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The Economic Adjustment Programme

Cyprus
7th Review - Summer 2015

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Directorate-General for Economic and Financial Affairs

The Economic Adjustment Programme
Cyprus, 7th Review – Summer

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The report was prepared in the Directorate General Economic and Financial Affairs, under the direction of Jakob Wegener Friis, Head of Unit and European Commission mission chief to Cyprus.

Contributors:

Declan Costello (Director), Leonor Coutinho, Servaas Deroose (Deputy Director General), Zivile Didziokaite, Leila Fernández-Stembridge, Jakob Wegener Friis, Nikolay Gertchev, Valeska Gronert, Duy Thanh Huynh-Olesen, Filip Keereman, Marianne Klumpp, Daniel Koerhuis, Robert Krämer, Ana Lope Garcia, David Lopes, Brendan Mac Namara, Mihai-Gheorghe Macovei, Géraldine Mahieu, Sarah Merzbach, Georgios Moschovis, Christophe Schwierz, and Stefan Zeugner. Julien Castiaux and Rajko Vodovnik provided statistical assistance.

The report was prepared in liaison with the ECB.

Comments on the report would be gratefully received and should be sent by mail or e-mail to:

Jakob Wegener Friis
European Commission
ECFIN
CHAR 12/006
B-1040 Brussels, Belgium
e-mail: Jakob-Wegener.FRIIS@ec.europa.eu

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EXECUTIVE SUMMARY

Staff teams from the European Commission (EC) and the International Monetary Fund (IMF), in liaison with the European Central Bank (ECB), visited Nicosia from 14 July to 24 July 2015 for the seventh 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 with the Cypriot authorities on policies that could serve as a basis for completion of the seventh review, reflecting the progress and policies under the programme.

The economic recovery has started, but unemployment remains high. Growth returned to positive territory in the first quarter of 2015, led by professional services and tourism and, on the demand side, private consumption, partly supported by lower energy prices, lower interest rates and the euro depreciation. The labour market shows signs of stabilisation, but unemployment remains high, hovering at around 16 percent. Prices continued declining, largely reflecting declines in the energy and tourism sectors. Growth is expected to settle at 0.5% this year, gradually regaining strength in 2016.

The fiscal developments continue to exceed expectations, with a primary surplus of 1.2% of GDP at end-June 2015, about 0.9pp of GDP better than envisaged in the sixth review. Taking into account the latest developments and updated macroeconomic projections, the 2015 government primary balance target has been revised from a surplus of 1.5% of GDP to a surplus of 1.9% of GDP. The authorities will need to continue implementing their budget prudently in light of existing risks, notably related to the uncertain fiscal impact of recently enacted tax reforms. If required, additional measures should be taken in order to achieve as from 2017 a lasting primary surplus of between 3% and 4% of GDP, which is warranted to maintain public debt firmly on a sustainable downward path. Minimising the impact of consolidation on vulnerable groups and designing a progressive fiscal consolidation remains central to the programme. The social welfare reform provides better protection of vulnerable groups and targets benefits to those most in need. Although implementation is delayed, the programme continues to support health care reforms that strengthen the sustainability of funding and a more equal access to public health services. The programme continues to promote a range of actions to activate the unemployed and combat youth unemployment. The reforms of the tax revenue and public administration are envisaged to improve tax compliance, fight tax evasion and make the public sector more effective in performing its tasks. The design of the fiscal consolidation combines an increased taxation of capital (interest income, immovable property, bank levy) with a higher corporate tax rate.

The financial situation of the banks is gradually improving, but a stronger implementation of financial sector reforms is needed to guarantee a sustainable stabilisation of the banking system. Even if there are some early signs that the rise of non-performing loans is levelling off, a decisive reversion of the NPLs trend has still to materialise. Addressing the excessive level of non-performing loans in the banking system remains the number one priority. It is a necessary condition for a sustainable stabilisation of the banking system and will require further steps as a matter of priority. To this end, legislation to expedite the transfer of title deeds and to facilitate the sale of loans should be adopted as soon as possible. Banks and cooperatives have increased their loans restructuring efforts and the first legal cases to make use of the new foreclosure framework have been initiated. However, the sustainability of the solutions offered remains to be ascertained. The overall deposit base has stabilised in spite of some contagion from the Greek turmoil, which impacted on deposit flows in the Greek banks' subsidiaries in Cyprus. However, these developments were relatively short lived and did not influence the overall stability of the banking sector. The Greek exposure of the four subsidiaries has been significantly reduced and the CBC in cooperation with the SSM is monitoring the situation closely. There is sufficient liquidity available in the banking system, but it is so far not used for lending to the economy with credit supply and demand remaining subdued. After posting losses in 2014, the banks as a whole have returned to profitability in the first quarter of this year, even though a significant part of it is due to interest income booked on non-performing loans. Continued restructuring of the banking sector is necessary to preserve the good progress made so far, not least in the cooperative banks, where governance needs to be further improved.

The reform of corporate and personal insolvency laws is being implemented. Banks and their clients are now taking up the use of these new tools, which facilitate voluntary agreement between creditors and debtors, since they provide for more balanced incentives than in the past. Together with the enhanced foreclosure framework, this framework is an important instrument to help reducing the excessive level of NPLs. The Insolvency Service has taken up duty and it is establishing the necessary infrastructure, including the licencing of insolvency practitioners. It is essential that any impediments to the effectiveness of the procedures should be removed, including measures which could weaken incentives for non-viable debtors to promptly pursue debt restructuring. It is equally important to ensure that the relief in legacy guarantees does not jeopardise the economic function of guarantees going forward and that the payment capacity of the guarantor is taken into account. The authorities will, with the support of the programme partners, closely monitor the effectiveness of the procedures in practice and will conduct a comprehensive review of the private sector debt restructuring legal framework by end December 2015. The authorities also made some progress with regard to other measures to speed up the resolution of the NPLs, notably with the Council of Minister adoption of the laws regarding to the sale of loans and the transfer of issued title deeds. Their adoption by the House of Representatives, expected to take place before the release of the next tranche of financial assistance, will constitute a key additional step to help resolving NPLs.

Some progress has been noted on important growth-enhancing reforms, but firmly moving ahead - including the privatisation process and the public administration reforms - is critical to restore sustained economic growth. The horizontal reform of the public administration has regained momentum, and the reform plan and the legislation on the wage bill, the appraisal system, the promotion system, and measures enhancing staff mobility were adopted by the Council of Ministers and submitted to the House of Representatives. Progress towards the privatisation of Cyprus Telecommunications Authority has also continued, albeit with some delays, with the legal proposal allowing for its conversion into a Limited Liability Company, a crucial step for its privatisation, adopted by the Council of Ministers. Also, the study on the unbundling of the Electricity Authority of Cyprus has begun, which will contribute to the Government's decision on the preferred form of legal unbundling. The revenue administration reform has also progressed steadily with notably the completion of the top management team and first steps to implement the new tax compliance strategy. The implementation of the welfare system reform is making headway even if the processing of the applications to the new Guaranteed Minimum Income scheme remains slow. Efforts to increase international tax cooperation have been maintained, with an almost complete cleaning up of the Companies' registrar and taxpayer registries. The implementation of the Anti-Money Laundering (AML) action plan continues to be on track.

However, other reforms have suffered from delays. The law on the State-Owned Enterprises' corporate governance, which aims at ensuring a more effective monitoring of the functioning of SOEs and minimising fiscal risks, has not yet been adopted. Also, the reform of the health sector has not progressed much since the last mission. The implementation of the Immovable Property Tax reform has been postponed to 2016 due to late adoption of the design of the new tax system. The public employment service still lacks capacity to fully handle its task. Efforts to reduce the significant title deed issuance backlog need to be accelerated, notably via a comprehensive streamlining of the issuance procedures. Finally, progress has been generally slow in developing a comprehensive strategy to restore Cyprus' growth potential, even if important growth-enhancing steps have been taken on various fronts.

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 October. Its approval would pave the way for a cash disbursement of EUR 500m by the ESM, and about EUR 124m by the IMF. Three prior actions were set for the granting of the eighth disbursement, relating to delayed steps of importance to reducing the level of NPL's and to key structural reforms. The first prior action concerns the adoption by the House of Representatives of legislation to solve the backlog of title deeds transfer. Moreover, even if not a prior action, adoption of the legislation regarding to the sale of loans is expected to take place before the release of the next tranche of financial assistance. The second and third prior actions relate to adoption by the Council of Ministers of legal proposals for the corporatisation of the Cyprus Telecommunications Authority (CyTA) and for the horizontal reform of the public administration. These are key structural reform commitments that have not progressed sufficiently.

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1. INTRODUCTION

The report assesses compliance with the terms and conditions set out in the MoU, as updated following the sixth review mission. Following agreement 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), the updated MoU was signed on 13 July 2015 by Mr Pierre Moscovici, Commissioner for Economic and Financial affairs, Taxation and Customs.

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 14 July to 24 July 2015 for the seventh quarterly review mission. A staff level agreement was reached with the Cypriot authorities on policies that could serve as a basis for completion of the seventh review.

This report is based on information obtained during the seventh review mission, taking into account economic and policy developments until end August 2015.

Three prior actions were set for the granting of the eighth disbursement, relating to delayed steps of importance to reducing the level of NPL's and to key structural reforms. The first prior action concerns the adoption by the House of Representatives of legislation to solve the backlog of title deeds transfer. Moreover, even if not a prior action, adoption of the legislation regarding to the sale of loans is expected to take place before the release of the next tranche of financial assistance.

The second and third prior actions relate to adoption by the Council of Ministers of legal proposals for the corporatisation of the Cyprus Telecommunications Authority (CyTA) and for the horizontal reform of the public administration. These are key structural reform commitments that have not progressed sufficiently fast. Following the adoption of the legislation on title deeds by the House of Representatives on 3 September 2015, and the adoption of the legal proposal regarding CyTA and the public administration reform by the Council of Ministers on 26 August, the prior actions have been considered to be met.

A successful seventh programme review would unlock the disbursement of ESM's eighth tranche to cover financing needs arising until the end of 2015. In light of the government's cash position and financing needs, the eighth ESM disbursement in cash would amount to EUR 500m to cover deficit financing and redemption needs. The IMF would disburse about EUR 124m.

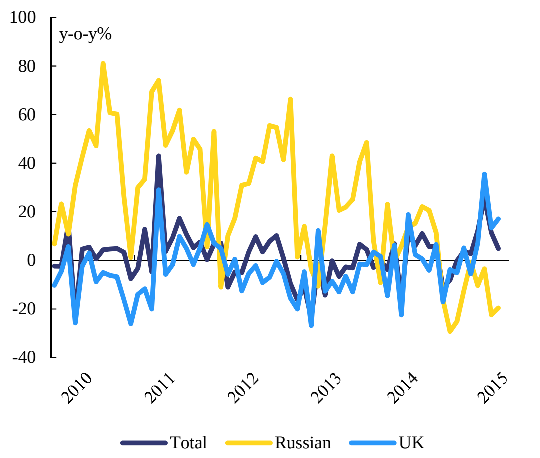
The report is organised as follows. Section 2 examines recent macroeconomic, fiscal and financial developments. A detailed assessment of compliance of programme conditionality is reported in Section 3. Section 4 looks at programme financing and debt sustainability, while Section 5 discusses risks to 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

Growth has resumed in the first quarter of 2015, with real GDP increasing by 0.4% y-o-y. Lower prices, including on energy products, a weaker euro, and lower interest rates have temporarily supported real private consumption and export growth. As a result, real private consumption growth picked up to 0.9%y-o-y. The annual decline in real public consumption was also less pronounced. Abstracting from the volatility in investment, exports, and imports created by the registration activity of vessels in Cyprus ([1]), the contraction of investment appears to be drawing to a close supported by a moderate resumption of new credit to the real economy. The underlying momentum of export growth is also regaining strength, sustained by positive growth in tourism arrivals, with the decline in Russian tourists in the first half of the year broadly offset by rising UK arrivals (Graph 2.1).

Graph 2.1: **Tourists arrivals**



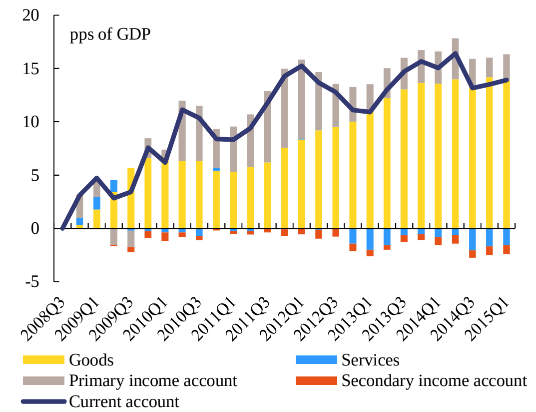
Source: Cystat

Increased activity in professional business services, which benefit from lower prices and euro depreciation, also help to support exports. Import growth slowed down significantly due to the base effect that had inflated growth in 2014. As a result, the contribution of net exports to GDP growth in the first quarter of 2015 was insignificant.

Although encouraging, growth in the first quarter of 2015 (at 1.5% q-o-q) was very strong compared to historical data, and partly driven by temporary factors. The support from the euro and energy prices is expected to gradually fade away over the course of the year, as some rebound has already taken place, but they will continue to affect the annual rate of change throughout the year. In the financial sector, a one-off intercompany transaction also artificially increased the stock of loans, also contributing to the strong first quarter outcome.

The current account balance improved from -5.1% of GDP in the fourth quarter of 2014 to -4.6% of GDP in the first quarter of 2015, according to BoP data. The improvement was driven by the primary income account (Graph 2.2), mainly due to higher net returns on foreign direct investments, while the deficit in the balance of goods and the surplus in the balance of services remained broadly unchanged.

Graph 2.2: **Cumulative current account adjustment**



(1) Graph shows BPM6 data back-casted with BPM5 data.
Source: Central Bank of Cyprus

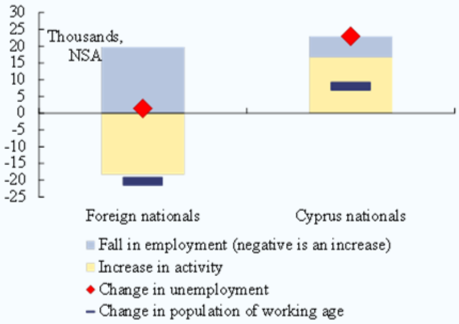
([1]) See Box 2.1, "The treatment of ship-owners in ESA2010 and BPM6", in European Commission (2015), The Economic Adjustment Programme. Cyprus, 6th Review – Spring 2015, Institutional Paper no 004, July 2015 for a discussion of how the new treatment of ship-owners has affected national accounts data.

Box 2.1: Labour Market Adjustment to the Sovereign Debt Crisis in Cyprus

The sovereign debt crisis in Cyprus has brought about a significant decline in employment, accompanied by a similar increase in the numbers of unemployed. From 2012Q3 to 2015Q1, total employment fell by about 25,900 persons in cumulative terms, while unemployment increased by about 24,300, leading to an unemployment rate of about 16%. The discrepancy between the fall in employment and the increase in unemployment is due to an overall lower labour market participation. Between 2012 Q3 and 2015 Q1, the total number of active persons in Cyprus has declined by about 1,600.

The aggregate number disguises important differences between foreigners and Cypriots. Since 2012 the employment of foreigners has decreased significantly more than that of Cypriot nationals (Graph1). The decline in the employment of foreigners since 2012Q3 has been matched by a decrease in the foreign (total and active) population, resulting in limited change to the number of foreign unemployed (Graph 1). Cypriot nationals have been less affected by employment cuts, but the number of Cypriot unemployed increased significantly due to their rising labour market participation.

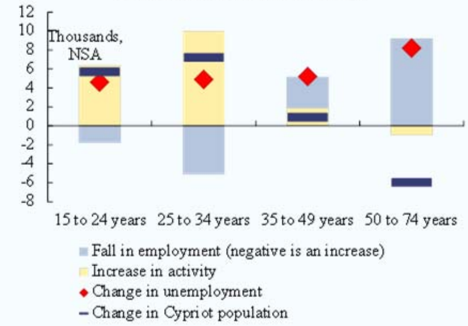
Graph 1: **Employment, activity and unemployment by nationality**
Cumulative change 2012Q3-2015Q1



Source: Eurostat, LFS statistics

The change in labour force participation is explained by various factors. For foreigners, the decline in active population matches almost one to one the decline in the foreign population of working age brought about by increased outward migration. In the case of Cypriot Nationals, the increase in the population of working age (by around 8,000) explains about half of the growth in active population (about 16,700), while rising activity rates explain the rest (about 8,700). This is particularly the case for the age groups 25-34 years and 35-49 years. Increased activity rates also explain the moderate decline in active population among individuals between 50 and 74 years of age compared to the decrease in the population in this age bracket (Graph 2).

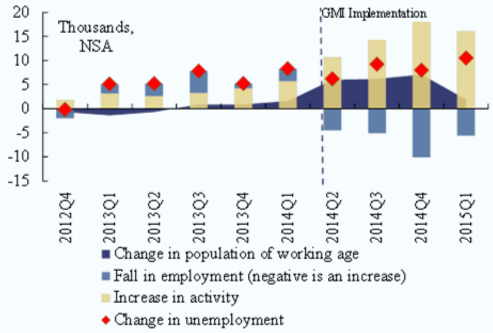
Graph 2: **Population, activity, employment, and unemployment of Cyprus nationals by age**
Cumulative change 2012Q3-2015Q1



Source: Eurostat, LFS statistics

The increase in female participation has been the main determinant of the rising activity among Cypriot nationals. The number of active Cypriot women has been increasing since the start of the crisis, and the increase has been significantly higher since 2014-Q2 (Graph 3).

Graph 3: **Activity, Employment and Unemployment, Cypriot Females**
Cumulative change 2012Q3-2015Q1



Source: GMI statistics and Eurostat, LFS statistics

This marked acceleration of the increase in activity coincides with an increase in female employment. It may also be correlated to the introduction of the new guaranteed minimum income scheme (GMI), which has a broader coverage compared to the previous social assistance scheme it replaced, as

(Continued on the next page)

Box (continued)

well as a stronger conditionality regarding participation in the labor market.

Job destruction has mainly affected those aged above 50, while employment of younger Cypriots increased. The young between 15 and 34 have been relatively favoured in terms of employment since 2012Q3 (increasing by 6,900), as they are more likely to have taken up certain types of jobs freed up by foreigners, including in the retail and tourism sectors; they have been targeted more by active labour market policies (national youth action plan, including the youth guarantee); and in general they constitute a cheaper source of labour, more flexible and more willing to take up part-time or temporary jobs. Despite this, youth unemployment (15-34 years) increased by about 9,500 since the crisis started, due to a rapid increase in labour market participation. However, workers older than 35, and particularly the ones older than 50, have been more hit by the crisis, and form the bulk of the long-term unemployed, raising the risk of the unemployment problem becoming structural.

It still remains to be seen whether the current increase in vacancies will be followed by a (lagged) reduction in unemployment, leading to a counter-clockwise movement of the Beveridge curve (Graph 4), or if instead the latter will shift outwards with unemployment persisting at high levels despite the increasing number of vacancies. To counter this risk, Cyprus has approved three new ALMP programs in 2015 targeting the long-term unemployed, with a budget of EUR 8.4m to be spent over 3 years.

Graph 4: Beveridge Curve

Source: Eurostat and Cystat

The unemployment rate has continued to hover around 16% in the first quarter of 2015. Employment and unemployment remained broadly stable in the first quarter of 2015 compared to the previous quarter. The aggregate developments mask important substitution effects within the labour market, with new entrants including Cypriot females and youth faring better in terms of employment. This evidence is shown in Box 2.1, which discusses how different segments of the labour market have adjusted to the sovereign debt crisis. The moderation of the decline in compensation per employee, observed since the end of 2013, continued in the first quarter of 2015, with a decline of 1.3%y-o-y, leading to a similar evolution of unit labour costs (which fell by 1.6%y-o-y in the first quarter of 2015).

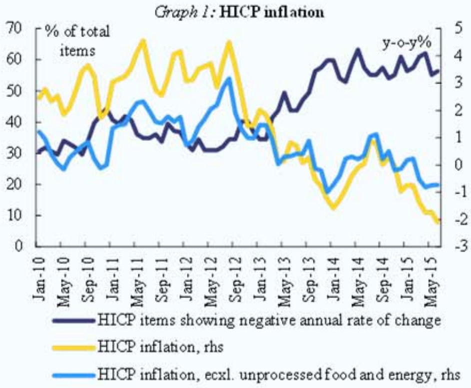
Inflationary pressure continues to be very weak. The HICP inflation rate has moved deeper into negative territory and fell to -2.1% y-o-y in June 2015 (Graph 2.3). This is partly due to lower energy prices, but also to low underlying cost pressure with core inflation (i.e. headline excluding unprocessed food and energy) at -0.7% y-o-y and in particular lower prices for tourism services in an effort to attract demand. See Box 2.2 for a discussion of recent developments in headline and core inflation. Despite the negative inflation, profit margins are still increasing, although at a slowing pace. Overall, the downward pressure on costs and prices is expected to be reflected into a negative growth of the GDP deflator for the year as a whole.

The housing market adjustment continued, albeit at a slower pace. The decline in nominal house price has moderated from its trough of -9.5% y-o-y in the first quarter of 2014 to -6.5% y-o-y in the first quarter of 2015. Housing demand continues to remain weak, as suggested by Bank Lending Survey and the relatively low and broadly stable level of housing sales.

Box 2.2: Harmonised Index of Consumer Prices and core inflation

The inflation rate of the Harmonised Index of Consumer Prices (HICP) ([1]) has gradually fallen from its high level of 4%y-o-y in 2011 to negative rates in mid-2013. Despite the weakening macroeconomic environment since mid-2011, HICP inflation rates remained relatively high until mid-2012, partly due to increasing prices of crude oil in euro terms. The latter have since then edged down, and reinforced the downward price pressure from the weak demand. In mid-2013, HICP inflation rates entered negative territory, alongside an increasing number of its components. ([2]) The declining rate of core inflation (headline HICP excluding energy and unprocessed food) suggests that demand factors played a dominant role in the moderation of HICP inflation rates since 2012.

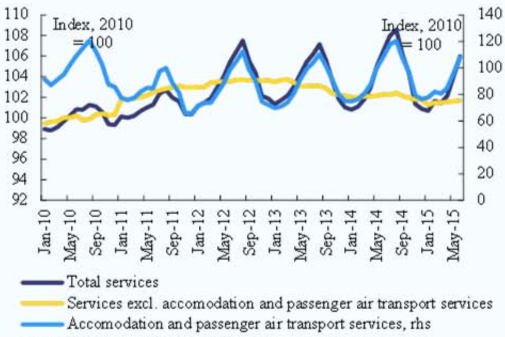
Graph 1: **HICP inflation**



Source: Eurostat and own calculations

The impact of underlying cost pressure was however masked by changes in the weights of some HICP components, which generated artificial seasonal patterns in inflation rates. Both core and headline inflation rates, which have shown remarkable similar movements since mid-2012, registered a seasonal pick-up over the summer months. This pick-up relates to the change of the weights of accommodation and passenger air transport services in the HICP index. ([3]) Graph 2 shows that prices of accommodation and passenger air transport services are subject to high seasonal movements, while other services show more stable prices. Reflecting the better resilience of tourism during the crisis, and therefore its increasing weight in the consumer basket, the total weights of accommodation and passenger air transport in the HICP index increased by more than 2 percentage points since 2011, against an average change of less than 0.3 percentage points since 2000. The higher weights of these more volatile price components increased the seasonality of services prices and explains a large part of the seasonal pick-up in prices observed in 2012 and 2014.

Graph 2: **Service price indices**



Source: Eurostat and own calculations

Other commonly used indicators for core inflation, such as the trimmed mean and weighted median inflation, are less affected by the changes in the weights and provide a better gauge of underlying cost pressure at the current juncture. The median inflation rate indicator measures the (weighted) median inflation rate instead of the mean as in the headline HICP inflation rate. The trimmed mean excludes the most volatile items ([4]). In this box, 15 items were excluded, including accommodation and passenger air transport, to abstract from the most volatile components which are primarily driven by the external environment.

([1]) The HICP differs from the national Consumer Price Index (CPI), mainly due to higher weights of tourist-related services.

([2]) The box entitled "Risks of Deflation?", in the ECB Monthly Bulletin, June 2014 provides a broad definition of deflation, where one of the indicators for deflation is the share of HICP items with negative rates of annual changes.

([3]) Coicop codes 11.2 and 7.3.3 respectively.

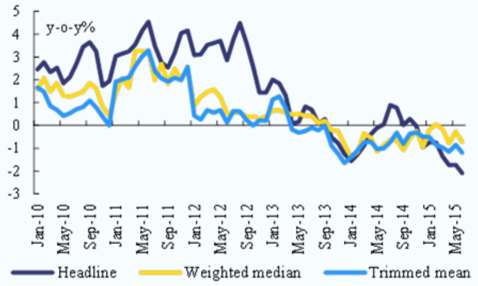
([4]) Accommodation and passenger air transport have shown the ninth and tenth highest volatility since 2001. See e.g. Clark, T. E. (2001) "Comparing measures of core inflation", Economic Review, Second quarter 2001, p. 5-31, Federal Reserve Bank of Kansas City for a discussion of the trimmed mean and weighted median inflation indicators.

(Continued on the next page)

Box (continued)

These two indicators show much lower inflation rates since 2012 when the automatic wage indexation scheme (COLA) was temporarily suspended (Graph 3). Despite the two hikes in the VAT rate in 2013 and 2014, underlying inflation has remained subdued.

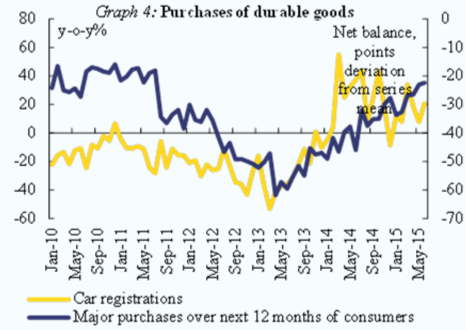
Graph 3: **Headline and core inflation**



Source: Eurostat and own calculations.

Low HICP inflation rates have supported the price-competitiveness of Cyprus and household consumption. HICP inflation in Cyprus has been lower than the euro area (Graph 2.3 in text), which has helped Cyprus to regain some of the lost price-competitiveness compared to euro area countries. In addition, while consumption of durables goods remains at relative low levels, the few available indicators suggest that the appetite to purchase durable goods is recovering, possibly supported by low prices and expectation that negative inflation will not be permanent. Car registrations have increased and consumers are increasingly likely to make major purchases over the next 12 months (Graph 4).

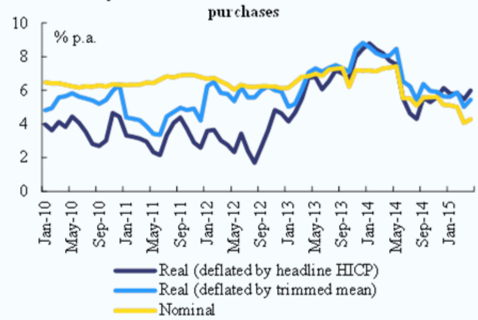
Graph 4: **Purchases of durable goods**



Source: Cystat and DG ECFIN

Low inflation has however increased the real burden of debt. Using the real interest rate as a proxy for the real debt burden ([5]) shows that the real debt burden has trended upwards from mid-2011/2012 to the end of 2013, depending on which real interest indicator used. Since 2014, the real debt burden has receded somewhat, also helped by lower lending rates, but remains high (Graph 5).

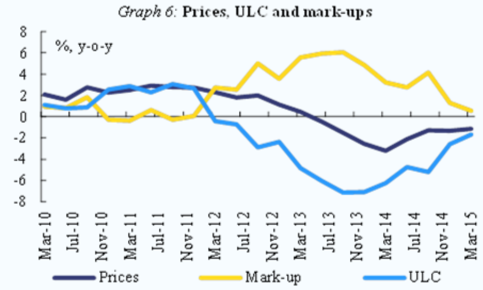
Graph 5: **Interest rate to households for house purchases**



Sources: Central Bank of Cyprus and Eurostat.

