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The Economic Adjustment Programme for Cyprus Fifth Review - Summer 2014

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The Economic Adjustment Programme for Cyprus

Fifth Review - Summer 2014

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The text reflects developments until 1 September 2014

EXECUTIVE SUMMARY

Staff teams from the European Commission (EC), European Central Bank (ECB), and the International Monetary Fund (IMF) visited Nicosia from 15 July to 25 July 2014 for the fifth review of Cyprus' economic adjustment programme, which is supported by financial assistance from the European Stability Mechanism (ESM) and the IMF. The objectives of Cyprus' programme are to restore financial sector stability, strengthen public finance sustainability, and adopt structural reforms so as to support sustainable and balanced long-run growth.

A staff-level agreement was reached on policies that could serve as a basis for the completion of the fifth review. The authorities have continued to meet the fiscal targets with significant margin in the first half of the year, as a result of prudent budget execution. In the financial sector, banks are advancing with their restructuring plans and capital raising, while supervisory monitoring of their actions and operational capacity to address non-performing loans has been enhanced. The authorities have also taken steps toward implementing their ambitious structural reform agenda.

While the recession is bottoming out, the outlook remains challenging. Output is expected to contract by 4.2% in 2014 unchanged compared with the fourth review, with growth in the tourism and professional services sectors cushioning weak activity in other sectors. Unemployment remains very high, although signs of a stabilisation are emerging. Prices have fallen in the first six months, although the pace of decline has slowed. Growth in 2015 is projected at 0.4%, with the recovery constrained by the high level of private sector debt and high level of non-performing loans. Risks remain significant, related to constraints to the supply of credit, as well as to the on-going crisis in Ukraine.

Reforms in the financial sector have progressed, but the high level of non-performing loans remains a cause for concern. Deposit outflows have eased, but developments differ across banks. Domestic payment restrictions have been lifted, in line with the government's roadmap. Bank of Cyprus and the cooperative sector have also continued to implement their restructuring plans, although serious challenges remain ahead particularly for the coop sector, where the framework for arrears management and governance should be strengthened further. To deal effectively with the non-performing loan problem, the necessary legal instruments need to be put in place. Cyprus has taken an important first step with the adoption by the council of Ministers on 30 July of a comprehensive outline of a modernised insolvency framework. As a next step, the House of Representatives adopted a reformed Foreclosure Law on 6 September. On-going efforts by banks to proactively raise capital in the private markets will be conducive to a smooth transition to the Single Supervisory Mechanism following the completion of the pan-European Comprehensive Assessment. The Cypriot authorities have continued to implement the Anti-Money Laundering (AML) action plan, focussing in particular on measures to strengthen effective supervision of financial institutions, lawyers, accountants and administrative service providers.

The authorities have continued to pursue a cautious fiscal policy, leading to a primary balance for the first half of the year exceeding the forecast by about ¾ pp of GDP. The 2014 government primary deficit is now estimated at 1.3% of GDP, 0.4% better compared to the fourth review. The authorities will need to continue implementing their budget prudently in light of lingering risks. As agreed at the onset of the programme, an additional adjustment will be necessary in the outer years to attain the long run objective of a sustained 4% of GDP primary surplus, which is needed to place public debt on a sustainable downward path.

Structural reforms have progressed. Although some delays were observed, notably in the areas of healthcare and state-owned enterprises' corporate governance, progress has been observed in a wide range of reforms. The welfare reform legislation was adopted and first payments are expected in autumn. The revenue administration has been strengthened with the adoption of the law formally establishing the new tax department and legal amendments enhancing compliance and strengthening collection enforcement powers. The privatisation unit has also started its work.

The review is expected to be concluded with all necessary decisions by the Eurogroup, the ESM Board of Directors, and the Executive Board of the IMF to be taken by end-December. Its approval would pave the way for a cash disbursement of EUR 350m by the ESM, and about EUR 83m by the IMF following the consent of the Executive Board of the IMF.

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1. INTRODUCTION

The report assesses compliance with the terms and conditions set out in the updated MoU. The MoU was updated following the fourth review mission and was agreed between the Cypriot authorities and the programme partners, i.e. the European Commission (EC), the European Central Bank (ECB), and the International Monetary Fund (IMF). On 24 April 2013, the European Stability Mechanism (ESM) Board of Governors approved the updated MoU. The Vice-President of the European Commission, responsible for economic and monetary affairs and the euro, Mr Olli Rehn, had already signed the first MoU on 26 April 2013, while acting Vice-President responsible for economic and monetary affairs and the euro Siim Kallas signed the updated MoU following the fourth quarterly review mission last 7 July 2014.

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

A joint EC/ECB/IMF staff mission visited Nicosia from 15 July to 25 July 2014 for the fifth quarterly review mission and reached agreement with the Cypriot authorities on policies that could serve as a basis for completion of the fifth review.

This report is based on information obtained during the fifth review mission, taking into account economic and policy developments until 1 September 2014. A new report will be published after the next review mission, including updated macroeconomic forecasts and assessment of policy developments.

By the time of disbursement, the two prior actions in the updated MoU for the granting of the sixth disbursement were met. The two prior actions concerned the insolvency procedure and the foreclosure framework. On the insolvency procedure the Council of Ministers adopted a comprehensive reform framework, establishing appropriate corporate and personal insolvency procedures. On the foreclosure framework, the House of Representatives amended the legal framework in relation to foreclosures and the forced sales of mortgaged property. The positive assessment regarding the respect of the two prior actions was delayed by the simultaneous adoption by the House of Representatives, together with the foreclosure law, of additional bills that would have had a significant negative impact of the effectiveness and applicability of the foreclosure law. Following the amendment of one bill and the revocation of the others, the prior actions have been considered to be met in early November.

A successful fifth programme review would unlock the disbursement of ESM's sixth tranche to finance fiscal needs arising until the end of the fourth quarter of 2014. In light of the government's comfortable cash position and limited financing needs, the sixth ESM disbursement in cash would amount to EUR 350m to cover deficit financing and redemption needs. The IMF would disburse EUR 83m. After the disbursement by the ESM and the IMF, the government's cash balance is estimated to amount to around EUR 0.7bn at the end of the year.

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

2. ECONOMIC DEVELOPMENTS AND OUTLOOK

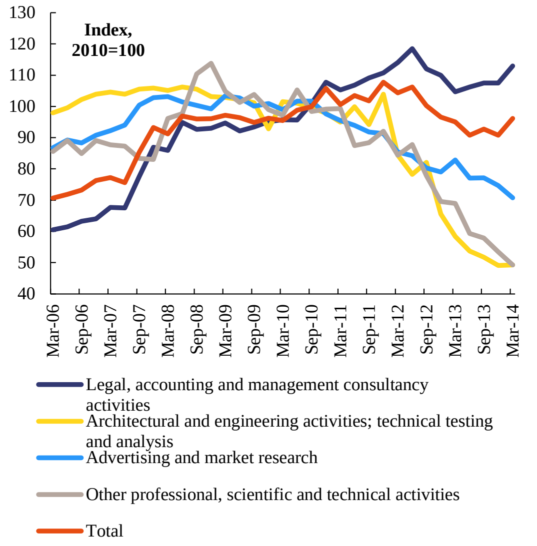
2.1. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

The recession is bottoming out, with the contraction in real GDP slowing to -4.0% y-o-y in first quarter of 2014. ([1]) This was somewhat less than the contraction of -5.1% y-o-y observed in the previous quarter. Nevertheless, the macroeconomic environment has remained difficult, notably due to the lack of credit, weakening corporate profits in most sectors, and declining labour income. The moderation of the decline in real GDP was broad-based, with private consumption slowing from -5.0% y-o-y in the fourth quarter to -3.4% y-o-y alongside improving consumer confidence, decelerating annual declines of retail sales, and increasing car registrations. The fall in real investment also moderated somewhat, but remained weak at -17.8% y-o-y in the first quarter against the background of low capacity utilisation and tight credit conditions. Public consumption was down by -7.0% y-o-y. Annual growth in export of goods and services returned to positive territory (0.1% y-o-y), as positive growth in export of goods more than offset the decline in export of services. Import growth remained negative at -4.8% y-o-y, reflecting weak domestic demand. As a result, net trade contributed positively to growth in the first quarter.

Real gross value added in the construction and financial sector continued to display the strongest annual declines in the first quarter, down by 27.8% y-o-y and 11.0% y-o-y, respectively. In the sectors of manufacturing and professional and administrative services, the negative trend appears to have been reversed on average, with real gross value added rising in quarterly and seasonally adjusted terms. A closer look at the turnover in professional, scientific and technical services shows that the benign developments were concentrated in legal, accounting and management activities while the remaining subsectors continued along its downward trend (Graph 2.1).

The annualised current account deficit widened to -2.5% of GDP in the year up to the first quarter of 2014, from -1.9% of GDP in the fourth quarter of 2013. The widening of the deficit was broad-based, with the balance in services and current transfer down by 0.3% of GDP each. The widening of the service account seems to be related to the later Easter holidays in 2014 (April in 2014 versus March in 2013), implying that no Easter holiday are included in the year up to the first quarter 2014.

Graph 2.1: **Turnover in professional, scientific and technical activities**



Source: Eurostat.

The unemployment rate has trended downwards since October last year, to stand at 15.3% of the labour force in May. Unemployment data was revised with the release of May Labour Force Survey data, and suggest that unemployment has been declining since October last year (Box 2.1 discusses recent unemployment developments). Employment, however, declined further (by 4.6% y-o-y in the first quarter), bringing the cumulative decline in employment to 13% since it peaked in the third quarter of 2008 (Graph 2.2).

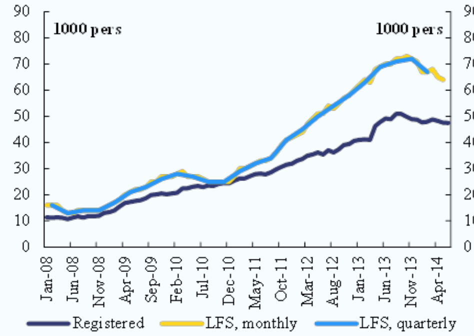
The decline in compensation per employee slowed to -4.5% y-o-y. All private sectors, with the exception of the financial sector, contributed to the moderation, reflecting later implementation of labour cost reductions in the financial sector than

([1]) Annual changes are based on non-seasonally adjusted data throughout the report.

Box 2.1: Recent labour market dynamics

Three unemployment indicators are available for Cyprus. i) A monthly series of registered unemployment, which measures the number of unemployed registered at the employment service; ii) a quarterly Labour Force Survey (LFS) unemployment statistic compiled by Cystat, which is survey-based and measures the number of persons who are actively seeking employment, not employed, and ready to take up employment with relatively short notice; and iii) a monthly Eurostat LFS unemployment indicator, which uses the monthly registered unemployment data to extend the quarterly LFS. In the context of monitoring labour market developments, the LFS indicators are of main interest, as the definition is harmonised across EU countries allowing cross-country comparisons. That said, the registered unemployment statistics also provide useful information and is continuously used when monitoring Cypriot labour market developments.

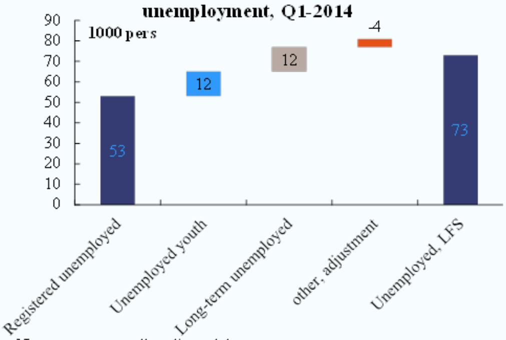
Graph 1: **Unemployment**



Note: seasonally adjusted data.
Source: Cystat and Eurostat

The registered and survey based unemployment indicators have developed differently during the crisis (Graph 1)**.** While at comparable levels from 2008 to 2010, LFS unemployment has increased faster than registered unemployment and by the beginning of 2014 the difference between the two indicators was around 20,000 unemployed. Most of the discrepancy between the two series can be explained by the increase in youth unemployment and long term unemployment (see Graph 2), two groups with few incentives to be registered at the employment office since they are less likely to be eligible for unemployment benefits. The LFS indicator is therefore likely to be a better gauge of the evolution of labour markets conditions that the registered unemployment series.

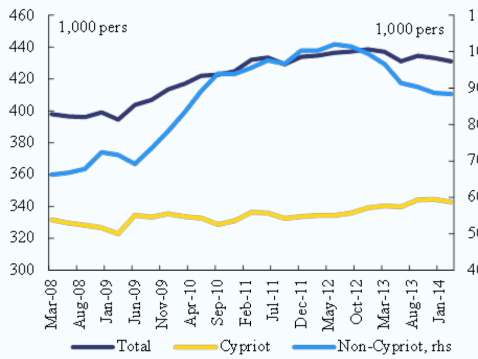
Graph 2: **Registered and survey based unemployment, Q1-2014**



Note: non-seasonally adjusted data.
Source: Cystat and Commission services.

Since October 2013, a gradual decline in the monthly LFS unemployment rate has been observed, despite the economy still being in recession. This is unusual as unemployment tends to be a lagging indicator of economic activity, as firms usually wait some time before hiring to see a more sustained recovery. Rather than reflecting a pick-up in employment growth (which is still declining), the fall in unemployment mainly reflects an increase in the number of non-Cypriots leaving the labour force (Graph 3) and growing number of discouraged workers, i.e. unemployed workers who leave the labour force temporarily until labour market prospects improves. The increased number of persons in active labour market programmes (ALMP) also explains some of the decline in unemployment, as in the LFS they are likely recorded as inactive while participating in ALMP, therefore leading to a reduction in unemployment but not to an increase in paid-employment.

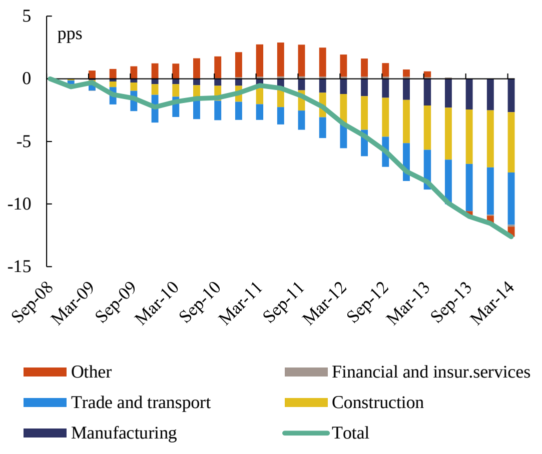
Graph 3: **Labour force, by nationality**



Source: Labour force survey.

in the other private sectors. The slowing decline in labour costs more than offset the improvement in productivity growth, leading to a moderation in the decline in unit labour costs.

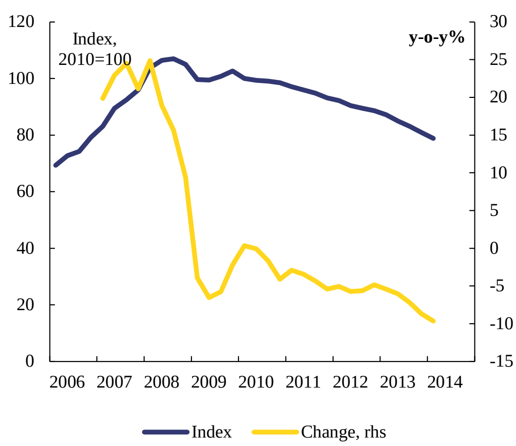
Graph 2.2: **Employment**



Source: Commission services.

The annual decline in house prices intensified to 9.7% in the first quarter of 2014 (Graph 2.3)**.** Demand for residential properties remained weak, amid tight credit conditions and declining labour income. According to the Bank Lending Survey, credit supply conditions for households were tightened in the second quarter, and households demand for credit also weakened. For the third quarter of 2014, further tightening of credit supply for households is expected, while the weakness in the demand of credit is likely to persist.

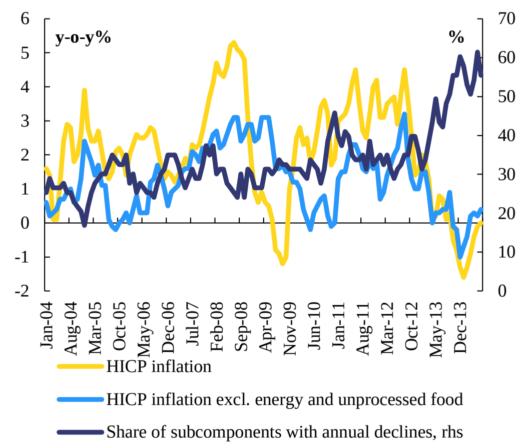
Graph 2.3: **Residential property prices**



Source: Central Bank of Cyprus.

HICP inflation reached a trough in January at -1.6% y-o-y. In June 2014, HICP inflation returned to positive territory (0.0% y-o-y), supported by VAT hikes and base effects from administrative reductions in energy prices last year. Compared to the 2008 period of negative inflation, mainly driven by commodity prices, the recent negative inflation has been more broad-based, with a higher share of HICP subcomponents declining (Graph 2.4). This reflects subdued domestic cost pressure and the ongoing labour cost adjustment, which continued to weigh on consumer prices, with core inflation (i.e. headline inflation excluding energy and unprocessed food) remaining at around 0.3% y-o-y for the last four months. The more volatile components of HICP inflation such as energy prices and unprocessed food inflation recorded a moderating decline in recent months.

Graph 2.4: **HICP inflation**



Source: Commission services.

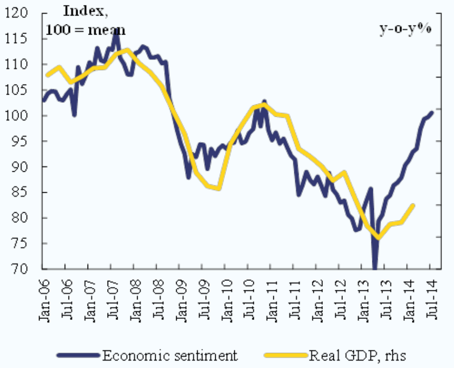
The decline in real GDP growth continued to slow in the second quarter of 2014, ([2]) alongside improving business sentiment and consumer confidence. While economic sentiment reached its long-term average towards the end of the second quarter, the recovery in real GDP growth has been more hesitant (Box 2.2). Short-term indicators suggest that value added in the

([2]) The Q2 flash GDP estimate was released on 14 August, after the finalisation of the macroeconomic forecast during the mission, and has therefore not been taken into consideration for the revised forecast.

Box 2.2: **Not so decoupled**

The economic sentiment indicator for Cyprus has improved markedly since the trough in April 2013, and in June 2014 it reached its long term average. The improvement reflects to a large extent improving confidence of consumers and in the manufacturing and service sectors. Construction confidence, on the other hand, has been more hesitant, where the improvement in employment expectations has been partially offset by weak incoming orders.

Graph 1: **Economic sentiment and real GDP**

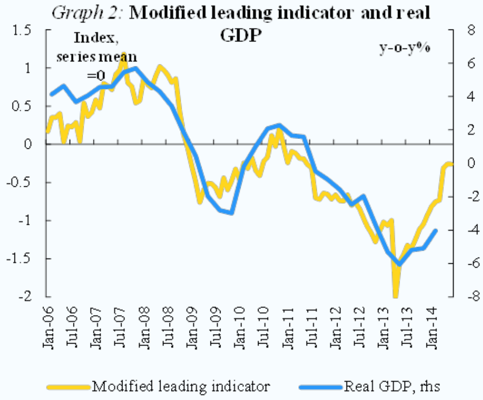


However, the improved economic sentiment has only to a limited extent been reflected in economic growth, suggesting some decoupling between soft short-term indicators and real GDP growth. The economic sentiment indicator is often considered as a leading indicator for growth. However, since the trough in real GDP growth in the second quarter of 2013, growth has been weaker then suggested by the economic sentiment indicator.

While seemingly decoupled, the diverging pattern largely relates to the weighting scheme used in the economic sentiment indicator. The weights of consumer confidence, manufacturing and the service are 20%, 40% and 30%, respectively. While more representative for the EU, these weights do not adequately reflect the structure of the Cypriot economy. Manufacturing contributed only marginally to growth in the 4 years preceding the outbreak of global economic and financial crisis in 2008. At the same time, construction activity and financial services explain 30-40% of growth over the same period.

The link with GDP growth is re-established using a weighting scheme representative for the Cypriot economy. A modified leading indicator was constructed using a weighting scheme consistent with the contribution to growth in the years prior to the outbreak for the global economic and financial crisis, and thereby giving financial services and construction sectors a more prominent role. The weights of consumer confidence and manufacturing are reduced to 5 and 10%, respectively, while the weight of services remains at 30%. The retail, construction and financial weights have been increased to 18%. Given that the confidence indicator for the financial sector is subject to high volatility due to a small sample size ([1]), the stock of MFI loans is used as a leading indicator for the financial sector instead of the confidence indicator. This modified leading indicator is shown in Graph 2, and shows a closer link to economic activity than the original economic sentiment indicator.

Graph 2: **Modified leading indicator and real GDP**



([1]) The financial sector confidence indicator is included in the services survey.

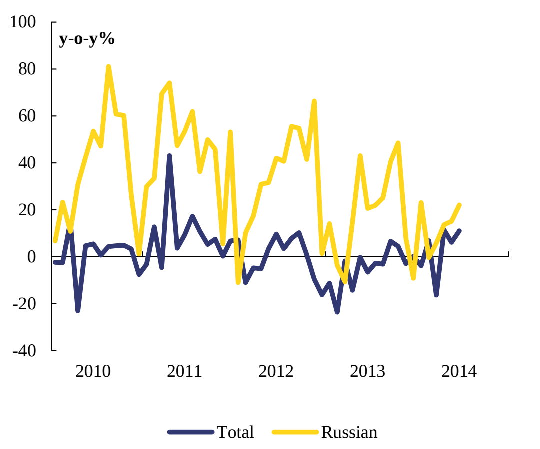
Table 2.1: **Main features of macroeconomic forecast**

		2013				Annual percentage change Fifth review forecast (July 2014)			Fourth review forecast (May 2014)		
		Curr. prices (EUR m)	% of GDP	2012	2013	2014	2015	2016	2014	2015	2016
GDP		16,504	100	-2.4	-5.4	-4.2	0.4	1.6	-4.2	0.4	1.6
Private consumption		11,447	69.4	-2.0	-5.7	-4.9	-0.2	1.5	-5.1	-0.2	1.5
Public consumption		3,079	18.7	-3.8	-5.0	-3.8	-2.2	-3.2	-2.7	-2.4	-3.2
Gross fixed capital formation		1,916	11.6	-18.3	-21.6	-17.0	1.3	3.9	-17.0	1.3	3.9
Exports (goods and services)		7,431	45.0	-2.5	-4.2	-2.4	1.9	2.9	-2.7	1.9	2.9
Imports (goods and services)		7,182	43.5	-5.4	-14.1	-6.9	-0.1	1.3	-6.9	-0.1	1.3
GNI (GDP deflator)		16,031	97.1	6.7	-5.7	-4.3	1.3	3.1	-4.3	1.3	3.1
Contribution to growth:	Domestic demand			-5.1	-7.9	-6.1	-0.4	0.9	-6.0	-0.5	0.9
	Inventories			1.2	-2.2	0.0	0.0	0.0	0.0	0.0	0.0
	Net exports			1.5	4.8	1.9	0.9	0.8	1.8	0.9	0.8
Employment				-4.2	-5.3	-4.0	0.4	1.5	-4.0	0.4	1.5
Unemployment (1)				11.9	15.9	17.6	17.0	15.8	18.6	18.0	16.8
Compensation per employee				-0.9	-5.9	-3.3	0.4	1.5	-3.0	0.4	1.4
Unit labour costs, whole economy				-2.7	-5.8	-3.0	0.4	1.4	-2.8	0.4	1.3
Real unit labour costs				-4.3	-4.2	-2.3	-0.6	-0.1	-3.0	-0.9	-0.4
GDP deflator				1.6	-1.5	-0.7	0.9	1.5	0.2	1.3	1.7
Harmonised index of consumer prices				3.1	0.4	0.0	0.9	1.3	0.2	1.1	1.7
Terms of trade				-0.6	-0.5	-0.3	-0.3	0.0	0.1	-0.1	0.0
Merchandise trade balance (2)				-21.8	-18.0	-16.6	-16.4	-16.1	-16.6	-16.4	-16.1
Current account balance				-8.3	-1.9	-0.1	0.2	0.6	-0.1	0.2	0.6

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

construction and financial sector continue to weigh on growth. At the same time, the sectors of tourism (Graph 2.5), trade and transport seem to have performed relatively better.

Graph 2.5: **Tourist arrivals**



Source: Cystat

Real GDP is forecast to decline by 4.2% (Table 2.1), **unchanged compared to the fourth review.** ([3]) Domestic demand is expected to remain weak, reflecting the needed deleveraging process in the private sector, together with further declines in wages and employment. Unemployment is foreseen to reach 17.6%, 1pp less than envisaged previously, reflecting the strong wage adjustment. HICP inflation is expected to moderate to 0.0% in 2014, down from 0.2% in the previous review. Weak domestic cost pressure is forecast to weigh more on the GDP deflator than expected during the fourth review mission, and the annual change in the GDP deflator has been revised down to -0.7%, from 0.2% in the previous mission.

In 2015 and 2016, GDP growth is forecast to gradually resume, at the same speed as previously expected, alongside a gradual strengthening of domestic demand. Despite the gradual recovery in activity, real GDP is expected to remain 10% below its peak-level observed in 2008 in 2016 (Graph 2.6). The recovery of HICP inflation and GDP deflator is now expected to be slower, reflecting that subdued domestic cost pressure is expected to prevail in the medium-term.

([3]) In the autumn of 2014, Cystat will release national accounts data in accordance with the ESA2010 standards. The new data is at the current stage not expected to be change the assessment of the underlying momentum of the economy, while initial estimates suggest that current national account data underestimate the level of nominal GDP (Box 2.3)

Box 2.3: The implementation of European Systems of Accounts 2010 for Cyprus

National accounts and government finance statistics for Cyprus released after 1 September 2014 will be produced according to the European Systems of Accounts 2010 (ESA2010) standards. ESA2010, building upon the existing ESA95, increases the precision and accuracy of the concepts, definitions, classifications and accounting rules, in order to ensure a higher degree of harmonization across Member States. ESA2010 contains new guidelines on important subjects such as financial services measurement, pensions and insurance, European accounts and government accounts. The first data release consistent with ESA2010 will be the annual national accounts data, expected to be transmitted to Eurostat towards the end of September and published in October. Historical data will be revised in accordance with the ESA2010 standards from 1995 onwards.

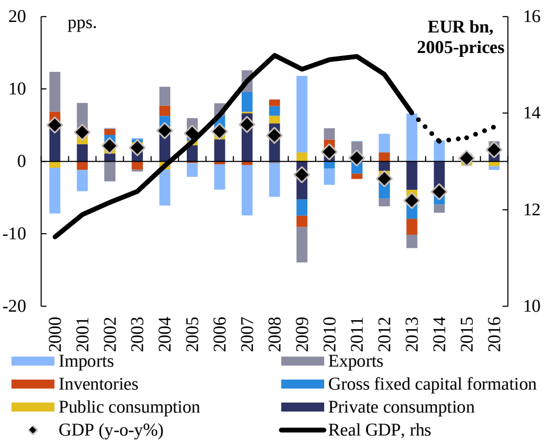
The implementation of the ESA2010 standards in Cyprus will only have a limited impact on the level of nominal GDP, as well as annual dynamics. The revisions are mainly due to a reclassification of research and development and military expenditures. According to the new ESA2010 standards, these items will be classified as gross fixed capital formation instead of intermediate consumption. In the case of Cyprus, the ESA2010 revisions are expected to be limited in nature due to little expenditure on these items and would amount to an upward revision of nominal GDP by around 1%. Moreover, reclassifications of units according to the residency definition which is clarified further in ESA2010 could also impact to a certain extent the nominal GDP in the case of Cyprus.

However, benchmark revisions are likely to have a significant effect on nominal GDP. Together with the implementation of ESA2010, Cystat will introduce benchmark revisions, i.e. changes related to new data sources and statistical models. Although the full analysis remains to be completed, preliminary estimates by Cystat suggest that the benchmark revisions will result in an upward revision of annual nominal GDP by approximately 8%. The main expenditure items affected are private consumption and exports of services. The revisions to private consumption mainly relate to the incorporation of the 2011 population census and are expected to lead to an upward revision of around 4% of nominal GDP per year. New methods to measure illegal activities are expected to support private consumption and nominal GDP by another 1% annually. Finally, other improvements, notably related to the exhaustive quantification of professional business services (i.e. legal, accounting and management consultancy activities), are expected to support annual nominal GDP by around 3%.

