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The Economic Adjustment Programme for Cyprus Fourth Review - Spring 2014

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The Economic Adjustment Programme for Cyprus

Fourth Review - Spring 2014

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EXECUTIVE SUMMARY

Staff teams from the European Commission (EC), European Central Bank (ECB), and the International Monetary Fund (IMF) visited Nicosia from 6 May to 17 May 2014 for the fourth 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.

Cyprus' programme remains on track. Fiscal targets for the first quarter of 2014 were met with a considerable margin, reflecting better than projected revenue performance and prudent budget execution. Progress has been made with the recapitalisation and consolidation of the cooperative credit sector, and banks are advancing with their restructuring plans. This has allowed for further liberalisation of domestic payment restrictions, in line with the government's roadmap. The authorities have also taken steps toward implementing their ambitious structural reform agenda.

While the recession is bottoming out, the outlook remains challenging. The contraction of output for 2014 has been revised down to 4.2% from 4.8%, given the better than expected outturn for 2013 and other recent indicators pointing to gains in confidence. While the increase in unemployment has slowed significantly, large non-performing loans are constraining the ability of banks to supply credit to the economy. As a result, the recovery is now expected to be more subdued than previously forecast, with growth projected at 0.4% in 2015 and only gradually improving thereafter, as domestic demand is weighed down by the need to reduce very high levels of indebtedness.

Reform in the financial sector has progressed, but the high level of non-performing loans remains an issue. Deposit outflows have eased somewhat and the liberalisation of domestic payment restrictions is progressing, in line with the government's roadmap. Supervision and regulation are being strengthened and will improve risk management in the banks, although some policies were delayed or partially completed. Considerable efforts are being put into improving arrears management. A new insolvency framework is in preparation, which should provide the right incentives for borrowers and lenders to find constructive solutions for dealing with non-performing loans. Also, a task force was established to study the title deeds issues. The authorities have further advanced in the implementation of the Customer Due Diligence framework and they continue strengthening the anti-money laundering supervisory function for financial institutions as well as other obliged entities under the anti-money laundering regime.

Fiscal performance has remained strong. Budgetary developments are on track vis-à-vis the targets in the Memorandum of Understanding. The 2014 government primary deficit is estimated at 1.7% of GDP, broadly unchanged compared to the third review. Building on the strong fiscal performance to date, the authorities will need to continue to implement their budget prudently. As agreed at the onset of the programme, an additional adjustment will be necessary in the outer years to attain the long run objective of a sustained 4% of GDP primary surplus, which is needed to place public debt on a sustainable downward path.

Structural reforms have progressed, although some delays have been observed. In the areas of public financial management, the secondary legislation for staffing the fiscal council has been adopted. Reforms of revenue administration are also advancing, although further efforts are needed to strengthen collection powers to resolutely address tax evasion and non-compliance. The head of the Privatisation Unit has now been appointed. The authorities have also advanced in their preparations to launch the reform of the welfare system. Progress is also being observed in a wide range of the goods and services market reforms, e.g. regulated professions, public administration review, tourism and energy.

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 mid-July. Its approval would pave the way for the disbursement of EUR 600m by the ESM, and about EUR 86m by the IMF.

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1. INTRODUCTION

The report assesses compliance with the terms and conditions set out in the updated MoU. The MoU was updated following the third review mission and was agreed between the Cypriot authorities and the programme partners, i.e. the European Commission (EC), the European Central Bank (ECB), and the International Monetary Fund (IMF). On 24 April 2013, the European Stability Mechanism (ESM) Board of Governors approved the updated MoU. The Vice President of the European Commission, responsible for economic and monetary affairs and the euro, Mr Olli Rehn, had already signed the first MoU on 26 April 2013, as well as the updated MoU following the third quarterly review mission last 1 April 2014.

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

A joint EC/ECB/IMF staff mission visited Nicosia from 6 May to 17 May 2014 for the fourth quarterly review mission and concluded that the economic adjustment programme remains on track.

By the time of publication, the three prior actions in the updated MoU for the granting of the fifth disbursement were met. The three prior actions concerned two fiscal-structural areas, namely public financial management and revenue administration. On public financial management, new legislation provided for the staffing of the Fiscal Council. On revenue administration, the enabling legislation for the establishment of a new tax agency was enacted, and the follow-up report detailing the actions to address the identified shortcomings was submitted to the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes.

A successful completion of the fourth review would pave the way for the disbursement of EUR 600m by the ESM, and about EUR 86m by the IMF. This will bring the total amount authorised for disbursement under the programme close to 60% of the overall international assistance of EUR 10bn.

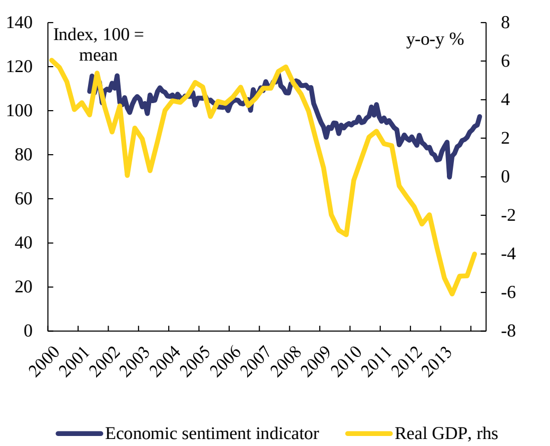
The report is organised as follows. Section 2 examines recent macroeconomic, fiscal and financial developments. A detailed assessment of compliance of programme conditionality is reported in Section 3. Section 4 looks at programme financing and debt sustainability, while Section 5 discusses risks to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

2. ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

Real GDP continued its slide in the fourth quarter of 2013, bringing the real GDP decline to -5.4% for 2013 as a whole. The macroeconomic environment remained weak, notably due to the lack of credit provision, weakening corporate profits in most of the private sectors, and worsening labour market conditions. The recession in 2013 was broad-based, with all domestic demand components displaying a higher rate of contraction in 2013 than in 2012, partly reflecting the gradual repair of corporate and household balance sheets. Despite the significant contraction, private consumption was more resilient than expected, partly supported by the dissolution of some provident funds, as well as the still strong net financial asset position of households. Also, some sectors such as tourism and professional business services proved more resilient than anticipated. While economic sentiment improved markedly in the second half of the year, the contraction in real GDP only moderated slightly (Graph 2.1). The decline in domestic demand brought about a significant import contraction and net trade contributed positively to growth.