Looking forward, high profit margins could partially absorb the envisaged moderate increase in unit labour costs (ULC) and keep a lid on HICP inflation over the short to medium term. The decline in ULC from 2012 to 2013 has only been passed partially to prices, leading to higher mark-ups (Graph 6). Likewise, when the recovery gains strength and the envisaged moderate pick-up in ULC begins, the high profit margins would leave some room to absorb the increasing cost, which could help to contain inflationary pressures over the short to medium term.

Graph 6: **Prices, ULC and mark-ups**

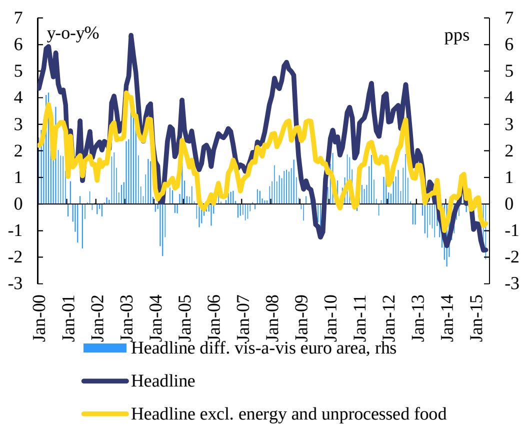


Source: Eurostat and own estimations.

([5]) A better proxy for the real debt burden is the ratio of the real interest rates times the loan stock plus amortisation to income. Assuming constant amortisation, and given a relatively stable loan stock, the real interest rate proxies the numerator in the debt burden ratio.

Real GDP growth continued its recovery in the second quarter of 2015, ([2]) alongside improving short-term indicators. Real GDP growth is estimated at 1.2% y-o-y as of Q2 2015, according to the latest flash estimate, which is in line with short-term indicators suggesting that the economy continues to regain strength. The economic sentiment indicator increased by 2.5 points in the second quarter (Graph 2.4), mainly due to a marked increase in consumer confidence. Hard short-term indicators extending into the second quarter such as retail trade, car registrations, credit card transactions, and tourist arrivals also continue to show positive trends.

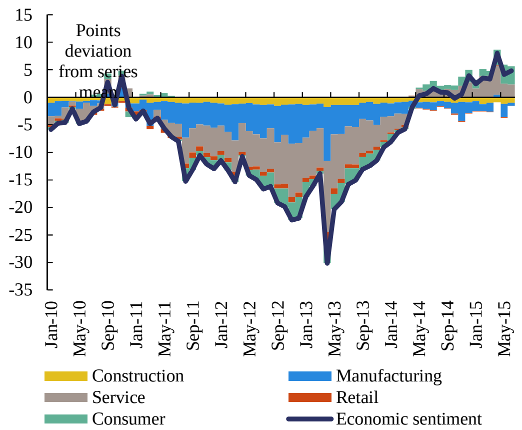
Graph 2.3: **HICP inflation**



Source: Eurostat.

The gradual economic recovery is expected to continue in the second half of 2015. In 2015 as a whole, the economy is expected to expand by 0.5% in real terms, mainly driven by external demand (Table 2.1), in line with the recovery of external partners and supported by euro depreciation. The modest resumption of credit to the economy is forecast to offer some support to investment, while private consumption will further recover on the back of lower prices. The modest growth will sustain the stabilisation of the unemployment rate at around 16%. HICP inflation and GDP deflator are forecast to remain negative, due to low energy prices and weak domestic cost pressure, and offset the modest real growth, leading to a decline in nominal GDP of 0.4% in 2015.

Graph 2.4: **Economic sentiment**



Source: Commission services

The recovery is forecast to gain pace in 2016. Further progress with the implementation of structural policies, together with a gradual deleveraging by both households and corporates should remove remaining impediments to growth and support a strengthening of domestic demand, which is forecast to be the main driver of economic growth going forward. The modern insolvency and foreclosure frameworks now in place are tools to start dealing with the high ratio of non-performing loans, even if further steps are needed as a matter of priority both with respect to the framework conditions, e.g. facilitating sale of loans, and the banks' efforts to implement sustainable restructuring solutions. This is necessary to gradually restore the health of the banking sector, loosen credit supply conditions and further support domestic demand and export. The ensuing growth momentum is expected to gradually ease unemployment. HICP inflation is forecast to turn positive in 2016, as energy prices rebound.

Risks to the GDP projection are broadly balanced. On the upside, low energy prices and the euro depreciation could support consumption and export more than currently envisaged. On the downside, potential negative spill-overs from the challenging external environment could jeopardise the fragile recovery. While direct spill-overs appear contained so far (Graph 2.5), the turmoil in

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

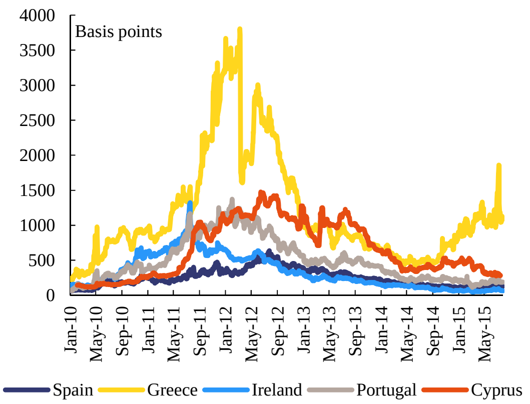
Table 2.1: **Main features of macroeconomic forecast**

	2014			2013	2014	Seventh review forecast (July 2015) 2015	2016	Sixth review forecast (May 2015) 2015	2016
		Curr. prices (EUR m)	% of GDP	Annual percentage change					
GDP		17,506	100	-5.4	-2.3	0.5	1.4	0.2	1.4
Private consumption		12,185	69.6	-6.0	0.4	0.6	1.1	0.4	1.1
Public consumption		2,751	15.7	-4.9	-8.7	-2.3	-0.9	-1.7	-0.8
Gross fixed capital formation		1,895	10.8	-17.1	-18.8	0.2	3.6	-0.9	3.6
Exports (goods and services)		9,704	55.4	-5.0	5.9	0.9	1.5	0.5	1.5
Imports (goods and services)		9,220	52.7	-13.6	8.1	0.3	1.0	-0.1	1.0
GNI (GDP deflator)		16,631	95.0	-7.0	-5.6	-0.9	1.6	-1.2	1.5
Contribution to growth:	Domestic demand			-7.6	-3.8	0.1	1.0	-0.1	1.1
	Inventories			-2.3	2.6	0.0	0.0	0.0	0.0
	Net exports			4.6	-0.9	0.4	0.4	0.3	0.3
Employment				-5.2	-1.9	0.1	1.2	0.0	1.2
Unemployment (1)				15.9	16.1	16.0	15.0	16.1	15.1
Compensation per employee				-6.0	-4.7	-0.3	1.1	-0.3	1.1
Unit labour costs, whole economy				-6.1	-4.2	-0.7	0.9	-0.6	0.9
Real unit labour costs				-4.7	-3.1	0.2	0.1	0.4	0.2
GDP deflator				-1.4	-1.2	-0.9	0.7	-0.9	0.7
Harmonised index of consumer prices				0.4	-0.3	-1.0	0.9	-0.8	0.9
Terms of trade				-0.7	2.2	0.6	-0.2	0.5	-0.4
Merchandise trade balance (2)				0.5	0.5	0.6	0.6	0.6	0.6
Current account balance (3)				-2.0	-4.0	-3.7	-3.3	-4.3	-4.4

(1) Eurostat definition, % of labour force (2) % of GDP (3) National accounts terms, % of GDP
Source: Commission services

Greece and the recent prolongation of the sanctions against Russia might weigh more on activity than currently foreseen. In the financial sector, slower than expected reduction of the high level of non-performing loans ratio could lead to a more prolonged period of tight credit supply conditions, stalling the economic recovery.

Graph 2.5: **Government bond spread vis-a-vis German Bund, selected countries**



Source: Thomson Reuters and IHS Data Insight

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

			Seventh review forecast (July 2015)		Sixth review forecast (May 2015)	
	2013	2014*	2015	2016	2015	2016
Real GDP (1)	-5.4	-2.3	0.5	1.4	0.2	1.4
Output gap (2)	-5.0	-5.5	-3.7	-1.6	-3.8	-1.7
General government balance (3)	-4.9	-8.8	-0.9	-0.1	-1.5	-0.1
Total revenue (3)	36.5	40.3	39.6	39.1	39.3	39.2
Total expenditure (3)	41.4	49.1	40.5	39.1	40.8	39.3
Primary balance (3)	-1.8	-6.0	1.9	2.4	1.5	2.5
Cyclical-adjusted balance (3)	-2.3	2.6	1.0	0.8	0.5	0.8
Structural balance (3)	-2.1	1.8	0.2	0.2	0.1	0.2
Gross debt	102.2	107.5	106.4	98.4	106.3	98.8

(1) % change (2) % of potential output (3) % of GDP
* Net off the one-off recapitalisation of the cooperative banking sector amounting to 8.6% of GDP in 2014.
Source: Commission services

2.2. FISCAL DEVELOPMENTS

Fiscal developments in the first half of 2015 are somewhat better than expected during the 6th review, due to both revenue and expenditure. On the revenue side, the better than expected outcome is due to higher indirect tax collections, one-off revenues from fines imposed by the competition authority, and frontloaded collection of certain fees. Developments on the expenditure side were largely driven by lower social transfers and generally prudent budget execution. Overall, the primary balance until June was 1.2% of GDP, about 0.9pp of GDP better than expected in the sixth review mission ([3]).

Excluding one-off revenues, general government revenue in the first half of 2015 was broadly stable compared to the same period last year. Higher VAT collections, which due to the normal lag in collections still benefitted from the hike in VAT rates in the first quarter of 2014 and from a large VAT refund paid in the first half of 2014, led to an increase in taxes on production and imports. This together with higher collections of social contributions and a one-off fine from the competition authority offset the sharp decline in revenues from the taxes on dividends and interest income. However, the decrease in one-off revenues driven by lower dividends received from the Central Bank of Cyprus led to a 0.8% y-o-y decrease of government revenue in H1 2015.

([3]) Estimates are based on ESA2010 quarterly projections, which are consistent with the IMF's quantitative performance criteria (in cash).

Excluding one-off expenditure, general government primary expenditure fell by 2% y-o-y in the first half of 2015, with all major expenditure categories contributing to the decrease. The largest decline was observed in intermediate consumption, due to prudent budget execution and lower fuel and electricity prices. In addition, the stabilisation of the labour market and the clean-up of the backlog in Q1-2014 resulted in lower expenditure on redundancy and unemployment benefits. Compensation of employees continued to follow a declining path, showing a y-o-y decrease of 1.7%, in line with reduced public sector employment.

The debt-to-GDP ratio is expected to have peaked at around 108% of GDP in 2014. The debt-to-GDP ratio is projected to reach around 106% in 2015, and to gradually decline until 2020, supported by the economic recovery and the primary surpluses.

2.3. FINANCIAL MARKETS AND FINANCIAL SECTOR DEVELOPMENTS

The recovery of the financial sector is underway with stabilised liquidity and prospects for a return to profitability. That said, a stronger implementation of financial sector reforms is needed to guarantee a sustainable stabilisation of the banking system. Deposits remained stable at aggregate level, despite the full lifting of all remaining payment restrictions on 6 April 2015. The worsening of the situation in Greece temporarily impacted deposit developments in the

Greek subsidiaries in Cyprus, but the instability was short lived and did not spread to the rest of the banking sector. The reliance on central bank funding was further reduced, thanks to the overall stabilisation of the deposits base and successful deleveraging. At the same time, the excessive level of non-performing loans in the banking system will require determined action by both policy makers and banks. This issue remains the number one priority and addressing it is a necessary condition for a sustainable stabilisation of the banking system.

There is tentative evidence that the slow pace of debt restructuring is picking up, but the level of NPLs remains a serious policy challenge. In March 2015, and based on the new EBA definition used since December 2014, NPLs on local operations of both banks and cooperative institutions reached 55.8% of credit facilities to non-financial corporations and 53.9% of loans to individual persons (Table 2.3). By May 2015, the two figures had changed only marginally, with a small decline in NPLs for NFC's and a small increase for household NPLs. Focusing on loans which are 90 days past due (excluding restructured loans), a decline in the absolute amount is noted based on provisional data for May which is an encouraging development. Among NFCs, construction and real estate sectors display the highest NPLs ratios, respectively at around 80% and 60%. The majority of household NPLs relate to mortgages, but non-performing consumer loans are also significant.

Tackling such an excessive level of NPLs remains the most pressing priority in the financial sector. It is expected that the new legal insolvency and foreclosure frameworks will provide balanced incentives for both debtors and creditors and thereby support the banks' efforts to reduce the NPL's. To have a material impact on the NPL performance will, however, require that the banks take resolute action in using these new tools. The provisioning coverage of NPLs remains broadly stable since end-2014 at about 33%, which is significantly lower than for the 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 and sensitive to changes in valuation policies.

The quality of loan restructurings of both banks and cooperative institutions is in need of improvement. The share of loans that have been restructured is slightly increasing. As of March 2015, restructured loans (performing and non-performing) accounted for about 27.8% of loans to non-financial corporations and 23.3% of loans to households (from 28.6% and 22.8 % by end-2014). The figures increased further to 31.1% for NFCs loans and 24.3% for household loans as of May 2015. This trend is indicative of restructuring efforts being made. However, a large share of the restructured loan facilities (about three quarters for NFC loans and about two thirds for individual facilities) is still reported as non-performing. This would suggest that restructurings are not sufficiently efficient, and that they are not capable of preventing loans from turning into arrears again. Thus, efforts should be deployed to improve the sustainability of the restructurings offered to borrowers.

After a protracted period of losses, financial institutions in Cyprus posted positive total returns in the first quarter of 2015, even though part of the interest income does not correspond to actual cash collections. The profit reached EUR 112mn in Q1 2015, which is about four times higher than a year ago. However, net interest income declined by 6% relative to Q1 2014, hand in hand with a decline in margins as interest rates on loans are reported to decline faster than those on deposits. In addition, it should also be noted that a significant part of this income is booked on non-performing loans, which are not matched by actual cash flows as unpaid interests are accrued. Administrative expenses increased by 6.9% in Q1 2015 relative to Q1 2014 and the cost-to-income ratio deteriorated from 40.3% in Q4 2014 to 41.2% in Q1 2015 (Table 2.3). On the positive side, income from net fees and commission improved by some 7.6% y-o-y. Provisions for impaired assets are elevated at EUR 249 m, but are 24.2% less than in Q1 2014. Thus, the sustainability of the return to profitability is still pending on a significant improvement in asset quality and on contained administrative expenses.

The Core Equity Tier 1 (CET1) capital ratio of locally active banks and cooperative institutions stood at 14.3% in March 2015, representing a notable increase on a yearly basis. The CET1 ratio stood at 12.5% in March 2014. The

Table 2.3: **Soundness indicators for the banking sector in Cyprus**

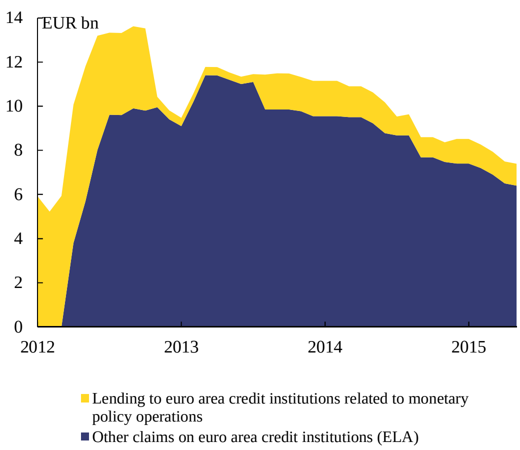
	2012				2013				2014				2015
in %	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	June	Sep	Dec	Mar
NPLs, loans to legal entitites (% of total)	18.0	18.9	20.3	22.6	24.7	30.2	39.7	44.4	45.6	49.1	50.4		
NPLs, loans to NFCs (% of total)												58.0	55.8
Restructered non-performing (% of total)						8.4	10.9	12.5	14.2	14.6	14.1	23.3	22.4
Restructured performing (% of total)						15.1	13.7	12.2	11.2	10.2	10.0	5.3	5.4
NPLs, loans to private individuals,	18.0	18.9	20.3	22.6	24.7	35.1	39.4	43.3	47.6	49.4	50.8	52.7	53.9
Restructered non-performing (% of total)						2.7	4.6	6.7	8.8	8.5	8.4	13.9	15.0
Restructered performing (% of total)						11.9	12.0	10.4	11.0	10.3	9.1	8.9	8.3
Coverage rate				47.9				37.7		35.8	36.3	32.9	32.6
Cost-to-income ratio	41.0	49.7	51.6	55.6	49.9	52.4	53.4	53.4	37.9	37.0	39.3	40.4	41.2
Net interest margin	2.8	2.4	2.3	2.3	1.7	2.0	2.3	2.4	3.1	3.2	3.1	2.9	3.0
Core Tier 1 ratio	6.1	7.3	6.9	4.5	12.1	11.9	11.6	12.1	12.5	12.9	14.8	14.2	14.3
Return on assets	1.6	-1.9	-1.7	-3.4	-5.4	-3.4	-2.5	-4.3	0.1	0.3	0.1	-0.6	0.6

Note: The NPL definition and reporting standards changed in December 2014. Since then the categories "loans to legal entities" and "loans to private individuals" include respectively loans to non-financial companies and loans to households only. This explains the structural breaks in the data series, namely with respect to the performing restructured loans to legal entities and the restructured NPLs to private individuals.
Source: Central Bank of Cyprus

improvement is due to banks' pre-emptive actions of increasing their capital position ahead of the publication of the ECB Comprehensive Assessment results in late 2014. Yet, preserving an adequate level of capitalisation of the banking sector is dependent also on the successful reduction of NPL's from current levels and the possible need for increased provisions for losses on delinquent borrowers. The continued return to viability of major financial institutions remains therefore highly vulnerable to the risk of insufficient tackling of NPL's.

Banks and coops reduced further their reliance on central bank funding, which went below EUR 7.4bn. On a yearly basis between May 2014 and May 2015, total reliance on central bank funding was reduced by almost EUR 3.2bn, i.e. 30% (Graph 2.6). In relative terms, the reduction concerns equally both the recourse to regular open market operations and other Eurosystem claims (Emergency Liquidity Assistance, ELA). In nominal terms, however, it is to be noted that EUR 2.8bn of ELA was repaid within a year. The decline in central bank borrowing is almost exclusively due to the positive developments within Bank of Cyprus. The aggregate improvement in liquidity is linked to the capital increase and sales of assets that several banks undertook, while the positive developments in the deposit base played a lesser role.

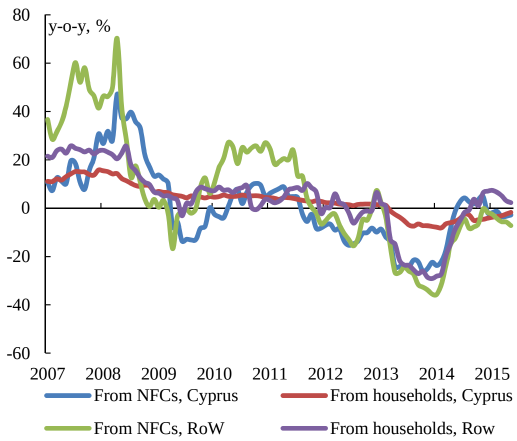
Graph 2.6: **Borrowing from the Eurosystem**



Source: Central Bank of Cyprus

Overall, deposits have stabilised since the last quarter of 2014 when the persistent outflows stopped. At system level, the deposit base started to stabilise as of October 2014, when the positive outcome of the ECB comprehensive assessment was announced. This also contributed to increasing banks' liquidity buffers. The stabilisation of the aggregate figure is due exclusively to the deposits of non-resident households, which grew by about EUR 400m in 2014 even though their positive growth reached a peak in January 2015. Other segments of depositors, however, continue to contract (Graph 2.7). In particular, both resident and non-resident non-financial corporations continue to reduce their deposits. In the first quarter of 2015, deposit inflows were recorded in the overall banking sector. In the second quarter of the year, the situation was impacted by external developments, while the overall deposit base remained almost stable. The liquidity situation of the Greek subsidiaries came under some strain following deposit movements due to the events in Greece. Fortunately, the concerns were relatively short lived and there was no contagion to other banks in Cyprus, including the ones which are not locally active (i.e. the foreign banks), which kept a stable deposit base.

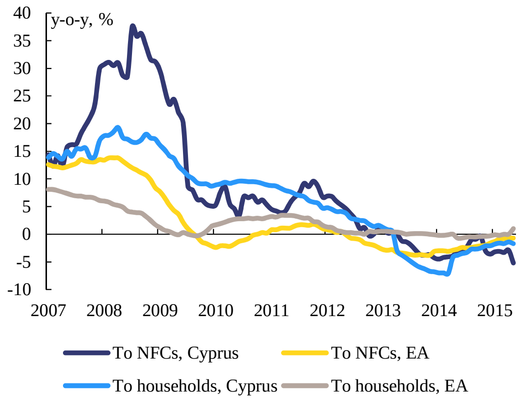
Graph 2.7: **Deposits developments**



Source: Central Bank of Cyprus

The contraction of the stock of loans for households has bottomed out since the end of 2013, while credit to non-financial corporations remains subdued. Loan growth, while still slightly negative, has been steadily improving (Graph 2.8), even though the accrual of interest arrears might be overstating the trend. The large increase of loans at the end of 2014 and early 2015 to the non-financial corporations mainly stems from the purchase of foreign loans portfolios by subsidiaries of international banks, and to a smaller extent, from capitalisation of accrued interest, therefore having little impact on the Cypriot economy. The reduction in financing sources to the economy is somewhat mitigated if lending to other financial intermediaries (leasing and factoring companies) is also considered and for which an increase in loans has been noted.

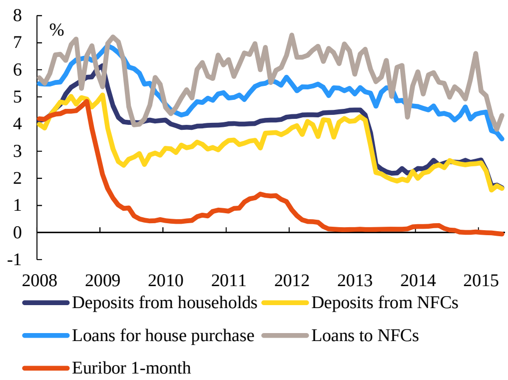
Graph 2.8: **Loan developments**



Source: Central Bank of Cyprus and European Central Bank

Regulatory action halted the rise in deposit interest rates. Following their sharp decline in mid-2013 as a result of a regulatory limit, deposit rates increased by about 60 basis points during 2014 (Graph 2.9). While this may have contributed to the reduction of deposit outflows, it also hinders a further lowering of lending rates. As a result, on 16 February 2015 the Central Bank further narrowed the maximum spread between Libor and the deposit interest rates that banks can offer from 300 to 200 basis points. As a result, both deposit and lending rates sharply dropped. For the period between February 2015 and May 2015, interest rates on new loans for house purchases declined by about 100 basis points, while the cost of new corporate loans was reduced by 70 basis points.

Graph 2.9: **Interest rates developments**



Source: Central Bank of Cyprus

3. PROGRAMME IMPLEMENTATION

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

The Cypriot authorities have made further progress in implementing the programme. Fiscal developments for 2015 exceed expectations, reflecting prudent budget execution. Reforms in the financial sector have progressed, but addressing the high level of NPLs remains the key priority. To that end, a comprehensive reform of corporate and personal insolvency laws has been adopted. Further steps are required as a matter of priority. Notably, legislation to expedite the transfer of title deeds and to facilitate the sale of loans should be adopted as soon as possible. The authorities have also taken steps toward implementing their ambitious structural reform agenda, albeit at a slower pace in some areas. Firmly moving ahead with structural reforms, including the privatisation process and the public administration reforms, is critical to cement the improvements in public finances and restore sustained economic growth.

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 the 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. The support to the authorities' Action Plan for Growth is also of importance in order to recreate a sustainable growth pattern that can generate new opportunities and quality jobs.

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 secure sound public finances.

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-Q1 and end-April 2015 is found in Annex 1.

The authorities should step up their efforts to pursue their ambitious reform agenda and increase its momentum. There were some delays and only partial compliance was observed in several key areas, notably on some financial sector reforms, privatisation, healthcare sector and SOE corporate governance. Continued full and timely policy implementation remains essential for the economic recovery and the success of the programme, not least in order to ensure a lasting improvement in the financial sector and a sustainable growth pattern going forward.

Table 3.1: **Summary of compliance with policy conditionality for the 7th review (Q2 and end-July 2015)**

	Status
Financial sector policy	**Partially compliant**. The financial situation of the banks is gradually improving, but a stronger implementation of financial sector reforms is needed to guarantee a sustainable stabilisation of the banking system. Compliance is registered in several areas: Banks continue to comply with the ongoing reporting requirements on debt restructuring; The Central Bank published a user-friendly guide for handling loans in arrears, and addressed some of its staffing issues; the new affiliation directive of the cooperative banks was adopted; First actions including licensing of insolvency practitioners have been taken by the newly established Insolvency Service which has submitted a detailed Action Plan for implementation. Several actions are only partially completed e.g. the Strategic Default Study, banks' report on the NPL targeting framework and on the provisioning impact of the obligatory transfer of title deeds. Non-compliance is often linked to delays in the transposition of certain EU Directives, such as the DGS and the BRRD, and the adoption of national laws, such as the law for the sale of loans and securitisation. Some actions were completed with delay like the amendment to the Financial Ombudsman law and, more importantly, some aspects of the restructuring plan of the cooperative banks such as the improvement of the lending policy and the identification of connected borrowers. On Anti-Money Laundering (AML) the Cypriot authorities continue to implement the Action Plan and overall progress has been steady in most areas, albeit with some delays. The CBC conducted 11 onsite inspections in 2014, 11 inspections as of end June 2015 and plans 8 further inspections plus possibly some follow-up audits in 2015. The main actions which remain ongoing mostly relate to adequate staffing of the supervisory authorities in the non-financial sector, staff training programmes in all authorities, and roll-out of the 2015 inspection plans.
Fiscal policy	**Compliant.** For 2015, the fiscal performance remains well on track. To reflect positive developments, as well as some one-off factors, the primary balance target has been adjusted to a surplus of 1.9% of GDP from 1.5% of GDP previously. As required, the Fiscal Strategy Statement based on the 6th review targets was adopted by the Council of Ministers in June.
Fiscal-structural measures	**Partially compliant.** On **public administration,** the horizontal reform of the public administration has regained momentum, and the reform plan and related legislation were adopted by the Council of Ministers, albeit with delay, [by late August]. On the first batch of vertical reviews, there is partial compliance, as the reform plan and law on local governments were adopted in July by the Council of Ministers, but were incomplete. On **privatisation**, compliance has been delayed but progress is being made overall, as: the corporatisation law [was adopted by the Council of Ministers in late-August], the tender for EAC's study on legal unbundling was launched with delay, due to pressure from trade unions, but has now been initiated; the detailed privatisation plan and method of privatisation for Limassol Port's concession agreement were submitted with delay, but the expression of interest was duly launched in mid-June. However, the corporate governance law on **state-owned enterprises (SOEs)** has not yet been adopted by the House of Representatives. On **revenue administration**, compliance is also partial. The section of international tax cooperation is compliant as the authorities observed the various reporting requirements and the statistics show continued improvements in responding timely to information requests. While notable progress has been made in the area of debt collection, further work is required to refine and implement the compliance strategy and risk analysis, as well as to complete the single registration process. There is non compliance on **Immovable Property Tax reform**, as most of the deadlines were missed with the postponement of the parliamentary discussion on the reform. This points to high risks for the implementation of the IPT reform. On **welfare reform**, compliance is only partial as no plans to reform the disability benefits have been provided. On **health**, non-compliance has been observed with the submission of the hospital autonomy bill and the preparation of the road map for the implementation of hospital autonomisation. On **public financial management**, compliance has been observed. An updated risk assessment report has been submitted to programme partners, and the action plan for strengthening sound practice standards for the Public Debt Management Office has been prepared. Further, albeit with some delay, the guidelines for public investment projects have been approved by the Council of Ministers.
Labour market	**Partially compliant.** On the implementation of ALMPs, despite substantial delays, there is now a list of measures covering 2015-2017, which will be updated as needed. However, there have been substantial delays in upgrading the capacity of the public employment services (PES). The launching of the tender for the recruitment of additional staff has been delayed. In the short term, a limited number of measures have been undertaken to enhance the capacity of the services but these fall short of what is required, and as a follow-up the authorities will finalise the programme fiche for the enhancement of PES under the ESF 2014-20 Operational Programme. In addition, there has also been a delay in formally adopting new procedures to ensure cooperation between the public employment services and entities providing social benefits.
Goods and services market	**Partially compliant.** On tourism, it is compliant with delay, as the consultant working on the National Tourism Strategy was selected in late-July. On housing market, the implementation of measures to streamline the issuance procedure has been slow, and the backlog for title deed issuances remains very significant, making compliance only partial. On energy, the deadlines regarding the resource fund have not been met. The resource fund law is in the process of legal vetting, while the legislation defining inflow and outflow rules for the resource fund is still in drafting stage.
Data reporting	**Compliant**

Source: Commission services

3.1. FINANCIAL SECTOR

3.1.1. Maintaining liquidity in the banking sector

The second and last phase of the Roadmap for the Gradual Relaxation of the Restrictive Measures, which related to the full external liberalisation of capital movements, was concluded as of 6 April 2015. The external controls on capital movements had de facto been lifted in mid-March when the very high transfer ceiling of EUR 1m was introduced. Following the complete liberalisation of capital controls in Cyprus, there has been no destabilisation of the liquidity of the banking system (see Box 3.1).Nevertheless, once the situation in Greece worsened, deposit outflows in the Greek subsidiaries intensified together with pressure on their liquidity buffers. However, so far outflows from the Greek subsidiaries remained contained to this segment and did not influence the stability of deposits in the rest of the banking sector.

