspection of commercial and cooperative banks (which will also include review and implementation of provisioning requirements), staffing, cost and budget assigned to each activity, and main training programs. To ensure that the CBC can effectively carry out its supervisory tasks, we will clarify the allocation of tasks and responsibilities in the governance structure of the bank and will address staffing issues related to retention and recruitment. Also by end-January 2014, we will require banks to submit the 2014 work program of their internal audit departments to the CBC.
- We stand ready to submit to Parliament by end-June 2014 draft legislation to introduce early corrective measures to enhance supervisory powers to address capitalization issues. This will help the broader integration of our regulatory and supervisory measures with European initiatives, including the Single Supervisory Mechanism.
- By end-January 2014, we will also amend as necessary our resolution law and define procedures to ensure the effectiveness of the resolution authority.

13. **We remain committed to strengthen the implementation of our AML/CFT framework**. Having recently amended our legal AML/CFT framework (end-September structural benchmark), commissioned an external audit of the implementation of AML measures by banks, and articulated an action plan to strengthen implementation, our efforts are concentrated in two areas:

- *Exchange of information*: To monitor progress in this area, following the September 2013 revision of the AML law, the Financial Intelligence Unit (FIU) will compile on a quarterly basis, statistics on financial information exchanged with other FIUs, both upon request and spontaneously, with a breakdown by country. Starting from the forthcoming 2012 annual report (which will be posted on the web), the FIU statistics will also include information on spontaneous exchanges of information broken down by country, in addition to the information already provided on exchanges upon request.

- *Follow-up on the AML audit findings*: The CBC has made progress with the follow-up on the auditor's findings regarding possible breaches of compliance with AML requirements by banks and will complete this work by end-January 2014.

- *AML supervision by CBC*: To address capacity constraints, the CBC will adopt a plan for 2014 aimed at strengthening the effectiveness and adequacy of resources of the AML/CFT supervisory function for financial institutions (end-February 2014 **structural benchmark)**. Onsite supervision will be stepped-up over the program period to a level commensurate to the size, complexity, and risk profiles of the financial institutions operating in the system.

C. Fiscal Policy

14. **We are committed to achieving our revised 2013 fiscal targets.** We maintained a cumulative primary surplus of 0.7 percent of GDP by end-September 2013, due to better-than-expected revenue collections and prudent execution of discretionary spending. This allowed us to meet with ample margins our end-September primary balance and primary spending targets, which were exceeded by 3.2 and 1.7 percent of GDP, respectively. Of this, 0.9 percent of GDP was due to postponing from the third quarter to October the compensation of Laiki pension funds for resolution-related losses. In light of fiscal outturns to date, we have revised our end-year primary deficit target for the general government (cash terms) to 2.6 percent of GDP (relative to 3.3 percent of GDP at the time of the first review).

15. **For 2014, we will target a primary deficit of 3.3 percent of GDP on a cash basis**. This is better than envisaged under our original program by 1 percent of GDP, reflecting the net effect on revenues (0.7 percent of GDP) of a higher 2013 base which more than offsets the weaker growth in 2014, but also some limited additional measures (0.3 percent of GDP) which advance part of the consolidation we will need to carry out in the medium term. The measures include further rationalization of allowances and overtime of public employees, better targeting of the social pension by introducing income criteria, reducing exemptions on pension contributions of previously exempted groups, and increasing the taxation of lottery winnings. Amendment of the 2014 draft budget incorporating a revised macroeconomic framework and our revised targets is a **prior action** for the completion of the second review. The budgetary impact associated with the eventual exploitation of hydrocarbon resources will be consistent with our program's medium-term fiscal and public debt targets. We will refrain from introducing any tax amnesties during the program period.

16. **We will support credit to SMEs through the provision of government guarantees.** To this effect, in 2014 the government will guarantee up to €115 million to banks for borrowing from the EIB for SME on-lending, to provide trade credits to small and medium enterprises (SMEs), and other ongoing projects. The end-December 2013 ceiling will be adjusted downwards to reflect the reduced probability of disbursement of the loan to EAC related to the Vassilikos power plant and updated guarantees for other projects. However, an adjustor of up to €130 million will be included in case the loan to EAC is actually disbursed. The debt ceilings for end-December 2013 and end-March 2014 will also be adjusted to accommodate the proceeds of the direct loans included in the 2014 budget to be spent in the course of 2014.

