

# **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**

In the financial sector area, key objectives constitute the implementation of the restructuring plans of Bank of Cyprus (BoC) and the coop sector, and the continued strengthening of supervision and regulation. In addition, a reform of the debt restructuring framework will be undertaken with a view to facilitating the voluntary workout of non-performing loans. Finally, the Cypriot authorities will continue to gradually lift capital restrictions in line with their roadmap, while safeguarding financial stability.

### **Progress since November**

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, Bank of Cyprus and the Cooperative Central Bank submitted to the CBC their restructuring plans, together with the capital and funding plans. The new Board of the Cooperative Central Bank put forward a roadmap for the next three months with key actions to undertake in order to kick-start the reform of the sector and appointed the new General Manager in December 2013. Second, the Central Bank of Cyprus adopted the loan origination directive on 4 December, thereby addressing some major causes for the build-up of NPLs in the sector. Third, the authorities proceeded with the implementation of the regulatory and supervisory reform as envisaged in the MoU. Supplementary information on the new Code of Conduct for dealing with troubled borrowers was published in November in order to enhance public awareness of the new framework. The effectiveness and governance of the Resolution Authority was reviewed. The series of non-performing loans according to the new definition have been published by the Central Bank of Cyprus. Work on the monitoring of banks' management of arrears, namely through key performance indicators, is progressing. In particular, the Central Bank of Cyprus has enhanced its operational capacity to follow the implementation of the restructuring plan of Bank of Cyprus.

As programme implementation has progressed, macro-financial stability has shown signs of improvement and the situation in the banking sector has started to normalise. The deposit base has stabilised and banks' liquidity buffers have strengthened. The Parliamentary Committee on Financial and Budgetary Issues approved the issuance of guarantees of up to EUR 2.9 billion on 27 January 2014 as contingency collateral in case of need.

## **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 joint CBC-Ministry of Finance task force will be set up **by end-February** to design a well-targeted communication strategy aiming to regularly communicate to market participants, information

regarding the roadmap and the progress already made in the implementation of the banking sector strategy.

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, and in order to safeguard financial stability, approval has been obtained from the House of Representatives for the issuance of additional government guarantees of up to EUR 2.9 billion on 27 January 2014 as contingency collateral in case of need, in line with State aid rules.

1.3. The Bank of Cyprus and the Cooperative Central Bank submitted their first capital and funding plans in November 2013 and January 2014, respectively. The CBC will continue to receive the updated plans **on a quarterly basis** and will transmit them to the ECB, the EC, the ESM and the IMF. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector, the gradual easing of restrictive measures, 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.

### **Regulation and supervision of banks and cooperative credit institutions**

1.4. Following the establishment of the legal framework for the credit register in December 2013, the authorities commit that the central credit register will be operational **by end-September**. By **end-May**, with external technical support, the CBC will complete an assessment of how to use it for supervisory purposes relative to best practices.

1.5. Having reviewed its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning, the CBC started introducing regulatory amendments. A new loan origination directive was adopted in October 2013. The new provisioning and disclosure directive will be finalised **by end-February** and will become effective for the publication of the 2013 financial statement concerning disclosure requirements. The CBC will require banks to submit **by end-March** an action plan for the full implementation of these guidelines starting from their 2014 annual accounts. Furthermore, with the aim to ensure timely implementation of newly introduced and upcoming EU rules on capital requirements and NPLs, the CBC has instructed banks to submit **by end-April** estimates of its potential impact on capital and **by end-June** profitability and coverage ratio.

1.6. Banks with restructuring plans will be required to submit, starting from **April 2014** and with reference date end-December 2013, **quarterly** reports describing the progress with the implementation of the restructuring plans. The reports will contain a set of key performance indicators including selected operational and financial targets developed by the CBC and communicated to the banks. The CBC units responsible for the supervision of BoC and coops will assess **on a quarterly basis** these reports. The first assessment of these reports will be submitted to the CBC Board by **end-May**.

1.7. The CBC (i) has put in place a work plan for 2014, including thematic on-site inspections and off-site reviews on loan restructuring and risk management, operations, and governance issues for the supervisory units responsible for BoC and the coop sector; and (ii) will provide them with sufficient resources to contract necessary technical support from banking and troubled debt restructuring experts. In addition, 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.