The Central Bank of Cyprus (CBC) continues to monitor closely the liquidity situation of the banking sector and stands ready to take appropriate measures to maintain sufficient liquidity in the system. Bank of Cyprus (BoC) and the Coops continued to submit their quarterly capital and funding plans to the CBC and to the programme partners. The government guarantees of EUR 2.9bn, granted at the start of the programme to facilitate the issuance of bank bonds in case of liquidity need, remain in place. If necessary to safeguard financial stability, the scheme can be used in line with State aid rules.

3.1.2. Monitoring the consequences of the Greek turmoil

The four main Greek banks (National Bank of Greece, Piraeus Bank, Alpha Bank and Eurobank) have subsidiaries in Cyprus. Although each subsidiary is small, the total of their deposits amount to about EUR 5.8 bn or 35% of GDP by mid-2015, therefore being systemically important for Cyprus. Since December 2014, on the announcement of early elections in Greece which eventually took place on 25 January, a gradual reduction of the deposit base of the four Greek subsidiaries was noted. An acceleration of deposit movements took place around the Greek bail-out referendum of 5 July. Following the granting by the Council on 17 July of a bridge loan to Greece, pressures on the deposit base of the four subsidiaries subsided. The asset side of the subsidiaries' balance sheet is almost no longer exposed to Greece. The liability side remains vulnerable to confidence spillovers from Greece. The CBC in cooperation with the SSM is monitoring the situation closely.

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

Compliance with the implementation of the recently established supervisory framework has been satisfactory. No new legal initiatives have been undertaken since the last review. The credit register is fully operational for credit assessment purposes. Moreover, the authorities continue working to expand the data held in the register and to improve its quality in order to use the credit register for macro-prudential purposes. Eventually a credit scoring system could be set up if a study (to be conducted) indicates its usefulness.

Various actions are taking place to improve debt resolution policies. Notably, the authorities are currently finalising a study that will, among other things, assess the extent of strategic default. The preliminary findings will be made available shortly. Also a consumer-friendly guide will be published by the authorities and the Banking Association to help distressed borrowers make informed decisions on debt restructuring. Following the creation of the SSM, the CBC has assessed its staffing needs in the micro-prudential supervisory area and the recruitment of additional personnel was finalised. Furthermore, the needs in other business areas are currently reviewed with the assistance of an external advisor.

However, a number of delays are to be reported. Regarding the transposition into national law of the Bank Recovery and Resolution Directive and the Deposit Guarantee Scheme Directive, the authorities are working intensively in order to finalise the transposition of both European directives without any further delay. The draft law amending the law on the Financial Ombudsman has been approved with a small delay in the beginning of July. More importantly, the amendment to the Banking Law limiting the sale of loans to third parties has not been repealed yet.

However, the relevant provision has been further suspended until 30 October.

The legal proposal enabling the sale of loans was approved, with delay, by the Council of Ministers at the end of July. The law should be adopted by the House of Representatives by end-September.

3.1.4. Integration of pension and insurance supervision

The provision of private pensions is scattered over many small funds and the insurance industry is characterised by many small companies. Following the bail-in of deposits during the rescue operation of Laiki and Bank of Cyprus in 2013, where the deposits of the pension funds were not exempted, some 1000 pension funds were unwound, leaving still some 1400 funds active managing about EUR 1.2 bn in assets (6% of GDP). The pension payments are mostly of the defined contribution type leaving the risk to the employee, while those related to public companies are of the defined benefit type, putting the risk with the employer or the state. There are four relatively large defined benefits funds which are registered and 77 small unregistered ones, managing also about EUR 1 bn in assets. In the insurance sector, there are some 20 active companies collecting a gross premium of about EUR 0.7 bn (4% of GDP).

The supervision of pension funds and insurance companies will be streamlined. Currently, the supervisor of the pension funds depends from the Ministry of Labour, while the supervisor of the insurance companies is attached to the Ministry of Finance. In order to improve supervision and exploit synergies as well as to respond to the challenges posed by the implementation of Solvency II from 1 January 2016, an action plan is being prepared for the integration of both supervisors. At the same time, supervision of pension funds and insurance companies will be improved taking into account international best practices and options will be studied to ensure independence, appropriate governance and sufficient administrative capacity. Finally, an inventory of pension funds is envisaged to obtain information on the volume and composition of their assets, type of pension scheme plan and composition of membership.

3.1.5. Recapitalisation, resolution and restructuring

3.1.5.1. Bank of Cyprus

The level of Non-Performing Loans (NPLs) has reached EUR 15.2bn or 63% of gross loans in the first quarter of 2015. The NPLs ratio continues to increase, but a levelling off is being discerned in the absolute amounts, as the bank starts to better control inflows from the retail and SME loan segment into the NPL portfolio. The bank continues to have a good monitoring on the corporate loan portfolio made up of fewer but larger loans. The changes to the legal framework in relation to foreclosures, in accordance with the MoU, are supporting the bank's efforts to manage NPLs. Developing a market for NPLs and removing impediments for the banks to obtain financial information on borrowers in arrears should further contribute to the work-out of non-performing loans.

The deleveraging of Bank of Cyprus is progressing and is reducing risk from the Greek and Russian exposures. Thanks to the sale of its Greek operations, BoC's exposure to Greece has almost disappeared. The sale of the subsidiary in Ukraine was signed in March 2014 and half of the payment was received immediately. The other half was received in March 2015. Thanks to deleveraging and increasing provisions, BoC's exposure to Russia has been significantly reduced. Total assets of the subsidiary in Russia fell from EUR 1.8bn in June 2013 to EUR 1bn in June 2015. On 30 June 2015, net exposure to Russia amounted to EUR 120mn, which was fully hedged to protect against the depreciation of the Rouble, while BoC's Russian subsidiary Uniastrum is announced to be sold.

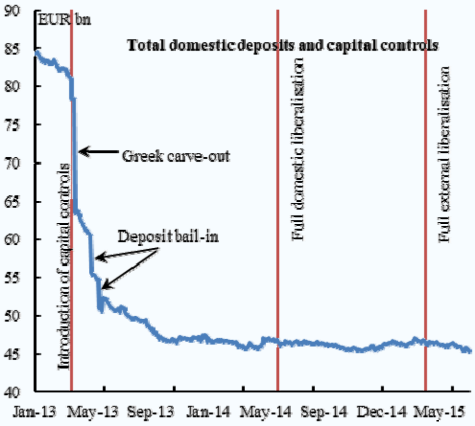
The capital position of Bank of Cyprus has slightly declined but remains above regulatory requirements. Thanks to the equity raising of around EUR 1bn in the third quarter of 2014, the capital position improved to 14.9%, fully loaded in September 2014. However, due to increased provisions and changes in estimates following the completion of the ECB Comprehensive Assessment, the capital position deteriorated to 13.9% in March 2015.

Box 3.1: Two years of capital controls in Cyprus

The last remaining restrictions on the free movement of capital in Cyprus related to external controls were lifted on 6 April 2015, about two years after their introduction. The full liberalisation step signalled the normalisation of the liquidity situation in the Cypriot financial sector and the return of investor confidence in the banking sector despite external vulnerabilities related to Cyprus' exposure to Russia and Greece. While in the meantime the situation has calmed down, even during the intensification of deposit outflows from the Greek subsidiaries in June due to the financial turmoil in Greece, it has not spread to the rest of the banking sector. Nevertheless, the final phasing out of external capital controls is too recent for a final verdict.

The administrative restrictions on capital movements were introduced by Cyprus in March 2013 in order to prevent disorderly capital flights and bank runs when the uninsured depositors in the two largest Cypriot banks were bailed in. A prolonged bank holiday was enforced from 16 March, followed by capital controls as of 28 March. As part of the agreement of the financial assistance programme with the international partners, in August 2013, a milestone-based strategy for the gradual relaxation of the capital controls – roadmap (see table below) - was adopted, which did not contain any specific time deadlines. The avowed intention of the authorities was to keep the controls for the shortest time possible, in order to contain any additional negative spill-over on the economy. Eventually, the objective was met and the roadmap was implemented steadfastly. The roadmap foresaw a gradual removal of restrictions on domestic transactions in terms of cash withdrawals, bank transfers and opening up of accounts, as well as on external transactions in terms of transfers of funds outside Cyprus and bank activity conducted with the international banks.

Fairly strict capital controls were enacted from the onset: (1) Cash withdrawals were limited to EUR 300 per day and bank account; (2) Carrying cash across the border was restricted to EUR 1000 per person and journey; (3) Payments with Cypriot credit cards abroad were limited to EUR 5000 per month, per bank and per person; (4) Fixed term deposits could not be terminated prior to maturity unless used to repay a loan within the same credit institution; (5) No interbank payments were permitted except those underlying "normal" business transactions which had to be duly justified. These measures helped contain the amount of deposit outflows, which had already surged to about EUR 3.8 bn during the first two weeks of March 2013. Nevertheless, immediately after this step, the authorities followed up with a partial relaxation of the newly introduced capital controls already in April 2013. Cash withdrawals, export of cash, ceilings on domestic and external bank transfers, conditions for termination of fixed-term deposits and the activity of international banks were relaxed. Despite positive spill-overs for the economic activity, this early partial relaxation of controls limited to some extent the effectiveness of capital controls, and deposits outflows continued in the beginning of the second quarter of 2013 (see graph).



Source: Central Bank of Cyprus

Deposits stabilised during the summer of 2013, when the fear of another deposit bail-in subsided and the confidence increasing effect of the relaxation measures started to take effect. In the second and third quarters of 2013, the total amount of deposit outflows decelerated to EUR 6.6 bn and EUR 2.6 bn, excluding one-off flows related to further deposit conversion measures. The positive trend strengthened in the last quarter of 2013 and after the adoption of the roadmap, when the total net deposit outflows came down to EUR 0.4 bn.

With the favourable evolution of the banks' liquidity positions and overall market

(Continued on the next page)

Box (continued)

Table 1:

Stage of the roadmap	**Milestone** *(between bracket and in italics: implementation date)*	**Relaxation step**
1st	(1) Completion of the recapitalisation and resolution of Bank of Cyprus *(July 2013)*	(1) Allowing the opening of fixed-term deposit account, for non existing customer created with funds from cash. *(August 2013)*
	(2) Completion of the Coops recapitalisation and restructuring strategy *(July 2013)*	(2) Allowing the opening of current account linked to new credit facilities granted to non-existing customer. *(August 2013)*
		(3) Abolition of the requirement for the presentation of justifying documents for transfers above EUR 300000 within the Republic. *(August 2013)*
		(4) Increasing the limit for transfers abroad to EUR 1000000 for normal business activity and upon presentation of justifying documents. *(October 2013)*
2nd	(1) Recapitalisation of Hellenic Bank *(September 2013)*	(1) Abolition of the restrictive measures relating to fixed term deposits. (*March 2014*)
	(2) Disbursement of funds under the macroeconomic adjustment programme for the recapitalisation of the Coops. *(January 2014)*	(2) Abolition of the current limit related to transfers within the Republic, regardless of the purpose. *(5 May 2014)*
	(3) Submission of the Coops restructuring plan to the European Commission. *(January 2014)*	
	(4) Approval of Bank of Cyprus' restructuring plan by the Central Bank of Cyprus. *(December 2013)*	
3rd	(1) Completion of the coops mergers *(30 March 2014)*	(1) Abolition of the restrictive measures relating to cash withdrawals *(March 2014)* and the cashing of cheques. *(5 May 2014)*
	(2) Tangible progress in the implementation of Bank of Cyprus' restructuring plan. *(May 2014)*	(2) Abolition of the restrictive measures prohibiting the opening of new accounts. *(30 May 2014)*
4th	(1) Progress in implementation of the macroeconomic adjustment programme.*(On-going)*	(1) Abolition of all restrictive measures relating to the transfer of funds outside the Republic. (*April 2015*)
	(2) Restoration of depositors' confidence in the Cyprus banking system. *(March 2015)*	(2) Abolition of the restrictive measures imposed on international banks, included in the catalogue of the relevant Decree for international banks. (*April 2015*)

confidence in the last months of 2013, it was possible to move to the implementation of the second stage of the roadmap. The restrictions on term deposits were abolished and the limits related to transfers within Cyprus were increased together with daily cash withdrawals. Furthermore, Bank of Cyprus unfroze the first tranche of the uninsured deposits, which had been obligatory converted into a 6, 9 and 12-month term deposits when the Bank had been taken out of resolution on the 31st of July 2013.

Despite the further relaxation of capital controls and the unfreezing of a part of the uninsured deposits, deposit outflows remained overall modest in the first half of 2014. They reached about EUR 0.9 bn in Q1-2014. During the following quarters of 2014, the depositor confidence together with the liquidity buffers of the banks further strengthened in parallel with the implementation of the financial assistance programme. The second quarter of 2014 witnessed deposit inflows in the Cypriot banks to the tune of EUR 0.2bn, despite heavy outflows from the coops. The latter were partly caused by discussions on schemes aimed at protecting the primary residence of debtors, which could have increased losses on residential mortgages for the coops which hold a relatively large portfolio of such loans. Therefore speculations emerged about a new round of bailing-in of deposits, which unsettled depositors in the coops. The overall stabilisation of the deposit base allowed for the full liberalisation of domestic capital controls as of 1 June 2014, signalling the opening of the fourth and last stage of the roadmap for the liberalisation of capital controls regarding the remaining external barriers.

The deposit base remained broadly stable in the second half of 2014, with outflows in foreign banks broadly offset by inflows in locally active banks. Deposit outflows from the coops continued during Q3 2014 to the tune of EUR 0.4 bn. Nevertheless, overall deposit outflows in Q3 2014 were limited to roughly the same amount because the deposit base remained broadly stable in the other locally active banks, which also compensated for some small outflows from the foreign banks. In Q4 2014 hefty deposit inflows in all locally active banks offset large outflows from foreign banks, leaving the deposit base broadly stable. The return of investor confidence, including in the coops, was a direct result of the positive evaluation of the banks' capital adequacy following the Europe-wide comprehensive assessment by the ECB.

Against this background, investor confidence in the Cypriot banking sector consolidated further during Q1 2015, leading to the decision to abolish the remaining capital controls on 6 April 2015. Deposit inflows reached EUR 0.9 bn in Q1-2015 and covered all types of banks. The return of depositors' confidence – a milestone for the full liberalisation of external capital controls – was deemed achieved by the Cypriot authorities, who ended such controls on 6 April 2015. [In retrospect, this decision may be considered ambitious because of two other major reasons: (i) although overall good, the progress with the implementation of the macroeconomic adjustment programme (a second

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Box (continued)

milestone of the roadmap) was on hold at the time of the decision as the programme was de-facto off track due to the suspension of the application of the foreclosure legislation and (ii) the external environment was volatile due to the financial turmoil in Russia and Greece. These concerns materialised in June 2015, when the deposit outflows from the Greek subsidiaries led to total deposit outflows of almost EUR 600 mn, but fortunately remained contained to this segment of banks.]

Overall, Cyprus managed to weather relatively well a period of financial instability, which followed the recapitalisation, resolution and restructuring of some of its major banks, including by bailing-in depositors. The introduction of capital controls was instrumental in ensuring an orderly adjustment of the Cypriot banking sector. Moreover, the return of investor confidence and the stabilisation of the financial sector were rapid, allowing the removal of capital controls within two years. The participation of Cyprus to the Eurozone, which enabled access to the ECB funding or ELA throughout the capital controls period, also contributed to this rapid stabilisation, and partly explains why capital controls lasted much less than in Iceland, where they remain in place almost seven years after their introduction in 2008.

The liquidity position of Bank of Cyprus has further improved. Due to the equity raising of around EUR 1bn in the third quarter of 2014, the reimbursement in early July of EUR 750mn of the recapitalisation bond that BoC acquired when it absorbed Cyprus Popular Bank, and the continuous sale of assets abroad, the bank has been able to decrease Eurosystem funding. Total borrowing from the Eurosystem stands mid-July 2015 at EUR 6.4bn, of which EUR 5.9bn of ELA and EUR 0.5bn normal ECB funding, compared to EUR 9.6bn mid-July last year. In particular, the reduction of ELA from its 2013 peak of EUR 11.2bn, is noteworthy.

Some medium-term targets for key performance indicators have already been met. In order to monitor progress with the implementation of the restructuring plan, BoC and the Cooperative Group have prepared an agreed set of key performance indicators (Table 3.2) which are updated quarterly and assessed against a medium-term target (Memorandum of Understanding § 1.4). Concerning BoC, key performance indicators related to capital and efficiency compare well to the objectives set. With respect to the targets in Table 3.2 on asset quality and funding, performance is moving in the right direction, but a real improvement in asset quality will be ascertained only with a substantial reduction in overdue loans, which is for the moment not observed.

3.1.5.2. The Cooperative Credit Institutions

The restructuring of the cooperative sector is progressing slowly. The key performance indicators (Table 3.2) indicate progress with implementing the restructuring plan, notably in terms of funding and cost efficiency, but the target for the capital ratio is still far from met, while meeting the targets for the provisioning levels and the reduction of loans in arrears will require a big effort. In this context, a manual on arrears management and restructurings has been developed and approved by the CBC. A restructuring toolkit has been set up too. Based on this, the first standardised solutions campaign is being implemented. A manual on recoveries has been developed too.

Following the technical assistance provided by the IMF on governance in the cooperative banks, work is being undertaken to make the Central Cooperative Bank (CCB) the effective head office of the sector, which is a different role from it had in past, namely a service provider to the affiliated Cooperative Credit Institutions (CCI). While the sector successfully moved to the new structure with the CCB almost fully owning the local CCI as subsidiaries, smooth and effective implementation of the Group's policies is to be improved by enhancing the control and operational functions of the centre.

Despite these achievements, serious challenges remain. Progress is needed with respect to

Table 3.2: **Key performance indicators for Bank of Cyprus and the Cooperative Group**

Category	Key performance indicators	Bank of Cyprus			Cooperative Group		
		Dec 2014	Mar 2015	Medium-term (2017)	Dec 2014	Mar 2015	Medium-term (2017)
Asset quality	**90 days past due coverage**	41%	42%	40 - 50%	44.3%	44.1%	> 60%
	Provsioning charge	3.6%	2.1%	<1.0%	1.3%	0.7%	< 2.0%
	90 days past due loans (bn EUR)				6.2	6.3	< 4.5
Funding	**Eurosystem funding** (% total balance)	31%	29%	< 25%			
	Loans to deposit ratio				81.6%	79.3%	< 85.0%
Capital	**Common equity tier 1**	14.0%	13.9%	> 12%	13.6%	13.3%	> 15%
	Leverage ratio (assets/equity)				11.3x	11.2x	< 10x
Efficiency	**Net interest margin**	3.9%	3.9%	≈ 3.25%	2.7%	2.7%	> 2.5%
	Fees and commissions/total income	13%	16%	↗			
	Cost-to-income ratio	36.0%	38.0%	40 - 45%	37.4%	37.2%	< 40%
	Number of branches (target is for Dec 2015)				292	263	258
	Number of employees				2703	2670	2580

Source: Bank of Cyprus and the Management Unit in the Ministry of Finance for the Cooperative Group

overcoming the continuous deterioration of the loan portfolios. Though deposit outflows have turned into inflows, the stabilisation achieved has to be maintained. The reimbursement in March of the EUR 1.5bn recapitalisation bond that the CCB acquired when it was recapitalised by the State, represents a large amount of cash which has to be invested. Finally, the organisational structure of the Group and the shareholder value of the cooperative sector remain a concern. To that end, the Management Unit of the Ministry of Finance will engage an external consultant to review the necessary steps, processes and procedures to maximise the return to the State.

3.1.6. Legal framework for private debt restructuring

A comprehensive reform framework, for corporate and personal insolvency as well as for the enhanced foreclosure procedure has been put in place. This legislation is an important instrument to help reducing the high level of NPLs, which is essential to restoring growth and job creation in Cyprus. The legislative framework of insolvency and foreclosure is now being implemented and the banks and their clients are now taking up the use of these new avenues. Importantly, the existence of these tools facilitates voluntary agreement between creditors and debtors, since they provide for more balanced incentives than in the past.

Banks have a major responsibility in making full and speedy use of the available tools to reduce NPL's and offer sustainable restructuring solutions to clients who do not have a sufficient repayment capacity. The Insolvency Service has taken up duty and is establishing the necessary infrastructure, including the licencing of insolvency practitioners. It will also monitor the performance of the insolvency framework.

It is essential that any impediments to the effectiveness of the procedures should be removed, including measures which could weaken incentives for non-viable debtors to promptly pursue debt restructuring. It is equally important to ensure that the relief in legacy guarantees does not jeopardise the economic function of guarantees going forward and that the payment capacity of the guarantor is taken into account.

In order to ensure that potential sources of malfunctioning are adequately addressed, more evidence from the implementation in practice will be needed. The authorities will, with support from programme partners, closely monitor the effectiveness of the procedures and will conduct a comprehensive review of the private sector debt restructuring legal framework by end December 2015. This will result in an action plan of modifications to the framework to correct any remaining deficiencies.

Box 3.2: A primer on the title deeds problem

Roughly half of the Cypriot housing stock built since 2000 and sold to home buyers is still legally owned by the developers who sold them. In these more than 50,000 cases, a property is legally owned by a developer, but has been sold to a home owner years ago. The home owner typically has paid most or the full sales price to the developer and taken possession of the home de facto. However, the legal transfer of the property from developer to seller, through the transfer of the title deed, has not taken place.

Unpaid developer mortgages prevent the transfer of ownership of the properties. In most cases, the developer registered a mortgage on the property in order to fund its construction. This mortgage must be removed before the legal ownership can be transferred from the developer to the home buyer. Developers often did not repay their mortgages, and therefore banks are reluctant to release the mortgage, which is needed for the transfer of property to the final buyer. In total, the outstanding loans to developers and home buyers entangled in the title deed problem are estimated to reach several billion euros, and to form a considerable share of non-performing loans (NPLs).

The title deed problem complicates the enforcement of loan payments and the restructuring of NPLs. Home buyers who did not receive their title deeds have an incentive to default on their home loans, since their creditors cannot foreclose on their property. Instead, it is the creditor of a non-performing developer who has the right to foreclose on the home. However, doing so would result in evicting the home buyer who already purchased the home, and leaving him with only a junior claim to the foreclosure proceeds. Foreclosing on such sold, but not transferred, property would be legal but would seriously undermine the attractiveness of Cyprus property markets to foreign investors and would be socially unacceptable. For this reason, banks do not foreclose affected developer projects, and the Cypriot House of Representatives barred them from doing so until 10 July 2015. Therefore both developers' and homebuyers' banks lack tools to enforce loan repayment and to incentivize debtors in difficulties to renegotiate their loans. Banks in these circumstances also have also an interest in avoiding loan restructuring in order to understate their losses.

Claims from junior creditors and tax debt also obstruct the transfer of title deeds. Court rulings in favour of the junior creditors of developers prohibit the legal transfer of sold and paid-for property. Moreover, the fact that home buyers lack the funds to pay the tax fees required for the legal transfer is another factor that hampers the transfer of property titles.

The title deed problem stems from a lack of due diligence in property transactions, and slow administrative processes. In many cases, developers did not use their property sales proceeds to pay off their mortgages on the sold property. Banks did not always monitor this practice or were not aware that payments had been made by the buyer to the developer. The authorities also have a substantial backlog in title deed *issuance*, i.e. the land registry has not completed the cadastral division of development projects into apartments or homes. A new property within a larger development (a new flat for example) the title of which has not been issued yet does not exist legally and thus cannot be transferred to its buyer. This administrative backlog mostly stems from the pre-2011 legal situation that made title deed issuance conditional on full compliance with building and planning permits (themselves subject to long delays).

A September 2015 law tries to disentangle the convoluted claims on existing title deeds by transferring property to home buyers. The law provides that home buyers who have paid the purchase price in full will have their titles deeds transferred, allowing their home loan to be converted into a mortgage. At the same time, unpaid developer mortgages on sold property will be shifted to unsold assets of the developer, when possible. A system of dedicated bank accounts will ensure that any remaining payment on property sales will be used to repay the developers' creditors. The reduction of the transfer fees enacted in July 2015 is also expected to reduce impediments to title transfers.

While progress has been made on speeding up title deed issuance, a comprehensive streamlining of the procedures is needed. Since 2013, roughly

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Box (continued)

half of the backlog in title deed issuance has been cleared. However, the pace of title deeds treatment has significantly declined since Q2 2015 and the backlog remains substantial. The land registry is refining its procedures to further speed-up the clearance of the backlog, but a broader reform seems needed.

Solving the issuance and transfer of title deeds will support the recovery in the Cypriot housing market. The Cypriot property market strongly depends on foreign investors, in particular for the most distressed assets (middle-class coastal holiday homes).

Foreign investment in the property market has dwindled with the crisis, and, due to the title deeds situation, did not return to Cyprus as it did in other Mediterranean destinations. A recovery of foreign investment would be key to supporting residential prices, and thus the collateral values of Cypriot banks.

In order to speed up the resolution of NPLs, the authorities submitted to the House of Representatives a draft legislation ensuring that property buyers, who have paid the purchase price in full, and for whom there is a title deed already issued, will have their title deeds transferred to them swiftly. The title deeds problem (see Box 3.2) is primarily due to the fact that there is an uncleared mortgage of the developer on the property, which impedes the transfer of the title to the buyer. The mismatch between the legal owner (usually developers) of the property and its final buyer impedes the resolution of NPLs. The draft legislation regarding property sales contracts registered up until end-2014 (the "legacy cases") has been made a prior action for the conclusion of this review.

Additionally, preparatory work has been performed for the creation of a sustainable system for the non-legacy cases, ensuring the transfer of the issued title deeds without delay and as automatically as possible. This system is envisaged to be based on a system of escrow account. Draft legislation for non-legacy cases shall be adopted by the Council of Ministers by end-October 2015. Moreover, the House of Representatives adopted a 50% reduction in transfer fees in order to incentivise the swift transfers of title deeds.

3.1.7. Anti-Money Laundering

There has been steady progress on the implementation of most of the Anti-Money Laundering (AML) action plan by the Cypriot authorities, albeit with some delays. Main advances were made on strengthening the supervision of financial institutions, lawyers, accountants and administrative service providers (ASPs). Progress has also been made towards improving the staffing of AML supervisory units.