The impact of the change to ESA2010 on the measurement of Cyprus' general government deficit and debt is likely to be insignificant. There are three main reasons why ESA2010 could affect general government deficit and debt. First, ESA2010 provides stricter criteria to determine whether a public corporation should be classified in the general government sector. Compared to ESA95, ESA2010 introduces a list of qualitative and quantitative indicators that need to be applied to assess whether the corporation is controlled by the general government, and whether it is a market or non-market producer. Second, ESA2010 foresees that lump-sum transfers paid to the general government to compensate the latter for taking responsibility for pension obligations will be recorded as financial advances, without an immediate effect on the deficit. Under ESA95, this transaction was recorded as a deficit-decreasing capital transfer to the general government. Third, ESA2010 foresees that interest payments under swap arrangements have to be recorded as deficit-neutral financial flows, while ESA95 foresaw a recording as property income (hence affecting the deficit/surplus). The results of a recent analysis by Cystat suggest that the impact of these three factors is likely to be insignificant in the case of Cyprus. Notably, a very limited impact on the deficit can be expected from changes in the recording of standardised guarantees (as financial assets/liabilities instead of contingent assets/liabilities).

To sum up, while the revisions due to the ESA2010 implementation can be expected to leave macro- and fiscal data broadly unchanged, benchmark revisions are likely to result in a substantial upward adjustment of nominal GDP. Taken together, the impact of the revisions would amount to around 9%. Key fiscal indicators, such as the debt-to-GDP and deficit-to-GDP ratios, are hence likely to be significantly affected by the denominator effect stemming from the benchmark revisions.

Graph 2.6: **Real GDP and contributions to growth**



Source: Commission services.

Risks remain tilted to the downside in the medium term. On the domestic front, risks are largely related to a slower resolution of non-performing loans and a prolonged period of tight credit supply conditions. In addition, the needed private deleveraging process could weigh more than currently envisaged on growth in the medium term. On the external side, Cyprus' sizeable financial and trade links with Russia (the latter most notably in tourism and professional services) mean that its exports could suffer, should negative spillovers emerge from the on-going crisis in Ukraine. However, short-term indicators on tourist arrivals have so far been unaffected. Upside risks for the Cypriot economy relate to potentially stronger than expected improvement in economic activity in other EU Member States. Also, for 2014 recent data suggest that, barring major negative events, the contraction in 2014 may turn out less deep than projected.

2.2. FISCAL DEVELOPMENTS AND OUTLOOK

Budgetary developments are well on track vis-à-vis the targets set in the MoU. The primary balance until June amounted to a surplus of 1.1% of GDP, which was about ¾ pp of GDP better than expected in the fourth review mission. ([4]) This is mainly driven by prudent budget execution, while revenue performed as expected.

([4]) Estimates are based on ESA95 quarterly projections, which are consistent with the IMF's quantitative performance criteria (in cash).

General government revenue up to June 2014 increased by 6% compared to the first half of 2013, largely driven by positive developments in other current resources. The significant y-o-y increase in other current resources is due to the higher dividend income received from the Central Bank of Cyprus, as well as to positive developments in grants received and in government sales, following the increase of fees gradually implemented over the course of 2013 as part of the programme measures. Despite the on-going recession, taxes decreased only slightly, while social contributions increased by 3%. All categories benefitted from the successful implementation of measures. The pattern of capital transfers received is driven by the statistical treatment of an agreement with an international bank on the restructuring of a government guaranteed loan. Compared to the quarterly projections of the fourth review mission, all revenue categories performed as expected.

Excluding one-off effects related to the booking of signing fees for gas exploration, general government expenditure up to June 2014 shows a decrease of about 5% y-o-y. Current expenditure fell by around 6% compared to the first half of 2013, driven mainly by the implementation of fiscal measures, a reduction of the contribution to the EU budget (in line with the adverse macroeconomic developments) and a moderation in early retirements from the public sector that reduced the cost of lump-sum pension payments. In addition, the re-negotiated lower interest rate on the loan granted by the Russian Federation in 2012 also supported these trends. Compared to the first half of 2013, the increase in social transfers mainly reflects the additional cost for cleaning the backlog of redundancy and unemployment payments, the cost of the still maturing general pension system and a base effect due to the postponement to the second half of 2013 of the payment of some benefits initially due in the first half of 2013 due to liquidity constraints. Signing fees for gas exploration were recorded as negative capital expenditure in 2013, which resulted in a sharp y-o-y increase of capital expenditure in the first half of 2014. Compared to the quarterly projections of the fourth review mission, almost all expenditure categories performed better than expected.

Table 2.2: **Key macroeconomic and budgetary projections**

	2012	2013	Fifth review forecast (July 2014) 2014	2015	2016	Fourth review forecast (May 2014) 2014	2015	2016
Real GDP (1)	-2.4	-5.4	-4.2	0.4	1.6	-4.2	0.4	1.6
Output gap (2)	-0.5	-3.8	-6.0	-3.7	-1.2	-6.1	-3.8	-1.3
General government balance (3)	-6.4	-5.4	-4.7	-5.2	-2.2	-5.3	-5.1	-2.4
Total revenue (3)	39.4	40.3	42.1	40.8	41.2	41.8	40.6	40.9
Total expenditure (3)	45.8	45.8	46.8	46.0	43.4	47.1	45.7	43.3
Primary balance (3)	-3.2	-2.0	-1.3	-1.6	1.2	-1.7	-1.6	1.2
Cyclical-adjusted balance (3)	-6.2	-3.8	-2.1	-3.6	-1.7	-2.6	-3.5	-1.8
Structural balance (3)	-6.6	-3.6	-3.2	-3.6	-1.7	-3.7	-3.5	-1.8
Gross debt	86.6	111.5	117.8	126.1	122.5	119.9	124.4	121.9

(1) Percentage change (2) % of potential output, (3) % of GDP.
Source: Commission services.

The debt-to-GDP ratio reached 122% of GDP in June 2014. The debt-to-GDP ratio is projected to peak at 126% in 2015, and to gradually decline towards 103% in 2020, supported by the economic recovery and the return to primary surpluses as from 2016 (see the debt sustainability analysis in Box 4.1).

Fiscal programme projections were revised to reflect the lower government spending in 2014, the updated macroeconomic forecast and the more detailed assessment of fiscal risks since the last review mission. For 2014, the updated projection shows a primary deficit of 1.3% of GDP, 0.4% of GDP lower than forecast in the fourth review mission (Table 2.2). The revision reflects the prudent budget execution leading to lower-than-expected expenditure in almost all items. This translates into a headline deficit of 4.7% of GDP, also about ½% of GDP better than projected during the last review. The fiscal projections for 2015 and 2016 remain largely unchanged, compared to the fourth review mission (see further details in chapter 3).

2.3. FINANCIAL MARKETS AND FINANCIAL SECTOR DEVELOPMENTS

The recovery of the financial sector is underway with some improvement in liquidity, but is still hampered by the rise in impaired assets. Deposits outflows broadly stabilized at aggregate level. The overall stabilisation of deposits occurred despite the full lifting of domestic payment restrictions at the end of May. The reliance on central bank funding was further reduced, assisted by asset disposals. However, despite progress in enhancing banks' operational capacity and policies to manage loans in arrears, both the amount and ratio of NPLs continued to rise to very high levels. The process is driven by the recessionary economic environment, still falling real estate prices and defaults by over-indebted borrowers. Resolute action to address this issue is called for in order to preserve the progress achieved so far in terms of bank recapitalisation and stabilisation of deposit outflows.

The amount of impaired assets continued to increase towards very high levels, whereas the management of arrears could not keep up with the increase. In April 2014, non-performing loans (NPLs) on local operations reached 42.9% and 51.7% of total credit facilities granted by commercial banks and cooperative credit institutions, respectively (Table 2.3). The increase in NPLs relative to December 2013 has been of 2.7% points in commercial banks and of 6.5% points in the coops, pointing to an accelerated deterioration of asset quality in the latter. The majority of NPLs (close to 70%) on the commercial banks' balance sheets stem from corporate loans, while more than 80% of NPLs on the coops' balance sheet come from individual exposures. NPLs to corporations represented 47.6% of banks' credit facilities and 43.3% of coops' loan book, of which the largest percentage concerns primarily construction and real estate activities, reflecting the misallocation of resources during the boom. NPLs to households stood at 43.7% and 54.1%, respectively in April 2014. The majority of household NPLs relate to mortgages, but non-performing consumer loans are also significant, especially in the coops. The provisioning coverage of NPLs stands at about

Table 2.3: **Distribution of non-performing loans**

%, end of April 2014	Banks NPL ratio	Banks % of total NPLs	Coops NPL ratio	Coops % of total NPLs
Loans to legal entitites, o.w.	47.6	69.8	43.3	18.4
Construction	69.6	24.7	71.6	4.0
Wholesale and retail trade	41.4	10.4	63.9	2.9
Accommodation and food services	58.5	6.6	53.9	1.2
Real estate activities	55.5	12.6	66.8	3.0
Loans to private individuals, o.w.	43.7	30.2	54.1	81.6
Household mortgages	39.0	18.2	45.4	33.0
Consumer loans	54.4	7.9	62.1	40.4
Total	42.9	100.0	51.7	100.0

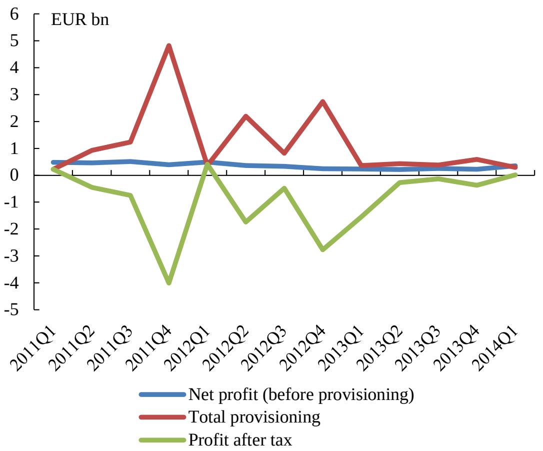
Source: Central Bank of Cyprus.

30% for commercial banks and 35% for the coops at end-March 2014, ([5]) which is significantly lower than for average European banks. It reflects a high level of collateralisation of loans, but at the same time renders banks vulnerable to large drops in the market value of the collaterals.

Commercial banks are more advanced than coops in terms of management of loans in arrears, but both the quantity and the quality of loan restructurings remain insufficient. As of April 2014, restructured loans (performing and non-performing) account for about 25% and 11% of banks and coops' loan portfolios respectively, which suggests that coops are still lagging behind in terms of arrears management, although the situation is improving with the share of restructured loans in coops having increased by almost 5pps (vs. 1pp in banks) since the beginning of the year. However, anecdotal evidence shows that in some banks more than two-thirds of the restructured loan portfolio turned non-performing again, suggesting that more sustainable restructurings would be needed.

The worsening of the quality of the loan portfolio negative impacted the profitability of banks. In the first quarter of 2014, commercial banks recorded profits again after seven quarters of losses (Graph 2.7). However, profits were small due to the fact that more than 80% of the pre-provision profitability was consumed by provisions. Higher profits were partly due to increased net interest income (up by almost 30% relative to the first quarter of 2013), primarily due to a significant improvement in interest rate margins after deposit rates declined during 2013.

Graph 2.7: **Profitability of commercial banks**



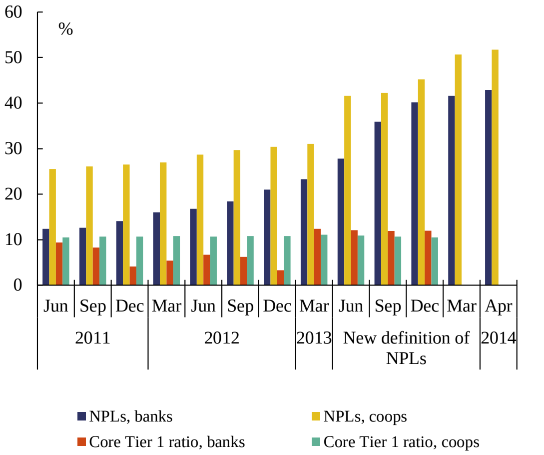
Source: Central Bank of Cyprus

At the same time, the high level of NPLs and relatively low provisioning levels make accrued interest a large component of interest income. Net fees and commissions were almost flat, whereas administrative costs were reduced by more than 10%, largely on account of lower staff expenses, reflecting banks' restructuring efforts. By contrast, the coops suffered a record loss of EUR 1.7bn in 2013, on account of total provisioning of EUR 1.9bn due to the sharp increase in NPLs during the year.

The CET1 capital ratio of locally active banks stood at 11.1% in March 2014, representing a slight increase compared to the previous quarter. Aware that the current very high level of NPLs requires adequate capital buffers, the banks are in the process of increasing their capitalisation ahead of the ECB's comprehensive assessment.

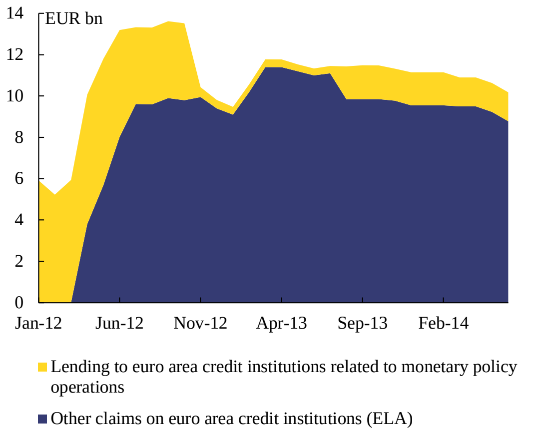
([5]) http://www.centralbank.gov.cy/nqcontent.cfm?a_id=13029

Graph 2.8: **Financial soundness indicators**



Source: Central Bank of Cyprus.

Graph 2.9: **Borrowing from the Eurosystem**



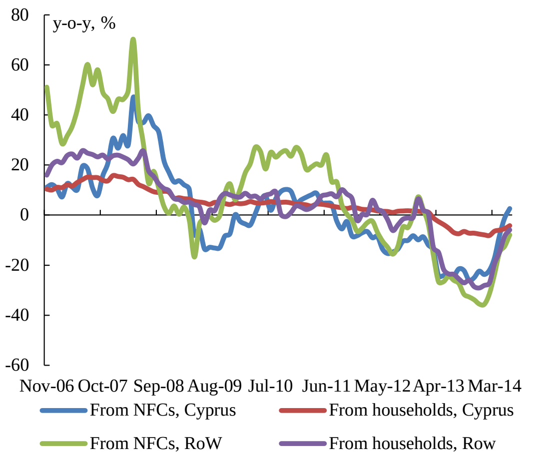
Source: Central Bank of Cyprus.

Banks reduced further their reliance on central bank funding, but the overall reliance remains large at above EUR 10 bn. From the beginning of the year until end-May 2014, total central bank funding declined by about EUR 520m to EUR 10.6bn (Graph 2.9). The sector's liquidity was boosted by the EUR 1.5bn recapitalisation of the Cooperative Central Bank in March and important divestitures from foreign exposure undertaken by Bank of Cyprus (BoC).

Aggregate deposit outflows continued in the first half of 2014, albeit at a slower pace and with some differences across banks. At system level, the deposit base started to stabilise as of May 2014, which also contributed to increase banks' liquidity buffers. Nevertheless, during the first five months of the year, deposits in domestic banks contracted by EUR 777m, out of which EUR 365 m belonged to domestic residents. Foreign banks recorded a net inflow of EUR 331m during the same period, benefiting from a recovery in foreign investor confidence. Domestic corporate deposits' annual decline decelerated from about 26% in October 2013 to around 1% in April 2014, while the contraction in domestic household deposits abated to about 5%. While deposits outflows slowed significantly in banks, in the coops the situation was more fragile.. Nevertheless, even outflows from the coops bottomed out and have shown signs of stabilisation recently.

Following allegations of money laundering, the Central Bank of Cyprus took over the management of one foreign bank branch without further macro-financial consequences. The US Department of the Treasury issued a notice on 17 July that the Federal Bank of the Middle East (FBME), a Tanzanian bank with a Cypriot branch, was classified as an entity of *Primary Money Laundering Concern*. FBME is a bank with EUR 1.6bn of assets (10% of GDP) and most of its deposits are from non-residents. The Central Bank of Cyprus took over the management of the branch on 18 July and the bank was placed on 21 July under resolution.

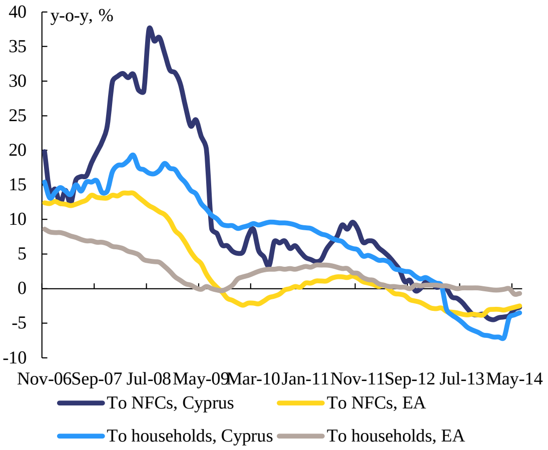
Graph 2.10: **Deposit developments**



Source: Central Bank of Cyprus.

The financial deleveraging in the economy continued as banks have reduced further their balance-sheets. Total assets in the banking sector declined by about 3% from December 2013 to March 2014 and reached around EUR 77bn, of which domestic institutions accounted for EUR 52bn or 315% of GDP. The speed of deleveraging was about the same in both the commercial banks and the coops. At the same time, the contraction of the stock of loans for both non-financial corporates and households has bottomed out since the end of 2013 (Graph 2.11).

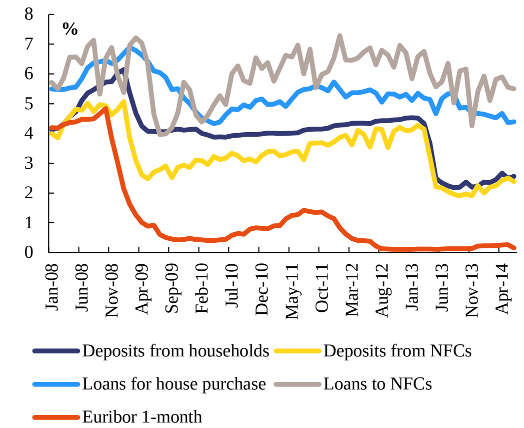
Graph 2.11: **Loan developments**



Source: Central Bank of Cyprus and European Central Bank.

After the big decline in deposit rates in mid-2013, following regulatory action, deposit interest rates were again on the rise. This largely reflects increased competition for deposits by banks. During January – May 2014, deposit rates increased marginally by about 20 basis points, contributing to the reduction of deposit outflows. Since the beginning of the year, the interest rate on new loans for house purchases declined by about 30 basis points while the cost of new corporate loans was broadly unchanged despite being significantly more volatile (Graph 2.12). As a consequence, the bank interest rate margin started to shrink moderately.

Graph 2.12: **Interest rate developments**



Source: Central Bank of Cyprus.

3. PROGRAMME IMPLEMENTATION

The fifth review mission by staff of the European Commission (EC), European Central Bank (ECB) and International Monetary Fund (IMF) reached agreement with the Cypriot authorities on policies that could serve as a basis for completion of the fifth review.

The Cypriot authorities have made further progress in implementing the programme. Fiscal targets for the first half of 2014 were met with a considerable margin, reflecting prudent budget execution. Progress has been made with the recapitalisation and consolidation of the cooperative credit sector, and banks continue to advance with their restructuring plans. This has allowed for a complete liberalisation of domestic payment restrictions, in line with the government's roadmap. The authorities have also taken steps toward implementing their ambitious structural reform agenda, notably with the adoption of the welfare reform.

One of the objectives of the programme enshrined in the MoU is to minimise the impact of consolidation on vulnerable groups. To this end, reforms in the areas of pensions and social welfare have been undertaken, and the reform of health care system is under way. The social welfare reform was explicitly aimed at providing better protection of vulnerable groups with the introduction of a guaranteed minimum income (GMI) scheme and better targeting of benefits to ensure public support for those most in need, including the working poor. Cuts in public sector pensions have been largely progressive. Health care reforms aim at strengthening the sustainability of the funding structure and will contribute, together with the implementation of a National Health System, to more equal access to public health services for all parts of the population. The programme also comprises a range of actions with regard to activating the unemployed and combatting youth unemployment, as well as an explicit commitment to preserve the good implementation of structural and other EU funds and to target EU funds to those areas that have the most important economic and social impact.

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

The design of fiscal consolidation measures aim at a more progressive tax system in several respects, by combining an increased taxation of capital (interest income, immovable property, bank levy) with a higher corporate tax rate. The VAT rate has also been increased. Where reductions in public sector emoluments have been necessary, they are predominantly progressive and target also certain benefits and privileges for senior officials. The objectives behind the necessary fiscal and fiscal-structural measures are clearly outlined in the introduction to these chapters of policy conditionality. Implementing the programme is instrumental to ensure that the disposable income of Cypriot households can start growing again over the medium-term and to bring public finances back to a sounder position.

A summary assessment of compliance with programme conditionality is provided in Table 3.1, while the specific assessment on the implementation of individual elements of conditionality with deadlines for end-Q2 and end-July is found in Annex 1.

The authorities should maintain the so far good track record in policy implementation. Cyprus seems to continue performing well at this stage. In particular, over the first five quarterly reviews, Cyprus has been fully compliant with the vast majority of assessed policy conditions, as agreed in the Memorandum of Understanding. Although policy conditionality is becoming more detailed, Cyprus' degree of compliance remains high. However, there were some delays and partial compliance was observed in several areas, notably on structural reforms. The authorities should step up their efforts and continue to pursue their ambitious reform agenda and maintain its momentum. Continued full and timely policy implementation remains essential for the success of the programme.

Table 3.1: **Summary of compliance with policy conditionality for the fifth review (end-July 2014)**

	Status
Financial sector policy	**Partially compliant.** Two important deadlines were missed. With respect to managing legacy Laiki, the appointment of an investment firm for the disposal of assets and for the management of the stake in Bank of Cyprus could not be finalised by end-June. The legal framework in relation to foreclosures and forced sales could not be amended by end-June either. Other important milestones of the financial sector reform, however, have been achieved. The examination started on the lending practices of Bank of Cyprus (BoC) and coops concerning related parties. The audited accounts of the coops were published. The Central Bank of Cyprus (CBC) recruited staff. The Resolution Law was adopted. Banks have strengthened their capacity to manage arrears and reporting in this respect. However, the coops were late in the recruitment of senior managers. On **Anti-Money Laundering (AML)** the Cypriot authorities are continuing the implementation of the Action Plan. In some areas, however, compliance has been partial and delays have occurred. The CBC has initiated the procedures to impose an administrative fine in a severe case of breach of AML regulations, but was non-compliant in the sense that these procedures have not been completed within the agreed deadline. The authorities have committed to finalize this process by end-August 2014 without any further delay and to make their decision public. Tools for off-site and on-site surveillance have been adopted but customized supervisory strategies still need to be developed and fine-tuned, and the process of applying and adjusting the supervisory tools remains ongoing. Formal training programs of supervisory staff still have to be institutionalized. The CBC is partially compliant in increasing its AML supervisory staff, and there have also been also delays in reinforcing the AML supervisory staff at the Cyprus Securities and Exchange Commission (CySEC).
Fiscal policy	**Compliant.** The fiscal performance until June 2014 is well on track. To reflect the positive developments in the first half of the year, the primary balance target has been adjusted to 1.3% of GDP (0.4% of GDP better than expected in the previous review).
Fiscal-structural measures	**Partially compliant.** On **health**, non-compliance has been observed in several fields, namely the initiation of the IT tender, the establishment of an Implementation Advisory Team and the review of the compulsory healthcare contributions by civil servants and pensioners, of the co-payment scheme for using public health care services, and of the income thresholds for free public health care. Additionally, further effort is needed to specify the roadmap for the implementation of the National Health Insurance Scheme (NHS) and the healthcare reform plan. On **public financial management**, the draft risk assessment report has been submitted to programme partners, whilst the guidelines for public investment projects have only been drafted, but have neither been issued nor implemented by the Ministry of Finance. On **revenue administration**, progress is overall satisfactory though a number of commitments were only partially met, notably the strengthening of collection powers and the improvement of the joint work programme on large and high risk taxpayers. In the area of international tax cooperation, the implementation of commitments taken to address the negative rating OECD Global Forum is progressing adequately though the requested progress report was submitted with some delay. On **Immovable Property Tax (IPT) reform**, the planned legislative amendments due in early-July were not adopted and programme partners were not consulted on the adopted changes to the current law. Moreover, the Q2-2014 deadline on the initial review of the tax regulations relevant for the foreclosure process, with a view to minimising the cost of foreclosure and subsequent sale of foreclosed property has been missed. Nevertheless, the general valuation projection and all other IPT with a Q2-2014 deadline (the communication strategy and the objections' management strategy) have also been completed on time. On **welfare reform**, the Council of Ministers adopted the final design of the welfare reform on time, while the House of Representatives adopted the respective legislation on the provision on the Guaranteed Minimum Income (GMI) with a slight delay. The authorities presented in early July 2014, for consultation with programme partners, a list of social benefits outside the GMI of which the beneficiary profiles and eligibility would be examined to serve as a basis for compensatory permanent measures. The authorities committed to include in the draft 2015 Budget Law additional measures to cover expected costs of the implementation of the welfare reform in 2015. To that end, a national registry of benefits, including the profiles and eligibility of all beneficiaries, is to be completed by November 2014.
Labour market	**Non-compliant**. The authorities have shared with the programme partners a draft of the National Action Plan for Youth Employment in July 2014, having therefore missed the May deadline. The Action Plan is now to be finalized by Q3-2014. The authorities have shared with programme partners a summary table of existing active labour market policies, but will submit a more comprehensive list including all measures (existing and envisaged) with the relevant intended aims, recipients and budgetary allocations by Q3-2014.

(Continued on the next page)

Table (continued)

Goods and services market	**Partially compliant**. Most of the Q2-2014 deadlines have been partially observed. In particular, (i) the Mergers Law was adopted with delay, while the transfer of qualified personnel to the Commission for the Protection of Competition (CPC) is on-going, with additional qualified personnel expected to be transferred in the next months. CPC's advocacy is also developing; (ii) the General Auditor's Office received staffing support, while the authorities have now committed to ensure its financial independence; (iii) on tourism, an updated progress report has been submitted, but the coordination plan involving all stakeholders and relevant authorities is incomplete and needs further fine-tuning. On housing market, the authorities defined administrative deadlines for the issuance of title deeds upon receipt of the certificate of division approval but partially met the conditionality on the submission of granular data on permits, deeds, and certificates required to proceed with issuance. Also, they have submitted only a draft action plan for the streamlining of procedures for the issuance of title deeds, focusing primarily on ways to deal with the backlog of title deeds pending at the Department of Lands and Survey (DLS) level. On energy, all Q2 deliverables have been received on time.
Data reporting	**Compliant.**

Source: Commission services.

3.1. FINANCIAL SECTOR

3.1.1. Maintaining liquidity in the banking sector

At the end of May 2014, the Cypriot authorities removed all remaining administrative restrictions on domestic financial transactions related to the free opening of current accounts. Thus, the third stage of the roadmap for the gradual relaxation of restrictive measures was successfully completed. As many factors influence liquidity flows in banks, it is difficult to disentangle the contribution of only one factor, i.e. the liberalisation of payment restrictions. Nevertheless, a preliminary assessment of the overall situation suggests that the measure has so far not had major negative impact on deposit outflows and liquidity shortfalls. The stabilisation trend of the deposit base at system level has continued in June and July. Deposit outflows from coops have abated and the liquidity situation of Bank of Cyprus has improved, although the bank still faces deposit outflows.

The Cypriot authorities are committed to move to the gradual implementation of the fourth stage of the roadmap, i.e. the liberalisation of external payments. The liberalisation of external restrictive measures will, however, only be considered after the successful completion of ECB's Comprehensive Assessment and a smooth transition to the Single Supervisory Mechanism (SSM). Moreover, the gradual relaxation of the external payment restrictions should be consistent with financial sector stability and the preservation of comfortable liquidity buffers. To this end, the authorities will update the roadmap, after conducting an analysis of deposit trends, and performing an audit of the implementation of restrictions.