1.8. 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.

1.9. 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.

1.10. By **end-April**, the governance directive will be revised specifying, among others, the interaction between banks' internal audit units and bank supervisors, in line with best practices.

1.11. The accounts of cooperative credit institutions are subject to an independent annual audit by an external, recognised and independent auditing firm. The CBC has 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.

1.12. The CBC will have sufficient staff to carry out its functions-in full independence as stipulated by the Treaties. Taking into account the imminent increase in the tasks of the CBC, owing in particular to the requirements imposed on the banking supervision department, recruitment will be accelerated and additional resources, with sufficient qualifications, will be allocated without delay.

1.13. 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- March**.

### **Monitoring of corporate and household indebtedness**

1.14. 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 annual Financial Stability Report, to be published at year-end will include an extended analysis on corporate and household indebtedness. Exceptionally to the year-end timing of the publication, the first report will be published by **end-April**. In addition, quarterly monitoring reports will continue to be submitted and their scope and content will be further enhanced.

1.15. Measures will be taken to deal with troubled borrowers. 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 order to ensure compliance with the new framework for the management of arrears, **by end-March 2014**, the CBC, with external technical support, will complete an assessment of the operational capacity of the commercial banks' loan workout units, including with respect to early arrears. Following the completion of the merger

process for the cooperative credit institutions, the corresponding deadline will be **end-May**.

- Banks will be required to report quarterly on restructuring progress and management of NPLs, with reference date **end-March** and submitted **by end-May**, using specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.), which were approved by the CBC in consultation with EC, ECB and IMF and informing ESM. Furthermore, banks will report monthly on early arrears (e.g. number and amount of past due loans within 1-90 days, type of actions taken, and number and amount of cured or uncured loans).
- 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** and serve as a basis for further policy recommendations on the arrears management processes in credit institutions. Following the findings of the review, as needed, revisions of the Arrears Management Directive and of the Code of Conduct will be introduced by **end-July**.
- By **end-June**, the CBC will introduce requirements for banks and coops to submit agreed-upon procedure reports prepared by their external auditors on banks' effectiveness of debt restructuring arrangements and strategies for the periods ending in December 2014, June 2015, December 2015, and June 2016.
- The role of the Financial Ombudsman with regard to hearing complaints on compliance with the arrears management process will be clarified **by end-March**.
- 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.

### **Increasing financial transparency**

1.16. Based on the findings of the April 2013 audit undertaken by MONEYVAL and an independent auditor, the Cypriot authorities have progressed in enhancing the anti-money laundering (AML) framework in line with best practices and are committed 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 establishment by the Cypriot authorities' of trust registers with the supervisory authorities (Action Plan – section 4.3.1)
- The supervisory competent authorities are reviewing 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). In carrying out its onsite supervisory program, the CBC will build on its follow-up work on the April 2013 audit regarding individual financial institutions.

- 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.

To ensure that adequate, accurate and current basic information on all types of legal persons registered in Cyprus could be obtained by the Registrar of Companies and be accessible by the public in a timely manner, the Cypriot authorities have committed to reform the Department of Registrar of Companies as foreseen in section 3.10.

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 of financial institutions**

### **Restoring adequate capital buffers**

1.17. The CBC increased the minimum Core Tier 1 capital ratio from 8% to 9% in December 2013. The CBC is assessing 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-March** 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 EU-wide stress test. In no circumstances will this revision lead to any distribution of capital by the banks which were found in the PIMCO exercise to face a capital shortfall.

### **Management of legacy Laiki**

1.18. In order to enhance the recovery value from the disposal of the assets of Laiki, the Resolution Authority will instruct the Special Administrator to appoint **by end-March** a well-recognised and independent consulting or auditing firm(s) or international institution(s) to provide services associated with the management of the disposal process, and be entrusted with the voting rights associated with Laiki's shares participation in BoC. As part of the terms of reference for the appointment of the consultants agreed in consultation with the EC, ECB and IMF and informing the ESM, a revised roadmap for the full disposal of the assets will be developed by **end-April** with a view to maximize value for creditors.

## **Restructuring of Bank of Cyprus**

1.19. To strengthen confidence in the bank, by end February the CBC agreed with BoC on the quarterly operational and financial indicators that will be communicated to the public on progress being made in the implementation of the restructuring plan.