D. Structural Fiscal Reforms

17. **We are committed to implement a comprehensive social welfare reform to protect vulnerable groups during the downturn.** The new system, centered on a new

Guaranteed Minimum Income (GMI) scheme, will ensure adequate and equitable protection of vulnerable groups while preserving work incentives. To this end, by end-November 2013 we will define the level of basic needs in order to achieve a decent standard of living and the composition of a minimum consumption basket. On this basis, by end-December 2013, we will complete the costing of the GMI to determine the benefit level and eligibility criteria and refine the means-testing mechanism. The GMI will be complemented by other well-targeted benefits, such as child or education benefits. The final design of the reformed social welfare system, including decisions on the type, level and eligibility criteria for GMI and any remaining benefits, consistent with the 2014 and medium-term budget ceilings, will be approved by the Council of Ministers by end-March 2014 **(structural benchmark)** after consultation with social partners. The reform will be implemented by end-June 2014 (existing **structural benchmark**).

18. **We are taking steps toward the integration of the Inland Revenue Department and VAT services into a new function-based tax administration**. On October 30, the Council of Ministers empowered the Ministry of Finance to initiate the revenue administration reform and established a governance structure—including a High-Level Steering Committee and an Executive Technical Committee—to oversee its implementation. Both the project manager and head of the integration reform project team have been appointed, as well as other members of the team, have been appointed, and work is underway. The reform implementation plan—now being drafted—will be approved by the government by end-December 2013, as planned. Also by end-December 2013, we will adopt short-term measures to establish a work program of joint audits to target high-risk taxpayers and large traders. In addition, legislative amendments will be passed, which aim at increasing the collection enforcement powers of the revenue administration and establishing full self-assessments for all income taxpayers (existing **structural benchmark**). In this context, we will also take initial steps to identify compliance risks.

19. We are proceeding with reforms of public financial management. A Fiscal Responsibility and Budget Systems Law will be adopted by end-December 2013 (existing **structural benchmark**). Also by then, the amendment to the Public Debt Management Law will be approved, assigning responsibility for monitoring the stock of guarantees to the Public Debt Management Office. Finally, to improve fiscal monitoring and reporting, since September, the Treasury department has assumed responsibility for the monthly collection and reporting of key financial indicators for the general government, and a "Statement of state-owned enterprises (SOE) and semi-government entities" will be included as an appendix to the 2014 budget.

20. **We remain committed to our privatization objectives.** We are determined to make progress with the privatization process in order to reap the benefits of efficiency gains expected from private ownership and generate the targeted proceeds of €1.4 billion by end-2018. To this end, we are preparing a plan specifying the portfolio of state-owned assets eligible for privatization, an estimate of expected receipts, and the timetable for individual transactions, indicating required preparatory steps and the estimated duration of each stage. The plan will be adopted by the Council of Ministers in early December 2013. By end-January 2014, we will adopt the institutional and legal framework to govern the privatization

process, providing, among others, for the establishment of a unit within the Ministry of Finance to implement the privatization plan.

E. Program Financing and Monitoring

21. **In line with our program commitments, we continue to undertake measures to limit financing needs**. We have restructured our bilateral loan with Russia providing for extended maturities and a lower interest rate. In addition, after finalizing its financial accounts by end-March 2014, the CBC Board will decide on the allocation of central bank profits of €0.4 billion (in line with CBC duties under the Treaties and the Statute) to be distributed to the government in 2014. Finally, an inventory of state assets has been completed, paving the way for a debt-to-asset swap to be decided by the CBC in accordance with its rules and the Treaty. This aims to reduce public debt by approximately €1 billion by end-June 2014.

22. **Implementation of policies under our program will continue to be monitored through quarterly PCs and reviews.** Our program includes continuous performance criteria, indicative targets, and structural benchmarks, which are defined in the attached Technical Memorandum of Understanding (TMU). As is standard in IMF arrangements, there is a continuous performance criterion on the non-accumulation of external payment arrears. We also include in our program a continuous performance criterion on non-intensification of restrictions of payments and transfers for current international transactions or to introduce multiple practices.