The Central Bank of Cyprus continued to monitor closely the liquidity situation of the banking sector and stand ready to take appropriate measures to maintain sufficient liquidity in the system. Bank of Cyprus and the coops submitted their first quarterly capital and funding plans to the Central Bank of Cyprus (CBC) and to the programme partners. Work is being undertaken for the preparation of the next submission of the funding and capital plans with an improved quality of projections.

3.1.2. Regulation and supervision of banks and the cooperative credit institutions

Further progress has been made toward the implementation of the new banking sector regulatory and supervisory framework. In line with the new provisioning and disclosure directive, which requests banks to disclose more information about the quality of bank assets and how they work out Non-Performing Loans (NPLs), the Cooperative Central Bank published its audited 2013 consolidated accounts on 2 July. As indicated in the previous report, for the remaining banks, this directive will be fully implemented by the time of the publication of the 2014 annual accounts. In the context of the enhanced monitoring of the institutions' restructuring plans, the CBC received the quarterly reports of Bank of Cyprus and of the Cooperative Group based on key performance operational and financial indicators, such as cost-income ratio, interest margin, loan-to-deposit ratio, etc. On 6 June, the CBC requested banks to produce a report on their past and current lending

Box 3.1: The ECB's Comprehensive Assessment and the Cypriot banking system

The ECB, in collaboration with national supervisors, is conducting a Comprehensive Assessment of 131 euro area banks' balance sheets, of which four from Cyprus. These are Bank of Cyprus, the Cooperative Central Bank, Hellenic Bank and Russian Commercial Bank. The purpose of the exercise is to examine the state of the banks before the ECB assumes supervision powers in November 2014. The comprehensive assessment is comprised of two main pillars. First, an asset quality review (AQR) checks the quality of banks' assets, including the valuation of assets, collateral and related provisions, based on banks' financial statements as of end-December 2013. Second, a stress test, done in close cooperation with the European Banking Authority (EBA), examines the resilience of banks' balance sheets to stress scenarios, spanning from December 2013 to December 2016.

The results of the examination will be disclosed in the second part of October, according to the ECB(1). Banks facing a capital shortfall will be requested to submit capital plans within a period of two weeks. Shortfalls arising from the AQR, or the baseline scenario of the stress test will need to be covered within six months, and shortfalls arising from the adverse stress scenario within nine months. If the supervisor concludes during the AQR process that material changes in asset valuations are needed because a bank is below the minimum regulatory requirements of 4.5% common equity tier 1 (CET1) due to significant accounting irregularities, this needs to be promptly communicated to the bank, which in turn has the legal obligation to restate its accounts and inform markets of the corrections.

The AQR consists of several steps, of which many have already been performed during the Pimco Due Diligence exercise. i) Assessment of accounting and provisioning policies; ii) direct loan file reviews for all portfolios except for those mentioned in iv); iii) risk classification and provisioning requirements review and remedial actions as necessary based on harmonised definitions for non-performing loans; iv) the application of a collective provisioning model for retail and small SME exposures; v) extrapolation of the findings of individual credit file reviews to remaining exposures within the corresponding portfolio/bucket; and vi) a review of trading and level 3 assets (less liquid assets for which market prices are not available). Except for the revision of trading book and level 3 assets that will not be applied to any bank in Cyprus(2), all the other elements of the AQR will be implemented on the participating Cypriot banks. Many of these elements were also common to the Pimco exercise of the Cypriot banking system conducted in 2013. The same can be said of the stress tests, although the parameters were very different.

The AQR and the baseline scenario of the stress test will be based on a capital benchmark of 8% CET1, and of 5.5% for the adverse scenario. Banks are required to maintain a static balance sheet throughout the duration of the stress tests exercise, with the balance sheet frozen at the levels observed as of end-2013. According with the Stress Tests methodology(3) an exception can only be granted if banks have already committed to implement restructuring plans validated by the European Commission or other EU institutions before 31 December 2013. The restructuring plan of the cooperative banks in Cyprus was approved by the Commission end-February 2014 and cannot be directly taken into account. The restructuring plan of Bank of Cyprus, submitted to the Central Bank of Cyprus in November 2013, thus ahead of the EBA deadline, could feed into the exercise.

The strict definitions of the Capital Requirements Directive IV and Capital Requirements Regulation are to be used. Thus, some capital components previously included in the EU banks' regulatory capital, like Deferred Tax Assets reliant on future profitability or preferential shares, will be gradually removed from the eligible capital instruments. Moreover, at least 60% of the potential losses generated by sovereign exposures in the available for sale accounting class (subject in the specific case of Cyprus to a haircut of around 9% for the 10-year maturity) will be deducted from banks' capitals. Additional provisions will also be required for the remaining sovereign exposures in the banking book.

(1)http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201407en.pdf?4483c06273561996a534889237984162

(2)http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201402en.pdf

(3)https://www.eba.europa.eu/documents/10180/669262/Methodological+Note.pdf practices to Board members and directors. After clarifying the role of the Financial Ombudsman, the necessary legal changes were voted by the Parliament on 10 July. Further discussions are, nevertheless, expected and additional legal amendments cannot be ruled out.

Nevertheless, some delays occurred, leading to partial compliance in a number of areas. Not all banks have submitted by the end-June deadline their estimate of the potential impact of newly introduced EU rules on their profitability and coverage ratios, despite the timely issuance of a circular letter requesting these estimates by the CBC in late March. The CBC has not completed its analysis of banks' quarterly reports on progress with the implementation of their restructuring plans, to be submitted to the CBC board. Similarly, the CBC governor and the executive directors still need to finalise their review of the CBC governance.

3.1.3. Recapitalisation, resolution and restructuring

Bank of Cyprus

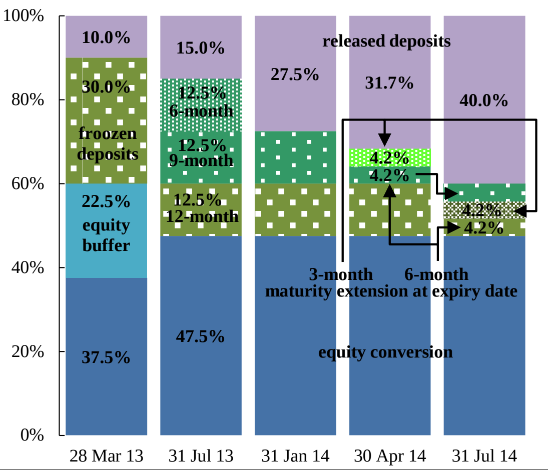
The operational implementation of the restructuring plan is broadly finalised. All planned branches and International Business Units have been closed. As far as the IT operations are concerned, the full migration of the IT system of Cyprus Popular Bank into Bank of Cyprus has been completed.

The level of Non-Performing Loans (NPLs) continues to increase in Bank of Cyprus. The migration of the IT systems and work for the on-going Asset Quality Review organised by the ECB temporarily slowed the management of NPLs. There are still inflows into the NPL portfolio from the retail and SME loan portfolio. However, the bank has a better grip on the corporate loan portfolio made up of fewer but larger loans. The announcement of changes to the legal framework in relation to foreclosures and sales of mortgaged property, in accordance with the MoU, is already supporting the bank's efforts to manage NPLs. Developing a market for NPLs and removing impediments for the banks to obtain financial information on non-performing borrowers should further contribute to the bank's efforts.

The liquidity position of Bank of Cyprus has improved. Due to the sale of its subsidiaries and equity stakes abroad, the bank had already repaid EUR 250m of ELA in March and April, and another EUR 170m in May. Furthermore, the Cypriot government has reimbursed EUR 950m of the recapitalisation bond that Bank of Cyprus acquired when it absorbed Cyprus Popular Bank. Following this operation, the bank has been able to refund EUR 450m of ELA in June and EUR 550m of Eurosystem Monetary Policy Operations in July. Total borrowing from the Eurosystem stands in July at EUR 9.6bn (of which EUR 8.8bn of ELA and EUR 0.9bn normal ECB funding), compared to last year's peak of EUR 11.2bn (of which EUR 1.4bn of Eurosystem Monetary Policy Operations and EUR 9.8bn ELA). Finally, the liquidity position of the bank is expected to improve by EUR 1bn during Q3 2014 as a result of the announced equity raising of around EUR 1bn.

Against this background and taking a prudent approach, the Bank of Cyprus released partially the third tranche of frozen uninsured deposits on 31 July 2014. About EUR 3bn of deposits have been blocked a year earlier as a liquidity safeguard measure in three equal tranches of six, nine and twelve-month deposits. While on 31 January the six-month deposits have been completely released, a gradual approach has been followed when the nine-month deposits matured (Graph 3.1). At the expiry date of the twelve-month frozen deposits, the same prudent way forward has been pursued, and one third was released, with the remainder rolled over in three and six month deposits, each also for one third. As a result, almost all deposits have been freed, namely 40% of the original amount of uninsured deposits on 28 March 2013 (EUR 8.4 bn). There remains 12.5% locked-in, of which two thirds matures on 31 October 2014 and the rest on 21 January 2015.

Graph 3.1: **Uninsured deposits at Bank of Cyprus: equity conversion and gradual release**



Source: Commission services.

The capital position of Bank of Cyprus has slightly improved. The capital position has been recalculated from CRD III to CRR/ CRD IV leading to a 10.6% common equity Tier 1 ratio at the end of Q1 2014 compared to 10.3% in terms of core tier 1. The capital position is expected to improve by 0.4 pp, thanks to the repayment of the Cypriot government bond and continuous bank deleveraging. A further strengthening is in the pipeline as a result of the announced equity raising of around EUR 1bn. On 28 July, the BoC's Board of Directors endorsed the capital increase, which is expected to be approved at a shareholders' meeting in mid-August.

The Cooperative Credit Institutions

The restructuring of the cooperative sector has achieved a number of milestones. The consolidated audited accounts were published for the first time in the history of the sector, and indicated a Core Tier I capital ratio of 14.1% at end-2013 (after correction of an error in the consolidation of the credit sector). The recruitment of the executive and non-executive members at the CCB and the CCIs was completed. The first quarterly report, including the agreed upon key performance indicators, was published in May. All policies relating to arrears management were finalised and the central NPL management division was set up in the CCB. Progress has been made also with respect to cost cutting. Salaries were reduced by over 15% on an annual basis, and the CCB initiated a pay equalization exercise within the framework of harmonising the organisational structures across the sector.

Despite these achievements, serious challenges remain ahead. The CCB still has to enforce the Group policies in a more robust way, thus avoiding possible contradiction or duplication of tasks with the regional managers at the level of individual CCIs. Progress is also needed with respect to overcoming the still on-going deterioration of the loan portfolios. Stronger deposit retention is also needed in order to reverse the negative trend in terms of liquidity. The authorities have committed to seriously tackle these and other issues, namely through the update of their restructuring plan. The updated MoU contains specific time-bound provisions where further progress is expected in the areas of i) arrears management, ii) Management Information System, iii) governance, iv) strengthening management capacity and v) communication.

Hellenic Bank

The level of NPLs continues to increase in Hellenic Bank as well. Although the level of NPLs is lower than in some of its Cypriot peers, in an international comparison it is still very high. Managing NPLs is the key priority for the bank for the next years. As in Bank of Cyprus, an Arrears Management Unit (AMU) has been created for mid- and large-sized corporates. The value of NPLs that are managed by this unit is EUR 1.1bn and the number of staff 50. Furthermore, the bank has appointed Oliver Wyman as an adviser to support the management of NPLs. A high percentage of the portfolio of the AMU is still classified as cooperative borrowers, among which only a small share is currently providing information on their financial and income situation. The bank hopes to be able to tackle better the delinquent borrowers with the amended foreclosure law and improved access to the financial situation of debtors in arrears.

The liquidity and capital situation of Hellenic bank remains satisfactory. In accordance with the MoU, the minimum capital requirement has been lowered from 9% core Tier 1 to 8% common equity Tier 1, bringing it in line with the requirements under the Comprehensive Assessment of the ECB. As a result, the trigger point of the bank's additional Tier 1 instruments (CoCo's) into equity has been reduced concomitantly and the bank enjoys a somewhat larger capital buffer. In the first quarter, the CT1 ratio stood at 8.9%.

3.1.4. Legal framework for private debt restructuring

The Cypriot authorities made progress in developing a comprehensive reform framework, establishing appropriate corporate and personal insolvency procedures. The framework envisages a reform of insolvency arrangements, for natural persons as well as for corporates, in line with international practices. With regard to personal insolvency, the framework aims to establish a modern bankruptcy process for over-indebted individuals, including an effective and timely discharge subject to proper safeguards, as well as a new streamlined process for over-indebted individuals with no assets and no income, and with relatively small unsecured debt. A critical part of the envisaged new personal insolvency framework is the introduction of a repayment plan for those debtors who can make payments towards their mortgage loans. The new insolvency arrangements for corporate debtors encompass an effective restructuring procedure, including large borrowers, as well as a modernised and effective liquidation process. Horizontal issues such as the establishment of an Insolvency Service, the development of reasonable living expenses guidelines and the regulation of insolvency practitioners is also included in the framework on which basis legislation will be prepared.

Progress was made in drafting the legal framework that establishes a new swift foreclosure procedure, which allows for auctions/sales to be conducted by mortgage creditors without interference from government agencies. The draft Law amends the Immovable Property (Transfer and Mortgage) Law no. 9 of 1965 and maintains as the only condition for the initiation of the foreclosure procedure a default of payment of more than 120 days past (the current law is a 30 days default period), while acknowledging that the mortgage creditor may be otherwise stayed from pursuing enforcement of its remedies by operation of other laws or rules. The draft Law contains swift procedures for obtaining market valuation of the property by independent valuators and rules regarding the reserve price. The draft Law also includes precise deadlines for all procedural steps and respective preclusive periods for appeals, as well as provisions to safeguard the integrity of the foreclosure process, including through transparency and anti-fraud provisions. The Law will be accompanied by a regulation on the procedural rules for sale by auction, which facilitates the swift and transparent performance of auctions without delay or hurdles. The new foreclosure procedure will be available for all mortgaged property. The amending Law, once adopted, will have immediate effect for all mortgaged property except primary residences for which the provisions will enter into effect by 1 January, 2015.

A Task Force on registered, but untitled, land sales contracts has been established. The Task Force prepared first recommendations on the removal of administrative hurdles and the release of encumbrances on properties to facilitate title transfer according to the land sales contracts. Further refinement of the recommendations is envisaged. A study assessing the magnitude of registered, but untitled land sales contracts and underlying mortgages is on-going.

3.1.5. Anti-Money Laundering

The Cypriot authorities have continued to implement the Anti-Money Laundering (AML) action plan, focussing in particular on measures to strengthen effective supervision of financial institutions, lawyers, accountants and administrative service providers.

The CBC has pressed ahead with its efforts to ensure that financial institutions have sound and effective AML/CFT systems. The annual risk management reports have been submitted by the banks to their respective boards and approved, with the exception of two banks for which board meetings are scheduled later in the year. The monitoring of whether business models have changed, triggering the need for banks to review their risk management, will be integrated once the restructuring of the supervision in connection with the Single Supervisory Mechanism is agreed. In line with its supervisory program for 2014, as of Q2-2014, the CBC had completed comprehensive onsite inspections at four credit institutions, making use of most of the examination procedures developed for that purpose. In this context, the banks also received feedback on whether their annual risk management reports met the expectations from a supervisory perspective. Moreover, the CBC carried out brief onsite visits of two days each to another nine banks. These visits served to assess whether the banks had updated their customer due diligence manuals and processes, and also to examine whether corrective actions had been taken by three of the banks that had previously received warning letters after the CBC follow-up on the cases revealed by the Deloitte report. As regards the inspections and onsite visits, the CBC shared anonymized information about their supervisory measures and enforcement actions applied for non-compliance and/or violations of laws and regulations. While the CBC has initiated the procedures to impose an administrative fine in one case, these have not been completed within the agreed deadline. The authorities have committed to finalize this procedure by end-August 2014 and to make public the decision whether to apply sanctions if applicable. The authorities are further committed to finalize the investigation initiated on the local branch of FBME Bank Ltd. and to take appropriate supervisory action based on its results. This branch has been put under resolution by the CBC after its designation by the US authorities as a financial institution of primary money laundering concern and following the measures taken by its correspondent Banks.

Following the initial application of the risk-based supervisory tool for offsite monitoring, the CBC has now fine-tuned the tool and assigned risk profiles to all financial institutions, although it has not yet developed customized supervisory strategies accordingly. The fine-tuning of the onsite supervisory tools has commenced, but needs to continue after a review of all eleven onsite inspections planned for 2014 has been carried out. At the same time, the CBC should also update the institutional risk profiles and supervisory strategies based on the results of the onsite inspections.

The supervisory authorities for the non-financial sector have further enhanced their risk-based approach to supervision. The questionnaires, which had been developed in the first quarter of 2014, have been sent out by both the Cyprus Bar Association (CBA) and the Institute of Certified Public Accountants of Cyprus (ICPAC). The response rate of ICPAC was 95% to date and the respondents have already been assigned risk profiles, while the remaining 5% will be assigned the highest risk rating if no answer is received. Also the CBA has not received replies to all the questionnaires sent out, but will follow up on the 440 law firms that have not answered to obtain the complete sample by mid-September. Based on the assigned risk profiles, the CBA and the ICPAC are to devise customized supervisory strategies. In order to facilitate inspections, these institutions have developed a methodology for onsite activities, including the required examination/verification procedures for onsite visits, covering inter alia risk assessment systems, policies and procedures, the compliance function, and training programs. The Cyprus Securities and Exchange Commission (CySEC) is in the process of completing the second phase of development by designing the methodology, including processes and procedures, for its risk-based supervision framework. In addition, the CBA, ICPAC and CySEC have shared anonymized information about their supervisory measures and enforcement actions related to non-compliance and/or violations of laws and regulations.

It is important that all supervisory authorities are adequately staffed to perform all their duties in an effective way. The CBC has so far not made sufficient progress in increasing the staff of its AML unit, therefore a deadline has been set to Q3-2014, and the CBC committed to having two additional staff with the relevant skills in the unit by this deadline. CySEC is also currently understaffed and is pursuing different options to overcome this deficiency.

The risk-based approach to AML/CFT supervision requires training of the supervisory authorities' staff, as professionals must also be educated to the application of risk-based AML/CFT measures. Thus, the CBC, CBA and ICPAC have developed customized AML/CFT training courses, covering inter alia customer due diligence, monitoring of transactions, identification and reporting of suspicious transactions, the compliance function, risk assessment systems, etc. Staff of the CBC, CBA and ICPAC were also trained in adequately implementing the newly developed offsite and onsite risk-based tools, although mostly by being closely involved in their development. In order to institutionalize the training and provide it on a regular and systematic basis, all supervisory authorities should establish a formal AML/CFT training program, including all the agreed training modules.

In collaboration with the AML supervisory authorities, the Unit for Combating Money Laundering (MOKAS) conducted seminars on AML requirements such as the filing of suspicious transaction reports, including the new duty to report suspicious transactions related to tax crimes. These seminars were addressed to the AML compliance officers of financial institutions and to lawyers, accountants and administrative service providers. In compliance with the MoU, MOKAS also continued to provide to the programme partners the breakdown of requests made and received to and by foreign financial intelligence units, including spontaneous disseminations.

In line with the plan to reform the Department of Registrar of Companies adopted in April 2014, the project team has begun its work. There have been delays in providing sufficient staff to the relevant section of the Department for processing the backlog of pending registration documents. Nevertheless considerable effort has been made and 17 persons have been allocated to the relevant section through mobility, and the authorities commit to add to the team another 14 persons by Q3-2014, following an extension of the deadline. Despite the delays in increasing staff, the authorities believe that the full update of the registry can still be achieved by January 2015. The mapping of all internal procedures in the Companies Section of the Department with the aim to simplify them has been initiated and the process of monitoring the compliance of companies with their regulatory requirements is ongoing. Basic information (i.e., the name and type of company, the registration number, the date of incorporation and status, the directors and company secretary as well as the registered office address) is now available free of charge via the website of the Department of Registrar of Companies. Nonetheless, the substantial backlog in updating the register limits the availability of accurate and current data.

3.2. FISCAL POLICY

The 2014 end-year primary deficit target was revised from 1.7% of GDP to 1.3% of GDP to reflect better-than-expected budgetary developments. The fiscal outcome until June was ¾% of GDP better than the quarterly estimates due to tight expenditure control in almost all expenditure categories. The projection for 2014 does not fully carry over this fiscal over-performance to the second half of the year, resulting in a revision of the 2014 primary deficit target by 0.4% of GDP. The revenue projections remain largely unchanged, though the proceeds for taxes on income and wealth were lowered to reflect the larger discount offered for early payment of immovable property tax. On the expenditure side, the lower-than-expected cost of compensation for public sector employees until June is expected to largely continue until the end of the year, driven by a faster deceleration of the public sector retirement wave resulting in lower lump-sum payments than anticipated previously. For social transfers, while some of the observed under-spending is expected to carry over to the year-end, the forecast also includes additional expenditure related to the GMI implementation and the maturing pension system.

The results of the Risk Assessment Report prepared by the Public Debt Management Office (PDMO) suggest that a large amount of government guarantees will be called over the period 2014-2016, adding significantly to the fiscal impact stemming from the called guarantees that were included in the fourth review mission projections. While uncertain at this stage, the updated projections follow a cautious approach and assume that the bulk of the calls will materialise in 2014 and 2015. ([6])

Despite the better-than-expected performance in 2014, the amount of consolidation measures needed for 2015 and 2016 has been revised slightly upwards to 1.9% of GDP (from 1.7% of GDP previously). Total revenue in 2015 and 2016 has been revised slightly down, to reflect the downward revision to nominal GDP as well as the

([6]) The fiscal effect of called guarantees on the revised projections is however limited, given that the buffers that were included in the 4th review mission projections are used to capture this effect.

Table 3.2: **Fiscal accounts, projections for 2014-2016**

million euros unless otherwise stated			Fifth review forecast (July 2014)			Fourth review forecast (May 2014)		
	2012	2013	2014	2015	2016	2014	2015	2016
Total revenue	**6,974**	**6,656**	**6,616**	**6,501**	**6,774**	**6,626**	**6,544**	**6,820**
Taxes on production and imports	2,633	2,396	2,368	2,416	2,524	2,362	2,421	2,533
Current taxes on income and wealth	1,962	1,916	1,797	1,792	1,866	1,805	1,821	1,900
Social contributions	1,510	1,475	1,477	1,506	1,550	1,483	1,510	1,552
Sales and other current resources (1)	858	863	954	784	832	960	790	833
Capital transfers received	11	6	20	2	2	16	2	2
Total expenditure	**8,109**	**7,553**	**7,356**	**7,326**	**7,134**	**7,459**	**7,373**	**7,225**
Total current expenditure	7,434	7,030	6,736	6,786	6,622	6,904	6,896	6,737
of which								
Intermediate consumption	865	741	743	757	725	775	774	746
Compensation of employees	2,819	2,567	2,369	2,350	2,335	2,385	2,349	2,328
Social transfers	2,606	2,682	2,682	2,674	2,595	2,710	2,733	2,623
Interest (2)	563	560	530	568	561	558	571	606
Subsidies	95	95	90	90	91	93	90	90
Other current expenditure	487	384	322	347	316	383	379	344
Total capital expenditure (3)	675	611	620	540	511	555	477	488
General government balance	**-1,135**	**-897**	**-740**	**-826**	**-360**	**-833**	**-829**	**-405**
% GDP	*-6.4*	*-5.4*	*-4.7*	*-5.2*	*-2.2*	*-5.3*	*-5.1*	*-2.4*
General government primary balance	**-572**	**-337**	**-210**	**-258**	**201**	**-275**	**-258**	**201**
% GDP	*-3.2*	*-2.0*	*-1.3*	*-1.6*	*1.2*	*-1.7*	*-1.6*	*1.2*

(1) The projection for 2014 includes the expected increase in the distribution of dividends by the CBC compared to the previous year. The 2015 and 2016 numbers will be adjusted once decisions are taken by the CBC on dividends in these years.
(2) This includes an annual interest saving of EUR 30m related to the CBC asset-debt swap, which is subject to a decision of the CBC board in full respect of the independence of the CBC, the Treaty and the rules and procedures of the Eurosystem.
(3) For 2013, this includes signing fees for gas exploration amounting to 1.1% of GDP, which are treated as negative capital expenditure (disposal of non-produced assets).
Source: Commission services.

fact that part of the existing bank levy are expected to be channelled as of 2015, to the bank resolution fund. The revenue forecast does not include the additional dividends expected to be distributed by the Central Bank of Cyprus in 2015 and 2016. The projection of primary expenditure, abstracting from yet-to-be specified measures, has remained broadly unchanged in 2015 and 2016. Lower intermediate consumption, a reduced contribution to the EU budget, and the lower base effect from lower social spending in 2014 offset the costs from the GMI implementation and from additional calls of government guarantees.

The revised MoU requires the authorities to submit for consultation with programme partners a proposal that will ensure the fiscal neutrality of the welfare system reform and the achievement of the 2015 fiscal deficit target. The final proposal will be agreed with programme partners by end-August 2014 and will be incorporated in the draft 2015 Budget, which will be adopted by the Council of Ministers by mid-September 2014 and submitted to the House of Representatives by end-September.

Further consolidation measures of lasting nature will be needed over 2017-18 to achieve the overarching objective of a primary surplus of 4% of GDP in 2018. The order of magnitude is currently estimated at around 1.7% of GDP over the two years, provided that the cyclical conditions are as supportive as currently forecast. However, there are obviously large uncertainties regarding the macroeconomic outlook, both with regard to the pick-up in real growth and the evolution of the GDP deflator. In order to even out the fiscal adjustment over these two years, the 2017 primary balance target was revised down from 3.0% of GDP to 2.5% of GDP.

Fiscal risks remain significant. The risks concern notably the government's large exposure to contingent liabilities and potentially adverse macroeconomic developments in the outer programme years.

3.3. FISCAL-STRUCTURAL REFORMS

3.3.1. Healthcare System

The government continues to signal strong commitment to the implementation of the National Health Insurance Scheme (NHS). Since his appointment in March 2014, the Minister of

Health has expressed his dedication to implementing the healthcare reforms as agreed in the Memorandum of Understanding (MoU), although progress over the last months has been rather limited. According to the current plan, the NHS is still foreseen to be implemented gradually, starting with primary care consultation services in mid-2015, and followed by outpatient specialist care and pharmaceutical care in January 2016, with full implementation by mid-2016.

An updated roadmap for the implementation of the NHS has been submitted. While being slightly more detailed compared to previous versions, it remains rather broad, partly because most policy decisions regarding the design of the reform are expected to be taken during the coming months. The amended General Health Care Scheme Law will be submitted to the House of Representatives by October 2014, with a view to approval by end-2014. Moreover, by Q3-2014, the government has committed to present all financial parameters of the first stage of NHS, including for example the total budget for primary healthcare consultations, the level of the insurance premium and of capitation fee as well as the minimum and maximum amount of citizens per general practitioner.

A delay has been observed in the initiation of the procurement tender for the IT infrastructure for the NHS, due to on-going discussions on infrastructure design and the tender procedure. It has been agreed that the tender will be finalised by December 2014.

The NHS will be initially based on a single payer insurer but could evolve into a multiple insurance system. As the government is interested in investigating the possibilities of moving towards a multi-payer system at a later stage, a study will be undertaken by an independent consultant, which will assess whether, when and under which conditions further efficiency, quality and access gains can be ensured through the implementation of a multi-payer insurance system.

The healthcare reform plan was adopted by the Council of Ministers in mid-July. The plan aims at giving more autonomy to hospitals and at restructuring all public health facilities, the Ministry of Health, the Health Insurance Organisation and other associated organisations. With a view to full implementation in Q2-2015, the plan needs to be further specified. In this regard, the authorities will share with programme partners by Q3-2014 a detailed restructuring plan of the public primary healthcare centres. Further, it is foreseen that public hospitals will complete the shadow-budgeting for all inpatient cases on diagnoses-related groups by Q3-2014 and for all in- and outpatient activities by Q4-2014.