1.20. Going forward the CBC will complete **by end-February 2015** a comprehensive technical assessment of BoC's restructuring plan with the aim to identify areas that require further strengthening and review.

## **Restructuring and recapitalisation of Hellenic Bank**

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

## **Restructuring and recapitalisation of cooperative credit institutions**

1.22. 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.

1.23. To this end, the restructuring plan for the cooperative sector was submitted to the EC in 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 to assume his tasks immediately after the approval of the recapitalisation aid and associated restructuring plan and commitments by the EC under state aid rules. The monitoring trustee will submit quarterly reports on governance and operations, as well as ad-hoc reports as needed and will work under the direction of the EC. In line with the EU state aid rules the trustee will be responsible for overseeing the implementation of the restructuring plan. This includes, inter alia, verifying proper governance and the use of commercial-basis criteria in key policy decisions and assessing the soundness of strategies to deal with loan arrears. The monitoring trustee will closely follow the bank's operations and shall have access to Board meeting minutes, and be observer at the executive committees and other critical committees, including risk management and internal audit functions.

1.24. 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**. 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. Following the completion of the merger process and the establishment of the final governance structure of the sector, the CBC will review its affiliation directive by **end-July**.

1.25. Upon completion of legal mergers 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-April**, 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% or the new minimum capital requirement to be determined as per paragraph 1.17.

1.26. 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 was established, 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.

1.27. As part of the implementation of the restructuring plan, the Cooperative Central Bank will leverage on external expertise. In particular such expertise will be drawn upon to develop policies and practices 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 and will be completed by **end-May**. The selection criteria for the CCB will be established by the Cooperative Central Bank and consulted by the Ministry of Finance with the EC, ECB and IMF and informing the ESM. As part of the relationship framework the CBC and CCB, in consultation with the Ministry of Finance management unit, will agree by **end-April** on quantitative indicators to allow for an adequate monitoring of the implementation of the coops' restructuring plan. In addition, main indicators and conclusions used in the monitoring exercise will be released as part of the quarterly public reporting in order to enhance confidence.

1.28. To limit risks and ensure appropriate and consistent risk management practices across the sector, by **end-January 2015**, the CBC will complete an assessment of the CCB's implementation of effective local and risk management programs for the CCIs on the basis of common policies and tools as well as a consolidated management program at the CCB level in line with the restructuring plan

### **C. Legal framework for private debt restructuring**

1.29. All unnecessary legal, administrative or other hurdles currently constraining the seizure and sale of loan collateral shall be removed so that the assets pledged as collateral can be recovered within a reasonable period deemed to be a maximum time-span of 1.5 years from the initiation of the relevant proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. The authorities commit not to introduce any further impediments to the seizure of assets pledged as collateral. Furthermore, they will establish a Task Force (comprising representatives of CBC, Ministry of Finance, the Law Office of the Republic and the Land Register) **by end-March** to prepare a study assessing the magnitude of registered, but untitled land sales contracts and underlying mortgages and develop recommendations **by end-June**.

1.30. The authorities will, in consultation with EC and IMF and informing the ECB and ESM, prepare a comprehensive reform framework to be endorsed by the Council of Ministers **by end-May**, establishing appropriate corporate and personal insolvency procedures. On the



basis of that framework, legislation will be prepared and submitted to the House of Representatives **by December 2014**.

1.31. The legal framework in relation to foreclosures and the forced sales of mortgaged property will be amended in consultation with the EC and the IMF and informing the ECB and the ESM, and adopted **by end-June**, to allow for private auctions to be conducted by mortgage creditors, while limiting the role of the Land Register in the auction process.

1.32. In the context of these reforms, the authorities will initiate a review by **end-June** and, **by end-December**, will formulate recommendations on the Civil Procedure Code and Court Rules in order to ensure the smooth and effective functioning of the revised foreclosure and insolvency frameworks.

1.33. The authorities will review the private sector debt restructuring legal framework in the **second half of 2015** with a view to assessing results and define additional measures as needed.

## **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 2014, listed in Annex 1; (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 and have progressed 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,<sup>1</sup> 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

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<sup>1</sup> 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

remain available to cover national contributions, including non-eligible expenditure, under the European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD and EFF/EMFF) in the framework of the 2007-2013 and 2014-2020 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.