23. **We authorize the IMF to publish the Letter of Intent and its attachments, and the related staff report.**

Table 1. Cyprus: Quantitative Conditionality 1/
(Millions of euros)

	Performance criteria				Indicative targets	
	Sep-13		Dec-13	Mar-14	Jun-14	Sep-14
	Target	Actual				
Floor on the general government primary balance 2/	-402	110	-435	24	-224	-94
Ceiling on the general government primary expenditure 2/	5,065	4,784	7,205	1,530	3,204	4,804
Ceiling on the stock of general government debt	18,521	18,403	18,668	18,658	18,042	18,380
Ceiling on the accumulation of new general government guarantees 4/	145	-2.2	25	65	90	115
Ceiling on the accumulation of external arrears 3/ 4/	0	0	0	0	0	0
Ceiling on the accumulation of domestic arrears 4/	0	0	0	0	0	0
Ceiling on the accumulation of tax refund arrears by the general government 4/	10	-7	10	10	10	10

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since January of the corresponding year.
3/ Continuous performance criterion.
4/ Cumulative since March 2013 for 2013 and since January 2014 for 2014.

Table 2. Cyprus: Conditionality for the Second Review

Measures	Timing	Status
Prior Actions		
Approval by the CBC of BoC's proposed set of quarterly targets for the next 12 months of key financial and operational indicators in critical areas and the terms of a quarterly report on progress relative to these targets	Before Board meeting	Met
Finalize an agreement between the Ministry of Finance and the CCB on the terms of the relationship framework defining, on the basis of international best practices, the responsibilities and governance boundaries between bank owners and the bank (MEFP ¶9)	Before Board meeting	Met
Submission to parliament of amendments to the 2014 budget in line with program's macroeconomic framework and revised targets	Before Board meeting	Met
Performance criterion		
There will be no measures to intensify restrictions on the making of payments and transfers for current international transactions or to introduce multiple currency practices	Continuous	Met
Structural benchmarks		
Adopt the legal framework for a central credit register	End-September 2013	Completed on November 28
Revise the anti-money laundering legal framework	End-September 2013	Met
CBC to instruct Hellenic Bank to launch an offer for private participation in the bank's capital	End-September 2013	Met
CBC to prepare an assessment of BoC's restructuring, business, funding and capital plans	End-October 2013	Met
Recapitalize Hellenic Bank in line with the capital needs identified by the PIMCO exercise 1/	End-December 2013	Met

1/ Required for the third review but completed ahead of time.

Table 3. Cyprus: Existing and Proposed Conditionality

Measures	Timing
Proposed New Structural Benchmarks	
Resolution Authority to instruct the Special Administrator to entrust the voting rights of legacy Laiki equity stake in BoC to a well-recognized and independent consulting or auditing firm(s) or international institution(s)	End-January 2014
Completion of an independent fair value assessment of the CCB's and CCI's assets aimed at quantifying the size of the government's stake in the sector and submission of the final restructuring plan of the CCI sector to the European Commission	End-January 2014
Adoption by the CBC of a plan to strengthen the effectiveness and adequacy of resources allocated to the AML/CFT supervisory function (TMU¶18)	End-February 2014
Completion by the CBC of an in-situ assessment of the degree of operational capacity of the banks' loan workout units to implement their arrears management plans	End-March 2014
Approval by the Council of Ministers of the final design of the reformed social welfare system, including decisions on the type, level and eligibility criteria for GMI and any remaining benefits, consistent with the 2014 and medium term budget ceilings	End-March 2014
Existing Structural Benchmarks	
Adoption of a law on fiscal responsibility and budget systems (TMU ¶16)	End-December 2013
Adoption of measures to fight tax evasion (TMU ¶17)	End-December 2013
Merger of the credit cooperative sector into a maximum of 18 institutions which will be recapitalized to fulfill the capital requirements under the law	End-March 2014
Implementation of a new social welfare system to improve the targeting of social assistance, consolidate welfare programs, and streamline administration costs	End-June 2014

Cyprus—Technical Memorandum of Understanding

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies (MEFP). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the Fund, European Commission and ECB on a timely basis before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the European Commission, ECB and the Fund with the necessary information for program monitoring.