No progress has been observed with regard to the review of the compulsory healthcare contributions by civil servants and pensioners, the co-payment scheme for using public health care services, and the income thresholds for free public health care. Further, the work on contingency measures as well as the possible adjustment of the pricing and reimbursement of pharmaceuticals appears to be limited and needs to be significantly accelerated. The MoU now requires the authorities to submit by Q3-2014 for consultation by program partners several reports reviewing these parameters and policies.

Good progress has been observed with the organisation of support from international experts, although the deadline for establishing an international advisory team has not been met. A mission organized by the World Health Organisation took place in July, which led to the identification of areas where international experts could assist with the implementation of the Cypriot healthcare reforms. The Ministry of Health is assessing different options to finance international assistance in this regard.

3.3.2. Public Financial Management and Budgetary Framework

The secondary legislation providing for the staffing of the Fiscal Council was adopted on 5 June and the signing of a MoU on information exchange between the Fiscal Council, Ministry of Finance, Central Bank of Cyprus, Statistical Services (Cystat) and University of Cyprus took place on 10 June. These were prior actions for the fifth disbursement. The members of the Fiscal Council's Board were appointed by the Ministerial Council on 4 June. With these steps finalised, the Fiscal Council can now start, albeit with delay, its tasks in the 2015 annual budgetary cycle. Three staff members of the Fiscal Council need now to be hired. In addition, work is ongoing for the finalisation of all secondary legislation to enable the full implementation of the Fiscal Responsibility and Budget System Law (FRBSL). This secondary legislation is expected to be tabled to the House of Representatives for adoption by Q4-2014.

An advanced draft risk assessment report on government guarantees has been submitted to programme partners. The FRBSL requires an annual fiscal risk statement to be published together with the budget. Against this background, a special risk assessment unit established under the Public Debt Management Office (PDMO) started working on a comprehensive database on government guarantees. Based on this database, the authorities submitted to programme partners during the review mission an advanced draft risk assessment report, with a view to the submission of a final version by Q3-2014. The report identifies a sizeable number of guarantees that are expected to be called in the years 2014-2016, which add significantly to the number that was anticipated previously. Given their criticality for fiscal developments, the Cypriot authorities have initiated work on institutional arrangements for the management of existing and future guarantees. This comprises the definition of clear responsibilities within and across ministries, as well as the design of procedures for the management of existing and new guarantees, including the restructuring and recovery of called guarantees.

The Ministry of Finance has prepared draft guidelines for public investment projects that are now under consultation with all line ministries, before being issued by the Minister of Finance. These draft guidelines provide that public investment projects proposed by line ministries will now be subject to a detailed project evaluation, entailing an assessment of their economic, social, environmental and budgetary impact, including a cost-benefit analysis, in line with the provisions of the Fiscal Responsibility and Budget System Law (FRBSL). The Cypriot authorities are envisaging to provide training to economic officers in each line ministry involved with the assessment of public investment projects, based on manuals that are to be prepared in the context of the technical assistance facilitated by the Support Group of Cyprus.

3.3.3. Privatisation and State-Owned Enterprises

The Privatisation Unit was formally established and approved by the Council of Ministers on 25 June. The Head of the Privatisation Unit and part of his staff started their work on 1 July. Additional staff is expected to be hired by October, allowing the Privatisation Unit to be fully operational by then. The Unit is creating the appropriate links with all different stakeholders, particularly with the three big State-Owned Enterprises (SOEs) planned for privatisation: CyTA (telecoms), EAC (electricity) and CPA (ports). The appointment of advisors is now a priority. The Privatisation Unit has launched the tenders for the financial and legal advisors for CyTA and EAC, in view of the requirements agreed. For CPA, which is not under the umbrella of the Privatisation Unit but under the Ministry of Communication and Works, only the technical advisor has been identified, while the selection process of both the financial and the legal advisors is running late. CPA requires more scrutiny, so as to ensure that CPA's concession agreement is signed within 2015. The Privatisation Unit is expected to prepare CyTA's detailed privatisation plan, including all characteristics of its transaction, by Q4-2014. CyTA is also expected to be converted into a Limited Liability Company by December this year.

Due to repeated delays, the SOEs corporate governance law was not adopted by mid-June, contrarily to what was expected. Delays were due to inconsistencies identified at a later stage with the Fiscal Responsibility and Budget System Law (FRBSL) including, inter alia, different definitions for SOEs, allocation of responsibilities, and process of strategic planning. Delays in the legal vetting procedure postponed the adoption even further. By the end of the mission, the Minister of Finance gave his final green light, while a second legal vetting round was launched. Considering the House of Representatives' summer recess, the law can only be adopted by September.

A SOEs Plan with a roadmap for the review of SOEs under internal review was submitted during the mission but was not detailed enough. The Plan contains seven SOEs, which are all currently undergoing significant financial losses, and includes only broad timelines for their review and restructuring. For two SOEs (Cyprus

Theatrical Organisation and Symphony Orchestra Foundation), a final review is expected by mid-October, while the final review and restructuring of the remaining five are envisaged for 2015. The MoU now requires that the SOEs' strategic plans include both detailed milestones and timelines.

3.3.4. Revenue Administration

The legislative amendments to enhance the collection powers of the tax authorities and to establish self-assessment for all income taxpayers were approved by the House of Representatives (HoR) in June, but they need further follow-up work. In particular, regulations must still be passed to detail the procedural rules for the seizure of movable assets. In addition, the Commissioner of the tax administration needs to issue a notification on the procedural rules for the garnishing of bank accounts (the updated MoU contains a new Q3-deadline in this regard). Therefore the requirement to strengthen collection powers by the tax authorities to ensure payment of outstanding tax obligations is only partially met, while the other measures (attributing personal responsibility for payment of company taxes, making non-payment of withholding taxes a criminal offence, enacting legislation to establish self-assessment) are fully compliant.

After the adoption of the enabling law to formally establish the new integrated tax agency, an interim tax commissioner was appointed on 16 July. The enabling law introduces rotation principles for the tax commissioner, determining a maximum term in office of 5 plus 5 years. A similar limitation applies to the assistant commissioners. In addition, the law establishes a new accountability framework, requiring, inter alia, annual reporting to the HoR and an annual declaration of the commissioner's financial position. As a next step, the focus is now shifting to the urgent need to appoint the fixed-term tax commissioner as well as two assistant commissioners and decide on the organisational structures in the new department.

The authorities have taken important initial steps towards the development of a comprehensive strategy to manage compliance risks. First, the authorities have integrated all tax data in a common platform for risk analysis purposes, which was an essential necessary step to seriously launch analytical work to identify compliance risks. The authorities therefore complied with the Q2-2014 deadline set in the fourth review mission, which had already been postponed twice. Second, progress was made with respect to the cleansing of the income tax register, which was clogged with inactive taxpayers, hampering the efficient and effective treatment of non-compliant taxpayers. About 55,000 taxpayers were removed or declared temporarily inactive in the register. However, there are not yet procedures in place to ensure that the register stays fully up-to-date in the future and there is further scope to exploit cross-checks with the VAT register to identify inactive taxpayers, leading to only partial compliance with this measure. Third, with a slight delay the authorities delivered a progress report on the joint work programme for large and high-risk taxpayers. While overall progress with the joint pilot audits appears satisfactory, the joint approach of the audits needs to be strengthened. Moreover, the authorities have so far neglected those elements of the programme which focus on measures to enhance voluntary compliance (e.g. improved services or informational campaigns), leading as well to only partial compliance.

Finally, to strengthen the analytical underpinning of their tax policy, the authorities have reinforced the tax policy unit in the Ministry of Finance, complying with the related MoU requirement. The unit is responsible for the large number of Cyprus' double taxation treaties, issues of international tax cooperation and eventually, also for dealing with broader tax policy issues. The monitoring of revenue performance is dealt with by another unit in the Ministry. Further follow-up work will be needed with respect to computing the VAT gap, which measures the difference between VAT that was actually collected and the VAT revenues that could have theoretically been collected had all taxpayers been fully compliant. A bottleneck to extending the number of years covered by the VAT gap appears to be the lack of supply-and-use tables available in the national accounts.

3.3.5. Public Administration Reforms

The first batch of reform plans on the Ministries of Health, Education, Agriculture, and local governments were submitted on a piecemeal basis and with some delay. Whilst the reform plan for health was adopted by the Council of Ministers in mid-July, the rest are planned for adoption between July and September. The reform plans are based on the findings of the reports prepared by the World Bank and UK experts earlier this year, although they also reflect the authorities' own initiatives in some cases (such as agriculture and education). The specific action plans allow the Cypriot authorities to testify their ownership and commitment to implement the reforms. The reform plan of Local Governments is probably the most challenging of all four. Although the Ministry of Interior manifests its full agreement with the experts' recommendations, political parties and municipalities are already showing strong antagonism to this reform (inter alia, reduction from 23 to 5 or 10 municipalities).

The public administration horizontal review is underway, albeit it will need to gain traction at the political level. The horizontal element of this reform includes, inter alia, the review of the remuneration and the appraisal systems in the public sector. The current political vacuum, caused by the absence of a Commissioner for Public Administration since early June has not been helpful in this regards.

3.3.6. Reform of the Welfare System

The welfare reform's legislation was adopted by the House Plenary on 10 July, with a slight delay as per MoU conditionality (end-June 2014). Application forms for the GMI were disseminated to all national post offices and district offices of the Ministry of Labour, Welfare and Social Insurance on 10 July. The authorities anticipate starting paying GMI beneficiaries in September.

In line with the welfare system's reform plan, the GMI is expected to be financed in a budget-neutral manner. Due to its expanded coverage relative to the current public assistance scheme (potential GMI beneficiaries will now include the working poor), the GMI is expected to result in an additional fiscal cost. For 2015 streamlining and better targeting of other non-GMI benefits (i.e. family benefits, education grants as well as other cash benefits) will be required to help ensure the fiscal neutrality of the welfare reform. The authorities presented in early July 2014, for consultation with programme partners, a list of social benefits outside the GMI of which the beneficiary profiles and eligibility would be examined to serve as a basis for compensatory permanent measures. The Cypriot authorities committed to include in the draft 2015 Budget Law additional measures to cover expected costs of the implementation of the welfare reform in 2015. To that end, a national registry of benefits, including the profiles and eligibility of all beneficiaries, is to be completed by November 2014. Also, a monitoring unit that will assess the reform's outcomes, including the number of applications and costs, targeting accuracy, coverage and impact on poverty as well as profiles and eligibility of non-GMI benefits has been established and is to be fully-staffed by end-September.

The transfer of competencies and responsibilities to the Ministry of Labour, Welfare and Social Insurance (MLSI) has progressed further but delays occurred. The integration of benefits under a single administrative framework is expected to help achieve efficiency gains and improve the scrutiny of applications to reduce abuse. The new administration will use the premises occupied by the Department of Social Welfare of the MLSI. In addition, to support the new administration, the MLSI has taken steps to transfer staff from the Department of Labour of the Ministry. In addition, the MLSI is making use of schemes funded by ESF and has hired 50 young unemployed for a short period (up to 6 months) to process the volume of applications and maintain an adequate customer-relations function.

Regarding the IT system, work on the different modules (ex. modules on application, eligibility, and payment) of the IT system has progressed in parallel. While the application module is finalised, and the interface module is currently tested, the payment module requires further work until it is able to start paying benefits in September.

3.3.7. Other Fiscal-Structural Reforms

International tax cooperation

Following the negative rating last November by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, the authorities at end-May submitted a follow-up

report to the OECD. As evidenced by the report, the authorities are now taking a comprehensive approach, linking the actions of the (former) Inland Revenue Department, the Registrar of Companies and those under the AML efforts. A progress report was received with a some delay, but shows adequate progress towards ensuring timely provision of relevant information in the future, notably: 1) the cleansing of the income tax register has led to the identification of 55,000 inactive companies; 2) two additional staff will be allocated to the international tax division dealing with the information requests by other countries related to direct taxes; 3) the implementation of the action plan to update and modernise the Registrar of Companies has progressed, though some difficulties were encountered with hiring unemployed graduates to help processing the backlog of annual return forms (see also section 3.1.5); 4) following the recently introduced obligation on trusts to register with one of the supervisory authorities, more than 3,200 trusts were registered; to monitor the requirement of at least one resident trustee who needs to hold complete information on the trust's beneficiaries, the supervisory bodies have developed a programme of onsite visits; 5) in July Cyprus signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Updated statistics on the performance related to the timely responses to information requests were received on time and continue to show a considerable improvement compared to the time period under review by the OECD Global Forum.

Progress towards ensuring systematic follow-up on tax information received has been adequate so far. The authorities have concentrated on a project to detect discrepancies between information received and information declared by taxpayers on savings income, which will be repeated on an annual basis. Access to databases by other government entities has been substantially expanded. However, in some cases the new access rights could be made use of more systematically, by ensuring more frequent access in practice.

Immovable property tax

The Immovable Property Tax (IPT) reform has been postponed until 2015, despite the on-time completion of the General Valuation by June. The General Valuation was completed in Q2-2014, updating for the first time after 33 years the immovable property values. However, the necessary legislative amendments to reform the IPT system in 2014 (see Box 3.2) were voted down by the House of Representatives. De facto, this deferred the IPT reform implementation to 2015, which would still be in line with the MoU. For the 2014 tax year, some amendments to the current system were adopted, mainly allowing for a more generous discount in case of early payment of the tax. Also, in cases where the transfer of title deeds from the developer to the buyer has been delayed, the amendments shift the burden of paying IPT from the developer to the buyer. While this could lead to higher compliance rate, this could also increase the risks of delayed payments due to longer procedures.

The authorities have designed strategies to minimise operational risks, notably by adopting plans to efficiently manage the communication of the IPT reform to the general public and to effectively address the potentially significant level of citizens' appeals, following the first general valuation since 1980. The new updated property values were published at end-July, allowing for a 6-month period of appeals.

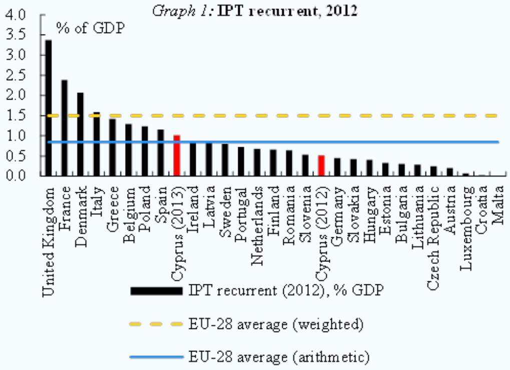
The study on reviewing property tax policy and administration is progressing well. The study aims at consolidating the collection and administration of the municipal property taxation and sewage tax, reviewing exemptions, and assessing the scope for shifting revenues from transaction to recurrent taxation. The first phase of this study has been prepared and was discussed during the mission, indicating that the respective Q1-2015 deadline for the implementation of the resulting proposals remains on track. The second (and last) phase of the study will be finalised in Q4 to also incorporate a review of the tax regulations relevant for the foreclosure process, in order to minimise the cost of foreclosure, as required in the MoU with an initial deadline of Q2-2014. Additionally, the studies relating to the improvement of the valuation model are planned for the second half of 2014. The findings of these studies would also be considered in the implementation of the IPT reform in Q1-2015.

Box 3.2: Immovable property tax reform: aiming a fairer system, with less distortions

Cyprus' immovable property tax (IPT) is based on outdated values, leading to a narrow tax base and an unfair tax burden. The IPT is based on 1980 property values. It therefore does not capture the price dynamics in various areas since then. Also, as no general valuation has occurred since then, many buildings are not registered in the cadastre and therefore not taxed.

A general valuation (GV) was therefore conducted in 2014, to form the basis of the IPT in 2015. This will place Cyprus in a good position in comparison to international practice, where most states are still using outdated cadastre values. In addition to provide updated valuations for existing and new building, the general valuation has been based on a broader collection of property characteristics, allowing for a more accurate and fairer valuation.

Graph 1: **IPT recurrent, 2012**



Source: Commission services.

Another possible shortcoming of Cyprus IPT is the historically high share of revenues coming from transaction tax, more prone to distortions. While revenues from recurrent taxation are broadly in line with other EU Member States (see Graph 1), transaction tax revenues have historically been high in Cyprus. For instance, transaction tax revenues amounted to about 80% of IPT revenues in 2011-12, which is high in international standards. ([1]) It peaked at 1.7% of GDP in 2007. However, the 2013 increase in recurrent property tax, the deep recession hitting the housing market, and the temporary halving of the transfer fees for new properties have significantly reduced the share of transaction revenues in 2013 (see Table 1). While a transaction rate has a moderating effect on house price booms and busts, high transaction tax tends to discourage transactions, it can hamper labour mobility and it also acts as a major disincentive for the title deeds transfers, as buyers are often not willing to pay this additional cost. It may also create an additional cost in case of foreclosure.

Table 1:
Recurrent and transaction IPT in Cyprus

IPT	Recurrent	Transaction	Recurrent
	EUR m (% GDP)	EUR m (% GDP)	% of total IPT
2011	12 (0.1%)	90 (0.5%)	12%
2012	23 (0.1%)	80 (0.5%)	23%
2013	102 (0.6%)	53 (0.3%)	66%

Source: Ministry of Finance.

A feature of the IPT in Cyprus is the high progressivity of the recurrent tax. This is due to two factors. First, the tax rate is progressive, with a tax-free threshold and eight tax rates ranging from 0.6% to 1.9%. Second, the tax is applied to the total value of the properties owned. As a result, the owner of several properties will be taxed at a higher rate on all his properties. While some countries apply a different tax rate to the second residence, the cumulative feature of Cyprus IPT is quite unusual. In addition, while some countries also apply progressive tax rate, the majority of EU countries have a flat tax rate associated with a moderate tax-free threshold to ensure some level of progressivity.

In 2015, a new IPT tax structure will be in place. The tax will be based on 2013 properties' valuations. In addition, a study has been commissioned to assess the scope to shift revenues from transaction to recurrent tax, to review the existing exemptions to broaden further the tax basis, and to investigate the scope for consolidating the administration and collection of municipal and communal recurrent tax rates. The result of this study will feed into the new tax structure for 2015.

([1]) While no harmonised data is available for the share of transaction taxes per se, non-recurrent tax on property (which is broader than transaction tax on immovable property only) amounts to about only 20% of property tax revenues in EU Member States.

3.4. STRUCTURAL REFORMS

3.4.1. Labour Market

Tripartite negotiations to extend the reform of wage indexation to the private sector are still on-going. While the private sector had accepted the lower frequency of indexation and the suspension of COLA during recession, agreement has not yet been found on the change from full indexation to partial indexation (at 50% of inflation). As required in the MoU, the government is also seeking an agreement to suspend wage indexation until end-2016, in line with what is done in the public sector. The aim is to reach an agreement by end-2014.

Delays have been registered with respect to the finalisation of the National Action Plan for Youth Employment. A first draft of the plan, which set the overall strategy for youth employment (including the establishment of a youth guarantee) has been shared with programme partners and should be finalised by Q3-2014, once discussions on the Operational Programme are concluded. This will also allow the submission of a comprehensive note summarising the full list of all active labour market policies (existing and envisaged) with the relevant intended aims, recipients and budgetary allocations.

Work is progressing satisfactorily to develop a uniform monitoring and evaluation methodology for activation measures, with the comprehensive report to be presented by Q3-2014. The authorities plan to use European funds (about EUR 2m, subject to the approval of the Partnership Agreement) to hire additional staff (about 30 persons for a period of three years) to strengthen the capacity of the public employment services, while further staff could be deployed through internal mobility following the public administration review.

3.4.2. Energy

To further develop a comprehensive strategy for the exploitation of Cyprus' domestic off-shore gas reservoirs and the transformation of its energy sector, the MoU included three interim commitments for Q2-2014: 1) submission of an update of the roll-out plan for the infrastructure required for gas exploitation; 2) submission of an advanced draft of specific legislation on the Sovereign Wealth Fund (SWF); 3) provision of a draft comprehensive outline of the market organisation and regulatory regime for the energy sector and gas exports.

The roll-out plan has been updated. The tender procedure on a 10-year supply contract for imported natural gas appears to be on track. Selected bidders have recently been invited for negotiations for the supply of natural gas. According to the tender timeline, a contract can be signed in the second half of 2014, and gas supply could start in 2016. The discussions revealed the need to take account of the impacts contractual arrangements can have on the gas and electricity market functioning. Further updates of the roll-out plan may be needed to account for major new developments, for example with regard to the size and quality of gas available for commercial exploitation.

As regards gas export infrastructure, the Government Agreement (GA) is expected to be finalised in the second half of the year, but the signing date is reported to be contingent on the government's final decision for the investment project(s). The GA is foreseen to detail the terms and conditions of the Liquefied Natural Gas (LNG) plant project with the operator of the Aphrodite gas field, and eventually other energy companies. Programme partners highlighted the importance of the financial and budgetary impact analysis, which the authorities are committed to undertake prior to the finalisation of the GA and supplementary agreements.

The draft SWF law has been submitted to programme partners. While the SWF has been established in the Financial Responsibility and Budget Systems Law (FRBSL), the SWF law lays out the governance structure of the SWF. Programme partners highlighted the need for clear rules governing the SWF's inflows and outflows in the secondary legislation implementing the FRBSL. The authorities are committed to submit a complete set of legislation (comprising the SWF law as well as secondary FRBSL legislation defining inflow and outflow rules) to the House of Representatives by Q4-2014.

In compliance with the MoU commitment, the draft comprehensive outline of the market

organisation and regulatory regime for the energy sector and gas exports has been provided to programme partners. On the basis of the documents provided**,** the discussions focussed on the determinants of the extraordinarily high electricity prices and the key aspects of the authorities' strategy to restructure the various segments of the energy sector, specifically: the organisation of gas exports; the organisation of the domestic gas market, the role of the national incumbent electricity company EAC and the unbundling of the network functions; competition and entry dynamics on the electricity markets and the resilience of the power grid, also in view of the envisaged rise in renewables-based electricity production; and the corresponding regulatory framework including the market arrangement rules for the electricity markets. Regarding the latter, programme partners emphasised the necessity of an inclusive, transparent and open consultation process. The discussions also touched upon the need to enhance the capacity of the regulator CERA to exercise its regulatory powers impartially and transparently. The comprehensive outline will be further updated by Q3-2014, with a view to a final outline by Q4-2014.

3.4.3. Services Directive and Regulated Professions

The Cypriot authorities, together with the Commission services, have identified potential legal amendments on the laws impeding the access and exercise of seven regulated professions, some of which are economically important (e.g. professions related to construction and real estate). This is a crucial step in the context of the Services Directive that should ultimately lead to the adoption of laws allowing for the opening of these professions. Final adoption of all legal amendments is expected by Q3. In parallel, Cyprus is currently undergoing a Mutual Evaluation Exercise on regulated professions (based on Directive 2013/55/EU), together with all other EU Member States, and which requires all Member States to provide detailed information on all the professions they regulate and their related activities.

3.4.4. Competition, Office of the Auditor General and Sectoral Regulatory Authorities

All required legislative steps on competition have been fulfilled, albeit with delay. The Mergers Law was adopted in mid-June, after two MoU deadline extensions. The transfer of qualified personnel to the Commission for the Protection of Competition (CPC) is on-going, with additional qualified personnel expected to be transferred in the next months. CPC's advocacy has also developed in the last weeks, including, inter alia, the signature of a MoU with the Hellenic Commission for Competition and the CPC's pro-activeness in submitting opinions on different laws. Technical Assistance will be facilitated by the Irish and the French Competition Authorities with respect to organisational and human resources' issues, as well as training on sector enquiries.

Progress is being made on ensuring the necessary staffing needs to the General Auditor's Office (GAO), without affecting overall government expenditure. The authorities have now committed to ensure its full financial independence.

The Cyprus Energy Regulatory Authority (CERA) needs to prepare itself for growing responsibilities as a result of the creation of a more competitive and diverse energy landscape. Against this background, although recruitment of additional staff is being considered, the organisation has not yet received the qualified staff required to ensure that it retains the ability to act independently of all market participants.

3.4.5. Housing Market and Immovable Property Regulation

Progress regarding MoU conditionality on the issuance of title deeds has been slow due to the decision of the Department of Lands and Survey (DLS) to shift its human resources towards the finalisation of the General Valuation (GV) project. In an attempt to speed up the issuance of title deeds, a circular has been sent to all DLS district offices, defining a three-month deadline for the issuance of title deeds upon receipt of the certificate of division approval (MoU deadline for definition of administrative deadlines: Q2-2014).

Also, the Cypriot authorities prepared draft proposals aiming to accelerate the issuance of final approval certificates by intensifying the ex-officio procedures provided by the Street and Building Permit Law of 2011, and by giving priority to properties with large number of units. An amendment of the Street and Building Permit Law, aimed at improving the enforcement of the deadlines for issuance of certificates of completion by the supervisor engineers (a necessary document for the issuance of the title deed), is waiting for the legal vetting of the Attorney's General Office. The MoU requires this amendment to be submitted to the House of Representatives by Q3-2014. Finally, in an effort to simplify procedures and unlock the transfer of any encumbrances without the written consent of the mortgagee, a draft bill amending the Transfers and Mortgaging Property Law No.9/65 was prepared and currently stands for legal vetting.

As per MoU conditionality, the DLS prepared a draft joint action plan to streamline process within the DLS and between DLS and other relevant public sector departments for the issuance of title deeds, but the action plan is not comprehensive enough. The draft joint action plan mainly focused on steps to clear the title deed issuance backlog, without providing a comprehensive approach to streamline all administrative processes within government departments. In its draft action plan, the DLS identified a number of 23,000 title deeds for which an application exist at the DLS, and proposed a timeframe for their handling before end-December 2014. In order to stick to this timeline, the number of staff at district offices dealing with the issuance of title deeds will be increased and there will be daily supervision of progress achieved. For further enhancement of this action plan, the updated MoU provides for the establishment of a working group under the responsibility of the Ministry of the Interior, which will review and streamline *all* procedures leading from the planning permit application to the issuance of title deeds.

Progress has been recorded with regard to the electronic access to the registries of title deeds, mortgages, sales contracts, and cadastre for the monetary financial institutions. Access will be provided through the implementation of a government gateway, expected to be available for use by the end-August 2014. The MoU requires compliance with this provision by Q4-2014.

The Supreme Court of Cyprus and the Ministry of Justice and Public Order are currently preparing a draft action plan for the elimination of court backlogs. Moreover, the relevant bill for the establishment of an Administrative Court, which will deal with all first instance administrative recourses, thus discharging the Supreme Court of this task, is expected to be discussed at the HoR Plenary in autumn.

3.4.6. Tourism

The first progress report on the implementation of the tourism action plan has been adjusted, whilst the required plan enhancing the coordination between tourism stakeholders and relevant authorities needs further fine-tuning. The final progress report is an improvement from the first two versions submitted in previous review missions. The attached tables to it also offer a clearer overview of the targets and actual results of the tourism strategy. However, with regard to the coordination plan, it does not yet offer a clear picture on who does what and it includes too many layers of consultation steps before making any decision. It therefore needs to be fine-tuned by Q3-2014. A proper assessment on the current Cyprus Tourism Organisation (CTO) legal framework, by identifying, inter alia, those articles that may hamper competition in the tourism sector, is now of paramount importance.

3.4.7. Growth strategy

The MoU encourages the authorities to develop a comprehensive and coherent growth strategy that will help the economy to move to a sustainable growth path. The growth strategy will need to take account the policies under the economic adjustment programme, notably, the on-going public administration reform, public financial management reform, as well as relevant EU initiatives. In late-May, the Cypriot authorities assigned the responsibility to kick-start work on developing the growth strategy to the Office of the Deputy Minister to the President. Under his mandate, the Ministerial Council also approved the creation of the Task Force for Growth, which is currently responsible to provide an action plan for the development and implementation of the growth strategy (MoU conditionality with deadline by Q3-2014). The growth strategy will be developed, coordinated and enforced through the single body that will evolve out of the Task Force for Growth and will be anchored in the national institutional framework. To launch the development of the growth strategy and to kick-off an inter-industry consultation on growth, the Office of the President and the British High Commission organised a conference that took place on 4 July. Technical assistance for the development of the growth strategy will be provided by the Support Group for Cyprus.

4. PROGRAMME FINANCING AND DEBT SUSTAINABILITY

Out of the EUR 10bn of external assistance agreed on 25 March 2013, EUR 5.8bn have already been disbursed by the ESM and the IMF. The ESM has disbursed EUR 5.35bn in five tranches, of which EUR 1.5bn for the recapitalisation of the cooperative banking sector in the form of ESM notes. The IMF has disbursed five tranches, totalling EUR 419m.