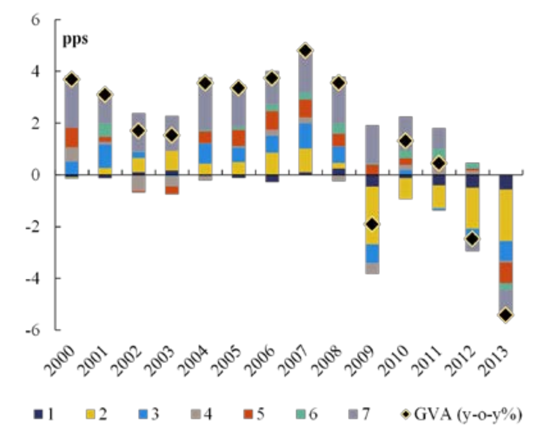
Graph 2.1: **Real GDP and economic sentiment**



Source: DG ECFIN and Eurostat

Significant labour costs and price adjustment led to a GDP deflator decline of -1.5% in 2013. While all components of the GDP deflator were in negative territory, the public consumption deflator (mainly driven by public wage evolution) and the private consumption deflator contributed the most to the negative pressures. Nominal GDP declined by 6.9%, broadly as anticipated at the onset of the programme.

Graph 2.2: **Real gross value added and components**



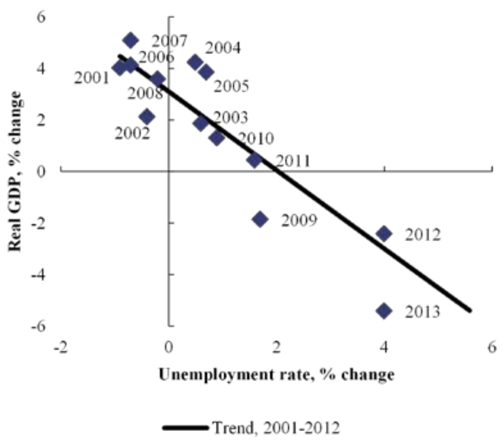
(1) Manufacturing, (2) construction, (3) wholesale and retail trade, (4) accommodation and food service activities, (5) financial and insurance activities, (6) professional business services, (7) others.
Source: Commission services.

Most sectors contracted in 2013, with a particularly strong decline in construction (Graph 2.2). While real gross value added in the construction sector has declined by 70% since the peak in 2008, the contraction in 2013 was particularly pronounced, partly reflecting the unwinding of the imbalances accumulated before 2008. Manufacturing, financial and insurance services also displayed large and intensifying contractions. The tourism-related sectors were holding up better, but still displayed negative real growth.

The current account deficit narrowed to -1.9% of GDP in 2013, from -6.9% of GDP in 2012. The improvement mirrors a smaller deficit in the goods balance, mainly reflecting import contraction, and a slight improvement in the exports of domestically produced goods. The balance of services also showed an improvement, as tourism revenues increased. The income and current transfer deficit remained broadly unchanged compared to 2012.

The decline in unit labour costs intensified further in 2013, mainly reflecting the ongoing labour cost adjustment. The reduction in compensation per employee helped to limit the cut in employment, which fell to the same extent as gross value added, leaving labour productivity almost unchanged. While unemployment further increased to 16.9% in December 2013, it was still significantly less than the real GDP contraction of -5.4% would suggest (Graph 2.3), partly reflecting a shrinking labour force due to migration outflows. Towards the end of the year, the increase in unemployment slowed, and quarterly dynamics suggests that employment could bottom out in some sectors.

Graph 2.3: **Real GDP and unemployment**



Source: Eurostat.

House prices declined by 6.8% in 2013, with the annual decline intensifying throughout the year. The ongoing price adjustment has reduced house prices by around 25% compared with the peak in mid-2008. Nevertheless, the adjustment has only reversed some of the house price appreciation since 2004. The fall in house prices reflects subdued demand for residential properties amid the deleveraging process in the private sector, worsening income prospects and tight credit conditions. While credit supply conditions for households were tightened in the second quarter, according to the Bank Lending Survey, households demand for credit also weakened. For the third quarter of 2014, further tightening of credit supply for households is expected, while the weakness in the demand of credit is likely to persist.

HICP inflation declined to 0.4% in 2013, moderating throughout the year and turning negative in the fourth quarter of 2013. The decline in HICP inflation reflected the weak domestic cost pressure and the ongoing wage and price adjustment, which would help restore competitiveness (see Box 2.1). While VAT hikes helped mitigate some of the downward pressure from the weak domestic cost pressure (Graph 2.4), core inflation eased further, with its two largest components (non-energy industrial goods and services) in negative territory. Processed food inflation remained positive, albeit lower than in the previous year.

Graph 2.4: **HICP inflation**

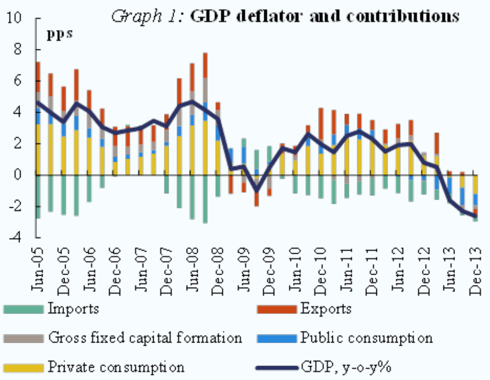
Source: Eurostat.