2. For program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "program exchange rates" as defined below, with the exception of the items affecting government fiscal balances, which will be measured at current exchange rates. The program exchange rates are those that prevailed on April 15. In particular, the exchange rates for the purposes of the program are set €1 = U.S. 1.308099 dollar, €1 = 129.0309 Japanese yen, €1.15222= 1 SDR.

3. For reporting purposes, the Ministry of Finance (MOF) and the Central Bank of Cyprus (CBC) will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the EC, the ECB and the Fund.

A. Quantitative Performance Criteria and Indicative Targets

Floor on the General Government Primary Cash Balance (performance criterion)

4. For the purposes of the program, the general government includes the institutions listed under this category according to ESA 95 for Excessive Deficit Procedure (EDP) reporting purposes. In particular, the general government includes:

- *The central government.* Includes the Constitutional Powers, the Constitutional Services, the Independent services, the Independent offices, the Ministries and the departments, services, and other bodies they supervise, 21 special purpose funds, and 14 semi government organizations.

- *The local governments*. Comprise 39 municipalities, 356 village authorities, and all agencies and institutions attached thereto which are classified as local governments according to ESA 95.

- *The social security funds.* These include the medical treatment scheme, the regular employees' provident fund, the social insurance fund, the holiday fund, the redundancy fund, and the protection of the rights of employees' fund.

- *Any newly created institution defined as general government under ESA 95.* This includes any new budgetary institution, special fund, social security fund, semi-government organization, municipality, village authority, and any other entity created during the program period to carry out operations of a fiscal nature. The government will inform the IMF, European Commission and ECB staff of the creation or any pending reclassification of any such new funds, programs, or entities immediately. The general government, as measured for purposes of the program monitoring, for a given year shall not include entities that are re-classified from outside general government into general government during that year.

5. The performance criteria are set on the general government cash primary balance (GGPCB), defined as the general government cash balance (GGCB) minus general government interest receipts plus general government interest payments. In turn, GGCB is defined as total revenue (tax revenue, social security contributions, grants and other revenue) minus total expenditure. The payment of called guarantees will be recorded as cash expenditures. Privatization receipts, as defined below, and the proceeds from the sale of land and buildings, will be excluded from revenue. The floor on the GGPCB in each year will be measured cumulatively from the start of that calendar year.

- Privatization receipts are those receipts associated with the disposal to private owners by a government unit of the controlling equity of a public corporation or quasi-corporation.

- The floor on the GGPCB will be adjusted downwards by the payments related to bank support, when carried out under the program's banking sector support and restructuring strategy. Transactions that may be excluded from the balance include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.

6. The floor on the GGPCB will be adjusted as follows:

- The end-December 2013 target will be adjusted downwards by the payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank up to €163 million. Should these payments be partially or totally deferred to 2014, the adjustor will be applied to the end-March 2014 target for the remainder payments, up to a cumulative amount of €163 million.

- The 2014 targets will be adjusted downwards by the dividends received from the CBC and the semi-government organizations.

Ceiling on the General Government Primary Expenditure (performance criterion)

7. General government primary expenditure (GGPE) includes compensation of employees, goods and services, subsidies, social benefits, other recurrent expenditure, and capital expenditure.

- The ceiling on the GGPE will be adjusted upwards by the payments related to bank support, when carried out under the program's banking sector support and restructuring strategy. Transactions that may be excluded from the balance include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.

8. The ceiling on the GGPCB of end-December 2013 will be adjusted upwards by the payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank up to €163 million. Should these payments be partially or totally deferred to 2014, the adjustor will be applied to the end-March 2014 target for the remainder payments, up to a cumulative amount of €163 million.

Ceiling on the stock of General Government Debt (performance criterion)

9. The general government debt constitutes total outstanding gross liabilities as defined by ESA95. This includes the debt of all institutions included in the general government as defined above and other ESA 95 adjustments. Debt will be measured at nominal value. The program exchange rate will apply to all non-euro denominated debt.