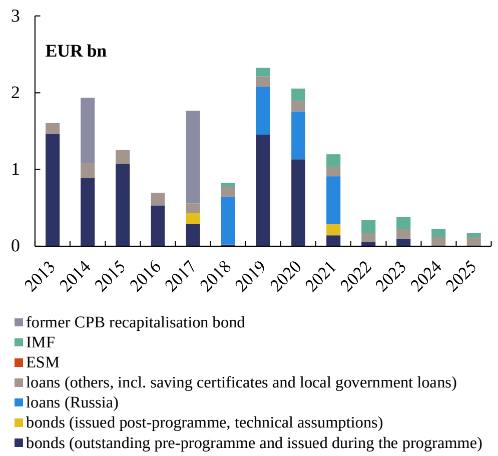
Total financing needs for the period Q2 2013-Q2 2014 proved to be below the initial projection. Total financing needs over the period Q2 2013-Q2 2014 amounted to EUR 4.2bn, of which EUR 1.5bn for financial sector recapitalisation, EUR 0.7bn for fiscal needs and EUR 2.0bn for medium- and long-term debt redemptions.([7]) The total financing needs were therefore well below the EUR 5.8bn initially projected. The difference, mainly due to better-than-expected fiscal performance, has allowed Cyprus to maintain a sizeable cash buffer.

Yields on Cyprus' foreign-law bonds and T-Bills have stabilised at around 5% and 4.5%, respectively. The yield for outstanding foreign-law bonds is now substantially lower than the 8% in January 2014 and the peaks in March or July 2013 exceeding 25%. Nonetheless, Cyprus' yields remain vulnerable to changes in financial markets' sentiment with regard to the other European periphery countries.([8]) T-Bill yields, although decreasing, remain high (at around 4.5%). Their roll-over mainly depends on relatively few domestic investors. Interest from foreign investors in Cyprus' T-Bills started to recover, albeit only for small amounts. By the end of June 2014, the outstanding T-Bill stock stood at EUR 915m, slightly lower than the EUR 970m at the inception of the programme.

Following a small issuance of a six-year Eurobond of EUR 100m in April 2014 via a private placement, Cyprus issued on 25 June 2014 a five-year Eurobond of EUR 750m at a yield of 4.85%. Demand from investors amounted to EUR 2bn. The proceeds from those two issuances as well as EUR 100m from cash reserves were used to pay down the capital and interest of the CPB bond for an amount of EUR 950m on 1 July 2014. The operation allowed Cyprus to smoothen the maturity profile of its debt, by shifting part of the amortisation burden from the peak year of 2017 to 2019. However, 2017 would remain a challenging year in terms of redemptions. As the CPB bond bears a nominal interest rate of 5.15%, the overall interest bill was also slightly reduced.

Moreover, on 2 June 2014, Cyprus started to issue six-year retail bonds for a small amount (of up to EUR 10m per month) to physical persons with an early redemption option. After two monthly issuances, the outstanding retail bonds amounted to EUR 11.3m.

Graph 4.1: **Medium- and long-term debt amortisations**



(1) The above amortisation pattern includes the repayment of the CPB recapitalisation bond. Under the current terms, the bond can be rolled-over until June 2017. The working assumption is that it will be redeemed in July 2017 by issuing a new bond at market conditions.
Source: European Commission.

Financing needs in the third quarter of 2014 are going to be higher than anticipated, but mostly related to a debt redemption which already took place. Based on the updated macro-fiscal projections, total financing needs for Q3 2014 are estimated to amount to some EUR 1.9bn, of which EUR 0.5bn for fiscal needs and EUR 1.4bn for debt redemptions which already took place in July 2014.

([7]) For comparison purposes, this excludes EUR 850m, raised on the market in Q2 2014 and subsequently used to partly repay the CPB bond in Q3 2014.
([8]) This is illustrated by a sizeable, albeit temporary increase in the Cyprus' bond yields following news related to the Portuguese financial group ESFG in the beginning of July 2014.

Box 4.1: Debt sustainability assessment

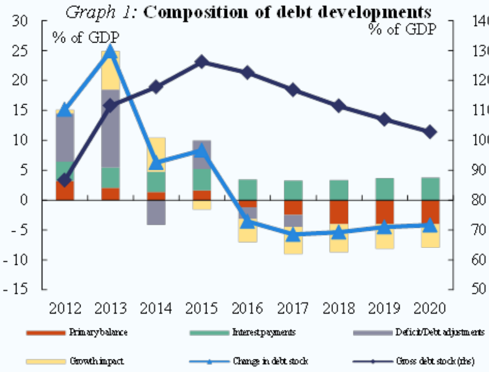
The updated macro-fiscal projection and the subsequent changes to the financing needs have only a minor effect on the debt projections. The debt trajectory is projected to peak at 126% of GDP in 2015, and to decline to 103% of GDP in 2020. The economic recovery and the return to primary surpluses as from 2016 remain favourable for the evolution of the debt-to-GDP ratio.

The interest bill for 2014-2016 is expected to be slightly lower than projected during the fourth review, driven by revised estimates of the path of future ESM lending rates and the reduced payments for the CBC loan following the loan-asset swap. The ESM interest rate is expected to be below previous assumptions for the period 2016-2020. Moreover, the partial refinancing of the CPB bond at a lower interest rate and lower interest payments to the CBC following the loan-asset swap leads to a reduction of the interest bill for these years. ([1]) After the programme horizon, the interest bill is projected to be influenced by higher market interest rates compared to those charged on ESM and IMF loans.

([1]) The interest saving related to the CBC debt swap is subject to a decision of the CBC board in full respect of the independence of the CBC, the treaty and the rules and procedures of the euro system.

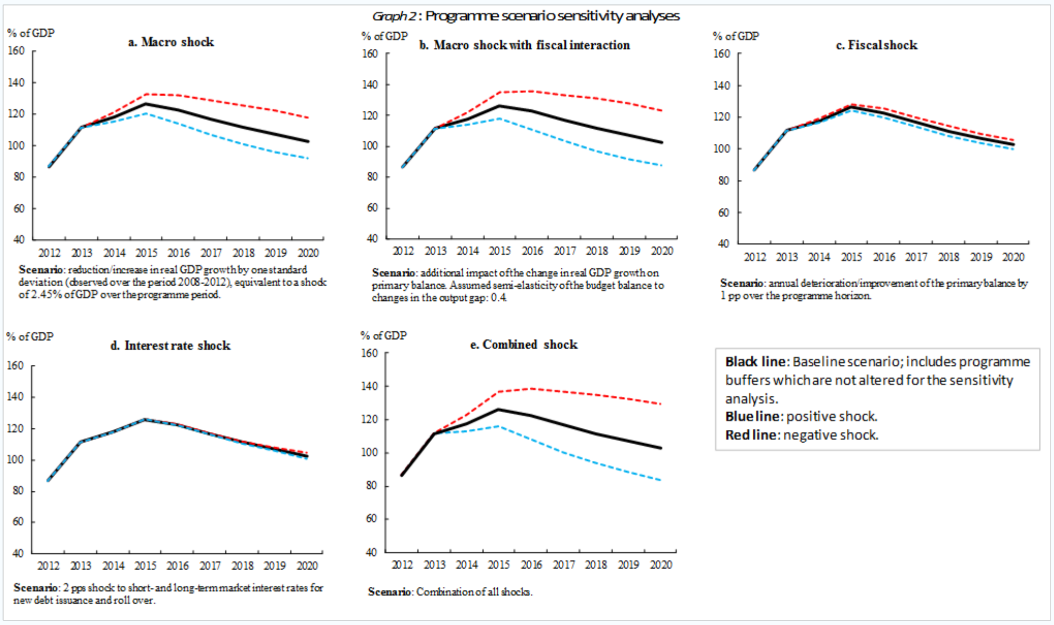
There are limited changes to the composition of the deficit/debt adjustments. The finalisation of the EUR 1bn loan-asset swap between the CBC and the Ministry of Finance has been shifted to Q4-2014. Deficit-debt adjustments continue to include the expected profit distribution by the CBC of about EUR 0.1bn in both 2015 and 2016. Privatisation proceeds are, as in earlier reviews, projected to materialise over a three-year horizon from 2015 onwards, amounting to a total of EUR 1.4bn.

Graph 1: **Composition of debt developments**



Source: Commission services.

Graph 2: Programme scenario sensitivity analyses



(Continued on the next page)

Box (continued)

Table 1:
Public debt trajectory, 2010- 2016.
(% of GDP)

	2010	2011	2012	2013	2014	2015	2016
Gross debt stock	**61.3**	**71.5**	**86.6**	**111.5**	**117.8**	**126.1**	**122.5**
Change in debt stock	**2.8**	**10.2**	**15.1**	**24.9**	**6.3**	**8.3**	**-3.6**
Primary balance	3.0	3.9	3.2	2.0	1.3	1.6	-1.2
Interest payments	2.2	2.4	3.2	3.4	3.4	3.6	3.4
Deficit/Debt adjustments	-0.6	5.5	8.1	13.0	-4.2	4.7	-1.9
Growth impact	-1.8	-1.6	0.6	6.5	5.7	-1.6	-3.9

The macroeconomic and fiscal performance continues to be a major risk for the evolution of the debt trajectory. A reduction (increase) in real GDP growth by one standard deviation (calculated over the period 2008-2012, equivalent to a shock of 2.44% of GDP) over the programme period would result in a sharp upward (downward) revision of the debt trajectory until 2020. An additional effect of a lower (higher) real GDP growth on primary balance would intensify the impact of the shock further. ([2]) Assuming an isolated fiscal shock to the primary balance of 1 pp over the programme horizon would result in more limited effect on the debt-to-GDP ratio until 2020. Higher (lower) short- and long-term market interest rates (by 2 pps, respectively) appear to have only a small effect on the debt trajectory until 2020.

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

Based on current assumptions, the fourth quarter financing needs related to debt redemption and budget financing are expected to amount to EUR 0.4bn. Over the fourth quarter, total debt redemptions are estimated to amount to around EUR 0.1bn and fiscal needs to around EUR 0.3bn.

A successful fifth programme review would unlock the disbursement of ESM's sixth tranche to finance fiscal needs arising until the end of the fourth quarter of 2014. In light of the government's comfortable cash position and limited financing needs, the sixth ESM disbursement in cash would amount to EUR 350m to cover deficit financing and redemption needs. The IMF would disburse EUR 83m. After the disbursement by the ESM and the IMF, the government's cash balance is estimated to amount to around EUR 0.7bn at the end of the year.

5. RISKS TO THE PROGRAMME

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

- A prolonged period of tight credit supply conditions and delays in the restructuring of the large and increasing stock of NPLs in the domestic banking system, which could potentially weigh on the economic recovery;

- A slower than expected return of confidence in the banking sector, following recapitalisation and restructuring;

- negative spillovers emerging from the ongoing crisis in Ukraine, which could weigh on economic activity;

- a potentially stronger or more protracted contraction of the economy, particularly in the medium term, related to slower than expected private sector balance sheet adjustment, further worsening of labour market conditions and steeper drop in real estate prices;

- inability to reach the agreed primary surplus targets established in the programme, due to insufficient policy measures, implementation shortcomings or adverse macroeconomic and financial developments;

- insufficient implementation of structural reforms, including in particular the implementation of the privatisation agenda, potentially leading to lower than expected privatisation proceeds; and

- lack of success in regaining market access at a reasonable borrowing cost, once the programme comes to its conclusion.

The annexes are the outcome of the fifth review mission, which took place from 15 July to 25 July 2014, and reflect information available up until 1 September 2014.

ANNEX 1

Compliance Table

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

	Actions for the fifth review (completed by Q2 and end-July 2014)	Assessment of compliance – Comments
1	FINANCIAL SECTOR REFORM	
1.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. The Cypriot authorities will ensure, in timely consultation with the EC, ECB, IMF and informing the ESM, that the relaxation of remaining domestic payment restrictions is consistent with financial sector stability and in line with the agreed strategy. Further progress under the program is needed before considering actions related to restrictions on the capital account.	**Compliant**
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. The additional government guarantees for the issuance of bank bonds of up to EUR 2.9 billion in nominal value could be used as collateral against liquidity, if necessary to safeguard financial stability, in line with State aid rules.	**Compliant** A prolongation of the guarantee scheme was approved by the European Commission until end-2014.
1.3	The Bank of Cyprus and the Cooperative Central Bank submitted their capital and funding plans in April 2014. 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 the reduction of borrowing from the central bank, with the objective to avoid asset fire sales and a credit crunch.	**Compliant** The capital and funding plans were submitted.
	Regulation and supervision for banks and cooperative credit institutions	
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 introduced regulatory amendments. A new loan origination directive was adopted in October 2013, though implementation has so far been hindered by lack of financial information to enable an effective assessment of the repayment capacity of borrowers. The new provisioning and disclosure directive will be fully implemented by the time of the publication of the 2014 annual accounts. For the co-operative credit institutions, the requirements of the new provisioning and disclosure directive will be fully applied in their 2013 annual accounts. Following a request by the CBC, banks will report on the potential impact of newly introduced and upcoming EU rules on their profitability and coverage ratios **by end-June.**	**Partially Compliant** The CBC issued on 26 March 2014 a circular letter to submit the impact assessment. Not all banks have submitted their estimations.
1.6	BoC and the coops submitted in April and May 2014, respectively, a quarterly report describing the progress with the implementation of the restructuring plans. The reports contain a set of key performance indicators including selected operational and financial targets developed by the CBC and communicated to these banks. The CBC units responsible for the supervision of BoC and coops will assess these and subsequent reports **on a quarterly basis** and submit their conclusions and proposed actions to the CBC Board within four weeks of the receipt of the reports.	**Partially compliant** The BoC team submitted its first report to the CBC board and the CCB team started preparing its report for submission to the CBC board.
1.7	**By end-July**, the governance directive will be revised specifying, among others, the interaction between banks' internal audit units and bank supervisors, in line with European regulations and international best practices.	**Ongoing**
1.8	The CBC will request **by end-May** the internal audit department of BoC (including transferred Laiki operations) and of coops to submit **by end-September** a special examination report on lending and debt restructuring practices of BoC and coops with respect to loans related to former and current managers, directors, members of Committee and major shareholders of the groups, with the aim to identify decisions that have led to disproportionate losses in net present value terms. The CBC will complete its assessment of internal auditors' main findings and take appropriate action, including by requiring the institutions concerned to take civil action where applicable, **by end-January 2015**.	**Compliant** The CBC has issued the request for such a report to the banks' internal auditors on 6 June.

(Continued on the next page)

Table (continued)

1.9	The independently audited consolidated accounts of the cooperative credit institutions for the year 2013 will be published **by end-June.**	**Compliant** The audited CCB consolidated accounts were published on the bank's website on 2 July.
1.10	The CBC will have sufficient staff to carry out its functions in full independence as stipulated by the Treaties. The current recruitment of experienced staff should be finalised **by end-June**. The CBC will further assess the need to increase its staff, taking into account the new tasks undertaken under this Memorandum of Understanding and the tasks imposed by the creation of the Single Supervisory Mechanism by end-October, and address the identified needs by end-December.	**Compliant** The recruitment procedure has been completed and the arrival of nine successful candidates is imminent.
1.11	In light of the new responsibilities taken on by the CBC, the revision of the Resolution Law and the transition to the Single Supervisory Mechanism, the Authorities will review the governance of the CBC **by end-June** and adopt the necessary legislative amendments by end-September.	**Partially compliant** The CBC Governor and the executive directors need to finalise the review of the CBC governance.
1.12	The authorities, in consultation with EC, ECB and IMF and informing the ESM, reviewed the effectiveness of the Resolution Authority, including its composition and governance, in March 2014. The amendments to the Resolution Law are to be adopted **by mid-July.**	**Compliant** The Resolution Law was approved by Parliament on 19 June. The CBC is the Resolution Authority. The CBC Governor and the two executive directors form the Resolution Committee and a Resolution Unit is being set-up independent of supervision.
	Monitoring of corporate and household indebtedness	
1.13	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. In addition, quarterly monitoring reports will continue to be submitted and their scope and content will be further enhanced.	**Compliant**
1.14	Measures will be taken to strengthen the management of non-performing loans and to deal with troubled borrowers. A framework for targeted private-sector debt restructuring is being established.	
	· Following the completion of the merger process for the cooperative credit institutions, an assessment of the operational capacity of the CCB's loan workout unit will be completed **by end-May.**	**Compliant** The CBC has appointed PWC to carry out this assessment.
	· Banks will be required to report quarterly on restructuring progress and management of NPLs. The first report, with reference date end-March, will be submitted **by end-June,** 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).	**Compliant** Banks have submitted the report and the CBC is reviewing them for inaccuracies
	· The CBC will, with assistance of an external expert, review banks' arrears management policies and practices, taking into account international best practices. The preliminary findings of this review will be presented to the EC, ECB and IMF, and informing the ESM, **by mid-July.** The review will be completed **by end-July** and serve as a basis for further policy recommendations on the arrears management processes in credit institutions. Following the review, revisions of the Arrears Management Directive and of the Code of Conduct will be introduced as needed, taking into account the developments and timelines in the Single Supervisory Mechanism, by end-September. The responsible CBC supervisory units will examine the implementation of the banks' action plans to correct deficiencies identified by the external expert and submit the main findings and recommendations to the CBC Board by end-November.	**Compliant** The consultant PWC presented the preliminary report by mid-July. **Ongoing** Finalisation of the report 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.	**Non-compliant** The CBC is preparing the circular letter. The deadline was shifted to end-September.

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Table (continued)

	· The role of the Financial Ombudsman with regard to handling complaints on compliance with the arrears management process was clarified by end-March. The necessary legal amendments to the Law on the Financial Ombudsman are to be adopted, in consultation with the EC, ECB and IMF and informing the ESM, **by end-June.**	**Compliant** The law was adopted on 10 July by Parliament, even though some amendments are problematic and further amendments of the law have been requested in the update MoU.
	· 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.	**Compliant**
	· The Cypriot authorities will prepare, **by mid-July**, an action plan for removing impediments for lenders to obtain adequate updated information on the financial situation of delinquent borrowers, under sufficient safeguards. These impediments will be fully removed by end-December.	**Partially compliant** The collection of information is ongoing and needs to be completed.
	· In order to encourage a market for distressed assets, the Cypriot authorities will prepare, **by end-June,** a report identifying impediments to transfer individual loans to third parties.	**Compliant with delay** A report was presented on 15 July.
	Increasing financial transparency	
1.15	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).	
	Section 1 - Customer Due Diligence	**Partially Compliant** Risk management reviews as required by changes in a bank's business model still to be integrated into the supervision, in connection with the future adaptation to the SSM (section 1.2.1); CBC onsite review program is ongoing (section 1.3.2).
	Section 2 - Reliance/introduced business	**Compliant** Guidance included as appendix 5 to the CBC circular of 3 February 2014 (section 2.1.2), and monitoring as part of onsite inspections (section 2.2.2, ongoing process).
	Section 3 - Suspicious Transaction Reporting	**Compliant** Seminars conducted by MOKAS in collaboration with the AML supervisory authorities (section 3.1).
	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)	**Partially compliant** Significant effort made but delays in further increasing staff for processing the backlog of documents.
	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.	

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	Section 5 - Supervision of financial institutions (Adequate resources, Risk-based supervisory tools for offsite monitoring, Risk-based supervisory tools for onsite monitoring, AML/CFT training program, Implementation of adequate supervision)	**Partially compliant** Delays in increasing the CBC AML staff (section 5.1.2). CBC compliant in adopting a methodology for onsite visits (section 5.3.1), but still to establish a formal AML/CFT training program (section 5.4.1).. On section 5.5.1.b. process leading to possible sanction is to be finalized by end-August. CBC also still to develop customized supervisory strategies based on institutional risk profiles (section 5.5.3), and update these profiles and supervisory strategies based on the results of its inspections (section 5.4.4).
	Section 6 - Supervision and monitoring of lawyers, accountants and TCSPs (Adequate resources, Risk-based supervisory tools for offsite monitoring, Risk-based supervisory tools for onsite monitoring, AML/CFT training program, Implementation of adequate supervision)	**Partially compliant** Additional resources still needed in CySEC (section 6.1.1); customized strategies still to be developed and formal training programs to be institutionalized by CBA and ICPAC (sections 6.2.2.3 and 6.4.1).
	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.	**Compliant** The programme partners reviewed a sample of the supervisory assessments and enforcement action by the supervisory authorities.
	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 3.9.	**Partially compliant** Basic information now available free of charge but substantial backlog in updating the register limits the availability of accurate and current data.
	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 thisinformation on the FIU website on an annual basis.	**Compliant** MOKAS provided to the programme partners the breakdown of requests made and received, including spontaneous disseminations, to and by foreign FIUs.
1.B.	RECAPITALISATION AND RESTRUCTURING Restoring adequate capital buffers	
1.16	The authorities will finalise the transposition of CRD IV and national discretions under the CRR **by end-June.** As part of this process, the authorities will fix the Common Equity Tier 1 ratio at 8% under Pillar 1 in line with the harmonised benchmark applied under the baseline scenario of the ECB Comprehensive Assessment. In no circumstances will the implementation of CRD IV and CRR lead to any distribution of capital by the banks which were found in the PIMCO exercise to face a capital shortfall. In line with CRD IV, the CBC will request significant banks to maintain capital buffers in excess of the minimum Pillar 1 requirement based on conservative assumptions and to take prompt action if needed.	**Partially compliant** CRDIV has not been transposed, but the transitional arrangements are published and guidance to banks on pillar II is given.
	Management of legacy Laiki	

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Table (continued)

1.17	In order to enhance the recovery value from the disposal of the assets of Laiki, the Resolution Authority instructed the Special Administrator to appoint a well-recognised and independent consulting or auditing firm(s) or international institution(s) to be entrusted with the voting rights associated with Laiki's shares participation in BoC. This appointment will be completed by end-September. The finalisation of the appointment of an advisor to provide services associated with the management of the disposal process shall be completed **by end-June**. As part of the terms of reference for the appointment of the advisor agreed in consultation with the EC, ECB and IMF and informing the ESM, an action plan for the full disposal of the assets will be developed **by end-July**, with a view to maximize value for creditors.	**Non compliant** The selection process of an investment advisor for the disposal of assets is ongoing.
1.18	BoC has progressed with the implementation of the restructuring plan and has divested operations and stakes abroad ahead of schedule. Moreover, to strengthen confidence in the bank, the CBC agreed with BoC on the operational and financial indicators on progress with implementing the restructuring plan that will be communicated quarterly to the public, together with the financial accounts.	**Compliant** The first publication of the KPIs coincided with the announcement of the first quarter 2014 results.
	Restructuring and recapitalisation of cooperative credit institutions	
1.20	The final restructuring plan for the cooperative sector was submitted to the EC in January 2014. . On the basis of that plan and the commitments submitted by the Cypriot authorities, the Commission approved restructuring aid for the cooperative credit institutions as compatible with the internal market on 24 February 2014. The cooperative credit institutions that benefited from public capital injections are subject to specific management rules and restrictions and to a restructuring process, which is being scrutinised by an external monitoring trustee. The monitoring trustee will submit quarterly reports on governance and operations, as well as ad-hoc reports as needed and is working under the direction of the EC. In line with the EU State aid rules, the trustee will, inter alia, verify 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 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	**Compliant**
1.21	The merger of individual cooperative credit institutions into 18 entities was completed in March. These mergers were 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.**	**Non compliant**
1.22	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 Cooperative Central Bank was established, to ensure that the Cooperative Central Bank adopts sound policies, 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.	**Compliant**
1.23	As part of the implementation of the restructuring plan, the Cooperative Central Bank has utilised external expertise to develop and implement policies and practices in the areas of arrears management and corporate restructuring. The recommendations made and deemed necessary by the authorities will be implemented. In addition, it will be ensured that the recruitment of executive and senior management of the CCB and CCIs takes place in line with international best practices and the established selection criteria, and will be completed **by end-May**. Moreover, to strengthen confidence in the sector, the CBC agreed with the CCB and the Ministry of Finance Management unit on the operational and financial indicators on progress with implementing the restructuring plan that will be communicated quarterly to the public.	**Compliant with delay** The recruitment of senior management has been completed with a delay. **Compliant** The publication of the KPIs was done on 2 July.
1.C.	LEGAL FRAMEWORK FOR PRIVATE DEBT RESTRUCTURING	

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Table (continued)

1.25 All 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	**Compliant** No further impediments were introduced.
1.26 The authorities established a Task Force to prepare a study assessing the magnitude of registered, but untitled, land sales contracts and underlying mortgages and to develop recommendations **by end-June**.	**Compliant with delay**.
1.27 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-July,** establishing appropriate corporate and personal insolvency procedures. A draft of the reform framework as well as an impact assessment of various options on lenders will be completed **by end-June,** and shared with the EC, ECB, IMF and the ESM. On the basis of that framework, corporate and personal insolvency legislation will be adopted, which will include licensing and regulation of insolvency practitioners by end-December.	**Compliant with delay** A draft strategy was submitted to the programme partners by mid-July and the plan was endorsed by the Council of Ministers by mid-August (prior action). The impact assessment is ongoing and the deadline shifted to end-August.
1.28 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**, with immediate effect for all mortgaged properties except primary residences (for which provisions will enter into effect by end-December, in line with the adoption of the insolvency legislation), to allow for private auctions to be conducted by mortgage creditors, without interference from government agencies.	**Compliant with delay** The legal framework in relation to foreclosure was amended on 6 September (prior action for the completion of the fifth review).
1.29 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	**Partially compliant** Work is ongoing.
2. FISCAL POLICY Key objectives	
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 3.5 of this Memorandum, will not be undertaken over the course of the programme period. The government will modify by mid-June 2014 the bill amending the road vehicles and traffic law so that it will not include the provision for a tax amnesty for the payment of annual road tax.	**Compliant**
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 275 million (1.7% of GDP) in 2014 corresponding to a headline deficit of 5.3% of GDP (respecting the 16 May 2013 Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Cyprus). 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).	**Compliant** The updated programme projection shows a deficit of the general government primary balance of 1.3% of GDP. The headline deficit is estimated at 4.7% of GDP.
Fiscal Policy in 2015 - 2016	
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 258 million (1.6% of GDP) in 2015, corresponding to a headline deficit of 5.2% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus). In 2016 the Cypriot authorities will achieve a general government primary balance surplus of at least EUR 201 million (1.2% of GDP), corresponding to a headline deficit of 2.4% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus). These targets and the underlying updated budgetary projection will be embedded in the 2015-2017 Fiscal Strategy Statement, which will be adopted by the Council of Ministers **by Q2-2014.**	**Compliant** The updated programme projection for 2015 shows a deficit of the general government primary balance of 1.6% of GDP, with a deficit in the headline balance of 5.2% of GDP. For 2016, the updated projection shows a primary balance surplus of 1.2% of GDP and a headline deficit of 2.2% of GDP.
3. FISCAL STRUCTURAL MEASURES Health care expenditure	

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Table (continued)

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;	**Non-compliant** No information received.
b) taking into account the findings of the functional review of the Ministry of Health, carry out health sector reforms, including restructuring all public hospitals/public health facilities, the Ministry of Health, the HIO, and other associated facilities/organisations based on a Reform Plan to be approved by the Council of Ministers **by Q2-2014**. The reform plan will provide for the autonomization of all public hospitals/public health facilities. All necessary legislative changes to be approved by the House of Representatives by end-November 2014 aiming at full implementation by Q2-2015; Public hospitals complete the shadow-budgeting for all inpatient cases on diagnoses-related groups by Q3-2014 and for all in- and outpatient activities by Q4-2014;	**Compliant with delay** The healthcare reform plan was adopted by the Council of Ministers in mid-July. The Reform Plan however lacks details on which reforms are envisaged and needs to be further specified.
c) taking into account the economic conditions, the implementation of the necessary complementary 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.	
4. The detailed road map for the implementation of the NHS will be agreed with programme partners **by Q2-2014.** The amended bill of NHS will also determine and clarify the respective role, governance and responsibilities (notably concerning the strategic policy, budget control, monitoring, audit and regulation) of the Ministry of Health and the HIO and will be approved by the House of Representatives by Q4 2014.	**Compliant** An updated roadmap for the implementation of the NHS has been submitted. While being slightly more detailed compared to previous versions, it remains rather broad, partly because most policy decisions regarding the design of the reform are expected to be taken during the coming months.
6. An Implementation Advisory Team will be established **by end-June 2014**, drawing on national and international expertise, to assist the Ministry of Health with the implementation of NHS and health sector reforms. A study by an independent consultant, to be chosen in consultation with programme partners, will be undertaken to evaluate the functional and financial sustainability of the NHS operated by single or multi payer agencies; the study will also assess how and when the precondition mentioned in paragraph c)3 (ie consumer information and transparency, contestable markets, freedom to contract, fiscal viability of insurance agencies, competition regulation and risk-adjustment) can be achieved.	**Non-compliant** Good progress is being made with the organisation of support from international experts, but an international advisory team has not yet been established.
e) initiate the tendering of the IT-infrastructure necessary for implementing the NHS **by Q2-2014;**	**Non-compliant** A delay has been observed in the initiation of the procurement tender for the IT infrastructure for the NHS, due to on-going discussions on infrastructure design and the tender procedure. It has been agreed that the tender will be finalised by December 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;**	**Non-compliant** No information received.
Public Financial Management	
3.3 The Cypriot authorities will:	
3.3 improve the risk-assessment analysis associated with government guarantees. To this end, submit for consultation with programme partners **by mid-July 2014** an advanced draft of the risk assessment report prepared by the Public Debt Management Office, with a view to a final version by Q3-2014. The report shall identify guarantees that are expected to result in calls in the current and following year;	**Compliant** The draft risk assessment report has been submitted to programme partners.