Real GDP was down by 4.0% y-o-y in the first quarter of 2014, according to the flash estimate, suggesting that the pace of the contraction in economic activity is slowing. Despite a marked improvement in soft indicators over the past year, GDP growth continues to be weaker than what is suggested by soft indicators. The decline in GDP continues to be broad-based, with short-term indicators pointing to contractions in construction and manufacturing, as well as in banking, transport, trade and other services.

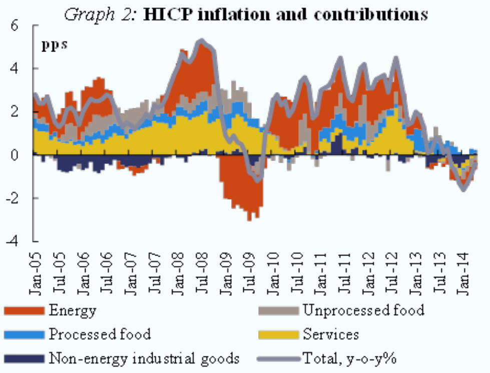
The recession is expected to continue in 2014, with real GDP forecast to decline by 4.2% (Table 2.1), **revised up from -4.8% in the third review.** The upward revision mainly reflects the positive carry-over from the stronger than expected growth last year, largely due to the resilience of

Box 2.1: Labour cost adjustment and consumer prices

Weak domestic cost pressure and sizeable spare capacity have exerted downward pressures on inflation and improved the price-competitiveness of Cyprus. The ongoing adjustment has brought GDP deflator and consumer price inflation into negative territory since mid-2013 (Graph 1). While all components of the GDP deflator were in negative territory, the public consumption deflator (mainly driven by public wage evolution) and the private consumption deflator contributed the most to the negative pressures. Looking at HICP inflation in Graph 2 (which is similar to the private consumption deflator), the decline was largely driven by falling commodity prices and a drop in core inflation, on the back of declining unit labour costs.

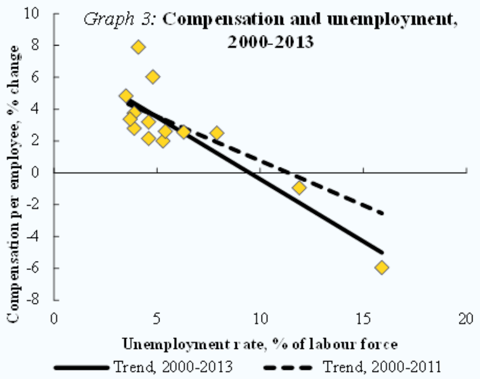


Source: Commission services.



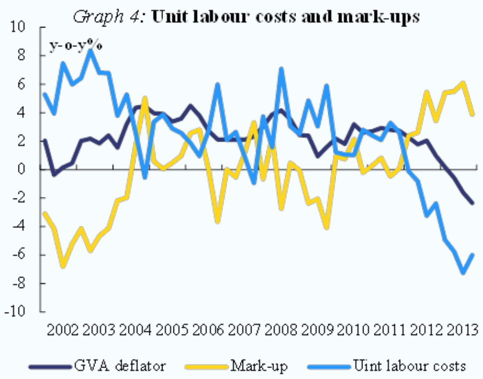
Source: Commission services.

The decline in unit labour costs reverts some of the losses in price-competitiveness experienced before the crisis and reflects the sharp adjustment of compensation of employees to the level of slack in the economy. Graph 3 shows that the adjustment of compensation per employee to the unemployment rate was particularly pronounced in 2012 and 2013, with the slope of the Phillips curve steeper when including the recent crisis than the historical experience would suggest. However, the fall in labour costs has been broadly in line with the initial programme forecast.



Source: Commission services.

Although the adjustment in labour costs was expected, the pass-through of the declining labour costs into the GDP deflator has been more pronounced than initially foreseen. As shown in Graph 4, historically, pricing behaviour of firms has tended to significantly reduce the pass-through of labour costs into prices, with changes in labour costs initially being largely offset by opposite adjustment in corporate mark-ups. Only gradually – and partially - have changes in labour costs been passed into prices. The recent period has been different, with a more significant pass-through of unit labour costs into prices, partly owing to a faster and stronger pass-through of public sector labour costs into the public consumption deflator. This also explains the current larger than usual difference between HICP inflation and GDP deflator, with the latter more strongly influenced by public consumption.



Source: Commission services.