The CBC is implementing and fine-tuning its new AML monitoring tools. The results of the offsite tool have been taken into account when developing the 2015 inspections programme. The outcome of the onsite inspections are being used to adjust risk weights in the offsite tool and to update the risk profiles.

The CBC has made progress in ensuring that credit and financial institutions have sound and effective AML/CFT systems, but still needs to improve its enforcement processes. The CBC has stepped up its AML supervision, and conducted onsite inspections of eleven banks in 2014 and eleven credit and financial institutions in the first half of 2015. Based on samples of customer records in the inspected credit and financial institutions, the CBC has uncovered deficiencies in key areas (customer due diligence, general awareness of AML obligations) which the concerned institutions should endeavour to correct. While this testifies of increasing effectiveness of on-site inspections, further efforts are needed to ensure that remedial and enforcement actions are taken in a timely manner: the examination letters for the 2014 inspections had not yet been issued at end July 2015.

The supervisory authorities of obliged entities in the non-financial sector are also enhancing their risk-based supervision. Offsite risk-based tools have been implemented by the Cyprus Bar Association (CBA), Cyprus Securities and Exchange commission (CySEC) and the Institute of Certified Public Accountants of Cyprus (ICPAC). The offsite tools were used to assign risk profiles to all firms and will be improved based on the results of the 2015 onsite inspections.

The implementation of the onsite inspection tools by the supervisors of non-financial sector entities is underway. By end-June 2015, CBA had undertaken more than 90 visits based on the new risk-based supervisory programmes. Findings so far suggest that most common deficiencies relate to the reliability of client data (non-certified copies, expired passports) and sanctions lists not having been checked. In general, it seems that law firms still need to improve staff awareness of AML issues. ICPAC is implementing its inspections programme: 109 inspections, of which 35 were focussed on AML, had been carried out as of end June 2015. No significant flaws have been detected, and petty issues are immediately highlighted for corrective action. The main weaknesses identified are related to the quality of risk-based client analysis and the application of proper customer due diligence procedures. CySEC fine-tuned its onsite inspection tool based on the results of three pilot inspections. For 2015, 19 inspections overall are planned. Corrective measures were required for all deficiencies identified.

Further efforts are needed to ensure that AML supervisory authorities are adequately staffed and trained in order to ensure effective supervision. Only CBA plans to implement its inspections plan without external support. The AML unit of the CBC is supported by external auditors to help undertake onsite visits since April 2015, while ICPAC has also recourse to external auditors but also needs to hire an officer to coordinate audit monitoring and AML reviews. CySEC has the most pressing needs, as it intends to recruit several officials and contract audit firms so as to carry out its inspections plan. All supervisory authorities have made use of training opportunities and developed training plans for 2015. However, they still need to formalise their respective AML training strategy.

The Financial Intelligence Unit MOKAS has modernised its tools, but still needs to publish the 2013/2014 data. MOKAS has introduced a new electronic filing system, allowing it to accelerate and deepen its analysis of suspicious transaction reports. Although quarterly data is being provided to programme partners in a timely manner, MOKAS still needs to publish its 2013 and 2014 annual statistics on its website.

3.2. FISCAL POLICY

The 2015 primary surplus target was revised upward, partly on the back of the good fiscal developments in the first half of the year. The 2015 end-year primary balance target was revised from a surplus of 1.5% of GDP in the sixth review to a surplus of 1.9% of GDP. On the revenue side, the revisions reflect an estimated lower negative impact from the new location rules regarding VAT for e-commerce services, some additional one-off revenues (related to fines imposed by the competition authority), partly offset by lower revenue from taxes on interest income and dividends. Expenditure was also revised downward reflecting lower unemployment and redundancy payments on the back of slightly better labour market situation, partly offset by a somewhat higher expected implementation rate for public investment.

Compared to 2014, the general government balance is expected to worsen in 2015, when excluding the one-off effects from banking recapitalisation in 2014. This reflects the contraction of nominal GDP in 2015, impacting mostly on tax revenues, but also other factors beyond the government control, such as the new location rules regarding VAT for e-commerce services, the loss of revenue linked to the financing of the national resolution fund and a decrease in dividend income from the Central Bank of Cyprus. On the expenditure side, the 2015 result is affected by expenditures related to the closure of Cyprus Airways and the introduction of the new Guaranteed Minimum Income scheme.

For 2016, the primary surplus target has been revised slightly downward from 2.5% of GDP to 2.4% of GDP. The reason for the small downward revision is two-fold. The upward revision of the 2015 target, due to one-off effects, does not carry over to 2016. Furthermore, updated actuarial projections for the social insurance pension scheme show larger costs than in the previous projections, the 2016 payment for the national bank resolution fund is now expected to be slightly higher than before and the recently adopted reduction of property transfer fees is expected to have a negative impact on revenues.

The current forecast suggests no need for further consolidation measures in 2016 and a rather small additional effort of lasting nature to achieve the primary surplus of 3.0% of GDP in 2017.

The fiscal target for 2017 was maintained at 3% of GDP and has for 2018 and beyond been left within a range of 3-4% of GDP. On current projections, a primary surplus in the order of 3% of GDP as from 2017 appears more than sufficient to maintain public debt on a firmly descending path and ensure with a significant margin a debt level below 100% of GDP by 2020, as envisaged at the onset of the programme (see chapter 4). At the same time, debt projections are sensitive to Cyprus' financing needs estimate until the end of the programme as well as to the balance of risks (see chapter 5). This speaks in favour of caution in already setting the target for 2018 and beyond at 3% of GDP, since a tighter requirement may be needed. Moreover, even if Cyprus has already reached its MTO, it remains important to continuously respect the requirements of the preventive arm of the Stability and Growth Pact, both in terms of maintaining a budgetary position in line with the MTO and avoiding any deviation from the expenditure benchmark. Hence, the forthcoming possible revision of the minimum bound of the MTO should be taken into account when setting the exact target for 2018 and beyond. As a technical assumption, the forecast assumes a fiscal target of 3.6% of GDP, as in the sixth review. Depending on the macroeconomic situation at the time, this may require limited additional measures in 2018.

Fiscal risks remain significant. Notably, the fiscal impact of the recently enacted tax reforms allowing notional interest allowance for new equity and a defence tax exemption for non-domicile tax residents remains largely uncertain and should be carefully monitored. The fiscal projections do not explicitly factor in a possible impact due to its inherent uncertainty, even in terms of the direction. Essentially, the reforms constitute tax incentives which have a priori a negative impact on revenues. However, there is a positive potential for revenues, but this will depend on whether or not these complex incentives work. Once there is more evidence on the potential impact on the tax base, an estimate of the fiscal impact will be incorporated into the forecast. Additional risks concern the government's large exposure to contingent liabilities and potentially adverse macroeconomic developments in the outer programme years. Generally, achieving the agreed fiscal targets requires the continuation of the authorities' commitment to prudent budget execution, despite possible political pressure for relaxation.

3.3. FISCAL-STRUCTURAL REFORMS

3.3.1. Public Financial Management and Budgetary Framework

Further progress has been made with a view to managing the fiscal risk from government guarantees. The Public Debt Management Office (PDMO) has updated the risk assessment report, accounting for the newest available data. In parallel, a guarantee office has been established under the Treasury, which will take over the responsibility for managing existing and future government guarantees, as well as for assessing the fiscal risk stemming from them. Accordingly, the next update of the risk assessment report, to be submitted to programme partners by October 2015, will be prepared by the guarantee office and will take into account methodological recommendations from technical assistance provided by the ESM. The authorities have also progressed further on establishing the institutional arrangements for the management of existing and future guarantees.

Efforts for strengthening the organisational capacity of the PDMO are on-going, with a view to building up strategies and skills to gain and maintain stable market access after the programme. In that regard, the PDMO has prepared a multi-annual action plan which lays out specific steps and detailed timelines, taking into account recommendations from technical assistance provided by the ESM. The action plan is still subject to approval by the Minister of Finance, after which it will be implemented on a continuous basis.

The guidelines for public investment projects have been adjusted with the assistance of the World Bank and were issued by the Council of Ministers in late-July. The issuance of guidelines was delayed by some time, due to objections manifested by line ministries, primarily with regard to the size of projects that are considered financially significant and for which the guidelines apply. A manual elaborating methodology, criteria and templates to be used, will also be provided to ensure consistency and standardisation in the project pre-selection, evaluation and selection process.

3.3.2. Privatisation and State-Owned Enterprises

The implementation of the privatisation plan is key to achieving the objectives of improving economic efficiency, attracting investment in Cyprus and reducing public debt. After a series of delays, due both to slippages at technical level and in some cases the difficulty of fostering political consensus around an ambitious privatisation agenda, a firm commitment from the Cypriot authorities appears necessary in order to ensure timely implementation of the privatisation plan.

Progress towards the privatisation of Cyprus Telecommunications Authority (CyTA) continues, despite delays. The Cypriot authorities are committed to privatise CyTA and have been working in that direction, with the full dedication of the Privatisation Unit created one year ago under the auspices of the Ministry of Finance. The legal proposals allowing for CyTA's conversion into a Limited Liability Company were subject to regular consultation with trade unions and stakeholders (e.g. line ministries, opposition parties). Their adoption by the Council of Ministers is set as a prior action for the conclusion of this review. Their full adoption by the House of Representatives is expected by October. The next step is to launch the expression of interest, the non-binding offers and the binding offers. The current timeline should lead to the signature of the privatisation agreement before the summer of 2016.

The preparation of the concession agreement for Limassol Port's commercial activities follows its course within schedule, with the recent launching of the expression of interest, to be followed by the selection of qualified bidders. In parallel, the Cyprus Ports Authority (CPA) has recently been converted into a regulatory body, and now needs to establish its regulatory framework. This implies restructuring CPA's functioning, together with defining new schemes of service. Ensuring a solid regulatory body should give further reassurance to potential investors.

The long-delayed study on the legal unbundling and ownership structure of the Electricity Authority of Cyprus (EAC) is under preparation, after the selection of the independent adviser in late July. The adviser is expected to submit an interim report in September, which the responsible Minister will present to the Council of Ministers, and on the basis of which the government will form its preliminary position on EAC's legal unbundling. The Council of Ministers will decide on EAC's form of effective and efficient unbundling in December 2015, in line with the principles of the Third Energy Package. This should ultimately contribute to improving the efficiency of the Cypriot energy market and increase transparency for potential investors. Once the form of legal unbundling is decided, the process leading to EAC's privatisation – in full or in part - will be initiated. Although the policy objective of privatisation of EAC remains intact with the Cypriot authorities, it appears that an intense stakeholder discussion and political leadership will be required to overcome political and trade union resistance.

Excessive delays have been accumulated on discussing the law on the State-Owned Enterprises' (SOEs) corporate governance, which has still not been adopted. The law aims at improving the corporate governance of SOEs to ensure a more effective monitoring of their functioning, while minimising fiscal risks. The law has been under discussion at the Economic and Financial Parliamentary Committee since early April. Stakeholders have erroneously linked this law to the Privatisation Law even if the law only concerns companies not intended for privatisation. It is important that the adoption of the SOEs law is not further delayed, considering the much needed reform of governance in SOEs and the mitigation of fiscal risks that this reform would allow.

3.3.3. Revenue Administration

Despite the complexity of the reform and integration process, the Tax Department has made overall good progress since the last mission. One positive development was the completion of the top management team through the appointments of two additional assistant Commissioners. In addition, the reform project now has a new manager, ending the long period during which the position has been vacant. The various headquarter units have started taking up their work and the integration of the second district office, after Famagusta, is foreseen for the fall. By September, the single registration process for taxpayers is expected to be in place, provided that the required IT solution is delivered on time by the Department of Information Technology Services.

The tax department is also working on the implementation of the new compliance strategy through action plans by each of the headquarter units in the design and monitoring division. So far, these action plans still miss certain elements and will need further work. More generally, going forward it will be important, on the one hand, to refine the compliance strategy further, particularly by strengthening the risk analysis and management, and on the other hand, to ensure that the new approaches will be followed in the district operations. Good progress was also achieved towards completion of new business processes and the new tax procedure code, which is undergoing a final round of substantive revisions by the authorities' legal drafting team. Nevertheless, the finalisation will probably take longer than anticipated during the last mission due to the many interdependencies with other work streams.

On tax debt management, the authorities have continued with the implementation of their debt collection plan. The garnishing of bank accounts was tested in further pilot runs and expanded to the international banks. As soon as the required IT solution for the automated selection of taxpayers is in place, garnishing of bank accounts can move into full implementation.

3.3.4. Public Administration Reforms

The horizontal reform of the public administration, which is key to ensuring public finance sustainability, has regained momentum after protracted discussions with programme partners and stakeholders. The Cypriot authorities have finalised a reform plan providing a mechanism safeguarding the fiscal sustainability of the wage bill (including both the compensation and the number of public employees), as well as a significant modernisation of the appraisal system (through written exams and interviews), the promotion system (opening promotion posts for all qualified candidates and linking further merit and promotion), and the rules governing staff mobility (enhancing mechanisms for staff redeployment). The adoption of the necessary legal proposals by the Council of Ministers was set as a prior action for the conclusion of this review.

The ongoing reviews of ministries and local governments present a mixed picture. On the one hand, the three main political ministries (foreign affairs, defence, justice and public order) have been reviewed by UK experts ahead of schedule and are currently preparing their reform plans for adoption in early 2016. Implementation is expected to take place in conjunction with the horizontal reforms. New expertise is currently being identified for conducting the reviews of remaining ministries and institutions (including SOEs). On the other hand, the reform plan and the law on local governments have both been adopted by the Council of Ministers, but without consultation with programme partners. Although the reform plan is a step forward, it lacks details on the rationale for the chosen new structure, the implementation deadlines remain vague, and more importantly, there is no fiscal impact analysis of the introduction of a reform of this scale. The local government reform is a crucial cross-cutting reform that affects key programme areas such as title deeds, horizontal public administration, and PFM compliance with FRBSL. The authorities have therefore committed to amend the implementation plan so as to address these concerns.

3.3.5. Reform of the Welfare System

The implementation of the Guaranteed Minimum Income Scheme (GMI) continues, but

poses challenges. Despite the allocation of new resources to this task, the processing of applications remains rather slow. In terms of its fiscal cost, the latest estimate indicates lower required spending due to substantially fewer than expected number of applications received. However, the House of Representatives adopted amendments to the GMI, which relax certain eligibility criteria. This will lead to an increase in the spending for the GMI, albeit not beyond the initially foreseen budgeted amount. While these amendments have ensured the Parliament's continued support for the reform, programme partners considered these changes premature when the reform has not yet been fully implemented. It would have been preferable to wait for the GMI assessment report that is due in Q3-2015 in order to identify possible deficiencies and how to address them.

There is only mixed compliance towards other commitments in the area of welfare reform. With respect to educational benefits, the authorities have shared their plans to consolidate the three existing benefits into one scheme and to modify eligibility criteria, without at this stage aiming at fiscal savings. Going forward, it will be important to ensure that eligibility checks are performed. With regard to the reform of disability benefits, the authorities plan to create a unified legislative and administrative framework, but have so far not been explicit whether they plan to introduce other changes. They committed to do so by mid-October.

3.3.6. Healthcare System

The hospital autonomisation process has been delayed, and the related Q2-2015 deadlines have been missed. The hospital autonomisation bill had been reviewed by programme partners and was ready for adoption. However, at end-June 2015, the Cypriot authorities decided not to submit the bill to the Council of Ministers, due to disagreements with labour unions. It is not clear at the moment when and how the Cypriot authorities envisage moving forward in that regard. Relatedly, the detailed road map for the implementation of hospital autonomisation, also covering the necessary work on regulations which are foreseen to complement the bill, has not yet been shared with programme partners. Work on the restructuring plan for the public primary healthcare centres, which will be part of the hospital networks, is however on-going.

NHS implementation has made no progress since last review, accumulating with past delays. Delays in finalising the NHS bill and complementary regulations as well as in initiating the procurement tender for the necessary IT infrastructure will make NHS implementation feasible, under the best case scenario, by Q1-2017. While the NHS bill had been put to public consultation at end-2014, its submission to the House of Representatives is not expected before a decision on the final design of the NHS is made, most notably whether the system will be based on a single or multi-payer insurance system. This uncertainty regarding the final design of the NHS remains and therefore continues to impedes progress on necessary preparatory steps for NHS, e.g. in preparing necessary regulations, in negotiating with stakeholders, in finalising the tender for preparing the necessary IT infrastructure, and in designing an appropriate communication strategy. These delays in finalising the NHS bill and complementary regulations as well as in initiating the procurement tender for the necessary IT infrastructure will make NHS implementation feasible under the best case scenario by Q1-2017.

3.3.7. Other Fiscal-Structural Reforms

3.3.7.1. International Tax Cooperation

The authorities have continued their efforts towards reversing the negative opinion by the OECD Global Forum on Transparency and Exchange of Information. In particular, they have continued work towards reducing the backlogs in the Department of the Registrar of Companies and cleansing the taxpayer registries. The improvements made up to now have resulted in a significant improvement in the Tax Department's response times to information requests by other countries. In addition, the authorities have also complied with the various reporting requirements under the programme, e.g. in relation to savings income and a country breakdown of non-resident deposit statistics.

3.3.7.2. Immovable property tax

The parliamentary discussion on the immovable property tax (IPT) reform legislation was delayed to September 2015, thereby postponing its implementation to next year. The necessary legislation on the structure of the new immovable property taxes was adopted by the Government only by end-June and submitted to the House of Representatives. However, the latter considered that it needed more time to deliberate on this reform and postponed its discussions until September. The House of Representatives however voted for the 50% reduction of the transfer fees. The postponement of the decision to the autumn makes the implementation of the IPT reform in 2015 impossible without severely compromising the tax collection. The authorities have committed to adopt the necessary legislations by end-October with an effect from January 2016 and to ensure the fiscal neutrality of such reform, also taking into account the transfer fees reduction.

3.4. STRUCTURAL REFORMS

3.4.1. Labour Market

Tripartite negotiations to extend the reform of wage indexation to the private sector have not much progressed. Wage indexation in the private sector remains suspended until end-2016, but there has been no agreement on the adoption thereafter of the reformed system established for the public sector. The private sector has accepted the lower frequency of indexation and the suspension of COLA during recessions, but no general agreement has been reached on the change from full indexation to partial indexation (at 50% of inflation). Over the medium term, it remains crucial that wage developments remain in line with Cyprus's economic fundamental so that the country's competitiveness is maintained vis-à-vis its European partners.

Efforts to improve active labour market policies (ALMPs) have been continued. Despite substantial delays, there is now a list of ALMPs for the period 2015-2017, which has been shared with programme partners and will be updated as needed. This list includes not only measures targeting the youth under the National Action Plan for Youth Employment but also measures targeting other vulnerable groups such as the long-term unemployed. In parallel, the implementation of the adopted methodology for continuous monitoring and evaluation of ALMP has been progressing according to plan, and a comprehensive report describing the full implementation will be finalised for consultation with programme partners by Q4-2015.

The public employment services (PES) is not yet able to respond effectively to their enhanced tasks. The launching of the tender for the recruitment of additional staff has been delayed to Q3-2015, and therefore the new staff will only be operational by Q4-2015. In the short term, a very limited number of measures have been undertaken to enhance the capacity of the services, including the creation of two teams to deal with the National Action Plan for Youth and with monitoring issues, respectively, and the update and simplification of circulars regulating the operations of PES to be uploaded in a new intranet. As a follow-up to these measures, the authorities will finalise as soon as possible the programme fiche for the enhancement of PES under the ESF 2014-20 Operational Programme. New procedures to ensure cooperation between the public employment services and entities providing social benefits have been introduced but have to be revised in light of the recent changes to GMI eligibility conditions.

3.4.2. Energy

For the monetisation of the Aphrodite gas field, instead of an expensive LNG plant, the Cypriot authorities appear to now envisage using a system of pipelines going onshore and into Egypt. The Field Development Plan (FDP) for the monetisation of the Aphrodite gas field has been submitted by the Block 12 partners. This plan reportedly foresees establishing a floating production facility, selling gas at the exit point of this facility and transporting it in offshore pipelines to the target markets, i.e. Egypt and Cyprus. The details of the plan are currently being examined, after which negotiations with the Block 12 partners will be carried out. Gas supply from Aphrodite is likely to commence at the earliest in 2021. The authorities remain committed to undertake a financial and budgetary impact analysis prior to approving the FDP. The latest state-of-play will be reflected in an update of the roll-out plan for the gas exploitation infrastructure, which the authorities have agreed to provide by Q3-2015.

Regarding gas imports, the natural gas company DEFA has shortlisted applicants for the interim supply of natural gas. Negotiations to finalise the details of the deal, including its duration, are on-going. It is expected that the contract will start in 2017.

The Sovereign Wealth Fund (SWF) has not yet been set-up. The SWF law, which lays out the governance structure of the SWF, is still in the process of legal vetting. The authorities have committed to submit the law to the House of Representatives by Q3-2015, but its adoption cannot be seen independently from ongoing political discussions in other areas. The legislation defining inflow and outflow rules of the SWF is still in drafting stage, with a view to submission to the House of Representatives by Q4-2015.

Progress has been made regarding the accounting and functional unbundling of EAC, which will result in at least four separate accounts (generation, supply, transmission, distribution) and two separate functions (network and commercial). Regarding legal unbundling, the advisory study for the unbundling of EAC has been initiated. An interim version of the study will be provided by September 2015, on the basis of which the Government will form its preliminary position.

3.4.3. Housing Market and Immovable Property Regulation

Despite some progress on the issuance of title deeds, the backlog of cases pending for six months or more remains significant. This hampers the functioning of the housing market and requires a significant acceleration of the efforts to streamline procedures. Issuing the bulk of pending title deeds is one of the measures that is needed to allow buyers who have paid the full purchase price to finally receive their property titles and thus help NPL resolution. Since Q3 2014, the land registry has issued ca. 15,000 titles. In 2015-Q2, it started processing more than 10,000 titles that were hitherto pending at the local authority level. Still, more ambitious measures for streamlining the title deed processes are needed in order to achieve the end-2015 target of 3,500 remaining titles for development projects pending at the land registry.

Beyond 2015, further efforts are needed to clear the backlog of cases that remain pending in certification procedures at local authority level**.** The relevant working group and task force have made some recommendations towards reducing the backlog and setting up sound future procedures, but many of the proposals have not yet been enforced. These notably include amendments to the Streets and Building Permit Law, still pending at the House of Representatives, enforcing strict deadlines for issuance of certificates of completion by the supervisor engineers. In addition, more comprehensive and bolder measures are required to rapidly eliminate the backlog. The authorities committed to submit by end September 2015 a report detailing the main obstacles for the issuance of title deeds and required certificates and recommending ways to speed up title deeds issuance from 2015, including any necessary draft legislation or other administrative measures. The report will notably include a catalogue limiting non-tolerated deviations from permits in order not to impede title deed transfer. These steps are crucial to solve the NPLs problem but also to support the property market going forward.

3.4.4. Tourism and Growth Strategy

First steps have been made with the preparation of the national tourism strategy. The tender for an external study on the national tourism strategy is about to conclude with the selection of successful bidders. Meanwhile, an assessment of the catering and entertainment establishment legislation is being done by the Government, helping identify the impediments to competition in the tourism sector. The preliminary assessment already reveals serious bureaucratic and licensing burdens, which will need to be followed up by legal changes to be undertaken in conjunction with local government reforms. Progress has been made on the aeropolitical front, including future bilateral connections with European and non-European countries. All of these initiatives are expected to bring the tourism sector back on a balanced and sustainable growth path.

A first progress report on the implementation of the Action Plan for Growth has been prepared and published. The Plan provides an update on priority measures, while increasing the Government's accountability on its endeavour to identify bottlenecks and key drivers of growth. Although progress has been generally slow in developing a comprehensive strategy, growth-enhancing steps have been taken on various fronts, including, for instance, the adoption of measures fostering the development of the shipping sector, on the basis of a study conducted by independent experts; or also the adoption of strategic planning on technical and vocational training ensuring an education and training system adapted to the needs of the labour market. Furthermore, the progress report shows that a variety of important initiatives have commenced to improve the business environment in Cyprus, such as the preparation of a Policy Framework for Facilitating Strategic Investments, including fast-track administrative procedures, of an Action Plan for Smart Regulation, and of a National Policy Statement on Entrepreneurship, which are all planned to be adopted by the end of the year.

4. PROGRAMME FINANCING AND DEBT SUSTAINABILITY

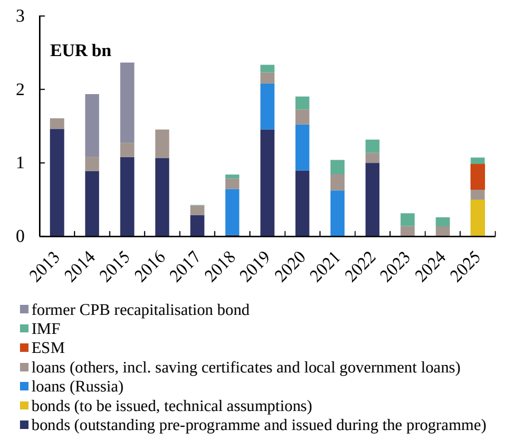
Out of the EUR 10bn of external assistance agreed on 25 March 2013, EUR 6.5bn have been disbursed by the ESM and the IMF. The ESM has disbursed EUR 5.8bn in seven tranches, of which EUR 1.5bn for the recapitalisation of the cooperative banking sector in the form of ESM notes. The IMF has disbursed six tranches, totalling EUR 718m.

Total financing needs for the period Q2 2013-Q2 2015 proved to be below the initial projection. The financing needs over the period Q2 2013-Q2 2015 included EUR 1.5bn for financial sector recapitalisation, EUR 0.8bn for fiscal needs and EUR 2.8bn for medium- and long-term debt redemptions.([4]) The lower-than-expected financing needs until now are due to more favourable fiscal developments than those envisaged at the initiation of the programme.

Yields on Cyprus' foreign-law bonds and T-Bills have remained at reasonably low levels at around 3.3% and 2.1%, respectively, in spite of headwinds from prevailing uncertainty in Greece. Robust program performance positively affected Cyprus' bond yield (with the yield for 5-year-to-maturity bond at 3.3% and 3-month T-bill primary market yield at 2.1% in early August). As from early-July, Cyprus's government bonds became eligible, according to the ECB's guidelines,([5]) to the Eurosystem public sector purchase programme. A continued decrease in T-Bill yields was facilitated by the regular T-bill auctions. By the end of June 2015, the outstanding T-Bill stock stood at EUR 731m, lower than the EUR 970m at the inception of the programme. In July 2015, six-year retail bonds, which Cyprus started to issue in June 2014, amounted to EUR 203m. Due to strong demand for those bonds, the authorities have again reduced their average coupon (having a step up structure) from 3.9% to 2.8%. The authorities will continue developing the government securities market to prepare for public debt management in the post-programme period.

The government did not use all the proceeds of a recent market issuance to redeem the CPB bond ([6]), putting aside EUR 240m to increase the Treasury cash balance. In June 2015, Cyprus repaid early an additional share of the CPB bond of EUR 0.75bn from the proceeds of the market issuance of April 2015, thus further reducing debt redemption needs after the current programme expires. Retaining part of the proceeds (EUR 0.24bn) allowed Cyprus to further increase its cash balance in line with the objective of having at least EUR 1bn liquid funds by the end of 2015, as set out in Cyprus' Medium-term debt management strategy (MTDS) ([7]).

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



(1) The above amortisation pattern assumes the repayment of the remainder of the CPB recapitalisation bond at the end of 2015, financed by issuing a new bond at market conditions. Contrary to the 6th review, it is not assumed anymore that the domestic bonds maturing in 2019 will be redeemed early.
Source: European Commission

([4]) For comparison purposes, this excludes a liability management exercise by Cyprus of partial early repayment of the CPB bond (of EUR 1.7bn), financed through market issuance.

([5]) https://www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html

([6]) In June 2012, the Cypriot government issued a EUR 1.89bn bond to provide Cyprus Popular Bank (CPB) with sufficient funds for re-capitalisation needs.