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Table (continued)

3.3 implement guidelines for public investment management, including project appraisals in line with the FRBSL provisions **by Q2-2014.** The authorities commit not to enter into any new tendering process and not to sign any public private partnership (PPP) contract before the implementation of the guidelines for public investment management;	**Partially compliant** Guidelines have been drafted but not yet issued by the Ministry of Finance.
State-owned enterprises and privatisation	
3.4 the law regulating the creation and the functioning of SOEs at the central and local levels will be adopted by the HoR **by mid-June 2014.** The law will enhance the monitoring powers of the central administration, while including reporting on SOEs in the context of the annual budgetary procedure. No additional SOEs will be created until the law has been adopted;	**Non-compliant** The SOEs corporate governance law should have been adopted by mid-June. Delays are due to inconsistencies with the FRBSL and a slower-than-expected legal vetting. The law should be adopted by September-2014.
3.4 the Cypriot authorities will submit for consultation with programme partners a plan with detailed timelines for the review of those SOEs that are under internal review **by Q2-2014;**	**Partially compliant** A SOEs Plan was submitted during the mission but was not detailed enough. The MoU now requires that the SOEs' strategic plans include detailed milestones and timelines.
3.5 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 June 2014;**	**Partially compliant** The Head and part of his staff (4 out of 10) have started their work. However, the Unit is expected to be fully operational by mid-October.
3.5 appoint independent advisors for the CPA privatisation **by Q2-2014**, in accordance with the privatisation plan;	**Partially compliant** Only the technical advisor has been appointed. The financial and legal advisors are still missing.
Revenue administration, tax compliance and international tax cooperation	
3.6 In order to complete the agreed short-term measures, the following actions will be undertaken without delay and in no case later than **by Q2-2014:**	
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;	**Compliant** The relevant amendment of the Assessment and Collection of Taxes Law was adopted by the House of Representatives on 19 June 2014.
harmonising the legislation among tax types so that not paying withholding taxes is a criminal offence;	**Compliant** The relevant amendment of the Assessment and Collection of Taxes Law was adopted by the House of Representatives on 19 June 2014.
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. The garnishing of bank accounts will not require prior court approval, but may allow for a short appeal period for the tax payer during which the relevant amount remains frozen; and	**Partially Compliant** The amendments of the Collection of Taxes Law and the VAT Law were adopted by the House of Representatives on 19 June 2014. However, in order to apply the new powers, secondary legislation needs to be adopted on the procedural details of the seizure of movable assets and the garnishing of bank accounts.
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.	**Compliant** The relevant amendment of the Assessment and Collection of Taxes Law was adopted by the House of Representatives on 19 June 2014.
The long-term reform will include the following sets of measures:	

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make the data from the IRD available to selected staff by the tax administrations via one platform, to be used for integral risk identification and analysis **by Q2-2014;**	**Compliant**
cleanse the income tax registers **by Q2-2014** and VAT registers by Q4-2014, by removing inactive cases and put in place a process to maintain the registers up-to-date;	**Partially Compliant** The cleansing exercise has started but has not yet fully made use of all data available to identify inactive taxpayers. Moreover, there is not yet a process in place to maintain the register up-to-date in the future.
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, with a view to setting up the integrated large taxpayer unit of the new tax department (see below) by Q4-2014; and	**Partially Compliant** First joint audits of large and high risk taxpayers have taken place, but no actions have been taken to test other strategies for enhancing voluntary compliance.
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.**	**Compliant** The unit was reinforced in end-March. However, difficulties were encountered in measuring the VAT gap for years after 2009, as the national accounts still do not provide sufficient details for these years.
3.7 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;	**Compliant** The assessment by the EC of the implementation of DIR 2011/16 is on-going. A Pilot was launched by TAXUD to clarify potential concerns. Cyprus has respected the time limit set by Art 10 of Regulation 904/2010 in 67% of all cases, which is better than the EU-average.
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;	**Compliant** The authorities have progressed with the exercise to identify taxpayers and match the information received with the information declared by the taxpayers. The exercise will be repeated on an annual basis.
improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer;	**Compliant** The tax authorities have wide access to databases. In practice, however, it needs to be ensured that some of these databases are accessed more frequently.
prior to the fifth disbursement of financial assistance, the authorities will submit to the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes the follow-up report detailing the actions to address the shortcomings identified, with a view to achieve full compliance. The authorities will continue with the swift implementation of the commitments taken to reverse the negative opinion by the OECD Global Forum and provide a progress report to programme partners **by Q2-2014.**	**Compliant with delay** The progress report was submitted with a delay of one month, but shows adequate progress.

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	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 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.	**Compliant** The assessment is taking place on an on-going basis.
	Immovable Property Tax Reform	
3.8	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;**	**Compliant** The GV was completed on time. New valuations have been published.
	Necessary legislative changes should be adopted by the House of Representatives **by early July 2014**, following consultation with programme partners. Legislation specifying the frequency of the mandatory update of the values in line with international best practices should be enacted by Q1-2015, following consultation with programme partners.	**Non-compliant** Legislative changes were not vetted by the Parliament. Programme partners were not consulted on amendments to the law.
	In order to ensure a smooth and timely implementation of the new immovable property tax and to minimise the operational risks, the authorities will present to the programme partners **by end-June 2014:**	
	a communication strategy aiming at informing of the goals of the property tax reform, the implications for citizens and the procedures of the new reform;	**Compliant** A communication strategy was submitted on time to the programme partners.
	a comprehensive objections' management strategy to effectively and timely deal with possible valuation complaints.	**Compliant** An objections' management strategy was submitted on time to the programme partners.
	In addition, the authorities will:	
	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. The study will also provide an initial review of the tax regulations relevant for the foreclosure process, with a view to minimising the cost of foreclosure and subsequent sale of foreclosed property **by Q2-2014.**	**Non-compliant** Q2-2014 deadline is shifted to Q3-2014.
	Public Administration Reform	
3.9	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. Based on the findings of this first batch, 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 in Agriculture, Education, local government indicated as high priority will be adopted by the House of Representatives by Q3-2014. The relevant legislation indicated as high priority on the Companies Registrar will be adopted by October-2014. The reform will start to be implemented by Q4-2014, in accordance with the reform plan.	**Partially compliant** Education and agriculture reform plans have been submitted to programme partners, but have not yet been approved by the Council of Ministers. The local governments reform plan has not yet been submitted to programme partners.
	Welfare System	
3.1	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.**	**Complaint with delay** The authorities adopted the design and respective legislation that provides for the enactment of all elements of the reform (e.g. GMI and its linkage to ALMP, new administration of benefits) with a slight delay.

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To this end, the Cypriot authorities will take the following steps:	
adopt the final design of the reformed welfare system by the Council of Ministers **by mid-June 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, along with provisions on the mandatory participation of beneficiaries to active labour market programmes;	**Compliant** - The Council of Ministers adopted the final design of the reformed welfare system on 18 June 2014.
by end-June 2014 establish a monitoring unit to assess the GMI outcomes (ie. number of applications and costs, targeting accuracy, coverage and impact on poverty);	**Compliant** - A monitoring unit is established at the Ministry of Labour, Welfare, and Social Insurance. To date, the Ministry assigned the Head of the monitoring unit; steps should now be taken for its full staffing.
provide for consultation with the programme partners **by end-June 2014** a list of social benefits outside the GMI of which the beneficiary profiles and eligibility will be examined and **by mid-July 2014**,contingency measures to ensure fiscal neutrality of the reform in 2014.	**Partially Compliant** - A list of benefits outside the GMI of which the beneficiaries and eligibility would be examined was provided on 4 July 2014 to serve as a basis for compensatory permanent measures. The Cypriot authorities committed to include in the draft 2015 Budget Law additional measures to cover expected costs of the implementation of the welfare reform in 2015. To that end, a national registry of benefits, including the profiles and eligibility of all beneficiaries, is to be completed by November 2014.
ensure that a comprehensive database and the necessary IT requirements, including all required interfaces with different databases to allow for the comprehensive verification of eligibility criteria, are in place to support the administration of the reformed welfare system **by end-June 2014;** and	**Partially compliant** Work on the three IT modules progressed. The application module is now finalised, the interfaces module is finalised and is currently being tested, while the payment module still requires some further work to be able to start paying benefits by September 2014. The IT system is expected to be fully operational by mid-September2014.
transfer all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour, Welfare 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 Q2-2014,** except the benefits to be provided by the Ministry of Education and Culture (education benefits) and the Ministry of Interior (benefits to displaced people).	**Compliant** All relevant competences and responsibilities related to the administration and provision of all social benefits have been transferred to the Ministry of Labour, Welfare, and Social Insurance. Additional temporary staff was hired in July 2014.
The reformed welfare system must be consistent with the fiscal targets defined in this MoU. Draft legislation providing for the new guarantee minimum income scheme (GMI) will be submitted for review to the programme partners before submission to the House of Representatives. The law will be adopted **by Q2-2014.**	**Compliant with delay** The House of Representatives adopted with a slight delay the respective legislation providing for the 'Guarantee Minimum Income (GMI) and other Social Benefits' on 10 July 2014.
4.LABOUR MARKET Activating the unemployed and combating youth unemployment	

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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 employment opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will submit **by end-May 2014** the National Action Plan for Youth Employment, which will include, inter alia, measures envisaged for support under the Youth Employment Initiative including also the implementation of the 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 and be coherent with the reform of the social welfare system (section 3.10) and the agreed budgetary targets.	**Non-compliant** The authorities have shared with the program partners a draft of the National Action Plan for Youth Employment in July 2014, having missed the May deadline. The Action Plan is now to be finalized by Q3-2014.
For this purpose, the authorities will submit **by end-May 2014** a comprehensive note summarising the full list of all active labour market policies (existing and envisaged) with the relevant intended aims, recipients and budgetary allocations.	**Non-compliant** The authorities have missed the May deadline and shared with program partners only a summary table of existing active labour market policies. A more comprehensive list including all measures (exiting and envisaged) with the relevant intended aims, recipients and budgetary allocations will now be submitted by Q3-2014.
5. GOODS AND SERVICES MARKET 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;**	**Partially compliant** The transfer of qualified personnel to the CPC is on-going, with additional qualified personnel expected to be transferred in the next months.
enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers. The amended law will be adopted by the HoR **by June 2014,** at the latest; and	**Compliant with delay** The Mergers Law was adopted in mid-June, after two MoU deadline extensions.
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.	**Partially compliant** CPC's advocacy is on-going. Technical Assistance will be facilitated by the Irish and the French Competition Authorities on organisational and human resource issues, while providing training on sector enquiries.
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.	**Partially compliant** Progress has been made on ensuring the necessary staffing needs. The authorities have committed to ensure its full financial independence.
Housing market and immovable property regulation	
5.3 The Cypriot authorities will:	
define binding administrative deadlines for the issuance of title deeds upon receipt of the certificate of final approval **by Q2-2014**. Moreover to ensure the enforcement of the deadlines for issuance of certificates of completion by the supervisor engineers, an amending bill concerning the Street and Building Permit Law will be submitted to the House of Representatives by Q3-2014, after consultation with the programme partners;	**Compliant** In a circular by the Departments of Land and Surveys (DLS) addressed to all DLS district offices sent on 17 July 2014, a three-month deadline was defined for the issuance of title deeds upon receipt of the certificate of division approval.

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	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**; This plan should detail the resources required across authorities, streamlined processes if needed, set clear deadlines for any consultations required for issuing a certificate of final approval, as well as means to enforce those deadlines;	**Partially Compliant** The DLS prepared a draft joint action plan identifying steps to take to speed up the issuance of the pending title deeds at the DLS, with limited reference of how to streamline the process within the DLS and between DLS and other relevant public sector departments for the issuance of title deeds.
	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. To that end, **by mid-July**, provide to programme partners granular data on the stock of backlogs of permits, deeds, and certificates and a strategy identifying ways to reduce this backlog and continue publishing the quarterly progress reviews, starting in Q3-2014;	**Partially Compliant** The DLS has produced and submitted to programme partners, data on the issuance of pending title deeds at the DLS level. The provision of data still needs to be expanded to include granular data on the stock of backlogs of permits, deeds and certificates required to proceed with issuance of title deeds.
	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 tourism action plan twice per year, including an assessment of its implementation based on performance indicators, by Q1 and Q3 every year, starting from 2014. An update of the first progress report will be presented to the programme partners **by Q2-2014.**	**Compliant with delay** The final progress report is an improvement from the first two versions submitted in previous review missions.
	present a plan enhancing the coordination of the various tourism stakeholders and relevant authorities **by Q2-2014**. The plan shall include concrete actions and a roadmap leading to an effective mechanism for coordination.	**Partially compliant** The coordination plan does not yet offer a clear picture on who does what and it includes too many layers of consultation steps before making any decision; it needs fine-tuning by Q3-2014.
	Energy	
5.5	The Cypriot authorities will:	
	formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy will be developed and updated under the full authority of the Cypriot Government and should include at least the following three key elements, to be presented to the programme partners for consultation according to the timeline specified below:	
	a roll-out plan for the infrastructure required for the exploitation of natural gas. This plan should take into account the relevant technical and commercial uncertainties and risks and should cover: the required investments, associated costs, financing sources and methods, ownership structure; major planning risks and bottlenecks; 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.**	**Compliant** An update of the roll-out plan has been submitted to programme partners.

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a comprehensive outline of the regulatory regime and market organisation for the restructured energy and gas sector, with a view to introducing open, transparent, competitive energy markets. The outline should take 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 a description of the sequence and timing of the major changes envisaged: the institutional framework; the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the setting-up of wholesale markets for gas and electricity; the customer's free choice of supplier; and the full unbundling of gas suppliers and customers,. The Cyprus authorities will in this context consider the intended use and duration of the available 'isolated market' and 'emergent market' derogations. An advanced intermediate draft will be provided **by Q2-2014**, with a view to a final outline by Q4-2014;	**Compliant** Draft outlines for the gas and electricity markets have been submitted to programme partners.
an 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. 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, established in the FRBSL (see 3.3), should be based on clear rules governing inflows and outflows, coupled with clear rules regarding dividends, fees and costs of government entities and stakes in the energy sector. These rules should be provided for in the FRBSL and the specific law on the resource fund and detailed in implementing legislation of FRBSL. An advanced draft of the specific law will be submitted to programme partners for consultation **by Q2-2014**, before its submission to the House of Representatives.	**Compliant** The draft resource fund law has been submitted to programme partners.
6.TECHNICAL ASSISTANCE	
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.	**Compliant**

Source: Commission services.

ANNEX 2
Macroeconomic Projections

Table A2.1: **Selected macroeconomic indicators**

	2010	2011	2012	2013	2014	2015	2016
Real economy			*(percent change)*				
Real GDP	1.3	0.4	-2.4	-5.4	-4.2	0.4	1.6
Domestic demand incl. inventories	1.9	-1.4	-3.8	-9.8	-6.2	-0.5	0.9
Total consumption expenditure	1.4	1.0	-2.4	-5.6	-4.7	-0.7	0.5
Private consumption expenditure	1.5	1.3	-2.0	-5.7	-4.9	-0.2	1.5
Government consumption expenditure	1.0	-0.2	-3.8	-5.0	-3.8	-2.2	-3.2
Gross fixed capital formation	-4.9	-8.7	-18.3	-21.6	-17.0	1.3	3.9
Exports of goods and services	3.9	4.5	-2.5	-4.2	-2.4	1.9	2.9
Imports of goods and services	4.8	-0.1	-5.4	-14.1	-6.9	-0.1	1.3
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	0.2	-0.8	-5.1	-7.9	-6.1	-0.4	0.9
Foreign trade	-0.6	1.9	1.5	4.8	1.9	0.9	0.8
Changes in inventories	1.8	-0.7	1.2	-2.2	0.0	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	1.9	2.3	1.6	-1.5	-0.7	0.9	1.5
HICP	2.6	3.5	3.1	0.4	0.0	0.9	1.3
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	6.3	7.9	11.9	15.9	17.6	17.0	15.8
Total employment	-0.2	0.4	-4.2	-5.3	-4.0	0.4	1.5
Compensation per employee	2.6	2.5	-0.9	-5.9	-3.3	0.5	1.5
Labour productivity	1.5	0.0	1.8	-0.2	-0.3	-0.2	0.1
Unit labour costs	1.1	2.5	-2.7	-5.8	-3.0	0.7	1.4
Public finance			*(percent of GDP)*				
General government balance	-5.3	-6.3	-6.4	-5.4	-4.7	-5.2	-2.2
Total revenue	40.8	39.9	39.3	40.3	42.0	40.8	41.2
Total expenditure	46.2	46.3	45.8	45.8	46.8	46.0	43.4
General government primary balance	-3.0	-4.0	-3.2	-2.0	-1.3	-1.6	1.2
Gross debt	61.3	71.5	86.6	111.5	119.9	124.4	121.9
Balance of payments			*(percent of GDP)*				
Current external balance	-9.0	-4.5	-8.3	-1.9	-0.1	0.3	0.6
Ext. bal. of goods and services	-6.2	-4.4	-3.2	1.5	3.5	4.2	5.0
Exports goods and services	42.0	43.5	43.5	45.0	46.2	46.9	47.5
Imports goods and services	48.2	47.9	46.7	43.5	42.8	42.7	42.6
Balance of services	20.6	20.0	18.6	19.5	20.4	21.0	21.6
Balance of goods	-26.8	-24.3	-21.8	-18.0	-16.9	-16.8	-16.7
Balance of primay income	-3.1	0.7	-4.2	-2.9	-3.3	-3.8	-4.0
Net current transfers	0.3	-0.9	-0.9	-0.5	-0.3	-0.2	-0.3
Memorandum item			*(EUR bn)*				
Nominal GDP	17.4	17.9	17.7	16.5	15.7	15.9	16.4

Source: Commission services.

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

percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	1.5	1.3	-2.0	-5.7	-4.9	-0.2	1.5
2. Government consumption expenditure	1.0	-0.2	-3.8	-5.0	-3.8	-2.2	-3.2
3. Gross fixed capital formation	-4.9	-8.7	-18.3	-21.6	-17.0	1.3	3.9
4. Domestic demand excl. inventories	0.2	-0.8	-4.9	-7.8	-6.1	-0.5	0.9
5. Changes in inventories (contr. to growth)	1.8	-0.7	1.2	-2.2	0.0	0.0	0.0
6. Domestic demand incl. inventories	1.9	-1.4	-3.8	-9.8	-6.2	-0.5	0.9
7. Exports of goods and services	3.9	4.5	-2.5	-4.2	-2.4	1.9	2.9
7a. - of which goods	12.2	22.6	1.0	0.5	-2.4	1.1	1.8
7b. - of which services	2.4	1.1	-3.2	-5.2	-2.4	2.0	3.2
8. Final demand	2.5	0.2	-3.4	-8.1	-5.0	0.3	1.5
9. Imports of goods and services	4.8	-0.1	-5.4	-14.1	-6.9	-0.1	1.3
9a. - of which goods	7.3	-3.6	-10.0	-17.4	-8.2	-0.1	1.1
9b. - of which services	-0.4	7.7	3.9	-8.5	-4.9	-0.1	1.6
10. GDP at market prices	1.3	0.4	-2.4	-5.4	-4.2	0.4	1.6
(Contribution to change in GDP)							
11. Final domestic demand	0.2	-0.8	-5.1	-7.9	-6.1	-0.4	0.9
12. Changes in inventories	1.8	-0.7	1.2	-2.2	0.0	0.0	0.0
13. Net exports	-0.6	1.9	1.5	4.8	1.9	0.9	0.8

Source: Commission services.

Table A2.3: **Use and supply of goods and services (value)**

percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	3.7	4.7	0.6	-6.0	-5.1	0.6	2.9
2. Government consumption expenditure	2.6	3.0	-4.9	-9.7	-5.9	-1.1	-1.9
3. Gross fixed capital formation	-3.7	-10.7	-17.0	-22.4	-17.4	2.8	6.7
4. Domestic demand excl. inventories	2.0	1.6	-3.2	-9.0	-6.7	0.5	2.4
5. Changes in inventories (contr. to growth)	0.1	0.0	0.2	-0.2	-0.2	-0.2	-0.2
6. Domestic demand incl. inventories	3.8	0.9	-2.0	-11.1	-6.7	0.6	2.4
7. Exports of goods and services	6.1	6.6	-0.9	-3.6	-2.3	2.9	4.5
7a. - of which goods	13.6	24.1	2.0	0.9	-2.3	2.1	3.3
7b. - of which services	4.8	3.4	-1.6	-4.7	-2.3	3.1	4.8
8. Final demand	4.5	2.5	-1.7	-8.9	-5.3	1.3	3.1
9. Imports of goods and services	7.0	2.1	-3.3	-13.2	-6.5	1.2	2.9
9a. - of which goods	9.6	-0.7	-8.1	-16.5	-7.8	1.2	2.7
9b. - of which services	1.6	8.4	6.3	-7.3	-4.4	1.2	3.2
10. Gross national income at market prices	5.4	6.7	-5.7	-5.6	-5.2	0.9	2.9
11. Gross value added at basis prices	3.8	3.2	-0.7	-6.4	-5.0	1.4	3.1
12. Gross domestic product at market prices	3.3	2.7	-0.9	-6.9	-4.8	1.4	3.2

Source: Commission services.

Table A2.4: **Implicit deflators**

percent change	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	2.1	3.3	2.6	-0.3	-0.2	0.9	1.3
2. Government consumption expenditure	1.6	3.2	-1.1	-4.9	-2.2	1.1	1.3
3. Gross fixed capital formation	1.2	-2.2	1.6	-1.0	-0.5	1.5	2.7
4. Domestic demand incl. inventories	1.9	2.4	1.8	-1.4	-0.6	1.1	1.5
5. Exports of goods and services	2.2	2.0	1.6	0.6	0.2	1.0	1.5
6. Final demand	2.2	2.0	1.6	0.6	0.2	1.0	1.5
7. Imports of goods and services	2.1	2.2	2.2	1.1	0.5	1.3	1.6
8. Gross domestic product at market prices	1.9	2.3	1.6	-1.5	-0.7	0.9	1.5
HICP	2.6	3.5	3.1	0.4	0.0	0.9	1.3

Source: Commission services.

Table A2.5: **Labour market and costs**

Percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Labour productivity	1.5	0.0	1.8	-0.2	-0.3	-0.2	0.1
2. Compensation per employee	2.6	2.5	-0.9	-5.9	-3.3	0.5	1.5
3. Unit labour costs	1.1	2.5	-2.7	-5.8	-3.0	0.7	1.4
4. Total population	2.6	2.6	1.5	0.4	0.4	0.4	0.4
5. Population of working age (15-64 years)	3.1	2.9	1.5	0.8	0.5	0.3	0.2
6. Total employment	-0.2	0.4	-4.2	-5.3	-4.0	0.6	1.5
7. Unemployment rate (1)	6.3	7.9	11.9	15.9	17.6	17.0	15.8

(1) Eurostat definition, % of labour force.
Source: Commission services.

Table A2.6: **External balance**

EUR bn unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Exports of goods (fob)	1.1	1.4	1.4	1.5	1.4	1.4	1.5
2. Imports of goods (fob)	5.8	5.8	5.3	4.4	4.1	4.1	4.2
3. Trade balance (goods, fob/fob) (1-2)	-4.7	-4.3	-3.9	-3.0	-2.7	-2.7	-2.7
3.1 p.m. (3) as % of GDP	-26.8	-24.3	-21.8	-18.0	-16.9	-16.8	-16.7
4. Exports of services	6.2	6.4	6.3	6.0	5.8	6.0	6.3
5. Imports of services	2.6	2.8	3.0	2.8	2.6	2.7	2.8
6. Service balance (4-5)	3.6	3.6	3.3	3.2	3.2	3.4	3.6
6.1 p.m. 6 as % of GDP	20.6	20.0	18.6	19.5	20.4	21.0	21.6
7. External balance of goods and services (3+6)	-1.1	-0.8	-0.6	0.2	0.5	0.7	0.8
7.1 p.m. 7 as % of GDP	-6.2	-4.4	-3.2	1.5	3.5	4.2	5.0
8. Balance of primary incomes and current transfer	-0.5	0.0	-0.9	-0.6	-0.6	-0.6	-0.7
8.1. - of of which, balance of primary income	-0.5	0.1	-0.7	-0.5	-0.5	-0.6	-0.7
8.2 - of which, net current transfers	0.0	-0.2	-0.2	-0.1	0.0	0.0	-0.1
8.3 p.m. 8 as % of GDP	-2.8	-0.2	-5.1	-3.5	-3.6	-3.9	-4.3
9. Current external balance (7+8)	-1.6	-0.8	-1.5	-0.3	0.0	0.1	0.1
9.1 p.m. 9 as % of GDP	-9.0	-4.5	-8.3	-1.9	-0.1	0.3	0.6
10. Net capital transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.1
11. Net lending (+)/net borrowing (-) (9+10)	-1.5	-0.8	-1.5	-0.3	0.0	0.1	0.2
11.1 p.m. 11 as % of GDP	-8.8	-4.3	-8.2	-2.1	-0.2	0.6	1.1

Source: Commission services.

Table A2.7: **Fiscal accounts**

	2010	2011	2012	2013	2014	2015	2016
				levels, EUR m			
Taxes on production and imports	2,679	2,612	2,633	2,396	2,368	2,416	2,524
Taxes on income and wealth	1,926	2,098	1,962	1,916	1,797	1,792	1,866
Social contributions	1,552	1,566	1,510	1,475	1,477	1,506	1,550
Other current resources (1)	948	851	858	863	954	784	832
Total current revenue	7,106	7,127	6,963	6,650	6,596	6,498	6,771
Capital transfers received	10	12	11	6	20	2	2
Total government revenue	7,116	7,139	6,974	6,656	6,616	6,501	6,774
Compensation of employees	2,758	2,875	2,819	2,567	2,369	2,350	2,335
Intermediate consumption	978	945	865	741	743	757	725
Social transfers	2,500	2,630	2,606	2,595	2,682	2,674	2,595
Interest payments (2)	391	426	563	560	530	568	561
Subsidies	62	85	95	95	90	90	91
Other current expenditure	436	500	487	384	322	347	316
Total current expenditure	7,103	7,449	7,425	6,937	6,726	6,776	6,612
Total capital expenditure (3)	911	811	675	611	620	540	511
Total expenditure	8,036	8,272	8,109	7,553	7,356	7,326	7,134
General government balance, EDP	-920	-1,132	-1,135	-897	-740	-826	-360
General government primary balance	-529	-706	-572	-337	-210	-258	201
				% of GDP			
Taxes on production and imports	15.4	14.6	14.9	14.5	15.1	15.2	15.4
Taxes on income and wealth	11.1	11.7	11.1	11.6	11.4	11.3	11.4
Social contributions	8.9	8.8	8.5	8.9	9.4	9.5	9.4
Other current resources (1)	5.4	4.8	4.8	5.2	6.1	4.9	5.1
Total current revenue	40.8	39.9	39.3	40.3	42.0	40.8	41.2
Capital transfers received	0.1	0.1	0.1	0.0	0.1	0.0	0.0
Total government revenue	40.9	39.9	39.4	40.3	42.1	40.8	41.2
Compensation of employees	15.8	16.1	15.9	15.6	15.1	14.8	14.2
Intermediate consumption	5.6	5.3	4.9	4.5	4.7	4.8	4.4
Social transfers	14.4	14.7	14.7	15.7	17.1	16.8	15.8
Interest payments (2)	2.2	2.4	3.2	3.4	3.4	3.6	3.4
Subsidies	0.4	0.5	0.5	0.6	0.6	0.6	0.6
Other current expenditure	2.5	2.8	2.7	2.3	2.1	2.2	1.9
Total current expenditure	40.8	41.7	41.9	42.0	42.8	42.6	40.2
Total capital expenditure (3)	5.2	4.5	3.8	3.7	3.9	3.4	3.1
Total expenditure	46.2	46.3	45.8	45.8	46.8	46.0	43.4
General government balance, EDP	-5.3	-6.3	-6.4	-5.4	-4.7	-5.2	-2.2
General government primary balance	-3.0	-4.0	-3.2	-2.0	-1.3	-1.6	1.2
Nominal GDP	17.4	17.9	17.7	16.5	15.7	15.9	16.4

(1) The projection for 2014 includes the distribution of exceptional dividends by the CBC. The 2015 and 2016 numbers do not yet account for extraordinary dividends, but will be adjusted once the decision is taken by the CBC, in line with its duties under the Treaty and the Statue. (2) This includes an annual interest saving of EUR 30m related to the CBC asset-debt swap, which is subject to a decision of the CBC board in full respect of the independence of the CBC, the Treaty and the rules and procedures of the Eurosystem. (3) For 2013, this includes compensation of pension funds amounting to 1.8% of GDP in 2013.
Source: Commission services.