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

		2013				Annual percentage change Fourth review forecast (May 2014)			Third review forecast (February 2014)		
		Curr. prices (EUR m)	% of GDP	2012	2013	2014	2015	2016	2014	2015	2016
GDP		16,504	100	-2.4	-5.4	-4.2	0.4	1.6	-4.8	0.9	1.9
Private consumption		11,447	69.4	-2.0	-5.7	-5.1	-0.2	1.5	-6.3	0.7	2.3
Public consumption		3,079	18.7	-3.8	-5.0	-2.7	-2.4	-3.2	-1.5	-2.7	-3.7
Gross fixed capital formation		1,916	11.6	-18.3	-21.6	-17.0	1.3	3.9	-18.1	1.3	3.9
Exports (goods and services)		7,431	45.0	-2.5	-4.2	-2.7	1.9	2.9	-2.7	1.9	2.8
Imports (goods and services)		7,182	43.5	-5.4	-14.1	-6.9	-0.1	1.3	-7.2	0.2	1.6
GNI (GDP deflator)		16,031	97.1	6.7	-5.7	-4.3	1.3	3.1	-5.7	3.8	3.5
Contribution to growth:	Domestic demand			-5.1	-7.9	-6.0	-0.5	0.9	-6.6	0.1	1.3
	Inventories			1.2	-2.2	0.0	0.0	0.0	0.0	0.0	0.0
	Net exports			1.5	4.8	1.8	0.9	0.8	1.9	0.8	0.6
Employment				-4.2	-5.2	-4.0	0.4	1.5	-4.4	0.8	1.7
Unemployment (1)				11.9	15.9	18.6	18.0	16.8	19.2	18.4	17.0
Compensation per employee				-0.9	-6.0	-3.0	0.4	1.4	-3.0	0.9	1.5
Unit labour costs, whole economy				-2.7	-5.8	-2.8	0.4	1.3	-2.5	1.0	1.8
Real unit labour costs				-4.3	-4.2	-3.0	-0.9	-0.4	-3.1	-0.5	0.0
GDP deflator				1.6	-1.5	0.2	1.3	1.7	0.6	1.5	1.8
Harmonised index of consumer prices				3.1	0.4	0.2	1.1	1.7	0.4	1.4	1.7
Terms of trade				-0.6	-0.5	0.1	-0.1	0.0	0.1	-0.1	0.0
Merchandise trade balance (2)				-21.8	-18.0	-16.6	-16.4	-16.1	-16.9	-16.7	-16.6
Current account balance				-8.3	-1.9	-0.1	0.2	0.6	0.0	0.4	0.6

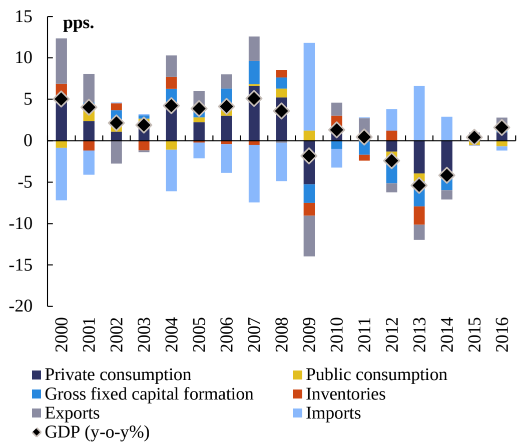
(1) Eurostat definition, % of labour force. (2) Percent of GDP.
Source: Commission services.

household consumption. Domestic demand is expected to remain weak, reflecting the needed, though more gradual than initially expected, deleveraging process in the private sector, together with further worsening of labour market conditions and wage adjustments. Unemployment is foreseen to increase further to 18.6%. In the first months of 2014, monthly HICP inflation dynamics suggests a bottoming out of the declines in consumer prices, which, combined with the base effects from administrative cuts in energy prices last year and VAT rate hikes this year, is expected to lead to a positive, albeit subdued, inflation in 2014.

In 2015 and 2016, GDP growth is forecast to gradually resume, albeit at a slower pace than previously expected, alongside a gradual strengthening of domestic demand (Graph 2.5). Domestic demand has been revised somewhat down, reflecting slower and more protracted than initially expected deleveraging by both households and corporates, which is expected to gradually remove impediments to more balanced growth over time. At the same time, the restoration of confidence in the banking sector is expected to gradually loosen the tight credit conditions, thus supporting domestic demand. Reflecting the expected pick-up in domestic demand, the labour market will recover slowly and HICP inflation will gradually accelerate.

Risks to the economic projections remain tilted to the downside. On the domestic front, slower than expected resolution of non-performing loans and a prolonged period of tight credit supply conditions could pose considerable risks to the real economy. In addition, the needed private deleveraging process could weigh more on growth than currently expected. On the external side, Cyprus' sizeable trade links with Russia (most

Graph 2.5: **Real GDP growth and contributions**

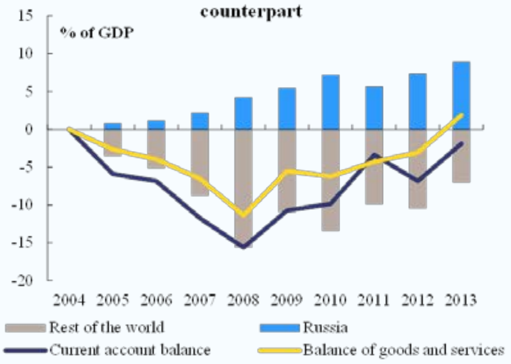


Source: Eurostat.

Box 2.2: Trade linkages with Russia

Russia is one of Cyprus' main economic trading partners. In 2013, the value of export of services to Russia exceeded the value to the 17 euro area countries, thereby making Russia the largest export market for services. Trade of goods with Russia is relatively limited, leading to a trade deficit vis-à-vis Russia of 0.1% of GDP. Import of goods and services from Russia is limited. As a result, Cyprus has a sizable trade surplus vis-à-vis Russia, which in 2013 more than offset the large trade deficit with the rest of the world (Graph 1).

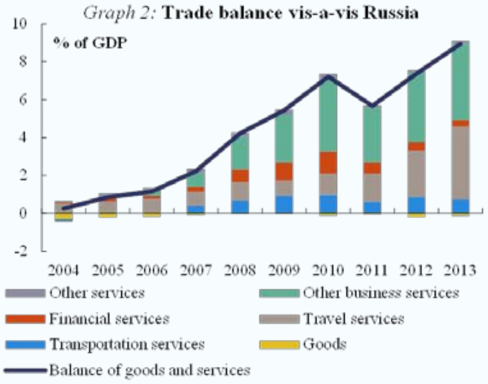
Graph 1: **Trade balance by geographical counterpart**



Source: Eurostat.

The trade surplus with Russia has been increasing since 2004, with the exception of 2011, and reached 9% of GDP in 2013. The increasing trade surplus with Russia is mainly related to tourism, in line with the increasing number of tourist arrivals from Russia (Graph 2). Other business services, such as consultant, legal, and accounting services, have also been growing, reflecting the increasing presence of Russian corporates, and now account for the largest part (about 4% of GDP) of the trade surplus with Russia. Financial and transportation services represent a smaller share.