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.

#### **Fiscal policy in 2014**

Based on the programme's current macroeconomic and fiscal projection and reflecting the 2014 Budget, the Cypriot authorities will achieve a deficit of the general government primary balance of EUR 277 million (1.8% of GDP) in 2014<sup>2</sup>, respecting the EDP recommendation of a headline deficit of no more than 8.4% in 2014. To this end, Cyprus will fully implement the permanent measures included in the 2014 Budget, amounting to at least EUR 270 million in 2014 (Annex 1).

#### **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 no more than EUR 340 million (2.1% of GDP) in 2015 and a surplus of at least EUR 201 million (1.2% of GDP) in 2016<sup>3</sup>, respecting the EDP recommendation of a headline deficit of no more than 6.3% of GDP in 2015 and 2.9% of GDP 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. 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.

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<sup>2</sup> 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.

<sup>3</sup> These targets need to be adjusted for expected dividends of EUR 0.2 billion, to be distributed by the CBC in line with CBC's duties under the Treaty and the Statue.

### 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) take further steps to control the growth of health expenditure; (3) enhance tax revenues by improving tax compliance and collection; (4) 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; (5) 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 (6) 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 agreed to provide **by February 2014** all information necessary to verify that, to the extent it falls under the control of their executive and legislative powers, 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.

#### 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 aiming at full implementation **by Q2-2015**;

- c) taking into account the economic conditions, the implementation of the necessary complimentary reforms, the results of the updated actuarial study and after consultation with the programme partners, implement a National Health System (NHS), to be fully in place **by mid-2016**. The NHS will ensure its financial sustainability while providing universal coverage. By **mid-2015**, a first stage of NHS, e.g. primary care, will be put into place. This first stage will be defined and adopted with the full roadmap to NHS **by April 2014**, which will also clarify the role of Ministry of Health and the HIO. The amending bill to NHS will be submitted to the House of Representatives **by Q2-2014**. The policies of the Ministry of Health on pricing and reimbursement of medical goods and services, including those related to pharmaceutical expenditure, will be revised in agreement with programme partners to contain projected spending levels under NHS.
- 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) complete the design of 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 Q2-2014**;
- 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;

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

### **Budgetary framework and public financial management**

3.3. The Cypriot authorities will:

- enact a Fiscal Responsibility and Budget System Law (FRBSL applicable to the entire general government sector, **prior to the granting of the fourth disbursement of financial assistance**. 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;

- 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 FRBSL, 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 **by mid-March 2014**;

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 Q1-2014**. All outstanding commitments should be timely and properly recorded and reported, on a quarterly basis, in the accounting system.
- improve the monitoring of government guarantees through a risk assessment analysis. To this end, ensure appropriate human resources at the Public Debt Management Office to carry out proper risk assessment of the outstanding stock of government guarantees.

### **Public private partnerships (PPPs)**

3.4. The Cypriot authorities will:

- regularly update the inventory of PPPs, including contingent liabilities 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, the Directorate General for European Programmes, Coordination and Development and the 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;
- implement secondary legislation and guidelines for public investment management, including project appraisals, in line with the FRBSL provisions **by June 2014**.
- 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 projects that 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:

- the Cypriot authorities will submit to the House of Representatives the law regulating the creation and the functioning of SOEs at the central and local levels, in order to enhance the monitoring powers of the central administration, while including

reporting on SOEs in the context of the annual budgetary procedure **by end-February 2014**. No additional SOEs will be created until the legal framework has been adopted.

- the Head of the new SOEs Unit and the Unit's supporting staff will start their work **by end-March 2014**;
- the Cypriot authorities will submit a plan **by Q2-2014** with detailed timelines for the review of those SOEs that are under internal review and will be restructured; and
- each SOE will submit a strategic plan to the competent minister for approval, in consultation with programme partners, as set out in Part V of the SOEs Law **by Q3-2014**.

3.6. The Cypriot authorities will implement the privatisation plan submitted to the programme partners to help improve economic efficiency by encouraging more vigorous competition and greater capital inflows and restore debt sustainability. The plan includes the privatisation of, inter alia, CyTA (telecoms), EAC (electricity), CPA (commercial activities of ports), as well as real estate and land assets. CyTA and CPA will be privatised **within the programme period** and EAC by mid-2018.