([7]) Available at: http://www.mof.gov.cy/mof/pdmo/pdmo.nsf/All/09FD892D97735FCCC2257DB7003EA752/$file/Cyprus%20MTDS%202015-2019%20Final%20EN.pdf

Box 4.1: Debt sustainability assessment

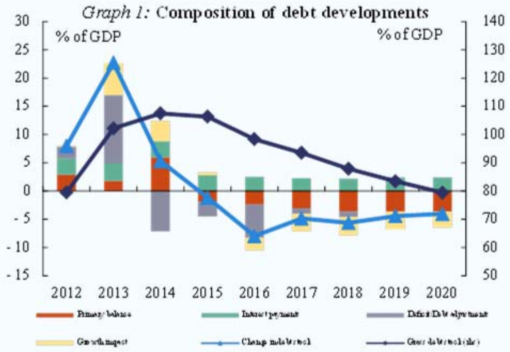
According to the updated projections, the debt-to-GDP peaked in 2014 and is projected to decline starting in 2015 from about 106% of GDP to about 79% of GDP in 2020. As pointed out in the previous review report, this debt path reflects the fact that the total financing needs over the programme period currently appear to be lower than expected at the onset of the programme, due to good fiscal performance and no additional financing needs in the financial sector envisaged at this stage. The effect of updated macro-fiscal projections and the subsequent changes to the financing needs on the baseline debt projections are rather limited. The economic recovery and the strong fiscal performance remain favourable for the evolution of the debt-to-GDP ratio.

The interest bill is expected to be lower than projected during the sixth review, mostly driven by a lower ESM lending rate. The ESM interest rate is expected to be below previous assumptions for the period 2015-2020. In the post-programme period, higher market interest rates compared to those charged on ESM and IMF continue to have an increasing effect on the interest bill.

Changes to the deficit-debt adjustment are limited. Privatisation proceeds are projected to materialise over a three-year horizon from 2016 onwards, amounting to a total of EUR 1.4bn. Regarding the loan-asset swap, its finalisation is still assumed by Q4-2015, with an expected amount of EUR 600m.([1])

([1]) 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.

Graph 1: Composition of debt developments



Source: Commission services.

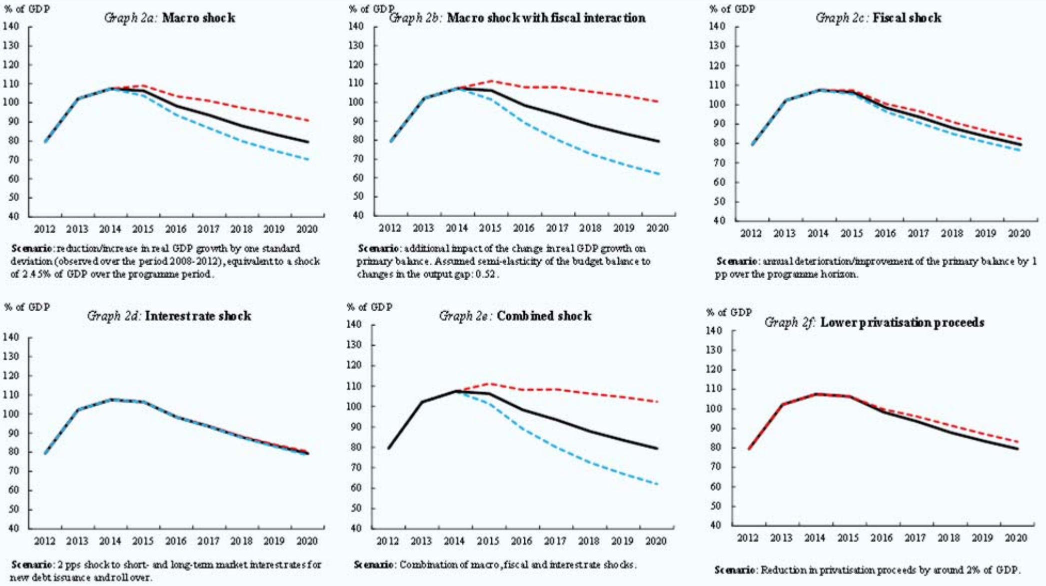
The macroeconomic and fiscal performance continues to be an important risk for the evolution of the debt trajectory until 2020. A reduction (increase) in real GDP growth by one standard deviation over the programme period would result in a sharp upward (downward) revision of the debt trajectory. The impact of the shock is further intensified, if an additional effect of a lower (higher) real GDP growth on primary balance is assumed.([2]) The effects of an isolated fiscal shock to the primary balance of 1 pp over the programme horizon as well as higher (lower) short- and long-term market interest rates (by 2 pps, respectively) would be limited. Assuming lower than currently envisaged proceeds from privatisation by about 4% of GDP in 2016-2018 would lead to a corresponding upward revision of the debt trajectory by 2020.

([2]) The scenario is based on a semi-elasticity of the budget balance to changes in the output gap of 0.52. In doing so, it is assumed that potential GDP stays constant.

(Continued on the next page)

Box (continued)

Programme scenario sensitivity analyses



Black line: baseline scenario.
Blue line: positive shock.
Red line: negative shock.

Financing needs in the third and fourth quarters of 2015 are assessed to be of EUR 0.1bn and EUR 1.1bn, respectively. Based on the updated macro-fiscal projections, total financing needs for Q3 2015 are estimated to amount to EUR 0.1bn, for redemption of debt. Over the fourth quarter total debt redemptions are estimated to amount to around EUR 0.9bn and fiscal needs to around EUR 0.2bn ([8]).

A successful seventh programme review would unlock the disbursement of ESM's eighth tranche of EUR 500m. The eighth ESM disbursement in cash would cover deficit financing and redemption needs, including a large debt repayment on 1 November 2015 of EUR 863m, while allowing Cyprus to maintain a comfortable cash balance, which seems warranted given the large uncertainties and risks related to the external environment. The IMF would this time disburse about EUR 124m. After the disbursement by the ESM and the IMF and excluding possible further market issuance, the government's cash balance is estimated to amount to around EUR 1bn at the end of 2015.

([8]) This excludes a possible further market issuance and redemption of the remaining CPB bond (working assumption).

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. Meeting specific targets and overall policy objectives are conditioned by the following downside risks:

- Delays in the restructuring of the large stock of NPLs in the domestic banking system could lead to a slower than expected return of confidence in the banking sector and thereby call into question the sustainability of the stabilisation of the banking system;
- Further negative spillovers stemming from Russia and Greece, which could weigh on economic activity;
- A prolonged period of tight credit supply conditions could weigh on the economic recovery;
- A potentially weaker economic recovery, particularly in the medium term, related to slower than expected private sector balance sheet adjustment, worsening of labour market conditions and subdued real estate price developments;
- Inability to reach the agreed primary surplus targets established in the programme, due to reform fatigue, 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.

ANNEX 1

Compliance Table

	Actions for the seventh review (completed by Q2 2015 and end-July 2015)	Assessment of compliance - Comments
1	**FINANCIAL SECTOR REFORM**	**(Compliant, compliant with delay, partially compliant, non-compliant)**
1.A.	**REGULATION AND SUPERVISION**	
	Maintaining liquidity in the banking sector	
1.1	After the complete removal of all restrictive measures on 6 April 2015, 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. Although liquidity has improved, additional government guarantees for the issuance of bank bonds remain available to be used as collateral against liquidity, but only if necessary to safeguard financial stability, in line with State aid rules.	**Compliant** On-going. The government guaranteed bond scheme continues to be available
1.2	The CBC will continue to receive the updated condensed capital and funding plans of core banks on **a quarterly basis,** and within two months of the end of each quarter, 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 resolution of non-performing assets, and the reduction of borrowing from the central bank, with the objective to avoid asset fire sales and a credit crunch.	**Compliant** On-going.
	Regulation and supervision for banks and cooperative credit institutions	
1.4	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, where relevant, financial indicators.	**Compliant** On-going.
1.5	The authorities will study the financial situation of borrowers. The study will, among other things, assess the extent of strategic default, with the objective of improving the effectiveness of debt resolution policies. The findings of the survey will be published in a report **by end-July.**	**On-going** The CBC Economic Research Department is in the process of finalising the study.

1.6	The CBC will ensure it has sufficient staff to carry out its functions in full independence as stipulated by the Treaties. The CBC, taking into account the tasks undertaken in relation to these policy measures new tasks following the creation of the SSM, and enforcement of the existing regulatory framework, has already assessed the staffing needs in the micro-prudential supervisory area and the recruitment process will be completed **by end-June**. The needs in other business areas of the CBC will be reviewed **by end-July** and for the Resolution Unit **by end-June**.	**Compliant** for the supervisory staff and the resolution staff. **On-going** for the other business areas, where an external advisor is consulted.
	Addressing corporate and household indebtedness	
1.7	Taking into account the formal letter of notice sent by the EC on 27 March 2015, the authorities will finalise without any further delay the transposition into national law of the Bank Recovery and Resolution Directive. The authorities will also ensure the timely transposition of the Deposit Guarantee Scheme Directive. To this end, the CBC will make available the necessary resources as a matter of urgency.	**Non-compliant** The transposition of the DGS is at the stage of legal vetting. The BRRD transposition is being finalised.
1.10	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).	**Compliant** On-going.
	• The CBC will make available on its website a comprehensive and user-friendly guide on the practical application of the amended Arrears Management Directive, published on 3 April, and of the Code of Conduct. Effective compliance with the Arrears Management Directive and the Code of Conduct will be ensured.	**Compliant** It was published in June 2015.
	• To ensure that banks offer long-term sustainable restructuring solutions, 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. Each quarter, and for the first time **by end-July,** the CBC will publish these targets, on an aggregated basis and for the ongoing and following quarters together with the past performance of the banks and an explanation for any possible discrepancy between targets and actual performance, as well as for the revision of the targets.	**On-going** The banks are supposed to submit the first reporting template to the CBC.

• Following the requirements introduced by the CBC in January, the banks and coops will continue to submit regularly to the CBC in the quarter following the reporting period the reports prepared by their external auditors on the effectiveness of their debt restructuring arrangements and strategies for the periods ending in June 2015, December 2015, and June 2016. Relying on the finding of the reports, the CBC will assess the appropriateness of restructuring solutions and submit to the SSM the findings and recommendations on the banks' internal policies and processes regularly, and for the first time **by end-June** based on the reports for the period ending in December 2014.	**Partially compliant** The first review reports were submitted by the banks. Their assessment by the CBC and submission to the SSM is delayed for one bank out of three.
• Legal amendments to the Law on the Financial Ombudsman were adopted in July 2014. **By end-June,** further 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.	**Compliant with delay** Legal amendments adopted on 9 July 2015.
• The Cypriot authorities, in view of financial stability considerations and on-going bank restructuring, commit not to introduce any new regulations which would interfere with the setting of bank lending rates. In particular no ceilings on bank lending rates would be introduced. Furthermore, the Cypriot authorities will reassess **by end-June** the recently adopted law entitled "The liberalisation of the interest rate and other related matters (amending) Law of 2015", for its compatibility with national law and international best practice and notably its retro-active application.	**Compliant** for the non-introduction of ceilings on lending rates. **Non-compliant** for the reassessment of the law.
• the legislation on the sale of loans will be approved by the Council of Ministers by **end-July 2015** and by the House of Representatives by end-September 2015. As a matter of priority, the amendment to the Banking Law limiting the sale of loans to third parties will be repealed.	**Compliant with delay** for the adoption of the legislation by the Council of Ministers.
• The identified impediments to the securitisation of assets will be removed and a legal proposal enabling securitisation of assets, in line with international best practices and EU law, will be submitted to the House of Representatives **by end-July.**	**Non-compliant** The draft law is under preparation.
• As a matter of priority, the amendment to the Banking Law limiting the sale of loans to third parties will be repealed.	**Non-compliant** The ban on the sale of loans is suspended until end-October 2015.
Legal framework for private debt restructuring	

1.12	Prior to the granting of the seventh disbursement of financial assistance, the authorities will, after taking into account comments by programme partners, present draft legislation to programme partners, that • ensures that property buyers who have paid the purchase price in full, will have their title deeds transferred within 6 months after their issuance; • puts obligations on all parties involved to ensure that the procedures releasing encumbrances and transferring the title can operate without delay and as automatically as possible; and • provides safeguards against abuse, inter-alia by introducing a mandatory escrow account to route all payments related to a property transaction, as well as adequate compensation for the parties involved, if available. **By end-June**, the legislative measures will be adopted by the Council of Ministers. Furthermore, the CBC will, in close cooperation with Ministry of the Interior, provide to programme partners a financial sector impact assessment regarding title transfers and lifting of encumbrances **by end-June.**	**Compliant** for the prior action and for the adoption of the legislation by the Council of Ministers (24 June 2015). **Partially compliant** for the impact assessment of the title deed transfers. Not all banks submitted their assessments.
1.14	Most of the legal and institutional arrangements are in place in order to start the implementation of the new insolvency regime. Any necessary additional administrative acts and regulations will be adopted by end-August. Amendments to the regulations regarding the liquidation of companies will be put in place by end-October. The authorities will step up efforts in order to minimize the transition period and to ensure the full functioning of the Insolvency Service, including IT infrastructure, and the availability of trained and licenced insolvency practitioners at the earliest possible. To this end, an action plan will be submitted to program partners **by end-June.**	**Compliant with delay** for the action plan.
1.15	Following the adoption of the regulation on the rules for sale by auctions, as required by the foreclosure law, any other measures, procedures or actions that may be required for the effective implementation of the law will be immediately implemented.	**Compliant** On-going.

1.16	As further measures with regard to the legal framework for the restructuring of debt, the authorities will in particular achieve the following: • the authorities will formulate recommendations on the Civil Procedure Code and Court Rules: (i) in order to ensure the smooth and effective functioning of the revised foreclosure law including the swift processing of appeals. The implementation of relevant legislative amendments should become effective **by end-July**; and (ii) in order to ensure the effective functioning of the new insolvency frameworks. The implementation of relevant legislative amendments will become effective by end-September. The recommendations and action taken by the authorities should also aim at improving the pace of court handling and the reduction of backlogs in courts.	**On-going** Waiting the feed-back from the Supreme Court.
	• Following the report on the legal framework for obtaining updated information on the financial situation of delinquent borrowers, the authorities will also issue recommendations **by end-July** regarding the financial statements of debtors in the context of enforcement measures. The adoption of the relevant amendments to the Civil Procedure Code and Court Rules will become effective by end-October.	**On-going** Waiting the feed-back from the Supreme Court.
	• Following the study of impediments on attachments to financial assets and earnings of delinquent borrowers, the authorities will also issue its recommendations **by end-July** regarding the improvement of individual enforcement procedures. The adoption of the relevant amendments to the Civil Procedure Code and Court Rules will become effective by end-October.	**On-going** Waiting the feed-back from the Supreme Court.
1.B.	**RECAPITALISATION AND RESTRUCTURING** **Restoring adequate capital buffers**	
1.17	The authorities adopted the transposition of CRD IV on 29 January 2015 and will fix the minimum Common Equity Tier 1 ratio at 8% under Pillar 1 **by end-June.**	**Non-compliant** A capital conservation buffer of 2,5% is imposed.
	Management of legacy Laiki	
1.18	The Resolution Authority will prepare, **by end-June**, a time-bound plan for completing the resolution of Laiki and will implement it without delay.	**Non-compliant** An investment advisor has been appointed on 6 May 2015. Another advisor will be appointed for the disposal of the BoC stake.
	Restructuring of Bank of Cyprus	

1.19	BoC has progressed with the implementation of its restructuring plan and has divested operations and stakes abroad ahead of schedule. Moreover, 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** On-going.
	Restructuring and recapitalisation of cooperative credit institutions	
1.20	The Cooperative Group will ensure timely and complete implementation of the already agreed restructuring plan and take further measures to improve its operational capacity (...). Based on the review of the sector's policies and operational capacity on debt resolution, which relied also on technical assistance from the IMF, the CCB will design **by end-June** a time-bound plan for addressing the identified deficiencies in a timely manner.	**Compliant with delay** for the implementation of the restructuring plan. **Compliant** for the time-bound action plan.
1.21	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, 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.	**Compliant** On-going.
1.22	To streamline execution of tasks, governance will be strengthened, avoiding parallel decision-making structures, also relying on technical assistance from the IMF through appropriate changes **by end-June.** By the same time, the CCB will make progress towards the centralisation of the control functions to the extent possible. The CCB will ensure strict compliance of the individual CCIs with all its policies. To strengthen the governance of the CCB over the CCIs, the amendment of the affiliation directive will be finalised **by end-June.**	**Complian**t On-going for the strengthening of governance. **Compliant** for the affiliation directive.
1.23	To ensure the implementation of the restructuring plan, the Group will continue to improve its management capacity and meet the employment targets according to the schedule communicated to the EC on 26 March 2015.	**Complian**t On-going. The employment targets have been modified with the agreement of EC (DG Competition).
1.24	The CCB will ensure the timely implementation of the time-bound action plan for addressing the deficiencies identified with respect to Financial Control and Reporting starting **by end-July.**	**Complian**t The implementation of the MIS started early June 2015.

1.25	Compliance with the relationship framework between the State and the CCB 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 relationship framework was amended **by end-May**. The effectiveness of the Management Unit of the Ministry of Finance will be reinforced with financial experts **by end-June.**	**Complian**t for review by the monitoring trustee. **Compliant** for the amendment of the Relationship Framework Agreement (29 May 2015). **Non-compliant** for the reinforcement of the Management Unit.
1.26	To preserve 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** On-going.
1.C.	**INCREASING FINANCIAL TRANSPARENCY**	
1.27	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).	**Partially compliant** The CBC has still to formalise the procedure warranting prudential supervisors to inform the AML team in case of a change in the business model of the bank they are supervising (AML Action Plan item 1.2.1). CBC onsite inspection program of banks is ongoing (AML Action Plan items 1.3.2 and 2.2.2).
	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** The implementation of the governmental action plan to reform the Registrar is ongoing and appropriate resourcing (AML Action Plan item 4.2.2) has to be ensured, once the need is clear after finalizing the re-organisation and streamlining of the processes.

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.	**Partially compliant** All supervisory authorities have made important progress, completed some of the AML Action Plan items (such as the fine-tuning of the supervisory tools and updates of the risk profiles after pilot inspections) and work is ongoing in particular as regards the onsite inspections. The main actions which remain to be undertaken mostly relate to adequate staffing of the supervisory authorities in the non-financial sector, staff training and roll-out of the 2015 inspection plans. For details on timelines see the AML Action Plan (Annex 2 to the MoU) items 5.4.1, 5.4.2, 5.5.2, 6.1.1, 6.4.1 and 6.5.1.
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 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.	**Compliant** The Trust and Company Services Providers Law has been adequately revised
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.	Please refer to assessment of compliance as regards 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.	**Partially compliant** MOKAS provided to the programme partners the breakdown of requests made and received, including spontaneous disseminations, to and by foreign FIUs. However, the 2013 and 2014 annual reports have not been published on the MOKAS website yet.
	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.	**Compliant** The CBC has undertaken an AML investigation and will take appropriate supervisory action based on the results.
2.	**FISCAL POLICY** **Fiscal Policy in 2015**	
	Based on the programme's updated budgetary projection, the Cypriot authorities will achieve general government primary surplus of at least EUR 264 million (1.5% of GDP) in 2015, corresponding to a headline deficit of 1.5% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus).	**Compliant** The updated programme projection for 2015 shows a surplus for the general government primary balance of 1.9% of GDP.
	Fiscal Policy in 2016 - 2018	
	In 2016 the Cypriot authorities will achieve a general government primary balance surplus of at least EUR 439 million (2.5% of GDP), corresponding to a headline deficit of 0.1% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus). The Cypriot authorities will achieve a general government primary balance of 3% of GDP in 2017 and 3% to 4% of GDP in 2018.	**Compliant** While the updated programme projection for 2016 shows a surplus for the general government primary balance of only 2.4% instead of 2.5%, the deviation is marginal and would not have occurred without the increase in the estimated contribution to the national bank resolution fund. The primary balance targets for 2017 and 2018 have not changed.
	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.**	**Compliant** The fiscal strategy statement was adopted in June.

3.	**FISCAL STRUCTURAL MEASURES** **Health care expenditure**	
3.2	To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following measures will be adopted: a) **By Q2-2015,** and taking into account the related WHO studies, the hospital autonomisation bill will be adopted by the Council of Ministers and submitted to the House of Representatives;	**Non-compliant** The hospital autonomisation bill has not yet been adopted by the Council of Ministers. Adoption is now expected by Q3-2015.
	b) A detailed road map for the implementation of hospital autonomisation will be submitted to programme partners **by Q2-2015;**	**Non-compliant** The road map for the implementation of hospital autonomisation has not yet been submitted to programme partners.
	Public Financial Management	
3.3	The Cypriot authorities will: • Improve further the risk-assessment analysis and management, **associated** with government guarantees. To this end, submit to programme partners **by Q2-2015** an updated version of the risk assessment report;	**Compliant** The risk assessment report has been submitted to programme partners. The next update of the report will be submitted to programme partners by October 2015, taking into account methodological recommendations from technical assistance provided by the ESM.
	• Drawing on the recommendations from technical assistance provided by the ESM and the IMF, submit to programme partners **by Q2-2015** an action plan for strengthening sound practice standards for the Public Debt Management Office;	**Compliant** The action plan has been prepared and submitted to programme partners. Following approval by the Minister of Finance, it will be implemented on a continuous basis.
	• Issue guidelines for public investment management, including project appraisals in line with the FRBSL provisions **by May-2015**. 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;	**Compliant with delay** The guidelines for public investment management have been approved by the Council of Ministers on 29 July 2015.
	State-owned enterprises and privatisation	

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 June 2015.** 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 has not yet been adopted and has been under discussion at the Economic and Financial Parliamentary Committee for months. Stakeholders erroneously assimilate this law to the Privatisation Law, hence the current blockage.
	• 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.**	**Ongoing** Pending adoption of the SOEs Law.
	Privatisations	
3.5	In order to pursue the privatisation process in the most diligent way, the Cypriot authorities will: • Ensure that the Privatisation Unit is fully operational as soon as possible, in line with the objectives and provisions of the Privatisation Law; • For the privatisation of Cyprus's Telecommunications Authority (CyTA): convert CyTA into a Limited Liability Company through the adoption of the necessary legislation for CyTA's corporatisation by the Council of Ministers **by June 2015** and by the House of Representatives by September 2015;	**Compliant with delay** The legislation was adopted in late-August, as a prior action before the eighth disbursement.
	• For the privatisation of Limassol Port's commercial activities: Prepare for consultation with programme partners a detailed privatisation plan, a valuation of the transaction and the specificities of the Port's method of privatisation **by June 2015**, after consultation with, and notification to, the relevant European Commission services; Launch the call for the Expression of Interest for the concession agreement **by June 2015**; Adopt the law enabling the conversion of the Cyprus Port Authority (CPA) into a regulatory body **by May 2015** and establish CPA's appropriate regulatory framework by October 2015, after consultation with, and notification to, the relevant European Commission services.	**Compliant with delay** The detailed privatisation plan and method of privatisation were submitted in two phases (June and July). The valuation of the transaction was shared in late-July. The EoI was duly launched in mid-June. The enabling law for CPA's conversion into a regulatory body was enacted in mid-June.

	• For the privatisation of the Electricity Authority Company (EAC): Finalise **by May 2015** the bidding process for the study on the unbundling and ownership structure of EAC. The study will comprise an international benchmarking, including cost structures of comparable electricity companies operating in a similar environment; Appoint the independent adviser conducting the study **by July 2015**;	**Compliant with delay** The tender was launched with delay, due to pressure from trade unions. The appointment of the adviser was compliant within July. The study has been initiated.
	• For the sale of land assets: appoint an independent adviser with relevant expertise that will develop a plan with detailed intermediate steps and timings for disposing of the identified land assets **by June 2015**;	**Compliant with delay** The adviser was appointed in due course, but the plan was submitted in July (i.e., one month after the deadline).
	Revenue administration, tax compliance and international tax cooperation	
3.6	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 this end, the authorities will :	**Partially compliant** The authorities prepared a paper outlining their new compliance strategy. However, the risk identification and analysis need to be improved. Implementation of the strategy has started but full implementation will only be achieved gradually in parallel with the full operational integration of the department.
	• Implement their new debt collection action plan, with a view to reducing collectible and unencumbered debt, while continuing the pilot run on garnishing of bank accounts, and prepare a quarterly progress report on the action plan's implementation starting in **Q2-2015**; and	**Compliant**
	• Submit to programme partners **by Q2-2015** detailed action plans by each of the headquarter units in the Design and Monitoring Division, outlining the steps to implement the compliance strategy in the Tax Department, including training of staff.	**Partially compliant** The authorities prepared action plans for each of the units but some of them still need to be fleshed out more, in particular with respect to implementation of the compliance strategy in the district offices.

	To progress with the operationalization of the integrated and function-based tax agency, in line with the adopted integration plan, the following steps will be taken: by Q2-2015, a single registration process will be put in place; and	**Non-compliant** Due to a missing IT element to be delivered by the Department of Information Technology Services the single registration process has not yet been implemented.
	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;	**Compliant** The compliance with the timelines is assessed on an on-going basis. Statistics show continuous improvements in improving the response times. The response times for requests related to value-added tax are above the EU average.
	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).	**Compliant** The statistics were provided on time and show continuous progress in providing timely responses.
	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. Following consultation with programme partners, the final design of the immovable property tax will be adopted by the Council of Ministers **by May 2015** and submitted to the House of Representatives **by Q2-2015** with a view to adoption in due time for being applied for the collection of the 2015 immovable property tax.	**Non-compliant** The reform was adopted by the Council of Ministers and submitted to the House of Representatives. It was not adopted by the House of Representatives and thus it was not implemented for 2015. Also, the design of proposed tax structure does not ensure the fiscal neutrality of the reform.

	• Adopt legislation specifying the frequency of the mandatory update of the values in line with international best practice **by Q2-2015**, following consultation with programme partners;	**Non-compliant** The legislation has not yet been adopted.
	• Implement **by Q2-2015** the recommendations of a study on the scope for consolidating the collection and administration of the municipal and communal recurrent property tax. By Q2-2015, the authorities will also review the tax regulations that may impede the leasing of immovable property;	**Non-compliant** The reform has not yet been adopted.
	• Continue the assessment of the relevance of the parameters used in the Computer Assisted Mass Appraisal (CAMA) model for the GV, **on a quarterly basis**;	**Partially Compliant** Some progress has been reported.
	• Present to the programme partners **by Q2-2015** an updated communication strategy aiming at informing the goals of the property tax reform, the implications for citizens and the required procedural steps.	**Non-compliant** The reform has not yet been adopted.
	Public Administration Reform	
3.9	With a view to the reform being adopted in 2015, the reform plan will be prepared for consultation with programme partners **by May 2015.** The reform plan and accompanying legal proposals will be adopted by the Council of Ministers **by June 2015** and submitted to the House of Representatives.	**Compliant with delay** The final reform plan was submitted in July, while its adoption, together with the appropriate legal proposals, took place in late-August, as a prior action before the eighth disbursement.
	• The first batch consists of the review of the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies. Based on the findings of the World Bank and the UK public administration report, the Council of Ministers will adopt the remaining reform plans for local governments, after consultation with programme partners, **by June 2015**. Following the adoption of the legislation indicated as high priority on the Companies Registrar, its reform will start to be implemented **by June 2015**. The relevant legislation in relation with the reforms in Agriculture, Education, and local governments indicated as high priority will be adopted by the House of Representatives by October 2015 and their reforms will start to be implemented by January 2016.	**Partially compliant** Both the reform plan and the law on local governments have been adopted by the Council of Ministers, but without consultation with programme partners. Although the plan is a step forward, it lacks details on the rationale for the chosen new structure implementation deadlines remain vague, and more importantly, there is no fiscal impact analysis of the introduction of a reform of this scale. The clean-up of the Companies Registrar is almost completed and the electronic filing of annual returns is effective.
	Welfare System	

3.10	To continue the implementation of the adopted welfare reform and monitor the implementation of the GMI, including its fiscal impact, the Cypriot authorities will take the following steps: • the monitoring unit will continue providing quarterly costing updates of the GMI, **at the end of each quarter, starting in Q1-2015;**	**Compliant**
	• **by Q2-2015,** prepare for consultation with programme partners, plans to consolidate disability benefits, in line with the adopted welfare reform;	**Non-compliant** Plans to reform the disability benefits have not yet been prepared. Discussions with stakeholders are on-going but the authorities have so far not been transparent about what are the main considerations in these discussions.
	• **by Q2-2015** submit for consultation with programme partners, a proposal to consolidate the student grant, the student package and the benefits previously administered by the Cyprus Scholarship Foundation into one scheme, with a view to implementing the single scheme for the academic year 2015-2016;	**Compliant** The authorities have prepared plans to consolidate the student benefits. These would, however, benefit from an analysis of the impact on various groups and the fiscal impact.
4.	**LABOUR MARKET** **Activating the unemployed and combating youth unemployment**	
4.4	The Cypriot authorities will continue the implementation of measures to address the identified shortcomings of the system of activation policies, including:	
	ii. Measures to enhance the administrative capacity of the public employment services. In this regard, a detailed description of all actions taken or envisaged in the short-term to improve the provision of PES services, including organizational changes will be prepared for consultation with program partners **by Q2-2015.** In addition, the tender for the recruitment of additional staff, through the 2014-20 ESF Operational Programme budget, will be launched **by end-May 2015**, and all staff will be operational by end-October 2015; and	**Non-compliant** The launching of the tender for the recruitment of additional staff has been delayed. In the short term, a limited number of measures have been undertaken to enhance the capacity of the services, but these fall short of what is needed.