Graph 2: **Trade balance vis-a-vis Russia**



Source: Eurostat.

notably in tourism and professional services)mean that its exports could suffer, should negative spillovers emerge from the geopolitical tensions between Russia and Ukraine (Box 2.2). Risks to HICP inflation are on the downside, reflecting possibly larger than anticipated pass-through of the on-going labour cost adjustment to consumer prices and larger than forecast negative base effects from the VAT hikes in 2014. Upside risks for the Cypriot economy relate to a potentially stronger than expected improvement in economic activity in EU Member States, and stronger than expected growth in the Cypriot tourist sector.

2.2. FISCAL DEVELOPMENTS AND OUTLOOK

The fiscal outcome of Q1-2014 suggests a continuation of the good fiscal performance recorded in 2013. With a primary balance surplus of 0.7% of GDP in Q1-2014, the fiscal outcome was better than the balanced primary outcome the authorities had anticipated in their quarterly estimates. The headline balance exceeded the quarterly estimate by the same margin, as interest payments turned out as expected. The better-than-expected performance is mostly due to the revenue side, which, driven both by high tax and non-tax

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

			Fourth review forecast (May 2014)			Third review forecast (February 2014)		
	2012	2013	2014	2015	2016	2014	2015	2016
Real GDP (1)	-2.4	-5.4	-4.2	0.4	1.6	-4.8	0.9	1.9
Output gap (2)	-0.7	-4.1	-6.1	-3.8	-1.3	-6.3	-3.5	-0.9
General government balance (3)	-6.4	-5.4	-5.3	-5.1	-2.4	-5.8	-6.1	-2.8
Total revenue (3)	39.4	40.3	41.8	40.6	40.9	41.5	40.2	40.7
Total expenditure (3)	45.8	45.8	47.1	45.7	43.3	47.3	46.3	43.5
Primary balance (3)	-3.2	-2.0	-1.7	-1.6	1.2	-1.8	-2.1	1.2
Cyclical-adjusted balance (3)	-6.1	-3.7	-2.6	-3.5	-1.8	-3.1	-4.5	-2.4
Structural balance (3)	-6.5	-3.5	-3.7	-3.5	-1.8	-4.1	-4.5	-2.4
Gross debt	86.6	111.5	119.9	124.4	121.9	122.2	126.4	123.1

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

revenues, ended up 0.5% of GDP above the estimate. Total expenditure also remained slightly below the authorities' estimate, driven by lower intermediate consumption and capital expenditure as well as the deceleration of the public sector retirement wave, which led to a reduction in lump-sum gratuity payments. Overall, the fiscal performance appears on track and the IMF's Q1 Quantitative Performance Criterion (QPC, in cash) was met with a significant margin.

However, the interpretation of the Q1-2014 fiscal data is somewhat difficult due to the impact of the bank holiday of March 2013. As banks were closed for an extended period of time and hence payments were not processed, a number of revenue and expenditure categories in the first quarter of -2013 displayed figures significantly below their historical values, which should be taken into account when assessing the durability of the better-than-expected trends. At this stage, a comparison with the authorities' estimates appears more appropriate than a y-o-y comparison. ([1])

In any case, the better-than-expected result on the revenue side appears to be largely driven by temporary factors. The 0.5% of GDP better-than-expected revenue is mostly due to collection patterns not fully accounted for in the authorities' monthly targets. Both other direct and indirect taxes, as well as non-tax revenues, performed above projections (see Table 2.2). Other direct and other indirect tax receipts benefited from a new surcharge levied on the annual motor vehicle circulation tax, which, although included in the annual target, had not been appropriately reflected in the authorities' quarterly estimates. The major tax categories (such as income taxes and VAT) appear to have continued their overall expected trends. The better-than-expected performance of non-tax revenues is largely explained by two one-off factors (a dividend from the ports authority received in January 2014 instead of December 2013 and a contractual guarantee called by the government). For social contributions, the performance is below expectations, but it is likely to be a temporary phenomenon, given that the quarterly estimates had not taken into account that the rate increase will result in better collections only with a lag of 2 months.

Total expenditure up to March was about 0.2% of GDP lower than targeted. The outcome was determined by lower-than-expected expenditure on intermediate consumption, partly due to the introduction of hospital fees leading to lower-than-projected expenditure on pharmaceutical products. Capital expenditure was again significantly lower than estimated by the authorities. The on-going deceleration of the public sector retirement wave resulted in somewhat lower lump-sum gratuity payments than projected earlier. These developments were, however, partly offset by higher social transfers, triggered by a significant effort to pay off the large amount of accumulated redundancy payments.

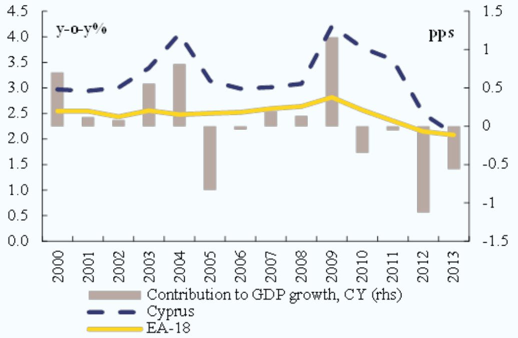
The debt-to-GDP ratio reached 112% of GDP in 2013. It is projected to peak at 124% in 2015, and to gradually decline towards 103% in 2020, in line with the debt sustainability analysis underpinning the programme (see Box 4.1).

([1]) Quarterly ESA95 estimates of the authorities are in line with the annual primary balance target enshrined in the MoU.