An appropriate regulatory framework is a prerequisite for the privatisation of natural monopolies. 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 the relevant secondary legislation.

In order to pursue the privatisation process in the most diligent way, the Cypriot authorities will:

- enact the Privatisation Law, **prior to the granting of the fourth disbursement of financial assistance**;
- establish the Privatisation Unit through the appointment of its Head and its experts, in line with the provisions of the Privatisation Law; the Unit will be fully operational **by mid-May 2014**. The terms of reference for the appointments will be prepared in consultation with programme partners;
- appoint independent advisors with relevant expertise and develop a plan with detailed intermediate steps and timings for disposing of the identified real estate assets **by Q3-2014**;
- appoint independent advisors for the CPA privatisation **by Q2-2014**, in accordance with the privatisation plan;
- appoint independent advisors for the privatisation of CyTA and EAC **by Q3-2014**, in accordance with the privatisation plan.

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**, which will be used for public debt reduction.

## **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. Most of the short-term programme has been implemented. However, the following actions will be completed **by Q1-2014**:

- 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 withholding taxes is a criminal offence and taking the necessary steps to ensure tax fraud is prosecuted as a criminal offence;
- strengthening powers by the tax authorities to ensure payment of outstanding tax obligations, including by providing authority to garnish assets or prohibiting the alienation or use of assets, including property and bank accounts, by the taxpayer;
- 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; and
- conducting 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, as well as on an evaluation of different risk treatment strategies. To further progress, the authorities will
  - make the data from the IRD, VAT Services and Customs and Excise Department available to selected staff by the tax administrations via one platform, to be used for integral risk identification and analysis **by Q1-2014**;
  - cleanse the income tax registers **by Q2-2014** and VAT registers **by Q3-2013**, by removing inactive cases and put in place a process to maintain the registers up-to-date;
  - further improve the joint work programme for large and high risk taxpayers and provide a progress report **by Q2-2014**; and
  - finalise the compliance risk management module for large taxpayers **by Q3-2014**.
- The full integration of the two tax departments, based on the adopted integration implementation plan. As next steps, the authorities will, amongst others:
  1. submit to the House of Representatives the enabling legislation to establish the new tax agency **by April-2014**; and
  2. set up the integrated large tax payer unit **by Q4-2014**.



In addition, the authorities will 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 VAT gap) **by Q2-2014**.

3.8. The Cypriot authorities will safeguard the timely and effective exchange of information on 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 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
- submit **by end-February 2014** to programme partners a comprehensive action plan to address the shortcomings identified in Phase 2 of the peer review by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, with a view to achieve full compliance with the OECD supplementary review. The action plan shall be implemented **by Q2-2014**. In addition, the authorities will monitor closely further progress in responding timely to tax information requests by third countries and, starting from **end-March 2014**, submit to the programme partners quarterly performance updates.

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**

3.9. The Cypriot authorities will reform the immovable property tax with the objective to improve the fairness of the tax burden and to increase the efficiency of the tax administration. To this end, the authorities will:

- implement a General Valuation (GV) for all immovable properties. The new values of immovable properties shall be determined on the basis of tangible building- and plot-related characteristics **by Q2-2014**;
- implement the recurrent immovable property tax based on the updated valuations for the tax year **2015**, at the latest. The design of the immovable property tax shall ensure progressivity and proceeds consistent with measure I.27 of Annex 1.

The Department of Lands and Surveys (DLS) and the Inland Revenue Department will prepare **by Q1-2014** a joint action plan outlining the required intermediate steps and deadlines, which will ensure a smooth and timely implementation of the new immovable property tax.

In addition, the authorities will:

- **by Q4-2014**, conduct an assessment of the relevance of the parameters used in the Computer Assisted Mass Appraisal (CAMA) model for the GV and identify possible missing parameters. Refine, if needed, the CAMA in light of this assessment **by Q2-2015**;
- conduct an assessment of the variance between GV assessed values and market price **by Q4-2014**. On this basis and following international best practices, **by Q1-2015** enact legislation specifying the frequency of the mandatory update of the values; and
- implement **by Q2-2015** the recommendations of a study on the scope for 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 for shifting revenues from transaction fees and taxes to recurrent taxation.

### **Public administration reform**

3.10. The Cypriot authorities have commissioned an independent external review of possible further reforms of the public administration. The review includes a horizontal and a sectoral element.