	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. A comprehensive note detailing the concrete measures undertaken in this regard, covering steps to avoid welfare dependency, and the links with social welfare services, will be prepared for consultation by program partners **by end-May 2015.**	**Partly compliant** New procedures to ensure cooperation between the public employment services and entities providing social benefits have been introduced but have to be revised in light of the recent changes to GMI eligibility conditions before being formally.
4.5	4.5. Having experience one of the steepest increases in the youth unemployment rate in the EU, and a rapid rise of young people not in employment, education or training (NEETs), Cyprus was urged to take swift action to create employment opportunities for young people and improve their employability prospects. (...) For this purpose, the authorities will prepare for consultation with programme partners a comprehensive list of all active labour market policies running in the period 2014-2015, with objectives, target group, recipients per year, budgetary allocations, and call dates **by end-May 2015.** This list will be updated to include also measures to be implemented in the period 2015-2016, by Q3-2015.	**Partly compliant** On the implementation of ALMPs, despite substantial delays, there is now a list of measures for the period 2015-2017 which includes not only measures targeting the youth under the National Action Plan for Youth Employment but also measures targeting other vulnerable groups such as the long-term unemployed. This list has been shared with program partners and will be updated as needed.
5.	**GOODS AND SERVICES MARKET** **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 ensure that: • **by Q2-2015,** the House of Representatives will adopt 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;	**Non-compliant** The legislation has not been adopted. It was submitted to the House of Representatives in March 2015.

	• The working group on title deeds issuance will review all procedures from the planning permit application to the issuance of title deeds (working closely with the Task Force on title deeds). **By end-June 2015**, the Cypriot authorities will submit for consultation with programme partners a report detailing the main obstacles for the title deeds issuance and recommendations on ways how to streamline these procedures during 2015, including a catalogue of tolerated deviations from building and planning permits. A further comprehensive streamlining of building, planning and title deed procedures will be proposed by the authorities following the completion of the in-depth analysis in progress.	**Partially compliant** A report was submitted with a delay, but it was not detailed enough. The catalogue of tolerated deviations was also not specific enough.
	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 as part of the Action Plan for Growth. To that end, the Cypriot authorities will:	
	• In order to prepare a national tourism strategy, the authorities will select the consultant to conduct a study **by June 2015**. An interim report will be submitted for consultation to the programme partners by November 2015, with a view to conclude it Q1-2016;	**Non-compliant.** The selection was not completed by end-June.
	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:	

	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, 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 are provided for in the FRBSL, but will be detailed in implementing legislation of FRBSL, which will be submitted to the House of Representatives by **Q2-2015.** The resource fund law, which defines the governance structure of the resource fund, will be submitted to the House of Representatives **by Q2-2015.**	**Non-compliant** The resource fund law is still in legal vetting and has not been submitted to the House of Representatives. Submission to the House of Representatives is now foreseen by Q3-2015. The legislation defining inflow and outflow rules for the resource fund is still in drafting stage, with a view to submission to the House of Representatives by Q4-2015.
6.	**Technical Assistance**	
6.1	Given the nature of the structural challenges Cyprus is facing, including a lack of specific skills in some areas and scarcity of resources, the Cypriot authorities will provide an updated request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-June 2015.** 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**
7.	**Growth Strategy**	
7.1	**By June 2015** the authorities will provide a monitoring report reflecting the progress in implementing the existing Action Plan for Growth. The monitoring report will also include an update on any studies which are in-preparation or on-going and are related to this Action Plan. The Cypriot authorities may request technical assistance to implement the Action Plan for Growth.	**Compliant**

ANNEX 2

Macroeconomic Projections

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

	2011	2012	2013	2014	2015	2016	2017
Real economy			*(percent change)*				
Real GDP	0.3	-2.4	-5.4	-2.3	0.5	1.4	2.0
Domestic demand incl. inventories	-2.0	-3.8	-9.7	-1.2	0.1	1.1	1.4
Total consumption expenditure	1.6	-1.1	-5.8	-1.5	0.1	0.8	1.0
Private consumption expenditure	1.8	-0.7	-6.0	0.4	0.6	1.1	1.2
Government consumption expenditure	0.7	-2.7	-4.9	-8.7	-2.3	-0.9	0.2
Gross fixed capital formation	-9.4	-20.7	-17.1	-18.8	0.2	3.6	4.0
Exports of goods and services	4.4	-1.6	-5.0	5.9	0.9	1.5	2.9
Imports of goods and services	-0.6	-4.7	-13.6	8.1	0.3	1.0	1.8
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	-0.7	-4.9	-7.6	-3.8	0.1	1.0	1.3
Foreign trade	2.4	1.7	4.6	-0.9	0.4	0.4	0.7
Changes in inventories	-1.4	1.0	-2.3	2.6	0.0	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	2.0	2.0	-1.4	-1.2	-0.9	0.7	1.3
HICP	3.5	3.1	0.4	-0.3	-1.0	0.9	1.3
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	7.9	11.9	15.9	16.1	16.0	15.0	13.7
Employment	0.5	-4.2	-5.2	-1.9	0.1	1.2	1.6
Compensation per employee	2.5	-0.8	-6.0	-4.7	-0.3	1.1	2.3
Labour productivity	-0.1	1.9	0.1	-0.4	0.4	0.2	0.4
Unit labour costs	2.6	-2.7	-6.1	-4.2	-0.7	0.9	2.0
*Public finance**			*(percent of GDP)*				
General government balance	-5.5	-5.8	-4.9	-8.8	-0.9	-0.1	0.7
Total revenue	36.9	36.2	36.4	40.3	39.5	39.0	38.7
Total expenditure	42.8	42.1	41.4	49.1	40.5	39.1	38.0
General government primary balance	-3.3	-2.9	-1.8	-6.0	1.9	2.4	3.0
Gross debt	66.0	79.5	102.2	107.5	106.4	98.4	93.5
Balance of payments			*(percent of GDP)*				
Current external balance	-3.2	-5.7	-2.0	-4.0	-3.7	-3.3	-3.1
Ext. bal. of goods and services	-3.4	-1.9	2.5	2.8	3.4	3.6	4.0
Exports goods and services	49.5	49.7	50.8	55.4	55.2	55.5	56.0
Imports goods and services	53.0	51.7	48.3	52.7	51.7	51.8	52.0
Balance of services	19.8	18.9	20.2	20.1	20.3	20.4	20.8
Balance of goods	-23.2	-20.8	-17.7	-17.4	-16.8	-16.8	-16.8
Balance of primary income	1.3	-2.8	-3.1	-5.3	-5.4	-5.2	-5.4
Balance of secondary income	-1.0	-1.0	-1.4	-1.5	-1.7	-1.7	-1.7
Memorandum item			*(EUR bn)*				
Nominal GDP	19.5	19.4	18.1	17.5	17.4	17.8	18.4

*Net of the one-off recapitalisation of the cooperative banking sector amounting to 8.6% of GDP in 2014.
Source: Commission services.

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

percent change unless otherwise stated	2011	2012	2013	2014	2015	2016	2017
1. Private consumption expenditure	1.8	-0.7	-6.0	0.4	0.6	1.1	1.2
2. Government consumption expenditure	0.7	-2.7	-4.9	-8.7	-2.3	-0.9	0.2
3. Gross fixed capital formation	-9.4	-20.7	-17.1	-18.8	0.2	3.6	4.0
4. Domestic demand excl. inventories	-0.7	-4.7	-7.5	-3.8	0.1	1.1	1.4
5. Changes in inventories (contr. to growth)	-1.4	1.0	-2.3	2.6	0.0	0.0	0.0
6. Domestic demand incl. inventories	-2.0	-3.8	-9.7	-1.2	0.1	1.1	1.4
7. Exports of goods and services	4.4	-1.6	-5.0	5.9	0.9	1.5	2.9
7a. - of which goods	14.7	0.1	-4.4	13.9	0.9	1.5	2.9
7b. - of which services	1.2	-2.2	-5.2	3.0	0.9	1.5	2.9
8. Final demand	0.0	-3.1	-8.1	1.2	0.4	1.3	1.9
9. Imports of goods and services	-0.6	-4.7	-13.6	8.1	0.3	1.0	1.8
9a. - of which goods	-3.2	-8.6	-14.8	9.4	0.3	1.0	1.8
9b. - of which services	5.2	3.6	-11.4	5.8	0.3	1.0	1.8
10. GDP at market prices	0.3	-2.4	-5.4	-2.3	0.5	1.4	2.0
(Contribution to change in GDP)							
11. Final domestic demand	-0.7	-4.9	-7.6	-3.8	0.1	1.0	1.3
12. Changes in inventories	-1.4	1.0	-2.3	2.6	0.0	0.0	0.0
13. Net exports	2.4	1.7	4.6	-0.9	0.4	0.4	0.7

Source: Commission services.

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

percent change unless otherwise stated	2011	2012	2013	2014	2015	2016	2017
1. Private consumption expenditure	4.9	2.3	-6.1	-1.0	-0.9	2.1	2.5
2. Government consumption expenditure	4.2	-3.6	-9.6	-13.0	-2.5	-0.7	1.8
3. Gross fixed capital formation	-10.7	-20.7	-17.4	-22.1	-0.6	5.1	6.0
4. Domestic demand excl. inventories	1.5	-3.0	-8.4	-6.0	-1.2	2.0	2.8
5. Changes in inventories (contr. to growth)	0.0	0.2	-0.2	0.2	0.2	0.2	0.2
6. Domestic demand incl. inventories	0.1	-1.8	-10.7	-3.7	-1.2	1.9	2.9
7. Exports of goods and services	6.1	0.0	-4.6	5.4	-1.0	2.7	4.3
7a. - of which goods	16.3	0.7	-2.4	15.4	-1.0	2.7	4.3
7b. - of which services	3.0	-0.2	-5.3	1.8	-1.0	2.7	4.3
8. Final demand	2.0	-1.2	-8.7	-0.6	-1.1	2.2	3.4
9. Imports of goods and services	1.6	-2.8	-12.6	5.3	-2.3	2.4	3.6
9a. - of which goods	-0.4	-6.8	-13.6	3.7	-2.3	2.4	3.6
9b. - of which services	6.0	5.6	-10.8	8.1	-2.3	2.4	3.6
10. Gross national income at market prices	7.5	-4.4	-7.0	-5.6	-0.9	1.6	2.8
11. Gross value added at basis prices	3.1	-0.6	-6.1	-4.2	-0.4	2.2	3.2
12. Gross domestic product at market prices	2.2	-0.4	-6.7	-3.4	-0.5	2.1	3.2

Source: Commission services.

Table A2.4: **Implicit deflators**

percent change	2011	2012	2013	2014	2015	2016	2017
1. Private consumption expenditure	3.0	3.0	-0.1	-1.4	-1.6	0.9	1.3
2. Government consumption expenditure	3.5	-0.9	-4.9	-4.7	-0.3	0.2	1.7
3. Gross fixed capital formation	-1.4	-0.1	-0.3	-4.0	-0.8	1.4	1.9
4. Domestic demand incl. inventories	2.2	2.0	-1.1	-2.4	-1.2	0.8	1.5
5. Exports of goods and services	1.7	1.7	0.4	-0.5	-1.9	1.1	1.3
6. Final demand	1.7	1.7	0.4	-0.5	-1.9	1.1	1.3
7. Imports of goods and services	2.2	1.9	1.1	-2.6	-2.5	1.4	1.8
8. Gross domestic product at market prices	2.0	2.0	-1.4	-1.2	-0.9	0.7	1.3
HICP	3.5	3.1	0.4	-0.3	-1.0	0.9	1.3

Source: Commission services.

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

Percent change unless otherwise stated	2011	2012	2013	2014	2015	2016	2017
1. Labour productivity	-0.1	1.9	0.1	-0.4	0.4	0.2	0.4
2. Compensation per employee	2.5	-0.8	-6.0	-4.7	-0.3	1.1	2.3
3. Unit labour costs	2.6	-2.7	-6.1	-4.2	-0.7	0.9	2.0
4. Total population	2.6	1.5	-0.2	-1.1	0.4	0.4	0.4
5. Population of working age (15-64 years)	2.9	1.5	-0.8	-0.1	-0.2	-0.2	-0.2
6. Employment	0.5	-4.2	-5.2	-1.9	0.1	1.2	1.6
7. Unemployment rate (1)	7.9	11.9	15.9	16.1	16.0	15.0	13.7

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

Table A2.6: **External balance**

EUR bn unless otherwise stated	2011	2012	2013	2014	2015	2016	2017
1. Exports of goods (fob)	2.5	2.5	2.4	2.8	2.8	2.9	3.0
2. Imports of goods (fob)	7.0	6.5	5.6	5.9	5.7	5.9	6.1
3. Trade balance (goods, fob/fob) (1-2)	-4.5	-4.0	-3.2	-3.0	-2.9	-3.0	-3.1
3.1 p.m. (3) as % of GDP	-23.2	-20.8	-17.7	-17.4	-16.8	-16.8	-16.8
4. Exports of services	7.2	7.2	6.8	6.9	6.8	7.0	7.3
5. Imports of services	3.3	3.5	3.1	3.4	3.3	3.4	3.5
6. Service balance (4-5)	3.9	3.7	3.7	3.5	3.5	3.6	3.8
6.1 p.m. 6 as % of GDP	19.8	18.9	20.2	20.1	20.3	20.4	20.8
7. External balance of goods and services (3+6)	-0.7	-0.4	0.5	0.5	0.6	0.6	0.7
7.1 p.m. 7 as % of GDP	-3.4	-1.9	2.5	2.8	3.4	3.6	4.0
8. Balance of primary and secondary incomes	0.0	-0.7	-0.8	-1.2	-1.2	-1.2	-1.3
8.1 - of which, balance of primary income	0.2	-0.5	-0.6	-0.9	-0.9	-0.9	-1.0
8.2 - of which, balance of secondary income	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3
8.3 p.m. 8 as % of GDP	0.3	-3.7	-4.5	-6.8	-7.1	-6.9	-7.1
9. Current external balance (7+8)	-0.6	-1.1	-0.4	-0.7	-0.6	-0.6	-0.6
9.1 p.m. 9 as % of GDP	-3.2	-5.7	-2.0	-4.0	-3.7	-3.3	-3.1
10. Net capital transactions	0.0	0.0	0.2	-1.6	-0.1	-0.1	-0.1
11. Net lending (+)/net borrowing (-) (9+10)	-0.6	-1.1	-0.1	-2.3	-0.8	-0.7	-0.7
11.1 p.m. 11 as % of GDP	-3.0	-5.5	-0.6	-13.1	-4.4	-3.8	-3.6

Source: Commission services.

Table A2.7: **Fiscal accounts**

	2011	2012	2013	2014	2015	2016	2017
			levels, EUR m				
Taxes on production and imports	2,711	2,722	2,491	2,615	2,591	2,590	2,730
Taxes on income and wealth	2,065	1,932	1,873	1,806	1,704	1,752	1,775
Social contributions	1,566	1,510	1,362	1,557	1,561	1,602	1,672
Other current resources	859	865	877	1,069	1,030	1,001	939
Total current revenue	7,200	7,028	6,604	7,048	6,886	6,945	7,116
Capital transfers received	12	11	6	5	6	6	6
Total government revenue	7,212	7,039	6,610	7,053	6,892	6,951	7,122
Compensation of employees	2,882	2,825	2,573	2,299	2,267	2,254	2,330
Intermediate consumption	871	811	744	655	620	625	611
Social transfers	2,630	2,606	2,509	2,576	2,592	2,606	2,581
Interest payments (1)	430	566	563	498	490	446	414
Subsidies	85	95	95	80	79	80	81
Other current expenditure	533	520	392	417	391	376	360
Total current expenditure	7,419	7,414	6,872	6,525	6,435	6,382	6,373
Total capital expenditure (2)	903	746	624	571	609	576	608
Total expenditure	8,334	8,169	7,501	7,097	7,048	6,963	6,985
General government balance, EDP	-1,070	-1,130	-891	-44	-156	-11	195
General government primary balance	-640	-563	-327	455	334	434	551
			% of GDP				
Taxes on production and imports	13.9	14.0	13.8	14.9	14.9	14.6	14.9
Taxes on income and wealth	10.6	10.0	10.3	10.3	9.8	9.8	9.7
Social contributions	8.0	7.8	7.5	8.9	9.0	9.0	9.1
Other current resources	4.4	4.5	4.8	6.1	5.9	5.6	5.1
Total current revenue	36.9	36.2	36.4	40.3	39.5	39.0	38.7
Capital transfers received	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Total government revenue	37.0	36.3	36.5	40.3	39.6	39.1	38.8
Compensation of employees	14.8	14.6	14.2	13.1	13.0	12.7	12.7
Intermediate consumption	4.5	4.2	4.1	3.7	3.6	3.5	3.3
Social transfers	13.5	13.4	13.9	14.7	14.9	14.6	14.0
Interest payments (1)	2.2	2.9	3.1	2.8	2.8	2.5	2.3
Subsidies	0.4	0.5	0.5	0.5	0.5	0.4	0.4
Other current expenditure	2.7	2.7	2.2	2.4	2.2	2.1	2.0
Total current expenditure	38.1	38.2	37.9	37.2	36.9	35.9	34.7
Total capital expenditure (2)	4.6	3.8	3.4	3.3	3.5	3.2	3.3
Total expenditure	42.8	42.1	41.4	40.5	40.5	39.1	38.0
General government balance, EDP	-5.5	-5.8	-4.9	-0.2	-0.9	-0.1	0.7
General government primary balance	-3.3	-2.9	-1.8	2.6	1.9	2.4	3.0
Nominal GDP	19.5	19.4	18.1	17.5	17.4	17.8	18.4

* Net of the one-off recapitalisation of the cooperative banking sector amounting to 8.6% of GDP in 2014
(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) For 2013, this includes compensation of pension funds amounting to 1.8% of GDP in 2013.
(2) 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

Table A2.8: **Debt developments**

	2011	2012	2013	2014	2015	2016	2017
EDP deficit (% of GDP)	-5.5	-5.8	-4.9	-0.2*	-0.9	-0.1	0.7
EDP gross debt (% of GDP)	66.0	79.5	102.2	107.5	106.4	98.4	93.5
			levels, EUR bn				
EDP deficit	-1.1	-1.1	-0.9	0.0	-0.2	0.0	0.1
Gross debt	12.9	15.4	18.5	18.8	18.5	17.5	17.2
Change in gross debt	2.1	2.6	3.1	0.3	-0.3	-1.0	-0.3
Nominal GDP	19.5	19.4	18.1	17.5	17.4	17.8	18.4
Real GDP	19.1	18.7	17.7	17.3	17.3	17.6	17.9
Real GDP growth (% change)	0.3	-2.4	-5.4	-2.3	0.5	1.4	2.0
			% of GDP				
Gross debt ratio	66.0	79.5	102.2	107.5	106.4	98.4	93.5
Change in gross debt ratio	9.5	13.5	22.7	5.3	-1.1	-8.0	-4.9
			Contribution to change in gross debt				
Primary balance	3.6	2.9	1.8	6.0	-1.9	-2.4	-3.0
Snow-ball effect	1.0	3.1	8.8	6.5	3.3	0.3	-0.8
of which							
Interest expenditure	2.2	2.9	3.1	2.8	2.8	2.5	2.3
Real growth effect	-0.1	1.6	4.6	2.4	-0.5	-1.5	-1.9
Inflation effect	-1.1	-1.4	1.2	1.2	1.0	-0.8	-1.2
Stock-flow adjustments	5.0	7.5	12.1	-7.1	-2.6	-5.8	-1.0

* Net of one-off recapitalisation cost of the cooperative banking sector amounting to 8.6% of GDP in 2014
Source: Commission services

ANNEX 3

Financing Needs and Sources

Table A3.1: **Estimated financing needs for the period 2015-2017**

cash data unless stated 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	1,434.2	121.1	152.1	834.6	102.6	1,281.9	340.1	6,247.7	1,606.6	1,933.3	2,371.2	1,492.6	420.2	787.3	2,232.0	1,727.4
among which:																						
domestic- (GRDS), foreign-law (EMTN) & CPB recap bonds	*0.0*	*1,416.9*	*47.0*	*1.0*	*243.9*	*91.0*	*1,351.6*	*55.5*	*146.6*	*794.1*	*17.6*	*1,216.6*	*332.4*	*5,714.2*	*1,464.8*	*1,742.1*	*2,175.0*	*1,055.9*	*287.4*	*19.6*	*1,453.1*	*896.0*
loans	*0.0*	*17.8*	*76.1*	*24.2*	*0.0*	*32.5*	*77.3*	*60.4*	*0.0*	*35.2*	*79.3*	*59.8*	*2.0*	*464.7*	*118.1*	*170.2*	*174.3*	*158.9*	*109.9*	*744.6*	*755.9*	*748.8*
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	0.0	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	7.8	54.3	100.9	175.9
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*	*7.8*	*54.3*	*100.9*	*175.9*
Financial sector recapitalisation	0.0	0.0	1,500.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1,500.0	1,500.0	0.0	0.0	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*	*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*
Fiscal financing needs /1	112.0	196.9	136.5	689.0	-9.5	-949.7	-8.3	23.3	15.5	-996.6	-11.3	-301.1	-476.2	-1,691.5	1,134.4	-944.2	-1,293.4	-1,628.7	-396.2	-523.5	-275.0	-271.4
memo items:																						
primary balance (in ESA terms)	*-53.1*	*86.5*	*-90.4*	*384.3*	*1,397.9*	*-85.7*	*-394.7*	*127.8*	*-93.0*	*-109.5*	*-284.0*	*152.1*	*-93.7*	*997.6*	*327.3*	*1,045.3*	*-334.4*	*-432.9*	*-550.3*	*-688.6*	*-715.0*	*-740.6*
interest (in ESA terms) /2	*159.5*	*106.2*	*173.9*	*123.8*	*124.5*	*68.9*	*177.1*	*127.7*	*111.2*	*104.9*	*191.6*	*82.5*	*126.1*	*1,518.4*	*563.4*	*498.2*	*490.2*	*445.5*	*413.7*	*418.7*	*467.9*	*487.3*
Programme financing needs /3	115.5	1,632.8	1,760.3	732.5	239.9	-821.1	1,425.9	144.4	167.6	-162.0	91.3	980.8	-136.1	6,056.2	4,125.5	989.1	1,077.7	-136.1	-	-	-	-
memo: total annual financing needs															*4,241.0*	*989.1*	*1,077.7*	*-136.1*	*31.8*	*318.1*	*2,057.9*	*1,632.0*

(1) This includes privatisation, market financing and other proceeds.
(2) This includes an annual interest saving of around EUR 20m 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) The net financing needs in Q2 2014 are reduced by the amount of EUR 850m, corresponding to proceeds of the market issuance. They are used in the following quarter to 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 credit 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 reforms

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. After the complete removal of all restrictive measures on 6 April 2015, the CBC, in consultation with the ECB, continues 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. Although the international environment remains challenging, overall liquidity has further improved. The government guarantees scheme for the issuance of bank bonds was prolonged until end-December 2015. If necessary to safeguard financial stability, the scheme can be usedin line with State aid rules.

1.2. The CBC will continue to receive the updated condensed capital and funding plans of core banks **on a quarterly basis**, and within two months of the end of each quarter, 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 resolution of non-performing assets, 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

1.3. The credit register is already operational for credit assessment purposes. The authorities will implement its use for supervisory and macro-prudential purposes, with a preliminary report **by end-September 2015.** The authorities will further expand the data elements held in the register and continue to improve data quality, with a view to facilitate the assessment of risk and credit supply decisions. They will furthermore investigate the creation of a credit scoring system available to banks and other creditors under sufficient safeguards and present an intermediate report **by end-December 2015**.

1.4 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, where relevant, financial indicators.

1.5 The authorities will study the financial situation of borrowers. The study will, among other things, assess the extent of strategic default, with the objective of improving the effectiveness of debt resolution policies. The preliminary findings of the study will be available **by end-October 2015** and final results will be published **by end-December 2015**.

1.6 The CBC will ensure it has sufficient staff to carry out its functions in full independence as stipulated by the Treaties. The CBC, taking into account the tasks undertaken in relation to these policy measures, new tasks following the creation of the SSM, and enforcement of the existing regulatory framework, has already assessed the staffing needs in the micro-prudential supervisory area and the recruitment process was completed. The authorities will assess by **end-October 2015**, the need for additional staff in order to ensure the functioning of the Single Resolution Board by 1 January 2016. In case staffing needs are identified, the recruitment should be finalised by **end-December 2015**. The needs in other business areas of the CBC have been reviewed and the recruitment process will be completed **by end-December 2015.**

1.7 Taking into account the formal letter of notice sent by the EC on 27 March 2015, the authorities will finalise without any further delay the transposition into national law of the

Bank Recovery and Resolution Directive. The authorities will also ensure as a matter of priority the transposition of the Deposit Guarantee Scheme Directive. The regulatory framework is being reviewed against European best practices and recent experience. In this context, **by end-November 2015,** banking regulations on loan origination will be further simplified.

Regulation and supervision of insurance companies and pension funds

1.8 The authorities will finalise without delay the transposition of Solvency II into national law. In order to streamline non-banking supervision, the authorities will prepare an action plan for the integration of the insurance sector supervision and the pension funds supervision. The options for improving the quality of the non-banking supervision and ensuring appropriate implementation of Solvency II and also for increasing the independence and improving the governance and administrative capacity of the non-banking supervision, taking into account international best practices, will be reviewed in a report to be prepared by the authorities, **by end-October 2015**. The report will set priorities for next steps, including an inventory of pension funds, their volume and composition of assets, type of pension scheme plan and composition of membership. A legislative proposal will be prepared taking into consideration the recommendations of the report and will be submitted to the House of Representatives **by end-January**.

Addressing corporate and household indebtedness

1.9 The Cypriot authorities will continue monitoring 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. The annual Financial Stability Report, to be published **by end-September 2015**, will include an extended analysis of corporate and household indebtedness. In addition, quarterly monitoring reports will continue to be submitted and their scope and content will be further enhanced.

1.10 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 improve data quality andreport **monthly** on restructuring progress and management of NPLs, using the agreed specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.) and 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), starting with September 2015 data.
- After CBC made available on its website a comprehensive and user-friendly guide on the practical application of the amended Arrears Management Directive, and of the Code of Conduct, continued effective compliance will be ensured.
- In order to allow distressed borrowers to make informed decisions and actively participate in resolving their situation, the authorities together with the Association of Banks, building on earlier work of the Central Bank, will create a consumer-friendly publication supported by an interactive website that explains the process of debt restructuring, including restructuring tools likely to be

proposed by banks, as well as insolvency and foreclosure processes, **by end-October 2015**.