Box 2.3: Understanding the fall in public investment

Cyprus demonstrated a significant drop in public investment in recent years. As often observed in financially constrained countries, public investment was sharply reduced, with negative impact on growth. When assessing this reduction of investment, it should be considered if it reflects an undesirable postponement of investment, which would reduce investment to a level so low that it could seriously affect the growth potential of the economy, or if it reflects a return to a level of public investment that is closer to the long-term historical average after a period of extraordinary public investment. Also, in a situation of profound economic change, some investment projects that used to be considered as priorities may have become economically less relevant or their expected rate of return may have declined

Graph 1: **Public gross fisxed capital formation**



Source: Eurostat.

The evolution of public investment since 2000 has been relatively volatile, peaking in 2009 and sharply dropping thereafter. In the period preceding Cyprus' accession to the EU in 2004, public investment rose markedly. It thereafter subsided until 2008, the year in which Cyprus introduced the euro. From 2000 to 2008, public investments have been on average close to 3% of GDP. After a sharp increase in 2009, partly intended to mitigate the onset of the recession, public investment has been on a downward trend, reaching a level well below its average over the last fifteen years (of 3.2% of GDP). Since 2010, public investment has contributed negatively to growth, in particular in the recession years 2012 and 2013 (Graph 1). The negative contribution to growth would be even larger, when incorporating second-round effects on private sector demand. At the same time, a more efficient public investment spending would mitigate the adverse impact on growth.

In the last five years, public investment expenditure in Cyprus was reduced by half (in % of GDP). Starting from a very high level in comparison with the euro area average, the share of public investment in GDP has decreased markedly since 2009, but remained in 2013 at the same level as recorded in the euro area. The decline is partly explained by particularly high public investments in 2009-2011. Exceptional needs for investment were notably satisfied in 2009, linked to a counter-cyclical support to the construction industry and to investments in preparation of the Presidency of the European Union. Major projects were finalised, including the extension and improvement of important highways and the construction of buildings to host European meetings.

In addition, part of the public investment reduction could reflect a higher use of Public Private Partnerships (PPPs). Particularly, it is worth noting that the authorities have proceeded with some PPPs projects in recent years of a total estimated value of EUR 3.4bn. This can further explain the reduction of spending on public investment in the years 2009-2013.

All in all, data seems to suggest that the sharp fall in public investment has not been caused only by the crisis. The fall in investment since 2009 partly reflects a return to a more normal public investment pattern after a period of high spending preceding the crisis. At the same time, public investment reached in 2012-13 a level well below the long-term average. Actions under the programme to reduce uncertainty, restart bank lending, improve the business environment and ensure a sustainable correction of public finances all contribute to bettering prospects for both public and private investment. Preserving a sufficient level of public sector investment and prioritising growth-enhancing projects is crucial to strengthen future growth potential of the Cyprus economy. Continuous monitoring of the amount and nature of public investment is necessary to ensure a sustainable pattern of growth.

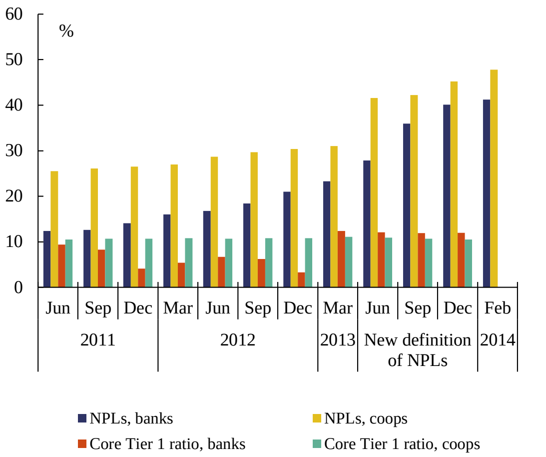
Fiscal programme projections were revised to reflect the updated macroeconomic forecast and some fiscal risks that have been materialising since the last review mission. For 2014, the updated projection shows a primary balance deficit of 1.7% of GDP. This is broadly unchanged from the last review, reflecting that positive effects from the better-than-expected outturns are offset by higher spending needs for called government guarantees (with a cost of about 0.5% of GDP). The authorities' prudent budget execution so far leaves enough space to meet these obligations. The headline deficit is projected at 5.3% of GDP, ½% of GDP better than projected during the last review, resulting from a significantly lower than expected ESM interest rate. The fiscal performance for 2015 is expected to be slightly better than projected during the third review mission, mainly driven by the carry-over of the better-than-expected fiscal projection for 2014. Despite the attenuation of the macroeconomic outlook, the primary balance target for 2016 is preserved.

2.3. FINANCIAL MARKETS AND FINANCIAL SECTOR DEVELOPMENTS

The stabilisation of the financial sector has progressed further, even though the quality of bank assets continued to deteriorate. Non-performing loans continued to rise, thereby posing risks and making the effort to enhance banks' capacity to work out delinquent assets even more important. Overall, banks managed to reduce their reliance on central bank funding, despite overall deposit outflows, thanks to asset disposal and loan repayments. Increasing non-resident deposits within the international banks indicate that this segment of the financial sector is regaining foreigners' confidence. The correction of the economy's excessive indebtedness seems to have abated, with the stock of loans for corporates and households having broadly stabilised since September. Additional restrictive measures have been lifted by the authorities, and further relaxation is envisaged, after close monitoring of latest developments and with due consideration for financial stability.

The quality of banks' assets continued to deteriorate despite further progress in setting up the arrears management. Non-performing loans (NPLs) on local operations, according to the newly introduced definition of July 2013, which is in line with the definition the European Banking Authority is expected to adopt by the end of this year, reached in February 41.3% and 47.8% of total credit facilities granted by commercial banks and cooperative credit institutions, respectively (Graph 2.6). NPLs to corporations represented 45.2% of banks' total credit facilities and 40.3% of coops' loan book. For households, these ratios stood at 42.5% and 49.9% in February. Disaggregated data per sector indicates that close to 70% of NPLs on the banks' balance sheet stem from corporate loans, while more than 80% of NPLs on the coops' balance sheet come from individual exposures (Table 2.3). For banks, delinquent assets concern primarily construction, household mortgages, real estate activities and wholesale and retail trade loans, which reflects the misallocation of resources during the boom.