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

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

and comprises two batches:

- the first batch is undertaken by the World Bank and the UK public administration and covers the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies. 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 plan after consultation with programme partners, which will be approved by the Council of Ministers **by Q2-2014**. The relevant legislation in relation with the reforms indicated as high priority will be adopted by the House of Representatives **by Q3-2014**. The reform will start to be implemented **by Q4-2014**, in accordance with the reform plan.
- 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**. They will include cost estimates and implementation timelines with detailed intermediate steps. Based on the findings of this review, the Cypriot authorities will agree on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers **by Q1-2016**. The relevant legislation in relation with the reforms indicated as high priority will be adopted by the House of Representatives **by Q2-2016**. The reform will start to be implemented **by Q3-2016**, in accordance with the reform plan.
- In addition, the authorities will review the impact of the changes to the public sector working hours and will present their findings to the programme partners **by Q4 2014**.

### **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 **by end-February 2014**;
- 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 **by end-February 2014**;
- adopt the final design of the reformed welfare system by the Council of Ministers **by Q1-2014** after consultation with social partners, followed by consultation 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).

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:

- i. 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;
- ii. 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
- iii. 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 Q2-2014**.

## 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 ensure the implementation of a set of agreed measures to address the identified shortcomings and weaknesses. These will include:

- i. the development of a coherent methodology for the continuous monitoring and evaluation of activation programmes, to be applied consistently across the different schemes. A comprehensive report will be presented **by Q3-2014** and as of then the new methodology will be applied, thereby enabling the assessment of the performance and effectiveness of all schemes;
- ii. completing the process of harmonisation, automatic collection, processing and exchange of data across the various schemes and between all implementing bodies **by Q1-2014**;
- iii. 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;
- iv. measures to enhance the administrative capacity of the public employment services via increased staff mobility and/or outsourcing of specific tasks **by Q2-2014**; and
- v. measures to enhance the cooperation between the public employment services 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 April 2014** the revised National Action Plan for Youth Employment, which will include, *inter alia*, measures envisaged for support under the Youth Employment Initiative aimed at establishing a Youth Guarantee, 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. For this purpose, the authorities will submit **by April 2014** a comprehensive note summarising the full list of all active labour market policies (existing and envisaged) with the relevant intended aims, recipients, budgetary allocations and sources of financing.

## 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 and regulated professions

5.1. 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.

The Cypriot authorities will 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. The Cypriot authorities will finalise their review **by Q1-2014**. Following completion of the review, the requirements that are not justified or proportional will be eliminated **by Q3-2014**.

### Competition, transparency and sectoral regulatory authorities

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

- continuing to provide sufficient and stable financial means, as well as qualified personnel in order to enhance its effective and on-going operation **by Q2-2014**;
- 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 end-March 2014**; and



- promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition **by Q2-2014**. The CPC may seek technical assistance to achieve this objective.

The Cypriot authorities will ensure **by Q2-2014** that the General Auditor's Office has sufficient financial means and personnel to carry out its functions and increased tasks, as originally stipulated by the European Commission's Monitoring Report on the Implementation of the Commitments made in the Accession Negotiations by Cyprus (Chapter 28, Financial Control/External Audit) and as restated in the 2014 EU Anti-Corruption Report.

The Cypriot authorities will continuously ensure that powers and independence of the National Regulatory Authorities (NRAs) are effective in accordance with the EU Regulatory Framework.

### **Housing market and immovable property regulation**

5.3. 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:

- define deadlines for the issuance of building certificates and title deeds and ensure their enforcement **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). The ex-officio cases will automatically be counted in the backlog from the date the certificate of final approval is being issued by the respective Local or District Authority. Moreover, prepare a joint action plan to streamline the processes within the DLS and between the DLS, the Local and District Authorities and the Ministry of Interior Technical Services **by Q2-2014**;
- 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;
- 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**; and
- improve the pace of court case handling, in order to eliminate court backlogs **by Q1-2016**.

### **Tourism**

5.4. 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 including an assessment of its implementation based on performance indicators, **by Q1 and Q3** every year, starting from 2014.