- To ensure that banks offer a long-term sustainable restructuring solutions, the CBC will agree with banks and coops on institution- and portfolio-specific targets to be set for the various phases of the restructuring process on a quarterly rolling basis. For banks under the direct supervision of the SSM, these targets will be subject to prior consultation with the SSM and will be duly communicated to the banks and coops. Each quarter, and for the first time **by end-July 2015**, the CBC will publish these targets, on an aggregated basis and for the ongoing and following quarters together with the past performance of the banks and an explanation for any possible discrepancy between targets and actual performance, as well as for the revision of the targets.Based on the actual and targeted restructuring performance of banks, and relying on the programme's macro-economic projections, the CBC will, **by end-September 2015**, put in place a framework to analyse the estimated path of system-wide loan restructuring and recovery.
- Following the first reporting exercise, the banks and coops will continue to submit regularly to the CBC in the quarter following the reporting period the reports prepared by their external auditors on the effectiveness of their debt restructuring arrangements and strategies for the periods ending in December 2015, and June 2016. Relying on the finding of the reports, the CBC will assess the appropriateness of restructuring solutions including by peer comparison among the banks covered in these reports and submit to the SSM the findings and recommendations on the banks' internal policies and processes regularly.
- The Cypriot authorities, in view of financial stability considerations and on-going bank restructuring, commit not to introduce any new regulations which would interfere with the setting of bank lending rates. In particular no ceilings on bank lending rates would be introduced. Furthermore, the authorities will reassess **by end-October 2015** the recently adopted law entitled "The liberalisation of the interest rate and other related matters (amending) Law of 2015".
- **By end-December 2015**, the Ministry of Finance, in cooperation with the Central Bank, will seek to identify potential tax disincentives to debt restructurings for banks, other creditors and borrowers and propose necessary adjustments, while taking into account fiscal implications.
- In order to stimulate 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, while providing sufficient safeguards to the borrowers under the Code of Conduct. Banks and non-bank entities should be able to acquire loan portfolios with the possibility of outsourcing operations. Any information obligation of the creditor should not be an impediment for the transfer and/or securitization of loans. To this end, the authorities have carried out an assessment of existing impediments and of required legislative amendments. This assessment included a review of the regulatory framework for non-bank third parties and a Task Force on the removal of the impediments has been set up.

- the legislation on the sale of loans will be approved by the Council of Ministers **by end-July 2015** and by the House of Representatives **by end-September 2015**. As a matter of priority, the amendment to the Banking Law limiting the sale of loans to third parties will be repealed.
- The identified impediments to the securitisation of assets will be removed and a legal proposal enabling securitisation of assets, in line with international best practices and EU law, will be adopted by the Council of Ministers **by end-October 2015** with a view to be adopted by the House of Representatives in 2015.

<u>Legal framework for private debt restructuring</u>

1.11. All legal, administrative or other hurdles currently constraining the seizure and sale of loan collateral will 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.

1.12. Prior to the granting of the eighth disbursement of financial assistance the House of Representatives will adopt the legislation on solving the backlog of title deed transfers, which was submitted by the Council of Ministers in June 2015.

Moreover**, by end-September 2015**, the authorities will present to programme partners draft legislation for non-legacy cases that:

- ensure that property buyers who have paid the purchase price in full, will have their title deeds transferred without delay and if possible in one month after the application for transfer or after the issuance of the title;
- put obligations on all parties involved to ensure that the procedures releasing encumbrances and transferring the title can operate without delay and as automatically as possible; and
- provide safeguards against abuse, inter-alia by introducing a mandatory escrow account system that will ensure that all payments related to a property transaction are processed in a safe manner, at low operational cost and without delay.

By end-October 2015, the legislative proposals on non-legacy cases will be adopted by the Council of Ministers.

The authorities will propose further legislative and administrative measures necessary to incentivise the swift transfer of title deeds, including legal or contractual standards for property sales contracts and connected loan and mortgage arrangements **by end-October 2015.**

1.13. The authorities will monitor on a continuous basis the implementation and performance of the new insolvency framework and ensure that it supports its objectives and principles, notably speeding up the reduction in the stock of non-performing loans, and reflects international best practice. The authorities will conduct a comprehensive review of the private sector debt restructuring legal framework **by end-December 2015**, with an action plan of modifications to the framework to correct any remaining deficiencies. Necessary adjustments to the insolvency and foreclosure frameworks, including legislative changes, will be adopted by the Council of Ministers **by end-January 2016**. These adjustments will include:

- removing any impediments to the effectiveness of the procedures, including measures which could weaken incentives for non-viable debtors to promptly pursue debt restructuring,
- ensuring that the relief in legacy guarantees does not jeopardise the economic function of guarantees going forward and that the payment capacity of the guarantor is taken into account.

1.14 Most of the legal and institutional arrangements are in place in order to start the implementation of the new insolvency regime. Any necessary additional administrative acts and regulations will be adopted **by end-August 2015.** Amendments to the regulation regarding the liquidation of companies will be put in place **by end-October 2015.** The authorities will step up efforts in order to minimize the transition period and to ensure the full functioning of the Insolvency Service, including adequate staffing, IT infrastructure, and the availability of trained and licenced insolvency practitioners at the earliest possible. To this end, the action plan as submitted to program partners will be implemented**.**

1.15. Following the adoption of the regulation on the rules for sale by auctions, as required by the foreclosure law, any other measures, procedures or actions that may be required for the effective implementation of the law will be immediately implemented.

1.16. As further measures with regard to the legal framework for the restructuring of debt, the authorities will amend Court Rules for the foreclosure law **by end-July 2015**. The authorities will recommend and adopt amendments to Court Rules for the effective functioning of the new insolvency framework **by end-October 2015**. The recommendations and action taken by the authorities should also aim at improving the pace of court handling and the reduction of backlogs in courts.

1.17 Within the competencies of the Ministry of Justice and Public Order a consultation committee, comprising of all relevant stakeholders, will be established with the purpose of examining and making recommendations aimed at: (i) the enhancement of the efficiency of court applications in civil and commercial cases (ii) improved and speedier enforcement of court decisions in civil and commercial actions, inter alia, by improved powers for enforcement agents and (iii) enhancement of the availability of financial information to Courts and enforcement agents in the context of the enforcement of court decisions. The consultation committee will work in close cooperation with the courts service. Relevant amendments to the Civil Procedure Law and any other laws, if deemed necessary, will be adopted by the Council of Ministers **by end-March 2016**, following consultation with programme partners. The authorities will request appropriate technical assistance from the programme partners in this regard.

B. Restructuring of financial institutions

<u>Management of legacy Laiki</u>

1.18 The Resolution Authority has appointed an investment advisor to manage the sale of Laiki's foreign assets. A second advisor will be appointed **by end-October 2015** to manage the disposal of Laiki's stake in BoC.

<u>Restructuring of Bank of Cyprus</u>

1.19 BoC has progressed with the implementation of its restructuring plan and has continued divesting operations and stakes abroad. Moreover, 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.

<u>Restructuring and recapitalisation of cooperative credit institutions</u>

1.20 The Cooperative 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 As regards management of arrears, the Group will continue to ensure that all relevant units have an appropriate level of skilled and professional staff, including, at a first stage, redeployment of existing resources and, at a second stage, leveraging on external expert service-providers. The CCB will continue to 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. The increased capacity of the Group to manage NPLs by the NPL Management Division will be fully used and will translate in the improvement of objective and verifiable indicators. Based on the review of the sector's policies and operational capacity on debt resolution, which relied also on technical assistance from the IMF, the CCB has designed a time-bound plan for addressing the identified deficiencies and will implement it in a timely manner.

1.21 To streamline execution of tasks, governance will be strengthened, especially in the decision-making process by avoiding parallel structures, also relying on technical assistance from the IMF through appropriate changes. The CCB has designed an action plan for addressing the identified deficiencies. The CCB will make progress towards the centralisation of the control functions, namely risk, audit and compliance **by end-October 2015**, subject to approval of the supervisory authority. The CCB will ensure strict compliance of the individual CCIs with all its policies.

1.22 To ensure the implementation of the restructuring plan, the Group will continue to improve its management capacity and meet the employment targets according to the schedule communicated to the EC on 26 March 2015. An incentive scheme for the staff in order to accelerate the reduction in NPLs and debt recoveries, in line with State aid rules, will be considered.

1.23 The CCB will ensure the timely implementation of the time-bound action plan for addressing the deficiencies identified with respect to Financial Control and Reporting starting **by end-July 2015**.

1.24 Compliance with the relationship framework between the State and the CCBwill 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 relationship framework was amended on 29 May 2015.

1.25 The CCB in cooperation with the Management Unit of the Ministry of Finance will engage an external consultant **by end-October 2015** to review the organisational structure of the Group and to advise on all necessary steps, processes and procedures , in order to enhance its shareholder value and prospects.

1.26 To preserve 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.

C. Increasing financial transparency

1.27 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). The competent supervisory authorities are committed to take appropriate remedial and/or enforcement actions whenever breaches of compliance are revealed.
- 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. The CBC intends to swiftly take appropriate actions regarding the local branch of FBME Bank Ltd., following its July 2014 inspection and follow-up visits, and the final rule issued by the U.S. authorities in July 2015.

2. Fiscal policy

Key objectives

The sustainability of public finances is of overriding importance in order to maintain stability in the economy and confidence of companies, citizens and foreign investors in economic prospects of Cyprus.

In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation in order to achieve a 3% of GDP primary surplus in 2017, 3% to 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, in particular reducing 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 correct the excessive general government deficit by 2016; and (4) to maintain fiscal consolidation over the medium term, continuously meeting 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 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 and informing the ESM on the adoption of policies that are not included in this Memorandum but that could have a material impact on the achievement of programme objectives.

Fiscal policy in 2015

Based on the programme's updated budgetary projection, the Cypriot authorities will achieve a general government primary balance of at least EUR 334 million (1.9% of GDP) in 2015, corresponding to a headline balance of -0.9% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus).

The Cypriot authorities will closely monitor and report timely on the fiscal impact of amendments to tax laws that have been or will be adopted in 2015, including,

- the notional interest allowance for new equity, and
- the defence tax exemption for non-domicile tax residents.

Fiscal policy in 2016-18

In 2016 the Cypriot authorities will achieve a general government primary balance surplus of at least EUR 433 million (2.4% of GDP), corresponding to a headline balance of -0.1% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus).

The Cypriot authorities will achieve a general government primary balance of 3% of GDP in 2017 and 3% to 4% of GDP in 2018.

After review by and consultation with the programme partners, the 2016 Budget Law will be adopted **by December 2015**. Ceilings for the period 2016-2018 will be established and will accompany the 2016 Budget Law document. Any deviation from the budgetary objectives contained in the 2015-2017 framework will be properly documented and reasons for such deviations will be provided to the programme partners.

If required, the Cypriot authorities will present the programme partners with a provisional list of measures to attain the primary surplus targets in 2017 and 2018.

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 improve the efficiency and coverage of the healthcare system, while controlling 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:

- **By Q3-2015**, and taking into account the related WHO studies, the hospital autonomization bill will be adopted by the Council of Ministers and submitted to the House of Representatives;
- A detailed road map for the implementation of hospital autonomization will be submitted to programme partners **by Q3-2015**;
- **By Q3-2015**, the detailed restructuring plan of the public primary healthcare centres will be prepared for consultation with programme partners, based on the recommendations put forward in the respective report;

- The authorities will continue delivering quarterly reports assessing the collection of private co-payments and compulsory health-care contribution for public servants and public servant pensioners.

- The Implementation Advisory Team will, in close cooperation with the Support Group for Cyprus, assist the Ministry of Health with the implementation of healthcare reforms and hospital autonomization. Further, the Cypriot authorities will consult in a timely manner with programme partners and provide all necessary information.

Taking into account the economic conditions, the implementation of the necessary complementary reforms, the results of the updated actuarial study, a National Health System (NHS) will be implemented to be fully in place in **2017**.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. NHS will be initially based on a single payer system. A multiple insurance system can be implemented if and when the necessary preconditions for achieving fiscal sustainability as well as efficiency and affordability gains (i.e. consumer information and transparency, contestable markets, freedom to contract, competition regulation and risk-adjustment) can be ensured. The authorities will take a decision on the final design of NHS and adopt the relevant legislations according to a timetable that will ensure implementation of the NHS in 2017. In order to ensure that the final design of the NHS is fiscally sustainable, the Council of Ministers will adopt, after consultation with programme partners, a binding set of contingency measures under NHS (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), which will ensure that the agreed budget limits of public health expenditure are not exceeded, whilst equitable access to healthcare is guaranteed.

<u>Public financial management</u>

3.3. The Cypriot authorities will:

- Improve further the risk-assessment analysis and management, associated with government guarantees. To this end, the Cypriot authorities will update **by October 2015-2015** the risk assessment report, taking into account methodological recommendations from technical assistance provided by the ESM;

- Approve the action plan for strengthening sound practice standards for the Public Debt Management Office **by September-2015**, and continuously implement this plan;

- Issue guidelines for public investment management, including project appraisals in line with the FRBSL provisions **by July-2015**. 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</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 October 2015**. 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.**

<u>Privatisation</u>

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 enhance 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. Privatisation will be conducted in conformity with State aid rules, as required by the Commission's Guidance Paper.[10]

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

- ensure that the Privatisation Unit is fully operational, in line with the objectives and provisions of the Privatisation Law;

- for the privatisation of Cyprus's Telecommunications Authority (CyTA):

    - convert CyTA into a Limited Liability Company through the adoption of the legislation for CyTA's corporatisation by the Council of Ministers **prior to the granting of the eighth disbursement of financial assistance**. This legislation will be adopted by the House of Representatives **by October 2015**;

    - in parallel, prepare, through the Inter-Ministerial Committee, and on the basis of the recommendations of the advisers, the privatisation structure and the transaction strategy, including the envisaged ownership structure.

- for the concession of Limassol Port's commercial activities:

[10] http://ec.europa.eu/competition/state_aid/studies_reports/swd_guidance_paper_en.pdf

- following the expression of interest, select the pre-qualified bidders **by August 2015**;
- launch the tender **by October 2015**, in order to receive all binding offers **by December 2015**;
- select the final bidder, sign the concession agreement, and have the transaction approved by the House of Representatives **by March 2016**;
- establish CPA's newly-adopted regulatory framework **by November 2015**, after consultation with programme partners, and notification to the relevant European Commission services;

- for the privatisation of the Electricity Authority of Cyprus (EAC):
  - submit the study on the unbundling and ownership structure of EAC for consultation with programme partners **by November 2015**, including an interim report **by September 2015**. The interim report will be presented to the Council of Ministers in order to inform the Government's preliminary position. The study will comprise an international benchmarking, including cost structures of comparable electricity companies operating in a similar environment;
  - taking into account the study, and in consultation with programme partners, the Council of Ministers will decide, by December 2015, on a form of effective and efficient unbundling, in line with the principles of the Third Energy Package, which ensures the customer's free choice of supplier and guarantees non-discriminatory access to energy networks to the benefit of suppliers and customers. This unbundling will be implemented by Q1-2016. The Council of Ministers' decision will take into account the overall impact on the economy and the economic efficiency gains of the unbundling of EAC's operations into different legal entities.
- for the sale of land assets:
  - adopt the plan with detailed intermediate steps and timings for disposing of the identified land assets **by October 2015**.

The privatisation plan identified by the Government after consultation with the programme partners will raise at least EUR 1 billion **by the end of 2016** and an additional EUR 400 million **by 2018 at the latest**, which will be used for public debt reduction.

Revenue administration, tax compliance, and international tax cooperation

3.6. 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.

Based on the comprehensive compliance strategy developed, the authorities will ensure its implementation **by Q4-2015**, and continue to develop thereafter. 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, as demonstrated in a risk analysis report due **by Q3-2015**. To this end, the authorities will

- implement their new debt collection action plan, with a view to reducing collectible and unencumbered debt, while continuing the pilot run on garnishing of bank accounts, and prepare the next quarterly progress report on the action plan's implementation **by Q3-2015**; and
- implement the action plans by each of the headquarter units in the Design and Monitoring Division, outlining the steps to implement the compliance strategy in the Tax Department, including training of staff, and prepare a progress report **by October 2015.**

To progress with the operationalization of the integrated and function-based tax agency, in line with the adopted integration plan, the following steps will be taken:

- **by Q3-2015**, a single registration process will be put in place; and
- the new tax procedure code, consistent with the compliance strategy and future business processes, will be submitted for legal vetting **by end-October-2015** and adopted by the Council of Ministers **by Q4-2015**.

There currently exist significant backlogs in the assessment of tax returns by the Cyprus Tax Department. The authorities will prepare a report **by end-October 2015**, in which they will quantify the payable taxes and refunds and propose an action plan to significantly reduce the backlogs.

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 continue enhancing 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;
- 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 Q4-2015**; and
- building on the corrective action already taken, continue with the swift implementation of the commitments taken with a view to reversing the negative opinion by the OECD Global Forum in the Global Forum annual plenary meeting.

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 imposed on paying agents for their application of the EUSD. **By Q4-2015**, the Cypriot authorities will provide to the European Commission a report on the results of audits of at least 4 out of the total of 16 paying agents established in Cyprus. The Cypriot authorities (CBC) will provide on an annual basis detailed sectoral deposit statistics with a breakdown of non-resident deposits by country; the statistics for 2015 are due **by Q1-2016**.

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:

- **By end-October 2015,** adopt the legislation on the reformed recurrent immovable property tax with effect **from January 2016,** based on the most updated General Valuation for all immovable properties. The new immovable property tax should be based on the recommendations of the study on the consolidation of property taxes, should ensure a broad tax base and should be fiscally neutral, taking also into account the reduction of the transfer fee. The amendments to the IPT legislation will be submitted for timely consultation with programme partners.
- adopt **by mid-October 2015,** legislation specifying the frequency of the mandatory update of the cadastral values to three years maximum from 2018 onwards,;
- continue the assessment of the relevance of the parameters used in the Computer Assisted Mass Appraisal (CAMA) model for the General Valuation, on a quarterly basis**.**

Public administration reform

3.9. The Cypriot authorities have commissioned and will commission reviews of possible further reforms of the public administration. The reviews include a horizontal and a sectoral element.

Based on the findings of the horizontal review submitted in 2014, the Cypriot authorities will prepare a reform plan, which will be based on the following principles:

- safeguard the fiscal sustainability of the public sector wage bill and the consistency with the medium-term fiscal targets. This will be ensured by reforming the wage setting mechanism and make salary increases subject to overall economic and fiscal conditions on the basis of objective indicators. The mechanism will ensure that the compensation of employees in the general government as a share of GDP will remain on a descending path over the medium-term.

- introduce a new appraisal system and a new promotion system that will establish a stronger link between merit and promotion by: (i) widening the base of eligible candidates, (ii) increasing the weight of merit in promotion decisions, including by introducing objective assessment criteria, written exams and/or assessment centres, and (iii) by involving more directly the Heads of Departments in promotion decisions;

- enhance staff mobility, by: (i) opening the promotion posts to the wider civil service, (ii) introducing a system of transfers within the public sector, (iii) a wider use of secondments and duty assignments, and (iv) ensuring that mobility is taken into account in the assessment of relevant experience in promotion decisions.

With a view to the reform being adopted by the House of Representatives in 2015, the legal proposals based on the reform plan will be adopted by the Council of Ministers **prior to the granting of the eighth disbursement of financial assistance**.

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 will comprise two batches:

- the first batch has consisted of the review of the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies. The relevant legislation in relation with the reforms in Agriculture, Education, and local government indicated as high priority will be adopted by the House of Representatives **by October 2015** for implementation **in 2016.** For the local governments, an implementation plan including concrete timelines and milestones will be amended by the Ministry of Interior **by September 2015**, after consultation with the programme partners for further discussion with the local governments and other stakeholders. The restructuring plan of the Companies Registrar will be finalised **by January 2016** and will start to be implemented **by March 2016**.

- the second batch covers 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 (former Planning Bureau) being covered under the PFM. The second batch includes also all SOEs, as well as the Constitutional and Independent Services (see Annex for detailed list). The results of the second batch will be presented **by December 2015** for all, except for the Constitutional and Independent Services, which will be presented **by March 2016**.All results will include 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 March 2016**, except from the Constitutional and Independent Services, which will be approved by the Council of Ministers **by May 2016.** The relevant legislation in relation with the reforms indicated as high priority will be adopted by the House of Representatives **by June 2016**. The reform will start to be implemented **by September 2016**, in accordance with the reform plan.

Welfare system

3.10. The Cypriot authorities introduced a Guaranteed Minimum Income (GMI) aimed at strengthening the protection of vulnerable households while ensuring an appropriate balance between welfare benefits and work incentives. Besides the introduction of the GMI, the adopted welfare reform plan also includes measures aimed at consolidating and streamlining other social benefits, and at improving the targeting of these benefits.

To continue the implementation of the adopted welfare reform and monitor the implementation of the GMI, including its fiscal impact, the Cypriot authorities will take the following steps:

- the monitoring unit will continue providing quarterly costing updates of the GMI, at the end of each quarter, next update due **in Q3-2015**;
- **by mid-October-2015**, prepare for consultation with programme partners, plans to provide a unified legislative and administrative framework for all disability benefits, in line with the adopted welfare reform and consistent with the achievement of the medium-term budgetary targets;
- the House of Representatives will adopt **by October 2015** and after consultation with programme partners, the legislation consolidating the student grant, the student package and the benefits previously administered by the Cyprus Scholarship Foundation into one scheme, with a view to implementing the single scheme for the academic year 2015-2016;
- **by Q3-2015**, the monitoring unit will provide an assessment report of the GMI and an analysis of the profile and coverage of beneficiaries;
- on the basis of a single view on social benefits under various ministries, drawing on their respective registries of benefits, **by Q1-2016**, the monitoring unit will finalize an assessment report of the welfare reform, including possible refinements in administrative structures and benefits.

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. Any legislative changes affecting existing conditions of employment or wages, will be shared for consultation with programme partners.

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. Wage indexation has been suspended in the private sector until end-2016. A tripartite agreement will be pursued with social partners by Q4-2015to ensure that the reformed wage indexation system (COLA) applicable to the public sector (lower frequency of adjustment, suspension at times of recession and partial indexation) is also adopted by the private sector when the period of COLA suspension ends.

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 continuethe implementation of measures to address the identified shortcomings of the system of activation policies, including:

- continuous monitoring and evaluation of all activation measures, in accordance with the newly adopted comprehensive methodology. A first report on the implementation of the monitoring system will be prepared for consultation with programme partners **by Q4-2015**;
- measures to enhance the administrative capacity of the public employment services. In this regard, as follow-up to the description of all actions taken or envisaged in the short-term to improve the provision of PES services prepared for consultation with programme partners**,** the project fiche for the enhancement of PES under the ESF 2014-2020 Operational Programme will be finalised **by Q4-2015,** subject to the availability of the template and guidelines**.** The draft fiche will be shared with program partners for consultation, prior to submission to the managing authority. In addition, the tender for the recruitment of additional staff, through the 2014-20 ESF Operational Programme budget, will be launched **by Q3-2015**, and all staff will be operational **by Q4-2015**; and
- 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. A comprehensive note detailing the concrete measures undertaken in this regard, covering steps to avoid welfare dependency, and the links with social welfare services, will be prepared for consultation by program partners **by Q3-2015.**

4.5. Having experience one of the steepest increases in the youth unemployment rate in the EU, and a rapid rise of young people not in employment, education or training (NEETs), Cyprus was urged to take swift action to create employment opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities have recently adopted a National Action Plan for Youth Employment, which includes, inter alia, measures envisaged for support under the Youth Employment Initiative covering 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 update for consultation with programme partners the comprehensive list of all active labour market policies for the period 2015-2017, including objectives, target group, recipients per year, budgetary allocations, and call dates, **by Q3-2015**.

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. On the basis of the comprehensive review of requirements affecting the access and exercise of activity of the regulated professions sector, the elimination of unjustified requirements for the specific case of engineers remains subject to close monitoring and possible further actions by the Commission, so as to ensure compliance with EU law.

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 ensure that:

- the title deed issuance backlog of immovable property units from development projects pending[11] for more than six months drops to less than 3,500 units **by Q4-2015** To that end, the Cypriot authorities will continue to provide to programme partners analytical data on the stock of backlogs of permits, deeds, certificates, and mortgages associated with the underlying properties and continue publishing the quarterly progress reviews. From January 2016 onwards, at least 3,000 pending titles will be issued per month to reduce the backlog on remaining projects.
- **by end-September 2015**, the House of Representatives will adopt 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;
- the working group on title deeds issuance will continue their review of all procedures from the planning permit application to the issuance of title deeds. **By end-September 2015,** the Cypriot authorities will submit for consultation with programme partners a report detailing the main obstacles for the issuance of title deeds and required certificates. The report with recommendations on ways how to speed up issuance in 2015, will include any necessary draft legislation or other administrative measures, including a catalogue of non-tolerated deviations from permits, in order not to impede title deed transfer. Moreover, the report will assess the scope for self-certification and provide recommendations on further comprehensive streamlining of building, planning and title deed procedures from 2016.

Tourism

5.4. Since tourism is one of Cyprus' largest economic sectors and a potential driver of future growth and employment, a reinvigoration of its competitiveness is necessary as part of the Action Plan for Growth. To that end, the Cypriot authorities will:

- present a progress report on the implementation of the tourism sector's action plan every **March** and **September** in 2015-16;
- provide a first draft of the assessment of the current regulatory framework governing the tourism sector (including the CTO law), in order to identify the

[11] Development projects refer to original titles with at least three contracts of sales deposited at DLS; pending refers to (i) applications for title deeds issuance, (ii) units that are eligible for the "ex-officio" issuance of title deeds, required certificates and permits.

impediments to competition in the tourism sector **by September 2015.** The assessment will be based also on the views of the established thematic stakeholder groups and in consultation with programme partners. All relevant legal amendments will be drafted **by December 2015** and will be adopted by the Council of Ministers **by February 2016**;

- in order to prepare a national tourism strategy, the authorities will select the consultant to conduct a study **by August 2015**. An interim report will be submitted for consultation to the programme partners **by November 2015**, with a view to conclude it **by March 2016**;
- continue implementing an aeropolitical strategy leading to the adaptation of Cyprus's external aviation policy, taking into account the EU external aviation policy and the EU aviation agreements, while ensuring sufficient air connectivity. The corresponding action plan 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 Q3-2015.**

  Prior to approving the Field Development Plan (FDP) of the Aphrodite gas field, the Cypriot authorities will undertake a financial and budgetary impact analysis of the FDP. The impact assessment will evaluate in detail the potential financial and budgetary impacts on the general government position as well as financing arrangements of the investment project chosen, with a particular focus on budgetary commitments that may arise;

  2. a comprehensive outline of the regulatory regime and market organisation for the restructured electricity and gas sector, with a view to introducing open, transparent, competitive energy markets. The outline was provided by Q4-2014 and lays out different options for the regulatory regime and market organisation. Based on this document, the Cypriot authorities will take a decision on the preferred option, taking into account the latest developments and the envisaged timeline for EAC unbundling. The Cyprus authorities will also provide to programme partners an analysis of the cost price of different sources of renewables compared to conventional primary energy sources (**by Q3-2015**).

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, 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 are provided for in the FRBSL, but will be detailed in implementing legislation of FRBSL, which will be submitted to the House of Representatives **by Q4-2015.** The resource fund law, which defines the governance structure of the resource fund, will be submitted to the House of Representatives **by Q3-2015**.

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 2015**. 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 Structural Reform Support Service.