10. The ceiling on the general government debt will be adjusted:

- Upwards (downward) by the amount of any upward (downward) revision to the stock of end-March 2013 general government debt.
- Upwards, by debt arising from payments for bank restructuring carried out under the program's banking sector support and restructuring strategy. These payments may include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.
- Upwards by the amounts disbursed under the EIB loan to finance projects authorized in the 2014 budget under the National Strategic Reference Framework.

Ceiling on the Accumulation of new General Government Guarantees (performance criterion)

11. The ceiling on new general government sector guarantees shall include domestic and external guarantees granted during the test period, as well as guarantees for which the maturity is being extended beyond the initial contractual provisions. The ceiling shall exclude guarantees granted under a risk sharing instrument of the EU structural funds (see COM (2011) 655 final) that do not create contingent liabilities for the Cypriot State. Government entities outside of the general government (e.g. state owned enterprises) but within the non financial public sector are not permitted to grant guarantees. The stock of guarantees at end March 2013 was €3.1 billion.

12. The ceiling on the accumulation of new general government guarantees will be adjusted:

- Upwards for the issuance of government guaranteed bonds to be used in monetary policy operations to boost BoC's liquidity up to €2.9 billion.

- Upwards for the issuance of government guarantees for the EAC Vassilikos Power Plant Phase IV loan up to €130 million.

Ceiling on the Accumulation of External Arrears (continuous performance criterion)

13. External payment arrears are defined as payments on debt to non-residents contracted or guaranteed by the general government, which have not been made within seven days after falling due. The stock of external payment arrears as of end-March 2013 was €0.

Ceiling on the Accumulation of Domestic Arrears (performance criterion)

14. Domestic expenditure arrears are defined as unpaid invoices that have past the due date by 90 days. In case no due date is specified on the supplier contract, an unpaid commitment is considered to be in arrears 90 days after the initiation of the invoice. The stock of domestic expenditure arrears as of end March 2013 was €0 million.

Ceiling on the Accumulation of VAT Refund Arrears by the General Government (performance criterion)

15. VAT refund arrears consist of unpaid VAT refunds that have past the due date for payment established in the tax legislation and/or the corresponding regulations. The stock of VAT refund arrears as of end March 2013 was €140 million.

B. Monitoring of Structural Benchmarks

16. **Adopt a law on fiscal responsibility and budget systems (end-December 2013).**

Specification. The adopted legal framework will contain the following elements:

- It will provide a comprehensive coverage of the general government sector and the government's financial relationships with state enterprises and other public entities that are outside the boundary of the general government sector.

- It will incorporate provisions (i) on fiscal transparency and accountability requiring the government to articulate a comprehensive, legally based and independently monitored fiscal strategy consistent with EU requirements and (ii) for the development over time of a disciplined and policy-oriented approach to budget decision-making by reducing the number of appropriations, adopting a top-down approach to budget preparation that is closely linked to the process of fiscal policy-making, and providing more flexibility to ministries and semi-governmental organizations.

17. Adopt measures to fight tax evasion (end-December 2013)

Specification. The adopted measures will include the following:

- Develop a work program for conducting targeted joint audits through end-December 2014;

- Amend relevant legislation to establish self-assessment for all income taxpayers;

- Pass legislation to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to seize assets, or prohibit the alienation or use of assets, including property and bank accounts, and turning the act and assistance of to tax evasion into a criminal offense.

18. The CBC to adopt a plan aimed at strengthening the effectiveness and adequacy of resources for the AML/CFT supervisory function for financial institutions (end-February 2014)

Specification. In order to address supervisory capacity issues, for the purposes of this structural benchmark:

- The authorities will develop, in consultation with Fund staff, a supervisory program for 2014, taking into account the risks faced by Cyprus that will include a combination of full AML/CFT inspections and thematic reviews focused on risks related to third party introducers, Politically-Exposed-Persons, and the laundering of the proceeds of tax evasion.

- In order to enable the AML/CFT supervision unit to implement its 2014 annual inspection program, adequate resources and staffing will be dedicated to perform all its supervisory tasks, including for off- and on-site activities. In this regard, by end-February, full-time resources will be allocated to complement the existing two full-time AML dedicated staff with a minimum of five additional experienced supervisors over the course of 2014.