- present a plan enhancing the coordination of the competent authorities having a direct link with tourism **by Q2-2014**. The plan shall include concrete actions and a roadmap leading to an effective mechanism for coordination.
- start implementing 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, which will include a concrete action plan, will be adopted **by Q1-2014**. The implementation of the action plan will be reviewed annually by the Cypriot authorities, starting **in Q1-2015**.

## **Energy**

5.5. 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;
- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector in the form of a concise summary report (first draft to be delivered **by Q4-2014**) and a collection of more detailed reports. This strategy constitutes a living document to be developed and updated under the full authority of the Cypriot Government and including at least the following three key elements, on which further work should be presented to the programme partners for consultation according to the timeline specified below:

1. updates on the *roll-out plan* for the infrastructure required for the exploitation of natural gas. This plan takes into account the relevant technical and commercial uncertainties and risks and hence 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; next update **by Q2-2014**.

Prior to finalisation of the forthcoming energy sector Government Agreement (GA) and its supplementary agreements 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 impacts 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 and gas sector, 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, the prospects of privatisation of SOEs in the energy sector, 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. The Cyprus authorities will provide clarity on the intended use of the available 'isolated market' and 'emergent market' derogations and indicate the intended duration of the latter derogations. An advanced intermediate draft **by Q2-2014**, with a view to a final outline **by Q4-2014**; 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. The resource fund, whose establishment and objectives are foreseen in the FRBSL (see 3.3), should be based on clear rules governing inflows and outflows, coupled with clear accounting rules regarding dividend and fees from government entities and stakes in the energy sector. To the extent that the FRBSL, does not cover the elements listed above, they should be provided for by the specific law on the resource fund, an advanced draft of which, informed by technical assistance advice will be submitted to programme partners **by Q2-2014**, before its submission to the House of Representatives.

Since these three key elements are strongly interdependent, they need to be developed in parallel over time and collated in one summary document. In addition, the strategy should take into account the uncertainty about 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 strategy 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-June 2014**. 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.

## **7. Growth Strategy**

7.1 Developing a comprehensive and coherent growth strategy based on Cyprus's competitive advantages would help the Cypriot authorities to kick-start the economy. The growth strategy should be integrated in the national institutional framework leveraging on the on-going public administration reform, public financial management reform, other commitments in Cyprus's Economic Adjustment Programme and relevant EU initiatives. The Cypriot authorities may request technical assistance to further develop this strategy.

## **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.

I.36 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;

I.37 A further targeting of social pensions;

I.38 An abolition of income tax exemption for certain pension schemes;

I.39 A reduction in the tax-free threshold for lottery gains;

### **Revenue measures**

I.40 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.41 Increase the standard VAT rate from 18% in 2013 to 19% in 2014.

I.42 Increase the reduced VAT rate from 8% to 9%.

I.42 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.43 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.44 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.

I.45 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.

## Annex 2

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

	<i>Heading/Deficiency</i>	<i>Action</i>	<i>Timeline</i>
1	<b><u>Customer Due Diligence</u></b>		
1.1	<b>Business profile</b>		
	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.	Compliant
1.2	<b>Customer risk profile</b>		
	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.	Compliant 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.	Compliant
	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.	Compliant
1.3	<b>Ongoing CDD</b>		
	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.	Compliant Q2-2014

2	<b><u>Reliance/introduced business</u></b>		
	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.	Compliant
	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	<b><u>Suspicious Transaction Reporting</u></b>		
	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	<b><u>Transparency of beneficial ownership</u></b>		
4.1	<b><u>Access to information</u></b>		
	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).	Compliant

<sup>4</sup> Under Cyprus law, there is no legal concept of “nominee director”, but it is used with reference to professionals who provide director services.

		4.1.2. In the case of nominees, either a) require nominee directors <sup>4</sup> 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).	Compliant
4.2	<b>Company Registry</b>		
	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. 4.2.2 Ensure the department of the registrar is appropriately resourced.	Compliant Ongoing
4.3	<b>Register of Trusts</b>		
	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	<b><u>Supervision of financial institutions</u></b>		
5.1	<b>Revise the AML/CFT supervisory structure within the CBC, ensuring it is adequately resourced</b>	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, <sup>5</sup> in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Compliant