Table A2.8: **Debt developments**

	2010	2011	2012	2013	2014*	2015	2016**
EDP deficit (% of GDP)	-5.3	-6.3	-6.4	-5.4	-4.7	-5.2	-2.2
EDP gross debt (% of GDP)	61.3	71.5	86.6	111.5	117.8	126.1	122.5
			levels, EUR bn				
EDP deficit	-0.9	-1.1	-1.1	-0.9	-0.7	-0.8	-0.4
Gross debt	10.7	12.8	15.3	18.4	18.5	20.1	20.1
Change in gross debt	0.8	2.1	2.6	3.1	0.1	1.6	0.1
Nominal GDP	17.4	17.9	17.7	16.5	15.7	15.9	16.4
Real GDP	15.1	15.2	14.8	14.0	13.4	13.5	13.7
Real GDP growth (% change)	1.3	0.4	-2.4	-5.4	-4.2	0.4	1.6
			% of GDP				
Gross debt ratio	61.3	71.5	86.6	111.5	117.8	126.1	122.5
Change in gross debt ratio	2.8	10.1	15.1	24.9	6.3	8.3	-3.6
			Contribution to change in gross debt				
Primary balance	3.0	3.9	3.2	2.0	1.3	1.6	-1.2
Snow-ball effect	0.4	0.8	3.8	9.9	9.1	2.0	-0.4
of which							
Interest expenditure	2.2	2.4	3.2	3.4	3.4	3.6	3.4
Real growth effect	-0.7	-0.2	1.7	5.0	4.9	-0.5	-2.0
Inflation effect	-1.1	-1.4	-1.1	1.4	0.8	-1.1	-1.9
Stock-flow adjustments	-0.6	5.5	8.1	13.0	-4.2	4.7	-1.9

Source: Commission services.

Table A3.1: **Estimated financing needs for the period 2013-2016**

cash data unless states otherwise *million euros, negative = surplus / revenue*	2013				2014				2015				2016	Programme period (2013Q2-2016Q1)	2013	2014	2015	2016	2017	2018	2019	2020
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1									
Amortisation of existing market debt excl. short-term	3.5	1,435.9	123.7	43.5	249.4	128.5	1,435.2	121.5	147.0	86.9	81.9	937.2	340.1	5,130.9	1,606.6	1,934.7	1,253.0	697.4	1,612.9	769.0	2,213.3	1,894.5
among which:																						
domestic- (GRDS), foreign-law (EMTN) & CPB recap bond.	*0.0*	*1,416.9*	*47.0*	*1.0*	*243.9*	*91.0*	*1,351.6*	*55.2*	*141.1*	*42.8*	*17.6*	*871.9*	*332.4*	*4,612.4*	*1,464.8*	*1,741.8*	*1,073.5*	*530.6*	*1,495.6*	*19.6*	*1,453.1*	*1,132.5*
loans	*0.0*	*17.8*	*76.1*	*24.2*	*0.0*	*32.5*	*77.7*	*60.4*	*0.0*	*38.2*	*58.6*	*59.8*	*2.0*	*447.3*	*118.1*	*170.6*	*156.5*	*143.8*	*94.3*	*726.4*	*737.2*	*729.6*
Amortisation of new market debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	143.8	0.0	0.0	0.0
Amortisation of offical lenders	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.1	56.0	111.5	160.0
ESM	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
IMF	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*7.1*	*56.0*	*111.5*
Financial sector recapitalisation	0.0	0.0	1,500.0	0.0	0.0	0.0	0.0	500.0	500.0	0.0	0.0	0.0	0.0	2,500.0	1,500.0	500.0	500.0	0.0	0.0	0.0	0.0	0.0
of which contingency buffer	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*500.0*	*500.0*	*0.0*	*0.0*	*0.0*	*0.0*	*1,000.0*	*0.0*	*500.0*	*500.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Fiscal financing needs	10.9	153.2	85.9	538.5	-8.0	-929.5	469.0	284.0	273.8	450.9	633.2	99.9	179.2	2,230.2	788.5	-184.5	1,457.8	109.5	-243.3	-132.0	-79.7	-61.0
memo items:																						
primary balance (in ESA terms)	*-153.4*	*104.1*	*-80.1*	*466.4*	*-114.3*	*-56.7*	*-11.7*	*392.7*	*-128.2*	*133.0*	*-68.0*	*321.2*	*-238.6*	*719.8*	*337.0*	*210.0*	*258.0*	*-201.0*	*-427.0*	*-712.0*	*-739.5*	*-768.1*
interest (in ESA terms) /1	*158.7*	*105.4*	*173.0*	*122.8*	*135.4*	*49.1*	*265.2*	*80.7*	*140.5*	*105.8*	*224.9*	*96.5*	*146.8*	*1,646.2*	*559.9*	*530.4*	*567.8*	*561.3*	*560.1*	*586.3*	*674.9*	*716.8*
Programme financing needs /2	14.4	1,589.1	1,709.6	582.0	241.4	-800.9	1,904.2	905.5	920.8	537.8	715.0	1,037.1	519.4	9,861.1	3,880.7	2,250.2	3,210.8	519.4	-	-	-	-
memo: total annual financing needs															*3,895.1*	*2,250.2*	*3,210.8*	*806.9*	*1,520.6*	*693.0*	*2,245.0*	*1,993.5*

(1) This includes an annual interest saving of EUR 30m related to the CBC asset-debt swap, which is subject to a decision of the CBC board in full respect of the independence of the CBC, the Treaty and the rules and procedures of the Eurosystem. (2) The net financing needs in Q2 2014 are reduced by the amount of EUR 850m raised on the market, used in Q3 2014 to partly redeem the CPB bond.

Source: Commission services.

ANNEX 4

Programme Documents

Memorandum of Understanding on Specific Economic Policy Conditionality

The economic adjustment programme is addressing 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 effective management of non-performing loans. At the same time, supervision and regulation should continue to be strengthened in the context of the ongoing transition to the Single Supervisory Mechanism. In addition, a reform of the debt restructuring framework will be undertaken with a view to facilitating the voluntary workout of non-performing loans, avoiding strategic defaults by borrowers. Finally, the Cypriot authorities will continue to gradually remove restrictive measures in line with their roadmap, while safeguarding financial stability.

Progress since May

The authorities continued to implement the reform of the financial sector. With respect to regulation and supervision, banks made progress towards compliance with the new directive on provisioning and disclosure. The audited consolidated accounts of the CCB were published on 2 July. The Parliament adopted the necessary amendments to the Resolution Law on 19 June. Supervisory resources of the CBC have been increased. The CBC has also issued a request to the internal audits of BoC and the coops to review their lending and debt restructuring practices with respects to loans related to former and current managers and directors on 6 June.

Despite progress with the management of arrears, the percentage of non-performing loans continued to increase. The authorities made progress in developing their strategy for a reform of the private sector debt restructuring framework. Amendments to the Law on the Financial Ombudsman were adopted on 10 July. The restructuring of the financial sector has progressed in line with the programme requirements. Most notably, both BoC and the CCB published the agreed key performance indicators on progress with implementing their restructuring plans. All restrictive measures on domestic financial transactions have been removed.

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. Having completely removed the domestic payment restrictions, the Cypriot authorities commit to continue implementing the fourth stage of the roadmap for the gradual relaxation of restrictive measures which was published on 8 August 2013. The Cypriot authorities will ensure, in timely consultation with the EC, ECB, IMF and informing the ESM, that the gradual relaxation of the external restrictive measures is consistent with financial sector stability and preserves comfortable liquidity buffers. The CBC will conduct on-site inspections of the implementation of the restrictions, and take appropriate supervisory actions, as needed. Further liberalisation of external restrictive measures will only be considered after the successful completion of the Comprehensive Assessment and a smooth transition to the SSM. After the results of the Comprehensive Assessment, the authorities will refine and publish an updated version of their roadmap **by end-November**, based on a detailed analysis of deposit trends.

1.2. 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. The additional government guarantees for the issuance of bank bonds of up to EUR 2.9 billion in nominal value could be used as collateral against liquidity, if necessary to safeguard financial stability, in line with State aid rules.

1.3. The CBC will continue to receive the updated capital and funding plans of BoC and the CCB **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 the reduction of borrowing from the central bank, with the objective to avoid asset fire sales and a credit crunch.

Regulation and supervision of banks and cooperative credit institutions

1.4. The authorities are proceeding with the establishment of the central credit register, which will be operational **by end-September** for credit assessment purposes. The CBC has received technical support on the use of the credit register for supervisory purposes and will, **by end-September**, develop options for the use of the credit register in line with best practices and finalise the content of the additional data to be collected by the credit register. The CBC has started preparations to harmonise the credit register at the euro area level, as a part of a broader process coordinated by the ECB, which is due to be completed in 2016.

1.5. Taking into account the transition to the SSM, the CBC remains committed to ensure the full implementation and enforcement of its regulatory framework with respect to loan origination, asset impairment and provisioning. The new provisioning and disclosure directive will be fully implemented by the time of the publication of the 2014 annual accounts.

1.6. BoC and the coops will continue to submit a **quarterly report** describing the progress with the implementation of the restructuring plans. The reports will contain the agreed set of key performance indicators, including selected operational and financial indicators. The CBC units responsible for the supervision of BoC and coops will assess these and subsequent reports **on a quarterly basis** and submit their conclusions and proposed actions to the CBC Board within four weeks of the receipt of the reports.

1.7. The governance directive will be revised **by end-July**, specifying, among others, the interaction between banks' internal audit units and bank supervisors, in line with European regulations and international best practices.

1.8. The internal audit departments of BoC (including transferred Laiki operations) and of coops will submit **by end-September** a special examination report on lending and debt restructuring practices of BoC and coops with respect to loans related to former and current managers, directors, members of Committee and major shareholders of the groups, with the aim to identify decisions that have led to disproportionate losses in net present value terms. The CBC will complete its assessment of internal auditors' main findings and take appropriate action, including by requiring the institutions concerned to take civil action where applicable, **by end-January 2015**.

1.9. The CBC will have sufficient staff to carry out its functions in full independence as stipulated by the Treaties. The CBC, in cooperation with the SSM, will further assess the need to increase its staff, taking into account the new tasks undertaken under this Memorandum of Understanding, tasks imposed by the creation of the SSM, and enforcement of the existing regulatory framework **by end-October,** and address the identified needs **by end-December**.

1.10. In light of the new responsibilities taken on by the CBC, and after the review of the governance of the CBC, the Cypriot authorities will adopt the necessary amendments **by end-September**, including by ensuring a separation between resolution and supervisory functions. The authorities will begin work without delay to transpose the Single Rulebook, including the Bank Recovery and Resolution Directive and the Deposit Guarantee Scheme Directive, into national law.

Monitoring of corporate and household indebtedness

1.11. 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. In addition, quarterly monitoring reports will continue to be submitted and their scope and content will be further enhanced.

1.12. Measures will be taken to strengthen the management of non-performing loans and to deal with troubled borrowers, taking into account the developments and timelines in the SSM. A framework for targeted private-sector debt restructuring is being established.

- Banks will continue to report **quarterly** on restructuring progress and management of NPLs, using the agreed specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.). Furthermore, banks will continue to 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).

- After completion of the review of banks' arrears management policies and practices, revisions of the Arrears Management Directive and of the Code of Conduct will be introduced as needed **by end-November.** The revised Code of Conduct will target only households and SMEs. These amendments will include, inter alia, a streamlining of the procedure including the clear determination of specific procedural steps and precise deadlines attached to them, facilitating swift procedures within an appropriate time-limit and including the identification of a start event and an end date to the restructuring procedure under the Code of Conduct. In this context, the CBC will also clarify the applicability of the Arrears Management Directive and of the Code of Conduct to backlog cases. The CBC will also incorporate in the Code of Conduct the definition for a unified measure of viability based on a reasonable standard of living as determined in the insolvency framework. The responsible CBC supervisory units will examine the implementation of the banks' action plans to correct deficiencies identified by the external expert and submit the main findings and recommendations to the CBC Board **by end-November**. In conducting their on-site inspections, the CBC will ensure effective compliance with the Arrears Management Directive and the Code of Conduct.

- To ensure that banks are held accountable for offering sustainable restructuring solutions, **by end-October**, the CBC will issue specific guidance to banks on operational and financial indicators, such as the ratios of proposed, concluded and successful restructurings, as well as on tools to determine the capital cost of restructuring solutions. **By end-November**, the CBC will agree with banks on institution- and portfolio-specific targets to be set for the various phases of the restructuring process on a quarterly rolling basis. The aggregated performance of banks and coops against overall targets on initiated negotiations, proposed solutions and sustainable solutions will be published by **end-February 2015**.

- Following the requirements to be introduced by the CBC **by end-September**, the banks and coops will submit the agreed-upon procedure reports prepared by their external auditors on the effectiveness of their debt restructuring arrangements and strategies for the periods ending in December 2014, June 2015, December 2015, and June 2016.
- Legal amendments to the Law on the Financial Ombudsman were adopted by 10 July 2014. **By end-November**, legal amendments will be adopted in order to clarify that the responsibility for assessing compliance with the Arrears Management Directive is not transferred to the mediators but remains with the CBC.
- The Cypriot authorities, in view of financial stability considerations and on-going bank restructuring, commit not to introduce any new administrative measures which would interfere with the setting of bank lending rates. In particular no ceilings on bank lending rates would be introduced.
- The Cypriot authorities will allow for lenders to obtain adequate updated information on the financial situation of delinquent borrowers under sufficient safeguards, via court order if necessary. To achieve this, the authorities will engage an independent legal consultant to provide a report **by end-October** assessing required legal amendments, taking into account relevant international best practices in this area. The authorities will develop a time-bound action plan **by end-November**, and start its implementation **by December**.
- The Cypriot authorities will prepare, with the assistance of an independent legal consultant, a study **by end-October** and a time-bound action plan **by end-November** for removing impediments for lenders to file for, and obtain, an attachment of financial assets and earnings of delinquent borrowers, as well as to realise such attachment in order to satisfy their claim, under sufficient safeguards. The implementation of this action plan will start **by December**.
- In order to encourage a market for distressed assets and to facilitate the issuance of securities by securitisation vehicles, the authorities will allow and facilitate lenders to transfer existing individual loans together with all collateral and securities to third parties at minimal transaction costs without having to obtain the consent of the borrower. Any information obligation of the creditor should not be an impediment for the transfer and/or securitization of loans. To this end, the Cypriot authorities will establish a Task Force, consisting of relevant stakeholders from the public and private sectors, which will finalise an assessment of existing impediments and of required legislative amendments **by end-November**. This assessment will include a review of the regulatory framework for non-bank third parties. The identified impediments will be removed and legislative amendments made **by end-January 2015**.

Increasing financial transparency

1.13. 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. The Cypriot authorities will finalise the application of appropriate enforcement actions **by end-August** with regard to any breaches of compliance revealed by the April 2013 audit, and will take a final decision to apply sanctions if applicable. The final decision will be made public.
- 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 3.9.

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.

To protect the integrity of the financial sector, the CBC took swift action to put the local branch of FBME Bank Ltd. under resolution following the measures taken by its correspondent banks after its designation by the US authorities as a financial institution of primary money laundering concern, initiated an investigation, and will take appropriate supervisory action based on the results.

B. Recapitalisation and restructuring of financial institutions

Restoring adequate capital buffers

1.14. The authorities will finalise the transposition of CRD IV and national discretions under the CRR **by end-September**. As part of this process, the authorities will fix the Common Equity Tier 1 ratio at 8% under Pillar 1 in line with the harmonised benchmark applied under the baseline scenario of the ECB Comprehensive Assessment. In no circumstances will the implementation of CRD IV and CRR lead to any distribution of capital by the banks which were found in the PIMCO exercise to face a capital shortfall. In line with CRD IV, the CBC will request significant banks to maintain capital buffers in excess of the minimum Pillar 1 requirement based on conservative assumptions and to take prompt action if needed.

Management of legacy Laiki

1.15. In order to enhance the recovery value from the disposal of the assets of Laiki, the Resolution Authority instructed the Special Administrator to appoint a well-recognised and independent consulting or auditing firm(s) or international institution(s) to be entrusted with the voting rights associated with Laiki's shares participation in BoC. This appointment will be completed **by end-September.** The finalisation of the appointment of an advisor to provide services associated with the management of the disposal process shall be completed **by end-August**. As part of the terms of reference for the appointment of the advisor agreed in consultation with the EC, ECB and IMF and informing the ESM, an action plan for the full disposal of the assets will be developed **by end-September,** with a view to maximize value for creditors.

Restructuring of Bank of Cyprus

1.16. BoC has progressed with the implementation of the restructuring plan and has divested operations and stakes abroad ahead of schedule. Moreover, to strengthen confidence in the bank, the CBC agreed with BoC on the operational and financial indicators on progress with implementing the restructuring plan that will be communicated **quarterly** to the public, together with the financial accounts.

1.17. 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, and with due consideration to the establishment of the SSM.

Restructuring and recapitalisation of cooperative credit institutions

1.18. The Cooperative Group has completed the change of the Group's company ownership and governance structure, reducing the number of CCIs to 18 with the CCB controlling and holding 99% of these CCIs and the State holding 99% in the CCB. The restructuring included the appointment of new Board members and staff at all management levels. It is acknowledged that a great effort has been undertaken by the cooperatives in this context, as well as in reducing the number of branches. Building on these achievements, the Group will ensure timely and complete implementation of the already agreed restructuring plan and take further measures to improve its operational capacity, notably in the following areas: i) arrears management, ii) Management Information System (MIS), iii) governance and iv) strengthening management capacity. None of these measures will preclude any additional requirement under State aid rules.

1.19. As regards management of arrears, the Group will ensure all relevant units have an appropriate level of skilled and professional staff, including by redeployment of existing resources and leveraging on external expert service-providers. The CCB will assume primary responsibility for all loans in arrears. Direct reporting lines to the relevant units of the CCB will be established for all staff of the Group engaged in arrears management. Use of the appropriate legal tools and of collection methods related to collateral will be demonstrated.

1.20. In order to equip senior management with adequate decision-making tools, the MIS will be improved. The overall IT infrastructure will be updated and fully integrated into the organisational structure of the Group and put under the direct control of the CCB, with the view of providing all the necessary data on a timely and accurate basis. The quality and validity of the existing data will be verified and monitored.

1.21. To streamline execution of tasks, governance will be strengthened, avoiding parallel decision-making structures. The roles of executive and non-executive CCB board members should be separated and clearly defined. To ensure the controlling function of the CCB, the affiliation directive will be reviewed. The CCB will ensure strict compliance of the individual CCIs with all its policies. Necessary actions to strengthen the governance of the CCB over the CCIs will be implemented **by end-November**.

1.22. To strengthen the implementation of the restructuring plan, **by end-November**, the management capacity of the Group will be reinforced, including with the assistance of external experts. The staffing, policies and procedures of the Accounting and Finance departments will be enhanced to provide exact and timely information to the executive management.

1.23. To this end, the Cooperative Group will submit to the European Commission a draft action plan, covering the following four areas i) arrears management, ii) Management Information System (MIS), iii) governance and iv) strengthening management capacity, **by end-August** and a final version **by 15 September**. Moreover, if further State aid is needed, the Group will submit to the European Commission an amended restructuring plan, also incorporating the above action plan, **by end-August** and a final version **by 15 September**. The amended plan will include updated financial projections, based on the Group's actual results at end-Q1 2014, and will include detailed actions to meet the commitments that have not been achieved yet.

1.24. The CCB will commission an independent audit company to perform **by end-November** an audit of Financial Control and Reporting, including of Management Information Systems. **By end-December**, to ensure that the identified deficiencies will be efficiently addressed, the CCB will submit an action plan to the SSM, informing the EC, ECB, IMF and ESM.

1.25. The CCB will develop an effective and clear communication strategy. **By end-September**, the CCB will implement a targeted communication strategy providing information about the situation of the sector and progress on restructuring. Also **by end-September**, the CCB will have implemented a centrally coordinated marketing strategy for the Group.

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 CCB was established, to ensure that the CCB adopts sound policies, 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 and the follow-up. To this end, the effectiveness of the Management Unit of the Ministry of Finance will be reinforced with financial experts **by end-September**.

1.27. To strengthen confidence in the sector, the CBC agreed with the CCB and the Ministry of Finance Management unit on the operational and financial indicators on progress with implementing the restructuring plan that will be communicated **quarterly** to the public.

1.28. To limit risks and ensure appropriate and consistent risk management practices across the sector, **by end-January 2015**, the CBC's staff will contribute to 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.

1.29. The programme buffer remains available for potential recapitalisation needs, in line with State aid rules.

C. Legal framework for private debt restructuring

1.30. All 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.

1.31. The Task Force on registered, but untitled, land sales contracts will**, by end-September**, finalise a study assessing the magnitude of registered, but untitled, land sales contracts and underlying mortgages, in close cooperation with the working group reviewing the issuance of title deeds under the MoU provision 5.3. Based on this assessment and the recommendations developed so far, the Task Force will coordinate the work of the authorities involved and develop, **by end-October,** an action plan addressing at least, (1) the removal of administrative hurdles for the transfer of title, (2) the provision of tools to encourage the release of encumbrances on properties to facilitate title transfer, and (3) the development of contractual standards for land sales contracts and connected loan and mortgage arrangements.

1.32. **Prior to the granting of the sixth disbursement of financial assistance**, the Council of Ministers will, following consultation with EC and IMF and informing the ECB and ESM, adopt a comprehensive reform framework, establishing appropriate corporate and personal insolvency procedures. A quantitative analysis of various options on lenders will be completed **by end-August**, and shared with the EC, ECB, IMF and the ESM. On the basis of that framework, corporate and personal insolvency legislation will be adopted, which will include licensing and regulation of insolvency practitioners **by end-December**. The following reforms shall be made to insolvency arrangements, in line with best international practices: (i) a modernized bankruptcy process for non-viable individuals, including an effective discharge subject to proper safeguards; (ii) streamlined processes for non-viable individuals with no assets and no income, and with relatively small unsecured debt; (iii) a repayment scheme for viable individuals; (iv) an effective restructuring procedure for legal entities, including large borrowers; (v) a modernised and effective liquidation process for companies; and (vi) regulation of insolvency practitioners. The parameters of the new repayment scheme for viable borrowers will be set and communicated once there is sufficient clarity on its impact on the financial institutions, and after consultation with the EC, ECB and IMF, and informing the ESM.

1.33. For the purpose of insolvency frameworks and processes, the authorities will develop parameters for the definition and calculation of reasonable living expenses applicable in the context of personal insolvency.

1.34. 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 the House of Representatives **prior to the granting of the sixth disbursement of financial assistance**. This new legal framework will encompass the relevant legislative amendments and will have immediate effect for all mortgaged properties except primary residences (for which provisions will enter into effect by 1 January 2015, in line with the adoption of the insolvency legislation). The legal framework will establish a swift foreclosure procedure, which will allow for auctions to be conducted by mortgage creditors, without interference from government agencies.

The relevant regulations on the procedural rules for sale by auction or other methods will be adopted expeditiously.

The new foreclosure procedure will include the following key elements:

a. it will be available for all mortgaged property;
b. the only condition for the initiation of the foreclosure procedure will be a default of payment of more than 90 days past, while acknowledging that the mortgage creditor may be otherwise stayed from pursuing enforcement of its remedies by operation of other laws or rules;
c. it will contain swift procedures for obtaining market valuation of the property by independent valuators;
d. it will allow for an initial auction with a reserve price at 80% of the market value, with a subsequent lowering of the reserve price at 50% after three months of the initial auction, and a new valuation after 12 months of unsuccessful auctions or sales after the initial auction, maintaining, a reserve price of 50% of this new valuation;
e. it will contain precise deadlines for all procedural steps and respective preclusive periods for appeals;
f. it will contain provisions to safeguard the integrity of the foreclosure process, including through transparency and anti-fraud provisions; and
g. the concurrent government regulation on the procedural rules for sale by auction will facilitate the swift and transparent performance of auctions without delay or hurdles.

1.35. In the context of these reforms, the authorities, **by end-October**, will formulate recommendations on the Civil Procedure Code and Court Rules in order to ensure the smooth and effective functioning of the revised foreclosure law, and implement these recommendations **by end-November**. **By end-December**, the authorities will review and prepare an action plan to strengthen courts to ensure swift processing of appeals in the foreclosure process. **By end-January 2015**, the authorities will formulate recommendations on the Civil Procedure Code and Court Rules in order to ensure the smooth and effective functioning of the envisaged new insolvency frameworks.

1.36. 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 2.5% 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,[9] will be saved or used to reduce debt. To the extent that over-performance is deemed permanent, this can reduce the need for additional measures in the outer years. Measures, such as tax amnesties, that could have an adverse impact on tax compliance and foster tax fraud and evasion, thereby counteracting efforts in line with paragraph 3.6 of this Memorandum, will not be undertaken over the course of the programme period.

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

[9] Windfall gains associated with hydrocarbons shall mean only the blocks’ licencing fees or related signature bonuses for exploration thereof. It is noted that any streams of revenues associated with hydrocarbon exploitation are dealt with under section 5.5, second bullet-point, indent 3

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 no more than EUR 210 million (1.3% of GDP) in 2014[10] corresponding to a headline deficit of 4.7% of GDP (respecting the 16 May 2013 Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Cyprus). 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

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 258 million (1.6% of GDP) in 2015, corresponding to a headline deficit of 5.2% of GDP[11] (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus).

With a view to maintaining fiscal consolidation over the medium term, the authorities will submit for consultation with programme partners a proposal that will ensure the fiscal neutrality of the welfare system reform and the achievement of the 2015 fiscal deficit target. The final proposal will be agreed in consultation with programme partners **by end-August 2014** and will be incorporated in the draft 2015 Budget, which will be adopted by the Council of Ministers **by mid-September 2014**.

After review by and consultation with the programme partners the 2015 Budget Law will be adopted by **December 2014**. 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.

[10] ESA95 budgetary targets: These targets are not directly comparable to, but remain consistent with the respective cash-based budgetary targets agreed between the authorities and the IMF in the context of the economic adjustment programme.

[11] The targets for 2015-16 do not include expected dividends of EUR 100 million per year, to be distributed by the CBC in line with CBC's duties under the Treaties and the Statute.

Fiscal policy in 2016-18

In 2016 the Cypriot authorities will achieve a general government primary balance surplus of at least EUR 201 million (1.2% of GDP), corresponding to a headline deficit of 2.2% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus).

These targets and the underlying updated budgetary projection will be embedded in the 2016-2018 Fiscal Strategy Statement, which will be adopted by the Council of Ministers **by Q2-2015**. After review by and consultation with the programme partners, the 2016 Budget Law will be adopted by **December 2015**.

In **Q2-2016**, the Cypriot authorities will present the programme partners with a provisional list of measures to attain a primary surplus of 2.5% of GDP in 2017 and 4% of GDP in 2018. The measures required will be included in the draft 2017 Budget Law.