- By end-February, tenders will be submitted to complement resources with external auditors with recognized supervisory experience, including for AML/CFT, to ensure that each onsite inspection visit can be supported by external support.

AML supervision's implementation:

- On a quarterly basis, in the context of the program review starting in the fourth quarter of 2013, the supervisory competent authorities will, on a confidential and anonymized basis grant Fund staff access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.

- With regard to the CBC, in line with the 2014 annual inspection program, onsite supervision missions will start in the first quarter and step-up during the year, as capacity builds and resources are expanded. The total number and quarterly profile of these inspections, as well as staffing objectives and levels will be subject to periodic review by the CBC and the Fund in light of experience.

Exchange of financial intelligence:

The Financial Intelligence Unit (FIU) will communicate to Fund staff, on a quarterly basis, detailed statistics on financial information exchanged with other FIUs, both upon request and spontaneously, with a breakdown by country

C. Reporting Requirements

19. Performance under the program will be monitored using data supplied to the IMF by the Ministry of Finance, Cystat, and the Central Bank of Cyprus. The authorities will transmit to the IMF staff any data revisions in a timely manner. Table 1 describes the supporting data needed for monitoring of the quantitative targets, the required frequency of the data, the institution/department responsible for providing the data, and the timing for provision of the data.

Table 1. Cyprus: Reporting Requirements			
Information required	**Data Frequency**	**Institution/Department responsible for providing information**	**Maximum time lag for submission after the end of the reporting period**
Detailed execution of revenues, expenditure and financing provided in EDP reporting format	Monthly	MOF. Budget Department/Cystat Government Financial Statistics.	27 days after the end of the month, except end-December data which will be provided30 days after the end of the month
Debt Issuance, Amortization, and interest cost details by type of debt instrument, maturity, currency, type of debt holder (resident, non-resident). Details on any financial balance sheet transactions	Monthly	MOF. Public Debt Management Unit.	27 days after the end of the month
Central Government Debt stock by type of debt instrument, maturity, currency, type of debt holder. Interest bill for each type of debt instrument on a monthly basis for the current year and the next year, and annual for each year thereafter until 2020	Monthly	MOF. Public Debt Management Unit.	27 days after the end of the month
Budgetary Central Government deposits in the Consolidated Fund and in the Banking System.	Monthly	MOF. Public Debt Management Unit.	5 days after the end of the month
Stock of expenditure and VAT refund arrears and their corresponding monthly flows (i.e. inflows, outflows) by type of expenditure.	Monthly	MOF. Customs & Excise Department, VAT Service	15 days after the end of the month
Stock of government guarantees and their monthly flows by institution.	Quarterly	MOF. Treasury Department.	27 days after the end of the month
Stock of external arrears	Monthly	MOF. Treasury Department.	15 days after the end of the month
Assets and liabilities of the central bank	Monthly	Central Bank of Cyprus	30 days after the end of the month
Assets and liabilities of the domestic operations of the banking system – aggregate monetary balance sheet of credit institutions by institutional category	Monthly	Central Bank of Cyprus	30 days after the end of the month
Assets and liabilities of the banking system (consolidated, including foreign operations), aggregate balance monetary balance sheet of credit institutions by institutional category	Quarterly	Central Bank of Cyprus	45 days after the end of the reporting period

Table 1. Cyprus: Reporting Requirements (Concluded)

Individual operational balance sheet of the domestic operations of the largest banks and coops with detailed information on deposits (by maturity, currency, and type of depositor), central bank funding, interbank funding, debt securities, loans provided to the public and the private sector, 1/	Monthly	Central Bank of Cyprus	30 days after the end of the month
Details for the largest banks and coops on liquid assets (cash and securities), liquidity position (i.e. the pool of assets eligible for ELA but not already encumbered), other assets and liabilities 1/	Daily	Central Bank of Cyprus	Next working day
Deposits by institution, currency, and residency and end-of-day liquidity buffers	Daily	Central Bank of Cyprus	Next working day
Financial soundness indicators—core set, deposits, NPLs, capital adequacy ratios	Quarterly	Central Bank of Cyprus	60 days after the end of the month

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