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<sup>5</sup> 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. <sup>6</sup> 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. <sup>7</sup>	Ongoing
5.2	<b>Develop risk-based supervisory tool(s) for offsite surveillance/monitoring activities prior to implementation</b>	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: <ul style="list-style-type: none"> <li>- a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products &amp; services, geographic locations/areas,<sup>8</sup> and delivery channels;</li> <li>- 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;</li> <li>- institutional risk profiles;</li> <li>- specific AML/CFT supervisory strategies (adapted to institutional risk profiles).</li> </ul>	Compliant
5.3	<b>Develop risk-based supervisory tool(s) for onsite inspections prior to implementation</b>	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: <ul style="list-style-type: none"> <li>-Corporate Governance;</li> <li>-Risk Assessment Systems;</li> <li>-Policies &amp; Procedures;</li> <li>-Compliance Function;</li> <li>-Internal &amp; External Audit Functions;</li> <li>-Training Program.</li> </ul>	Q1 – 2014
5.4	<b>Establish Formal AML/CFT Training Program</b>	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: <ul style="list-style-type: none"> <li>- newly developed offsite and onsite risk-based tools;</li> <li>- customer acceptance policies;</li> </ul>	Q2 – 2014

<sup>6</sup> FATF Immediate Outcome (IO) 3

<sup>7</sup> See BCP 2.6c

<sup>8</sup> 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).

		<ul style="list-style-type: none"> <li>- customer due diligence (CDD);</li> <li>- monitoring of transactions;</li> <li>- identification and reporting of STR;</li> <li>- funds transfers;</li> <li>- correspondent banking;</li> <li>- recordkeeping;</li> <li>- compliance function;</li> <li>- internal controls;</li> <li>- audit functions;</li> <li>- corporate governance;</li> <li>- risk assessment systems</li> </ul>	
		5.4.2 Provide CBC supervisory staff with ongoing training to ensure adequate knowledge of risks and supervisory techniques.	Ongoing
5.5	<b>Implement adequate supervision</b>	5.5.1.a. CBC to establish corrective actions and follow-up on the cases revealed by Deloitte. 5.5.1.b. Apply appropriate enforcement actions with regard to any breaches of compliance, and apply sanctions if applicable.	Compliant Q1-2014
		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.	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.	<b><u>Supervision and monitoring of lawyers, accountants and TCSPs</u></b>		
6.1	<b>Align resources with</b>	6.1.1 Ensure adequate human resources and technical capacity to undertake effective AML/CFT monitoring.	Ongoing

	<b>risks</b> <b>Establish an effective monitoring structure for AML/CFT matters</b>	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.	
6.2	<b>Develop risk-based tool(s) for Offsite surveillance/monitoring activities prior to implementation</b>	6.2.1 Design, develop, adopt, and pilot a risk assessment methodology and tool(s) that provides for: <ul style="list-style-type: none"> <li>- a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products &amp; services, geographic locations/areas, and delivery channels;</li> <li>- 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;</li> <li>- risk profiles;</li> <li>- specific AML/CFT monitoring strategies (adapted to institutional risk profiles).</li> </ul>	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	<b>Develop risk-based tool(s) for Onsite inspections prior to implementation</b>	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: <ul style="list-style-type: none"> <li>- Risk Assessment Systems</li> <li>- Policies &amp; Procedures</li> <li>- Compliance Function</li> <li>- Training Program</li> </ul>	Q2 – 2014 (CBA and ICPAC)  Q3-2014 (CySEC)
6.4	<b>Establish Formal AML/CFT Training Program</b>	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: <ul style="list-style-type: none"> <li>- newly developed offsite and onsite risk-based tools</li> <li>- customer acceptance policies</li> <li>- customer due diligence (CDD)</li> <li>- monitoring of transactions</li> <li>- identification and reporting of STR</li> <li>- recordkeeping</li> <li>- compliance function</li> <li>- risk assessment systems</li> </ul>	Q2– 2014 (CBA and ICPAC)  Q4-2014 (CySEC)



		etc.	
6.5	<b>Implement adequate supervision</b>	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.	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 <sup>9</sup>
- ii. Authority for the Supervision of Cooperative Societies <sup>10</sup>
- iii. Competition Protection Commission

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<sup>9</sup> It functions according to *acquis communautaire* prescriptions and it employs only a limited number of people (4 persons).

<sup>10</sup> The relevant organisation is dealt within the context of the financial sector part of the MoU.