Graph 2.6: **Financial soundness indicators**



Source: Central Bank of Cyprus

Banks and coops differ noticeably with respect to their loan restructuring policy. Restructured loans account for a significantly lower share in the coops' loan portfolio, which suggests that they are relatively late in the pro-active management of their early arrears (Table 2.4). Total restructured facilities reached almost 25% of bank loans, which compares with less than 6% in the case of the coops. The fact that restructured non-performing loans have been increasing, while restructured performing loans have been declining since June 2013 puts some doubts on the efficiency and timeliness of banks' loan rehabilitation techniques.

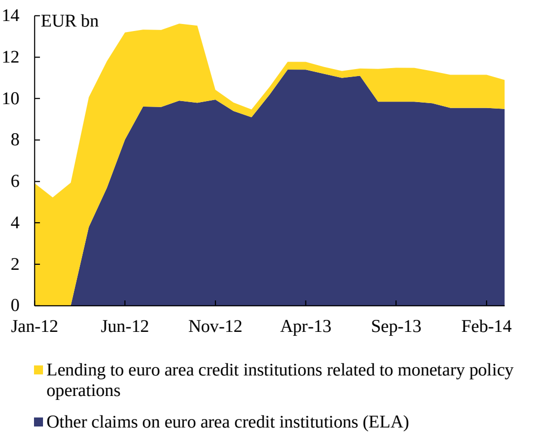
Table 2.3: **Distribution of non-performing loans**

%, end of February 2014	Banks		Coops		All credit institutions	
	NPL ratio	% of total NPLs	NPL ratio	% of total NPLs	NPL ratio	% of total NPLs
Loans to legal entitites, o.w.	45.2	70.3	40.3	18.5	44.8	57.8
Construction	66.6	23.4	66.6	4.1	66.6	18.8
Wholesale and Retail Trade	39.1	10.0	58.7	2.9	40.2	8.3
Accommodation and Food Services	54.5	6.1	49.7	1.1	54.2	4.9
Real Estate Activities	47.9	12.0	55.6	2.4	48.3	9.7
Others	32.1	18.8	28.1	7.9	31.6	16.2
Loans to private individuals, o.w.	42.5	29.7	49.9	81.5	45.6	42.1
Household mortgages	38.0	17.9	41.7	33.7	39.3	21.7
Consumer loans	53.3	7.8	58.3	39.4	56.2	15.4
Credit facilities to sole traders	44.5	2.3	68.7	4.6	64.0	2.9
Others	39.2	1.6	45.8	3.8	41.8	2.1
Total	41.3	100.0	47.8	100.0	42.7	100.0

(1) Aggregated averages may not add up because of intercompany loans
Source: Central Bank of Cyprus.

The developments with respect to NPLs and restructured loans highlight the importance of further enhancing credit institutions' capacity to cope with the arrears management issue. In this context of worsening loan quality, banks' core Tier 1 ratio stood at 12.0% in December 2013, slightly below the 12.4% level it reached in March 2013.

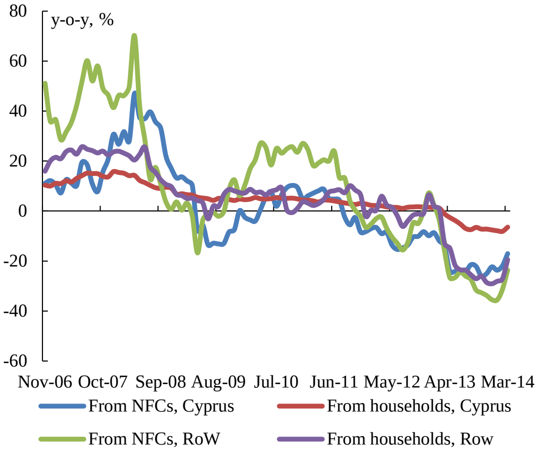
Graph 2.7: **Borrowing from the Eurosystem**



Source: Central Bank of Cyprus.

Banks managed to decrease their reliance on central bank funding by EUR 250m in the first quarter of 2014, despite further deposit outflows. Total central bank funding declined to EUR 10.9bn in March (Graph 2.7). The sector's liquidity has benefited positively from the successful recapitalisation of the Cooperative Central Bank by the State for EUR 1.5bn in March, as well as Bank of Cyprus divesting from foreign exposure. However, aggregate deposit outflows continued in the first quarter of 2014, albeit at a slower pace and with some differences across banks. Overall, deposits contracted by EUR 823m, out of which EUR 458m were held by domestic residents. Foreign banks benefited from a net inflow of EUR 179m during the same period, which suggests that international clients' confidence is returning.

Graph 2.8: **Deposit developments**



Source: Central Bank of Cyprus

Deposits declined further in the first quarter of 2014, but relative to a year ago outflows are abating. The outflows were mainly in the cooperative sector, partly driven by unfounded market rumours of renewed instability in the cooperative sector. Annual aggregate declines in deposits, however, have started to level off from their peaks at the end of 2013 (Graph 2.8).

Box 2.4: Relaxation of administrative measures in Cyprus – state of play

Administrative restrictions on financial movements were put in place in March 2013 given the imminent risks for the stability of financial market and the banking system in Cyprus related to the uncontrollable outflow of deposits. An extended banking holiday was imposed from 16 March, followed by capital controls from 28 March 2013. These restrictions were justified in the prevailing circumstances, but given that they constituted a serious limitation to the free movement of capital, they were to be proportionate to the objective of preventing the risk for the financial stability of Cyprus and applied for a strictly limited time necessary for that purpose. In order to streamline the process of lifting the restrictive measures, a mile-stone roadmap was adopted in August 2013 (see Table). About one year later, considerable progress in the elimination of controls has been achieved and all limitations applying inside the country have been lifted.