3. Fiscal-structural measures

Key objectives

Cyprus enjoyed above euro-area average growth rates for more than a decade and in parallel expanded its public sector employment, support and services considerably. Looking ahead, if the public sector is to provide appropriate support for the sustainable and balanced growth of the Cypriot economy, fiscal-structural reform steps are needed to ensure the long-term sustainability of public finances, to provide the fiscal space necessary to support the diversification of the economy, and to alleviate the adverse impact on jobs and growth arising from Cyprus' exposure to external shocks. In this context, the objectives are: (1) to improve the efficiency of public spending and the budgetary process by means of an effective Medium-Term Budgetary Framework (MTBF) that is fully compliant with the Directive on requirements for budgetary frameworks and the Treaty on Stability, Coordination and Governance (TSCG); (2) 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.

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) All necessary legislative changes related to the implementation of the Health Reform Plan will be approved by the House of Representatives **by end-November 2014** aiming at full implementation of the Plan **by Q2-2015**. The reform plan will take into account the restructuring of all public hospitals/public health facilities, the Ministry of Health, the Health Insurance Organisation (HIO), and other associated facilities/organisations. It will also take into account the findings of the functional review of the health sector public entities and the analysis of the function and structure of the Ministry of Health. The reform plan will provide for autonomisation of all public hospitals/public health facilities. Public hospitals will complete the shadow-budgeting for all inpatient cases on diagnoses-related groups **by Q3-2014** and for all in- and outpatient activities **by Q4-2014**; **by Q3-2014**, the detailed restructuring plan of the public primary healthcare centres will submitted for consultation with program partners;
b) taking into account the economic conditions, the implementation of the necessary complementary 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**.

1. The NHS will be developed and implemented based on the fundamental principles of free choice of provider, social equality and solidarity, financial sustainability and universal coverage of a minimum benefit basket.

2. Implementation will be carried out in three stages. **By mid-2015**, in the first stage of NHS, primary care consultation services will be covered. **By 1 January 2016**, outpatient specialist care and pharmaceuticals will be added to the benefits covered. Full implementation of NHS will be achieved **by mid-2016**.
3. NHS will be initially based on a single payer agency. The system may evolve into a multiple insurance system provided that the necessary preconditions for achieving efficiency and affordability gains (i.e. consumer information and transparency, contestable markets, freedom to contract, fiscal viability of insurance agencies, competition regulation and risk-adjustment) can be ensured. While respecting the deadlines of the health care reform plan and of the NHS implementation plan, a study by an independent consultant, to be chosen in consultation with programme partners, will be undertaken to

evaluate the functional and financial sustainability of the NHS operated by single and multi-payer system; the study will also assess how and when the preconditions for a multi payer system, as mentioned above, can be achieved.

4. **By October 2014,** submit to Parliament, the amended NHS Law. All financial parameters of the first stage of NHS, including the total budget for primary healthcare-consultation, the level of insurance premium, capitation fee level, and minimum and maximum amount of patients per general practitioner, will be provided **by 1st September** for consultation with program partners.
5. Based on the detailed road map for the implementation of the NHS, the amended bill of NHS will also determine and clarify the respective role, governance and responsibilities (notably concerning the strategic policy, budget control, monitoring, audit and regulation) of the Ministry of Health and the HIO and will be approved by the House of Representatives **by Q4 2014**.
6. Finalize the tendering of the IT-infrastructure necessary for implementing the NHS **by December 2014**.
7. 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, **by Q3 2014**.
8. An Implementation Support Team will be established by end-August 2014, drawing on national and international expertise, to assist the Ministry of Health with the implementation of NHS and health sector reforms.

c) Starting in Q3-2014, prepare quarterly reports, to be submitted for consultation by program partner assessing the collection of compulsory health-care contribution for public servants and public servant pensioners and all co-payments for using public health care services against envisaged proceeds, and present suggestions for policy changes if needed;

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, capacity planning) **by Q4-2014**, in order to ensure that the agreed budget limits of public health expenditure are not exceeded, whilst ensuring equitable access to healthcare;

e) 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**,** and submit **by Q3 2014** the conclusions of the review for consultations with program partners;

f) Continue to publish clinical and prescription guidelines and to audit their implementation; continue to establish the system for health-technology assessment.

g) 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), with a report to be submitted for consultation by program partners **by Q3-2014**.

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

<u>Public financial management</u>

3.3. The Cypriot authorities will:

- improve the risk-assessment analysis associated with government guarantees. To this end, submit to programme partners by **Q3-2014** the final version of the risk assessment report prepared by the Public Debt Management Office. The report shall identify guarantees that are expected to result in calls in the current and following year;
- adopt a comprehensive medium-term debt-management strategy, **by end-October 2014,** aimed at: (i) smoothing the debt redemption profile and reducing refinancing risk; (ii) diversifying across instruments and types of investors; (iii) ensuring a smooth functioning of the domestic Treasury bill market; and (iv) enhancing risk-assessment of contingent liabilities from government guarantees. This will help paving the way for a sustainable return to market access in due time.
- issue guidelines for public investment management, including project appraisals in line with the FRBSL provisions **by Q3-2014**. The authorities commit not to enter into any new tendering process and not to sign any public private partnership (PPP) contract before the issuance of the guidelines for public investment management; and
- regularly update the PPPs inventory, including contingent liabilities and include it both in the annual budget law and in the annual financial report.

<u>State-owned enterprises and privatisation</u>

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

- the law regulating the creation and the functioning of SOEs at the central and local levels will be adopted by the House of Representatives **by September 2014**. The law will enhance the monitoring powers of the central administration, while including reporting on SOEs in the context of the annual budgetary procedure. No additional SOEs will be created until the law has been adopted;
- each SOE under internal review will submit a strategic plan with detailed milestones and timelines to the competent minister for approval, in consultation with programme partners, and in line with the FRBSL and SOEs Law provisions, **at the latest 3 months after the completion of each internal review.**

3.5. 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 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:

- ensure that the newly-established Privatisation Unit is fully staffed **by October 2014**, in line with the provisions of the Privatisation Law;

- submit the assessment of market conditions and the evaluation of Limassol Port (competitive position, physical and operational conditions) **by October-2014**;

- appoint the CPA financial advisor **by October-2014**, who will then submit a detailed privatisation plan and a valuation of the transaction **by December-2014**;

- appoint the CPA legal advisor **by October-2014**;

- submit CPA's final method of privatisation **by November-2014**, after consultation with, and notification to, the relevant European bodies on the proposed transaction structure;

- establish CPA's appropriate regulatory framework **by December-2014**, after consultation with the relevant European bodies;

- appoint independent advisors for the privatisation of CyTA and EAC **by end-October 2014**, in accordance with the privatisation plan;

- approve, through the Council of Ministers and on the basis of the recommendations of the advisors, a detailed plan for the privatisation of CyTA, including the main characteristics of the transaction, **by Q4-2014.** CyTA will be converted into a Limited Liability company **by December 2014;**

- appoint independent advisors with relevant expertise and develop a plan with detailed intermediate steps and timings for disposing of the identified land assets **by November 2014**;

- agree the terms of reference for the independent advisors' study on the unbundling of EAC's operations in different legal entities **by Q4-2014** and complete the unbundling **by Q2-2015**. The study will comprise an international benchmarking, including cost structures, of major existing electricity producers vis-à-vis other electricity companies.

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.

<u>Revenue administration, tax compliance, and international tax cooperation</u>

3.6. The Cypriot authorities will continue reforming the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection and the fight against tax fraud and evasion, with a view to increasing fiscal revenue.

To ensure effective application of the recently enhanced legal powers to enforce tax collection, the authorities will adopt the necessary regulations for the seizure of movable property and issue the notification on the procedural details for the garnishing of bank accounts **by Q3-2014**.

A comprehensive compliance strategy 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

- design a new joint debt collection strategy **by Q3-2014** and complete pilot runs on each of the new powers for garnishing of bank accounts and seizure of movable and immovable assets **by Q4-2014**;
- **by Q4-2014**, complete the cleansing of the income tax and VAT registers by removing inactive cases, including through cross-checks using the new common data platform, and put in place a process to maintain the registers up-to-date;
- conduct two pilot projects aimed at enhancing voluntary compliance of large and high-risk taxpayers **by Q4-2014**, and finalise the compliance risk management module for large taxpayers **by Q3-2014**, with a view to setting up the integrated large taxpayer unit of the new tax department **by Q4-2014**; and
- **by Q3-2014**, present a first high-level draft of an integral strategy for the prosecution of tax fraud as a criminal offence, including an evaluation of the required investigative and legal resources needed in the new tax department. A final strategy will be elaborated **by Q4-2014.**

To progress with the operationalization of the newly established integrated and function-based tax agency, in line with the adopted integration plan, the authorities will

- approve organisational structures for the tax department and appoint the Commissioner on a fixed term and the two assistant Commissioners **by Q3-2014**; and
- establish a common taxpayer database **by Q3-2014**.

3.7. 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;
- continue improving the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident

individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States; and

- ensure that the tax authorities have continuous access to databases of other public entities in order to facilitate and expedite the provision of the requested information **by Q4-2014**; and

- continue with the swift implementation of the commitments taken to reverse the negative opinion by the OECD Global Forum and provide an updated progress report to programme partners **by Q3-2014.**

In addition, the authorities will monitor closely further progress in responding timely to tax information requests by EU and third countries. The authorities will submit to the programme partners quarterly performance updates (within 14 days of the end of the quarter).

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

3.8. 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 the recurrent immovable property tax for the tax year **2015** based on a General Valuation (GV) for all immovable properties, determined on the basis of tangible building- and plot related characteristics. The design of the immovable property tax should ensure a broad tax base and IPT proceeds not lower than in 2013. A draft of the proposed tax rates and thresholds will be submitted for timely consultation with programme partners **by Q4-2014**. Following consultation with programme partners, the final design of the immovable property tax will be adopted by the House of Representatives by **Q1-2015**;

- adopt legislation specifying the frequency of the mandatory update of the values in line with international best practices by **Q1-2015**, following consultation with programme partners;

- implement by **Q1-2015** the recommendations of a study on the scope for consolidating the collection and administration of the municipal and communal recurrent property tax and sewage tax. The study, to be completed **by Q3-2014**, will also review existing exemptions and derogations from property taxation. Moreover it will report on the scope for shifting revenues from transaction fees and taxes to recurrent taxation. Furthermore, it will provide an initial review of the tax regulations relevant for the foreclosure process, with a view to minimising the cost of foreclosure and subsequent sale of foreclosed property**. By Q3-2014,** the authorities will also review the tax regulations that may impede the leasing of immovable property;

- conduct an assessment of the variance between GV assessed values and market price **by Q4-2014,** as well as an assessment of the relevance of the parameters used in the Computer Assisted Mass Appraisal (CAMA) model for the GV. Identify possible missing parameters and refine, if needed, the CAMA in light of this assessment **by Q1- 2015;**

- **by Q3-2014,** adopt a strategy to correctly identify all property owners in the property register;

- present to the programme partners **by Q1-2015** an updated communication strategy aiming at informing of the goals of the property tax reform, the implications for citizens and the procedures of the new reform, as well as an updated comprehensive objections' management strategy to effectively and timely deal with appeals.

<u>Public administration reform</u>

3.9. 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 is 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 October 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 January 2015.** The relevant legislation indicated as high priority will be adopted by the House of Representatives **by Q1-2015.** Full implementation will be **by Q4 2015** and, in accordance with the reform plan.

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. Based on the findings of this first batch, the Cypriot authorities will agree on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers **by Q3-2014.** The relevant legislation in relation with the reforms in Agriculture, Education, local government indicated as high priority will be adopted by the House of Representatives **by Q4-2014**. The relevant legislation indicated as high priority on the Companies Registrar will be adopted **by October-2014.** The reform will start to be implemented **by Q1-2015**, in accordance with the reform plan.

- the second batch will cover all remaining Ministries (Labour, Welfare and Social Insurance, Communications and Works, Energy, Commerce, Industry and Tourism, Interior, Defence, Justice and Public Order, Foreign Affairs), and the Ministry of Finance, including the Treasury and the Directorate General for European Programmes, Coordination and Development (ex: Planning Bureau) being covered under the PFM. It will also include all SOEs (subject to the decisions taken under the provisions of 3.4 and 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

3.10. The Cypriot authorities have reformed the welfare system by introducing a Guaranteed Minimum Income (GMI) aimed at strengthening the protection of vulnerable households while ensuring an appropriate balance between welfare benefits and work incentives (as further specified in section 4.3 below). The Cypriot authorities have started implementing the new GMI as of mid-July 2014. Besides the introduction of the GMI, the reform plan also includes measures aimed at consolidating and streamlining other social benefits, and at improving the targeting of these benefits.

To ensure efficient use of public funds within the welfare system and the consistency of the reformed welfare system with the fiscal targets defined in this MoU, the Cypriot authorities will take the following steps:

- **by end-September 2014,** the monitoring unit will make a preliminary assessment of the reform's outcome, including the number of applications and costs and provide an update of the costing of the GMI;

- build a national registry of benefits, including the profiles and eligibility of all beneficiaries, cross-checked with other databases, to be completed by **end-November 2014**.

- on the basis of the national registry of benefits, by **end-March 2015**, the monitoring unit will finalize an assessment report of the welfare reform, including possible refinements in administrative structures and benefits.

- ensure that a comprehensive database and the necessary IT requirements, including all required interfaces with different databases to allow for the comprehensive verification of eligibility criteria, are in place to support the administration of the reformed welfare system **by mid-September 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 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. A tripartite agreement will be pursued with social partners **by Q4-2014** for the suspension of wage indexation in the private sector until 2016 and the application thereafter of the reformed wage indexation system (COLA) applicable to the public sector (lower frequency of adjustment, suspension at times of recession and partial indexation).

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 implementation of the reform of the social welfare system, which ensures 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, should be pursued as described in section 3.10.

4.4. The Cypriot authorities will continue the implementation of measures to address the identified shortcomings of the system of activation policies, including:

i. the development of a coherent methodology for the continuous monitoring and evaluation of activation measures, to be applied consistently across the different ALMP. 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 measures;

ii. measures to enhance the administrative capacity of the public employment services via increased staff mobility and/or outsourcing of specific tasks **by Q3-2014**; and

iii. measures to ensure the effective cooperation between the public employment services, the social welfare services and the benefit-paying institutions in the activation of the unemployed who are recipients of social assistance, including by establishing clear procedures for the automatic exchange of information and a transparent system linking benefit receiving with job-search efforts.

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 employment opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will submit **by Q3-2014** the final National Action Plan for Youth Employment, which will include, *inter alia*, measures envisaged for support under the Youth Employment Initiative including also the implementation of the 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 and be coherent with the reform of the social welfare system (section 3.10) and the agreed budgetary targets. For this purpose, the authorities will submit **by Q3-2014** a comprehensive note summarising the full list of all active labour market policies (existing and envisaged) with the relevant intended aims, recipients and budgetary allocations.

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.

On the basis of the comprehensive review of requirements affecting the access and exercise of activity of the regulated professions sector (such as lawyers, engineers, architects), the Cypriot authorities will eliminate by law the requirements that are not justified or proportional **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:

- continuously ensuring that CPC has sufficient and stable financial means, as well as qualified personnel, in order to enhance its effective and on-going operation; and
- continuously promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition.

The Cypriot authorities will continuously ensure that the General Auditor's Office has sufficient personnel to carry out its functions and increased tasks, and that it is financially independent, 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 swift transfer of property rights. 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:

- **by Q3-2014**, submit to the House of Representatives, after consultation with the programme partners, amendments to the Street and Building Permit Law to ensure the enforcement of the deadlines for issuance of certificates of completion by the supervisor engineers;
- **by end-November 2014**, the House of Representatives will adopt amendments of the Transfers and Mortgaging Property Law in order to accelerate the timeframe for banks' consent on the issuance of title deeds.
- **by August 2014**, create a working group under the responsibility of the Ministry of Interior, which, in close cooperation with the Task Force on title deeds under the MoU provision 1.31 and the Task Force for Growth, will review and streamline all procedures leading from the planning permit application to the issuance of title deed. This working group will also provide the necessary assistance to the Task Force on title deeds under the MoU provision 1.31, to allow for a quantification of this problem. **By Q3-2014**, submit for consultation with programme partners a report with recommendations on how to streamline these procedures, including a catalogue for tolerated deviations from building and planning permits as well as binding deadlines for each of those procedures and means to enforce them, with a view to their implementation **by Q1-2015.**
- 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. To that end, **by end-September 2014**, provide to programme partners granular data on the stock of backlogs of permits, deeds, certificates, and mortgages associated with the underlying properties, and a strategy identifying ways to reduce this backlog and continue publishing the quarterly progress reviews, starting **in Q3-2014**;
- 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**. To that end, provide detailed statistics on court backlogs and duration of court

proceedings to programme partners on a quarterly basis starting **in Q4-2014**, submit a draft action plan for the elimination of court backlogs, including the electronic filing of new documents **by end-October 2014,** and enact legislation to establish an Administrative Court **by Q4-2014.**

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 tourism 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 an updated plan enhancing the coordination of the various tourism stakeholders and relevant authorities **by Q3-2014**. The plan shall include concrete actions and a roadmap with a concrete timeline leading to an effective mechanism for coordination, while specifying who is responsible for the tourism strategy and how the Council of Ministers is involved in the process;
- provide an assessment of the current CTO law in order to identify, together with programme partners, which articles may hamper competition in the tourism sector **by Q1-2015**, taking into account the public administration functional review's second batch;
- in view of the reorganisation of CTO's various units, the authorities will submit a roadmap **by Q4-2014**, including milestones needed to reach the targets set in the tourism strategy. This roadmap will provide the basis for monitoring of the tourism strategy implementation;
- 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. The action plan approved by the Council of Ministers in May 2014 will be implemented **as of Q3-2014** and will be reviewed annually by the Cypriot authorities, in consultation with the programme partners.

Energy

5.5. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package is fully and correctly implemented;
- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy will be developed and updated under the full authority of the Cypriot Government and should include at least the following three key elements, to be presented to the programme partners for consultation according to the timeline specified below:
  1. a *roll-out plan* for the infrastructure required for the exploitation of natural gas. This plan should cover: the required investments, associated costs, financing

sources and methods, ownership structure; major planning risks and bottlenecks taking into account also technical and commercial uncertainties; a projection of the revenue streams over time; the configuration and timing for the development of the necessary transmission infrastructure, accounting for European projects of common interest; and an appropriate sales framework for the off-shore gas supply for both exports and domestic markets aimed at maximising revenues. Next update **by Q4-2014.**

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 envisaged LNG project 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 and market organisation* for the restructured energy and gas sector, with a view to introducing open, transparent, competitive energy markets. The outline should take into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, competition and entry dynamics on the electricity markets (also in view of the envisaged rise in electricity production from renewable energy sources), 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 a description of the sequence and timing of the major changes envisaged: the institutional framework; the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the setting-up of wholesale markets for gas and electricity; the customer's free choice of supplier; and the unbundling of electricity and gas networks to the benefit of suppliers and customers, taking into account the potential use of certain derogations in accordance with acquis The Cyprus authorities will in this context consider and inform programme partners about: i) the intended use and duration of the available 'isolated market' and 'emergent market' derogations, ii) a preliminary assessment of the technical and economic potential for further increasing electricity production by renewable energy sources, , also accounting for the scope for improving the capability of the transmission and distribution system to integrate renewable electricity. This assessment will be followed by an analysis (**by Q3 2015**) of the cost price of different sources of renewables compared to conventional primary energy sources; iii) envisaged measures to improve the capacity and independence of CERA to carry out its functions, including sufficient staffing. An updated draft outline will be provided **by Q3-2014**, with a view to a final outline **by Q4-2014**; and

3. an 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. 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, established in the FRBSL (see 3.3),

should be based on clear rules governing inflows and outflows, coupled with clear rules regarding dividends, fees and costs of government entities and stakes in the energy sector. These rules should be provided for in the FRBSL and detailed in implementing legislation of FRBSL, an advanced draft of which will be submitted to programme partners for consultation **by Q3-2014**, with a view to submission to the House of Representatives **by Q4-2014.** The resource fund law, which defines the governance structure of the resource fund, will be submitted to the House of Representatives **by Q4-2014**.

Since these three key elements are strongly interdependent, they need to be developed in parallel over time and collated in one summary document. For some of the technical aspects of the above key elements, technical assistance, where requested, will be provided.

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-December 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 The Cypriot authorities will develop a comprehensive and coherent growth strategy that will help the economy to move to a sustainable growth path. The growth strategy will take into account the on-going public administration reform, public financial management reform, the commitments in the Cyprus Economic Adjustment Programme and relevant Union initiatives. The growth strategy will aim at, inter alia, creating a more attractive business environment, addressing administrative complexity, implementing more streamlined and simpler procedures, and it will also take into account the Partnership Agreement for the implementation of the European Structural and Investment Funds. The growth strategy will be developed, coordinated and enforced through the single body that will evolve out of the Task Force for Growth already established and will be anchored in the national institutional framework.

By Q3-2014, the authorities will provide, in consultation with the programme partners, an action plan for the development, and implementation of the growth strategy. 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 %.

In addition:

A compensation scheme for provident and retirement funds in Cyprus Popular Bank. The scheme should meet the following criteria: (i) ensure comparable treatment with such funds in Bank of Cyprus, (ii) take into account the cash-flow and actuarial position of each fund in determining timing by which the compensation will take place, (iii) minimise the impact on the general government deficit and ensuring its one-off nature. Given the social welfare nature of provident and retirement funds, the Cypriot authorities will earmark an amount of up to EUR 299 million out of the state budget, for such compensation, of which up to a maximum of EUR 154 million can be released, before the second review of the adjustment programme.

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

	Heading/Deficiency	*Action*	*Timeline*
1	**Customer Due Diligence**		
1.1	**Business profile**		
	Business profiles not always properly established.	1.1.1 CBC to provide guidance to ensure that obliged entities engage in adequate training of all staff involved in establishing customer business relationships and opening accounts, so that business profiles are properly determined and assigned.	Compliant
1.2	**Customer risk profile**		
	Lack of understanding of cumulative risks in complex ownership structures / introduced business.	1.2.1 CBC to provide sufficient guidance to ensure that obliged entities have sound and effective risk management systems in place to identify and understand ML/TF risks within their customers, products and services, geographical locations/areas, and delivery channels. Risk management systems should include an overall policy for identifying and understanding, measuring, controlling, and monitoring ML/TF risks. The risk management policies, procedures and measures should be submitted to the board for approval on an annual basis, or as required by changes in the business model.	Compliant Ongoing
	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	**Ongoing CDD**		
	Higher risk customers/changes in risk not dealt with appropriately on an ongoing basis. Particular issues relating to PEPs.	1.3.1 CBC to issue additional guidance to ensure that financial institutions have sound and effective systems and measures in place to demonstrate enhanced ongoing monitoring for higher risk clients, including PEPs. 1.3.2. CBC to ensure that financial institutions have sound and effective systems and measures including updated CDD measures.	Compliant Ongoing

2	**Reliance/introduced business**		
	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.	2.2.1 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. 2.2.2 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.	Compliant 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	**Suspicious Transaction Reporting**		
	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.	Compliant
4	**Transparency of beneficial ownership**		
4.1	**Access to information**		
	Ensure that transparency and availability of beneficial ownership information is in line with international standards and best practice.	4.1.1 Revision of Trust and Company Services Providers Law as appropriate and AML Law to ensure that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to the domestic competent authorities and their foreign counterparts; and revise the directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, ICPAC). 4.1.2. In the case of nominees, either a) require nominee directors[1] 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	Compliant Compliant

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

		shareholders be authorised or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs).	
4.2	**Company Registry**		
	Efficiency of Companies' Registrar as an important aid to CDD.	4.2.1 Carry out a third party review of the functioning of the Companies' Registrar and communicate results to the programme partners. 4.2.2 Ensure the department of the registrar is appropriately resourced.	Compliant Partially compliant Q3 - 2014
4.3	**Register of Trusts**		
	Enhance the transparency of trusts in line with international standards and best practice.	4.3.1 CY to establish trust registries with the supervisory authorities for all express trusts established under CY law, where the name of the trust and the name and address of the trustee will be contained therein. The trust registers will be accessible by the supervisory authorities in order to facilitate them in their supervisory duties.	Compliant
5	**Supervision of financial institutions**		
5.1	**Revise the AML/CFT supervisory structure within the CBC, ensuring it is adequately resourced**	5.1.1 Revise and/or establish organisation structure and management within the CBC's Banking Supervision and Regulation Department (BSRD) to address AML/CFT matters,[2] in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Compliant

[2] 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.[3] 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.[4]	Partially compliant Q3 - 2014
5.2	**Develop risk-based supervisory tool(s) for offsite surveillance/monitoring activities prior to implementation**	5.2.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas,[5] and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - institutional risk profiles; - specific AML/CFT supervisory strategies (adapted to institutional risk profiles).	Compliant
5.3	**Develop risk-based supervisory tool(s) for onsite inspections prior to implementation**	5.3.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: -Corporate Governance; -Risk Assessment Systems; -Policies & Procedures; -Compliance Function; -Internal & External Audit Functions; -Training Program.	Compliant
5.4	**Establish Formal AML/CFT Training Program**	5.4.1 Establish a formal AML/CFT training program for CBC staff to ensure adequate implementation of the offsite and onsite tools. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools; - customer acceptance policies; - customer due diligence (CDD);	Partially compliant Q4 – 2014

[3] FATF Immediate Outcome (IO) 3
[4] See BCP 2.6c
[5] 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).

		- monitoring of transactions; - identification and reporting of STR; - funds transfers; - correspondent banking; - recordkeeping; - compliance function; - internal controls; - audit functions; - corporate governance; - risk assessment systems	
		5.4.2 Provide CBC supervisory staff with ongoing training to ensure adequate knowledge of risks and supervisory techniques.	Ongoing
5.5	**Implement adequate supervision**	5.5.1.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 Non-compliant. End-August
		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.	Compliant Compliant Ongoing Ongoing
		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.	Compliant Ongoing

6.	**Supervision and monitoring of lawyers, accountants and TCSPs**		
6.1	**Align resources with risks** **Establish an effective monitoring structure for AML/CFT matters**	6.1.1 Ensure adequate human resources and technical capacity to undertake effective AML/CFT monitoring. The level of resources should be commensurate with the size, complexity, and risk profiles of each business and professional. To meet this objective, if deemed necessary by the supervisory authorities, hire AML/CFT experts with the necessary professional skills and experience (e.g. professionals having performed monitoring or supervision of these professions abroad) – subject to necessary confidentiality restrictions.	Ongoing
6.2	**Develop risk-based tool(s) for Offsite surveillance/monitoring activities prior to implementation**	6.2.1 Design, develop, adopt, and pilot a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas, and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - risk profiles; - specific AML/CFT monitoring strategies (adapted to institutional risk profiles).	Compliant (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.	Compliant (CBA and ICPAC) Compliant (CBA and ICPAC) Ongoing (CBA and ICPAC) Q3-2014 (CySEC, for 6.2.2.1, 6.2.2.2. and 6.2.2.3)
6.3	**Develop risk-based tool(s) for Onsite inspections prior to implementation**	6.3.1 Design and develop a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: - Risk Assessment Systems - Policies & Procedures - Compliance Function	Compliant (CBA and ICPAC) Q3-2014

		- Training Program	(CySEC)
6.4	**Establish Formal AML/CFT Training Program**	6.4.1 Establish formal AML/CFT training program and develop and deliver customised AML/CFT training courses. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools - customer acceptance policies - customer due diligence (CDD) - monitoring of transactions - identification and reporting of STR - recordkeeping - compliance function - risk assessment systems etc.	Ongoing (CBA and ICPAC) Q4-2014 (CySEC)
6.5	**Implement adequate supervision**	6.5.1. On a quarterly basis, in the context of the programme review, starting Q4-2013, the CySEC, CBA and ICPAC will, on a confidential basis, share anonymised information with the programme partners by granting access, to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	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 3.9 will cover the following areas:

Ministries and the Departments/Services falling under each Ministry

i. Ministry of Labour, Welfare 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 the Directorate General for European Programmes, Coordination and Development (ex Planning Bureau), is being reviewed under the PFM.

Constitutional Powers /Services

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

Independent Services/Authorities

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

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

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

[12] It functions according to *acquis communautaire* prescriptions and it employs only a limited number of people (4 persons).
[13] The relevant organisation is dealt within the context of the financial sector part of the MoU.

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