7. Growth Strategy

7.1. Cyprus is developing a Growth Strategy in order to identify existing bottlenecks and key drivers of growth, based on the country's comparative advantages, and to provide concrete recommendations to support growth, including ways to improve the business environment. The strategy will be designed and implemented in conjunction with national stakeholders and in line with the country's National Reform Programme. To this end, the authorities will present an updated progress report to programme partners **by December 2015**, reflecting the progress in implementing the Presidency’s Action Plan for Growth. The following specific initiatives of the Government as included, among others, in the Action Plan for Growth, will be approved by the Council of Ministers:

- a Policy Framework for Facilitating Strategic Investments, including fast-track administrative procedures, **by December 2015;**
- an Action Plan for Smart Regulation **by October 2015;**
- a National Policy Statement on Entrepreneurship **by November 2015.**

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.	Compliant
		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.	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.	Compliant
		1.3.2. CBC to ensure that financial institutions have sound and effective systems and measures including updated CDD measures.	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.	Compliant
		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.	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).	Compliant
		4.1.2. In the case of nominees, either a) require nominee directors[12] and nominee shareholders to disclose the identity of their nominator to the company and to the company register; or b) require that all nominee directors and nominee shareholders be authorised or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of	Compliant

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

		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.	Compliant
		4.2.2 Ensure the department of the registrar is appropriately resourced.	Ongoing
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	**<u>Supervision of financial institutions</u>**		
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,[13] in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Compliant
		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.[14] 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.[15]	Compliant

[13] in accordance with BCP 2 and FATF 26-27
[14]FATF Immediate Outcome (IO) 3
[15]See BCP 2.6c

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,[16] 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); - monitoring of transactions; - identification and reporting of STR; - funds transfers; - correspondent banking; - recordkeeping; - compliance function; - internal controls; - audit functions; - corporate governance; - risk assessment systems	Partially compliant Q3 - 2015
		5.4.2 Provide CBC supervisory staff with ongoing training to ensure adequate knowledge of risks and supervisory techniques.	Ongoing

[16] 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).

5.5	**Implement adequate supervision**	5.5.1.a. CBC to establish corrective actions and follow-up on the cases revealed by Deloitte.	Compliant
		5.5.1.b. Apply appropriate enforcement actions with regard to any breaches of compliance, and apply sanctions if applicable.	Compliant
		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. Subsequent to the successful development of the tools stipulated under 5.2 and 5.3, the CBC will undertake the following:	Ongoing
		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.	Compliant
		5.5.3.2 Assign institutional ML/TF risk profiles to financial institutions reviewed under the pilot exercise.	Compliant
		5.5.3.3 Develop customised supervisory strategies for financial institutions reviewed under the pilot exercise.	Compliant
		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
		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.	Compliant
		5.5.4.2 CBC to update the institutional risk profile and supervisory strategy based on the results of the pilot inspection.	Compliant
6.	**<u>Supervision and monitoring of lawyers, accountants and TCSPs</u>**		
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**	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	Compliant

	implementation	inherent ML/TF risks, as identified and measured; - risk profiles; - specific AML/CFT monitoring strategies (adapted to institutional risk profiles).	
		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.	Compliant
		6.2.2.2 Assign ML/TF risk profiles to businesses and professionals reviewed under the pilot exercise.	Compliant
		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
6.3	**Develop risk-based tool(s) for Onsite inspections prior to implementation**	6.3.1 Design and develop a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: - Risk Assessment Systems - Policies & Procedures - Compliance Function - Training Program	Compliant
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
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:	Compliant

	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 2015	
	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.	Compliant

Annex 3

The Public Administration Review: Second Batch of Studies

The second batch of studies will cover the following areas:

Ministries and the Departments/Services falling under each Ministry

Ministry of Labour, Welfare and Social Insurance

Ministry of Transport, Communications and Works

Ministry of Energy, Commerce, Industry and Tourism (excluding the Companies Registrar and Official Receiver, to be covered in the first batch of studies)

Ministry of Interior

Ministry of Defence (excluding the National Guard and Cyprus Army)

Ministry of Justice and Public Order

Ministry of Foreign Affairs

Note: Ministry of Finance, including Treasury and the Directorate General for European Programmes, Coordination and Development (formerPlanning Bureau), is being reviewed under the PFM.

Constitutional Powers/Services

Law Office

Audit Office

Public Service Commission

Independent Services/Authorities

Educational Service Commission

Internal Audit Service

Office of the Commissioner for Administration (Ombudsman)

Office for the Commissioner of Personal Character Data Protection

Tender Review Body

Refugee's Review Body

Cyprus: Letter of Intent

Nicosia, September 4, 2015

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington DC

Dear Ms. Lagarde:

In the attached update of the Memorandum of Economic and Financial Policies (MEFP), we describe progress and policies toward the objectives of the economic program of the Cypriot government, which is being supported by an arrangement under the Extended Fund Facility.

Our program, underpinned by the firm commitment of the authorities, is bearing results and laying the ground for sustained growth, increased employment, and improved living standards for the Cypriot population. The economic recovery that started in early 2015 has continued, despite a challenging external environment. The financial situation of the three largest banks has strengthened, with encouraging evidence that loan restructuring is proceeding at a faster pace. Fiscal performance has exceeded expectations and, as a result, we have met all end-June and continuous performance criteria (PCs). Despite some delays, we have also made significant progress on the program's structural reform agenda, with all but one of the structural benchmarks implemented in full. The sole exception was the end-June SB related to adoption by the Council of Ministers (COM) of legislation to accelerate the transfers of title deeds. This legislation, which has already been adopted by Parliament, focuses only on legacy cases. Legislation to address title deed transfer in non-legacy and new property transactions will be adopted by the COM by end-October.

Looking forward, in support of our program objectives,

- In the financial sector, we will continue to prioritize addressing the high level of NPLs. Following on the reforms to date, we will make the private debt restructuring framework fully operational, including by tackling the current backlog of unissued and un-transferred title deeds, monitoring the implementation of the new insolvency and foreclosure frameworks on an ongoing basis and further improving them as needed. We will also continue to strengthen financial sector supervision and the tools to enforce the restructuring of loans by the banking system. We are vigilant of potential external spillovers and are ready to take measures, if necessary.
- We will continue to pursue a sound fiscal policy that supports growth while improving the public debt position.

- We will advance on our structural reform agenda, notably on tax administration, the management of fiscal risks, and public administration reform. We will also move forward on critical growth-enhancing reforms, including the privatization program.

Financing of our program remains adequate, and based on the above, we request the following:

- Completion of the eighth review under the EFF arrangement and the purchase under this arrangement in the amount of SDR 99 million.
- Modification of performance criteria for end-September and end-December 2015.
- Establishment of new or modified SBs (Table 2).

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

Sincerely,

/s/	/s/
Harris Georgiades	Chrystalla Georghadji
Minister of Finance	Governor of the Central Bank of Cyprus

Cyprus: Memorandum of Economic and Financial Policies

A. Recent Developments and Outlook

1. **Economic performance continues to exceed expectations.** Economic indicators point to a moderate expansion in the second quarter of 2015, following positive growth in the first quarter after almost four years of recession. The recovery continues to be led by professional services and tourism and, on the demand side, private consumption. There have been no appreciable spillovers to the real economy from events in Greece. However, the unemployment rate is still high, hovering at around 16 percent. Prices continued declining through June, largely reflecting declines in the energy and tourism sectors. The three largest banks continue on the path to normalization and sovereign debt yields have declined further, benefitting from purchases by the Eurosystem under the Public Sector Purchase Program started in July.

2. **We continue to expect a gradual economic recovery**. Reflecting the continued positive momentum in the second quarter, we have revised our growth forecast for 2015 to 0.5 percent (from 0.2 percent). Arrivals from other origins are expected to largely offset the negative impact on tourism from a weak Russian economy, while the favorable performance of the business services sector is anticipated to continue. On the demand side, investment and private consumption are now expected to be somewhat stronger, supported in part by new bank credit. For the years ahead, the forecast remains unchanged; growth is projected at 1.4 percent in 2016 and around 2 percent thereafter, supported by a gradual recovery of private consumption and investment. Accordingly, we expect a gradual decline in unemployment. We now project inflation to be slightly more negative this year at -1 percent and return to positive territory in 2016. The outlook is subject to positive and negative risks. On the external front, direct spillovers from Greece are expected to remain contained given reduced trade links, while we continue to closely monitor links through the financial sector. There could be also indirect effects through confidence and EU external demand. A positive impact of euro depreciation on exports, further compression of yields due to the ECB's quantitative easing, and a milder contraction in Russia than assumed constitute upside risks. On the domestic front, slower than expected cleanup of NPLs and the ensuing impact on private sector balance sheets and credit growth could stymie the recovery.

B. Financial Sector Policies

Addressing High NPL Levels

3. **We remain committed to addressing the high level of NPLs in our banking system as a matter of priority.** The NPL ratio of the core domestic banking sector has stabilized, remaining at 59 percent at end March. We continue to attack this problem from three fronts, aimed at encouraging voluntary debt restructuring and increasing the pace of durable solutions, with the ultimate objective of expediting the cleanup of private sector balance sheets and reviving credit growth. First, we are taking steps to ensure effective implementation of the recently established foreclosure and insolvency regimes. Second, we continue strengthening the enforcement of supervisory tools for arrears management. Finally, we are revising the legislation

to facilitate banks' disposal of distressed assets. To enhance public awareness on this subject, by end-September 2015, we will issue, in collaboration with the Association of Banks, a consumer-friendly publication and launch an interactive website to explain the process of debt restructuring, including tools likely to be used by banks and the insolvency and foreclosure processes.

Legal Framework

- **Foreclosure and insolvency regimes.** The effective implementation of the adopted legal frameworks is organized along two broad workstreams. First, we are taking the actions needed to fully operationalize the new frameworks. Second, we are identifying and will make adjustments to the frameworks, including through any necessary amendments to the legislation.

    - **Implementation.** To facilitate implementation of the foreclosure framework and allow the courts to process cases on a timely basis, we revised the relevant court rules in July. With respect to the insolvency regime, we have established the new Insolvency Service, which centralizes the administration of the new framework, including by appointing staff and making it possible to initiate insolvency procedures. We have also put in place the processes to license insolvency practitioners and have started granting licenses. Moreover, we have adopted all administrative acts and regulations needed to ensure the functioning of the insolvency regime (end-August **structural benchmark**). We will prepare and implement an action plan for capacity building for the actors responsible for the implementation of the insolvency framework, including the courts. This will include training and the development of standardized materials. Going forward, by end-October 2015, we will review the relevant court rules to ensure that they facilitate effective functioning of the new insolvency processes and reduce the courts' workload, seeking to increase court capacity to process cases on a timely basis. With the aim of improving the efficiency of court processes and post-court enforcement, by end-March 2016, the Council of Ministers, following consultation with relevant stakeholders and program partners, will adopt amendments to the Civil Procedure Law and any other relevant laws, including to (i) limit interim applications and interlocutory measures in line with international best practices; and (ii) increase the availability of information on debtors' financial situation.

    - **Framework review.** To ensure that the new insolvency framework achieves its objectives, we will monitor its performance on a continuous basis and make adjustments as needed. By end-December 2015, we will conduct a comprehensive review of the private sector debt restructuring legal framework with an action plan for modifications to the framework to correct any deficiencies. Building on the recent changes, the review will also seek to identify potential tax disincentives to debt restructuring for banks, other creditors and borrowers and propose necessary adjustments, while taking into account fiscal implications. On the basis of the review, by end-January 2016, the Council of Ministers will adopt any necessary adjustments to the insolvency and foreclosure frameworks (**modified structural benchmark)**. This will include (i) removing any impediments to the effectiveness of the procedures, in particular, the possibility of debtors to apply to the court for suspension of enforcement without any obligation on the part of the debtor; and (ii) ensuring guarantors are not shielded from their payment obligations without due regard to their payment capacity.

- **Title deeds.** We are taking steps to address the backlog of immovable properties that were purchased without proper transfer of title to, *inter alia*, restore the smooth functioning of the property market. In June, the Council of Ministers adopted legislation ensuring that for legacy cases the ownership of titles reflects the economic ownership of the property (**existing structural benchmark**), and the legislation was adopted by parliament in early September. It provides for the swift transfer of titles and the release of encumbrances, while providing safeguards against abuse and a rule-based mechanism aimed at treating buyers, sellers, and holders of collateral in an equitable manner taking into account compliance with their obligations related to the property transaction and enabling adequate compensation, if available. To ensure that the ownership of titles reflects the economic ownership at all times, by end-October 2015, the Council of Ministers will approve legislation to deal with non-legacy and new property transactions (**new structural benchmark**). The legislation will enable swift transfer of titles once the purchase price has been paid in full, the release of encumbrances, and a system of escrow to ensure the safety of payments. By end-October 2015, we will present to program partners legal or contractual standards for property sales contracts and connected loan and mortgage arrangements. We will also propose further legislative and administrative measures necessary to incentivize the swift issuance and transfer of title deeds.

Banks' arrears management

- ***Debt resolution reporting and targeting.*** To encourage banks and coops to reduce NPLs and ensure continuous monitoring, the CBC has agreed with banks and coops on institution- and portfolio- specific targets for the various phases of the restructuring process for two quarters ahead. The aggregate targets and performance against them during the last quarter have been published (end-July **structural benchmark**). The results show that the pace of restructurings has increased substantially, although we will continue monitoring the sustainability of the solutions. The data quality and coverage of our supervisory reporting framework for NPLs and restructuring will be improved further by requiring banks to submit monthly data in line with specific requirements starting with September data.

- **Projected performance of loan restructuring**: Based on the actual and targeted restructuring performance of banks, the new debt restructuring legal framework, and the program's macroeconomic framework, the CBC will, by end-September 2015, analyze the estimated path of system-wide loan restructuring and recovery. We will also continue to study the financial situation of borrowers to inform macro-prudential policies and to further adjust the loan restructuring strategy. The CBC will have preliminary findings available by end-October 2015, with the aim of publishing final results by end-December 2015.

- ***Supervision of bank's management of problem assets***. The CBC needs to strengthen its capacity and skills to effectively supervise the banks' problem assets policies and operations, including with the support of external expertise.

Disposal of distressed assets

- ***Secondary market for loans.*** To facilitate the transfer of existing loans, the Council of Ministers approved a draft law to enable the sale of loans in line with CBC directives while retaining the protections of borrowers offered under the Code of Conduct. The law will be adopted by Parliament by end-September 2015 (**new structural benchmark**). In addition, the Council of Ministers will adopt by end-October 2015 draft legislation to remove existing impediments to the securitization of assets. The bill includes, inter alia, the removal of the requirement to obtain prior consent of borrowers and any changes to the tax system deemed necessary. The law will be adopted by Parliament by end-December 2015 (**new structural benchmark**).

Restructuring of the Cooperative Credit Sector

4. **We continue making progress with the restructuring of the coops sector.** Building on the thorough restructuring already undergone by the sector, our actions remain focused on strengthening the sector's capacity, including by speeding up loan restructuring. To this end, work is proceeding on the following areas:

- ***Governance.*** We have modified the organizational structure of the Cooperative Central Bank (CCB), taking into account the regulatory obligations and the SSM's views, with the aim of streamlining the responsibilities of the CCB's divisions. To strengthen the oversight of the CCB over the Cooperative Credit Institutions (CCIs), in June, we amended the affiliation directive. Going forward, we will continue to increase the efficiency and to simplify the structure of the sector. To this end, by end-October 2015 we will submit a time-bound action plan to centralize the sector's control functions, namely risk, audit and compliance, subject to approval by the competent supervisor.

- ***Financial control and risk processes.*** The CCB has embarked, since June, on a plan to strengthen its financial control and reporting processes, including by upgrading the management information systems. The implementation strategy has been designed to ensure a smooth transition and takes into account the CCB's additional responsibilities in the areas of finance and risk management. The new structure of the financial control division, including the upgrade of staffing and capabilities, will be completed by March 2016.

- By mid-October 2015, we will retain an external consultant to identify the necessary actions to enhance the sector's shareholder value and prospects, including by reviewing its structure.

Maintaining Adequate Liquidity

5. **We will continue to ensure adequate liquidity in our banking system.** Following the full liberalization of deposits and external flows, the CBC continues to monitor conditions and stands ready to take appropriate measures following the procedures and rules of the CBC and the Eurosystem. Although liquidity has improved, additional government guarantees in line with state aid rules for the issuance of bank bonds could be used as collateral against liquidity, but only if necessary to safeguard financial stability.

Strengthening Financial Sector Supervision

6. We will continue strengthening banking supervision. To this end, we are making progress on three important areas:

- **Transition to the SSM.** We will ensure sufficient resources are available at the CBC to carry out its duties on supervision and resolution. Accordingly, we have already hired 10 additional staff to address resource needs in the area of banking supervision. We are also reviewing our regulatory framework against European best practice and recent experience. To this end, by end-November 2015 we will streamline our directive on loan origination.

- **Expanding credit information.** Accurate information on the payment performance of individuals and enterprises facilitates the assessment of risk and credit supply decisions. We will strengthen the credit registry by establishing a credit scoring system available to banks and other creditors. As a first step, by end-December 2015 and drawing on external expertise, we will determine the additional data needs.

- **Resolution of Laiki.** The resolution authority has finalized a plan for completing the resolution of Laiki. To this end, the Resolution Authority has appointed an investment advisor to manage the sale of Laiki's foreign assets. A second advisor will be appointed by end-October 2015 to manage the disposal of Laiki's stake in BoC.

7. We remain committed to implementing our agenda to reinforce insurance and pension fund supervision.

Strengthening the AML Framework

8. We continue strengthening the implementation of the AML/CFT framework. Work in this area is proceeding as follows:

- **AML/CFT supervision of banks:** The CBC is conducting onsite inspections according to the 2015 supervisory plan and in line with the new risk-based AML/CFT supervision methodology. It will apply, as needed, appropriate supervisory measures. In the course of 2015, the CBC will streamline the inspection procedures to reduce the time between the visit to the financial institution, the finalization of the report and the imposition of sanctions, when appropriate. 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. The CBC intends to swiftly take appropriate actions following the July 2014 inspection and follow up visits, and the final ruling issued by the U.S authorities in July 2015.

- **AML/CFT supervision of professions:** The Cyprus Securities and Exchange Commission will recruit additional qualified supervisors and conduct inspections according to its yearly supervisory program, and the CBA and ICPAC will continue providing training to their staff to enhance their inspections.

- **Registrar of Companies:** Work is underway to restructure the Department of the Registrar of Companies. By end-December 2015, we will strike off the registry the backlog of companies non-compliant with the requirement to submit annual reports. A reorganization of the department, with a view to modernize its operations in line with the new law, with implementation beginning by end-March 2016.

C. Fiscal Policy

9. **The cash primary balance through June exceeded our target by a substantial margin.** The general government accounts had a cash primary surplus of 0.3 percent of GDP, compared with a target of a 0.4 percent of GDP deficit. This outcome reflects buoyant VAT revenues, as well as temporary factors, such as change in payment profile of airport royalties which led to higher collections earlier in the year; and lower-than-expected unemployment and redundancy benefits.

10. **We have raised the cash primary balance target for 2015 to 1.3 percent.** The revision of 0.3 percent reflects the lower unemployment and redundancy outlays, some revenue overperformance, and one-off non-tax revenue. Despite the favorable revenue outturn through June, we will maintain a prudent stance in light of the temporary nature of some of the factors behind this outturn and the uncertainty associated with the external environment. In this respect, we will let automatic stabilizers operate if economic activity turns out worse than forecasted, but any over-performance due to faster GDP growth would be saved. Spending on the recently adopted mortgage subsidy scheme will be contained and will not lead to increased overall expenditure outlays. The envisaged reform of the immovable property tax, combined with the recent reduction of the property transfer fee, will be fiscally neutral. In addition, we will monitor the impact of changes to tax laws introduced in 2015. These include the notional interest allowance for new equity and the defense tax exemption for non-domicile tax residents.

11. **The medium term fiscal targets remain unchanged.** For 2016 and 2017, we will target surpluses of 2.4 and 3 percent of GDP, respectively. The unchanged 2016 primary surplus mainly reflects expected a continued reduction in unemployment and redundancy benefits and a previously unprogrammed dividend from the telecom company (CyTA), which will offset the revenue impact from the implementation of the EU directives on changes to the VAT place of supply for certain services and the contribution to the National Resolution Fund. For 2018 and beyond we will continue to target a primary surplus between 3 and 4 percent of GDP.

D. Structural Reforms

12. **We are implementing our comprehensive welfare reform that ensures a guaranteed minimum income (GMI) for all those in need.** We will take actions to ensure that the new welfare system is fully in place and that outcomes are promptly analyzed:

- In line with the adopted welfare reform, by mid-October 2015 we will prepare plans to unify the legislative and administrative framework for all disability benefits ensuring consistency with medium term budgetary targets. The plan to consolidate education benefits will be adopted by Parliament by end-October 2015.

- By end-September 2015 we will finalize an assessment report of the implementation of the GMI, including main outcomes, the number of applications, fiscal costs, targeting accuracy, and coverage. The assessment will also discuss possible refinements going forward.

- By end-December 2015, we will build a registry of benefits in line with our new welfare law including the profiles and eligibility of all beneficiaries, cross-checked with other databases.17

- By end-March 2016, and with the registry in place, we will re-examine the overall welfare reform to realize efficiency gains from the consolidation of all information on welfare programs.

13. We are advancing our tax administration reform. Our efforts are focused on finalizing the integration of the two previously existing tax authorities into the single Department of Taxation by end-June 2016 and on enhancing tax collection.

- **Addressing assessment backlogs and tax arrears:** We have identified a large backlog of un-assessed tax returns which may entail substantial collectible revenue. To address this, by end-September we will establish a project team, which will identify the size and nature of the unassessed tax returns and determine the taxes and refunds due. By end-October 2015, we will prepare an action plan to reduce this backlog. We continue to implement our tax debt recovery plan including the use of the new enforcement powers. To monitor progress, in June, we prepared the first quarterly implementation report, specifying targeted groups, collection enforcement measures used, and recovered debt.

- **Reforming the revenue administration:** We have appointed two assistant commissioners, thereby completing the senior management team. Going forward, we will establish a single registration process for all domestic taxes by end-September 2015, as well as finalize the cleansing of the taxpayer register by end-December 2015. By end-December 2015, the LTO established in January will be fully functional including taxpayer services, risk assessment and compliance activities aiming to continuing to expand coverage of revenue collections. In line with this goal, we will allocate appropriate human resources. We will also establish an integrated legal framework for tax procedures under a new tax procedures code, to be approved by the Council of Ministers by end-December 2015. In order to mitigate the risk of revenue loss during the integration process the Performance and Monitoring Unit will prepare a monthly update of performance indicators, including registration, filing, payment and debt collection. Based on these indicators we will prepare a quarterly assessment report to analyze performance and identify remedial actions, as needed. The first report will be prepared by end-October 2015. We will consider possible changes to the legal framework governing the criminal tax investigation unit to introduce judicial oversight.

14. We are enhancing the management of fiscal risks arising from government guarantees and finalizing the implementation of the Fiscal Responsibility and Budget Systems Law (FRBSL). The stock of government guarantees (about 20 percent of GDP) may pose risks to our public finances. In early September, the Council of Ministers approved the institutional framework to monitor and manage existing and new government guarantees **(existing structural benchmark)**. Recent improvements in our risk assessment analysis will be incorporated into the updated risk assessment report we will prepare by end-October 2015. In order to ensure the full implementation of the FRBSL, the public investment guidelines have been

[17] The registry of benefits will entail establishing a single view of social benefits for each beneficiary via an interface which will link three registries: Ministry of Labor, Welfare and Social Insurance, the Ministry of Education and Culture and the Ministry of Interior.

approved by the Council of Ministers and Parliament will adopt the FRBSL regulations and the law regulating the creation and functioning of SOEs by end-October 2015.

15. We remain committed to the privatization of state-owned enterprises. Privatization is expected to improve economic efficiency, help to reduce our public debt, and encourage foreign direct investment. We have received expressions of interest in the concession of the commercial activities of the Limassol port and a significant number of bidders have been pre-qualified, paving the way for the start of the due diligence process. The regulatory framework of the Cyprus Port Authority (CPA) will be amended and implemented by end-November 2015. The concession agreement will be signed before the end of the program. Legislation to convert CyTA into a limited liability company will be adopted by parliament by end-October 2015. We are committed to finalizing CyTA's privatization by mid-2016. In July, we hired an independent energy advisor to prepare a study for the unbundling and ownership structure of the Electricity Authority of Cyprus (EAC). Any decision regarding the unbundling of EAC will be implemented by end-March 2016.

16. We are continuing reforms in other areas aimed at boosting growth prospects and strengthening the public administration.

- We are implementing the Action Plan for Growth for which a key aim is improving the business environment. To this end, we will develop a time-bound action plan to strengthen the enforcement of contracts, including streamlining judicial procedures. To stimulate private investment, the Council of Ministers will adopt by end-December 2015 a framework to attract strategic investments, through fast-tracking administrative procedures for licensing. In addition, to support the development of the tourism sector, by end-September 2015 we will produce an initial assessment of the regulatory framework governing the sector. All necessary legal amendments to modernize the framework will be approved by the Council of Ministers by end-March 2016. Finally, with a view of improving the business environment, an action plan to implement Smart Regulation will be adopted by the Council of Ministers by end-October 2015.

- To enhance the effectiveness of our public administration, while also ensuring its affordability, in early September 2015, the Council of Ministers will approve a reform package including a revision of the wage setting framework and the opening of promotion posts to the wider civil service. The package will be adopted by Parliament by end-December 2015 **(existing structural benchmark).** Salary and employment decisions will be consistent with general government compensation of employees as a share of GDP remaining on a descending path over the medium term. We will complement this with reforms to enhance staff mobility to promote the efficient allocation of human resources.

E. Program Financing and Monitoring

17. Financing for our program is assured. In line with the practice in most other European countries, we will transfer the rights and liabilities associated with coins issuance from the CBC to the MoF and receive additional financing of €100 million associated with this transfer by end-December 2015. In addition, the CBC is expected to transfer an additional €100 million in central bank profits to the government during 2016, in line with CBC duties under the Treaties and the Statute. We intend to issue additional debt in the international markets before the end of this year to smooth maturities, minimize refinancing risk after the program and ensuring comfortable cash buffers, in line with our debt management strategy, market conditions permitting.

18. Implementation of policies under our program will continue to be monitored through quarterly PCs and reviews. Our program includes performance criteria and structural benchmarks defined in Tables 1 and 2 and in the Technical Memorandum of Understanding (TMU). In particular, there are also continuous performance criteria on the non-accumulation of external payment arrears, on non-imposition of restrictions of payments and transfers for current international transactions, and on non-introduction of multiple currency practices.

19. We authorize the IMF to publish the Memorandum of Economic and Financial Policies, its attachments, and the related staff report.

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

	Performance Criteria			Performance Criteria	
	Jun-15			Sep-15	Dec-15
	Target	Adjusted target 2/	Actual		
Floor on the general government primary balance 2/	-71	-75	52	300	232
Ceiling on the general government primary expenditure 2/	3,124	3,128	3,081	4,659	6,660
Ceiling on the stock of general government debt	19,966		19,214	19,269	18,532
Ceiling on the accumulation of new general government guarantees 3/	40	27	27	93	133
Ceiling on the accumulation of external arrears 2/ 4/	0		0	0	0
Ceiling on the accumulation of domestic arrears 2/	0		-2	0	0
Ceiling on the accumulation of tax refund arrears by the general government 2/	33		13	33	33

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since January of the corresponding year. The primary balance and primary spending targets were adjusted down and up by €4 million, respectively, reflecting compensation of pension fund payments during 2015:Q2 in line with the TMU.
3/ Adjusted downwards due to €13 million lower EIB guarantees than anticipated in line with the TMU.
4/ Continuous performance criterion.

Table 2. Structural Benchmarks

Measures	Timing
Existing structural benchmarks	
Parliamentary approval of a reform package including a revision of the wage setting framework	End-December 2015
New and modified structural benchmarks	
Adoption by Parliament of legislation to enable the sale of loans in line with CBC directives while retaining the protections of borrowers offered under the Code of Conduct	End-September 2015
Approval by the Council of Ministers of legislation for the issuance and transfer of title deeds in non-legacy and new property transactions	End-October 2015
Adoption by Parliament of legislation to remove existing impediments to the securitization of assets	End-December 2015
Adoption by the Council of Ministers of any necessary adjustments to correct deficiencies of the insolvency and foreclosure frameworks, including legislative changes	End-January 2016 (modified SB)

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