During the initial period, until the beginning of April 2013, very strict measures applied in order to cope with the pent-up demand for cash and transfer requests piled up during the extended bank holiday. (1) Cash withdrawals were limited to up to EUR 300 per day and per bank account. (2) Carrying cash across the border was only allowed up to EUR 1000 per person per journey. (3) Payments with Cypriot credit cards abroad were limited up to EUR 5,000 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. Ex-post verification of the documents was accepted for transfers within the country or abroad up to EUR 5,000 per day per account; between EUR 5,000 and 200,000, they were subject to bulk approval by the Payments Authorisation Committee; and above EUR 200,000, approval of the individual transaction was necessary.

Within the first month after the introduction of the capital controls, domestic restrictions were eased in several little steps and international banks benefited from a special regime. By 25 April 2013, ten decrees were issued to relax restrictions on domestic banks. (1) Cash withdrawals remained limited to up to EUR 300 per day for natural person, but were increased to EUR 500 for legal persons. (2) The export of cash was allowed up to EUR 3,000 per person per journey. (3) Limits on card payments were abolished. (4) The higher of EUR 5,000 or 20% of a fixed term deposit could be transferred to a current account. (5) For natural persons, transfers within the country up to EUR 10,000 were allowed without justification and for legal persons up to EUR 50,000. (6) For the transfers within the country and for normal business continuity, the limit for individual approval was increased to EUR 300,000. (7) Ex- post verification of the documents was accepted for transfers abroad up to EUR 500,000 per day per account; between EUR 50,000 and 1m, they were subject to bulk approval by the Payments Authorisation Committee; and above EUR 1m, approval of the individual transaction was necessary. Furthermore and very importantly, the first decree for international banks, issued on 25 April, abolished capital controls for eligible foreign banks (branches and subsidiaries), with respect to their cross border operations, which is their main business activity. These banks represent about 30% of the Cypriot banking sector. As their funding is provided by the foreign parent bank, they have a limited impact on domestic liquidity, justifying the application of less strict regime.

A mile-stone based strategy for relaxing capital controls was adopted on 8 August 2013. Within this framework, restrictions were to be removed gradually, first on domestic transactions followed by cross-border transfers. Any decision to abolish a restriction has to take into account the progress in restructuring the banking system and the impact of the measure on financial stability.

In the second half of 2013, the first stage of the roadmap was implemented. After April 2013 and until the end of the year, another fourteen decrees were released as the first two milestones related to the resolution of Bank of Cyprus and the restructuring strategy of the cooperative banks were met. (1) By mid-May, transfers within the country were increased to EUR 15,000 per month for natural person and to EUR 75,000 for legal person without presenting any justifying documents. (2) By end-August, cashless payments for the purchase of good or services to an account held in another credit institution were allowed without Committee's approval, but ex-post verification remained in

(Continued on the next page)

Box (continued)

Stage of the roadmap	Milestone *(between bracket and in italics: implementation date)*	Relaxation if milestone is met
1st	(1) Completion of the recapitalisation and resolution of Bank of Cyprus *(July 2013)* (2) Completion of the Coops recapitalisation and restructuring strategy *(July 2013)*	(1) Allowing the opening of fixed-term deposit account, for non existing customer created with funds from cash. *(August 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)* (2) Disbursement of funds under the macroeconomic adjustment programme for the recapitalisation of the Coops. *(January 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)*	(1) Abolition of the restrictive measures relating to fixed term deposits. (*March 2014*) (2) Abolition of the current limit related to transfers within the Republic, regardless of the purpose. *(5 May 2014)*
3rd	(1) Completion of the coops mergers *(30 March 2014)* (2) Tangible progress in the implementation of Bank of Cyprus' restructuring plan. *(May 2014)*	(1) Abolition of the restrictive measures relating to cash withdrawals *(March 2014)* and the cashing of cheques. *(5 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. (2) Restoration of depositors' confidence in the Cyprus banking system.	(1) Abolition of all restrictive measures relating to the transfer of funds outside the Republic. (2) Abolition of the restrictive measures imposed on international banks, included in the catalogue of the relevant Decree for international banks.

place. (3) Also in August, the 19th Decree relaxed the opening of new fixed-term deposits if they are credited with fresh cash (EUR 5,000 as a minimum), in an effort to absorb liquidity outside the banks. (4) Moreover, opening current accounts linked to credit facilities granted for new customers were allowed for domestic as well as for international banks. (5) By end-October, "normal" business transfers abroad and with supporting documentation were allowed up to EUR 1m per transaction, while above that amount, they remained subject to individual approval by the Committee.

The four milestones for moving to stage two of the roadmap were met at the end of January 2014. As banks' liquidity position and the overall market confidence were assessed positively, it was decided to proceed to stage two of the roadmap (see Table). (1) On 21 February 2014, the obligation to roll-over term deposits at maturity was abolished and on 28 March the ban on early termination of term deposits was lifted. (2) The limits related to transfers for any purpose within the country have been increased in February to EUR 20,000 for natural and EUR 100,000 for legal person, and again in March to EUR 50,000 and EUR 200,000, respectively. Limits were eventually completely abolished on 5 May, marking the completion of stage two of the roadmap.

The remaining administrative restrictions on domestic transactions were lifted by end-May 2014. The merger of the cooperative banks into 18 entities was achieved in March, while the other milestone was the achievement of sufficient progress in the restructuring of Bank of Cyprus. On 5 May, restrictions on the cashing of cheques were lifted and on 30 May the opening of new accounts within Cyprus and at domestic banks was allowed. With this last relaxation, stage three has been completed, which means that the free circulation of money, both in cash or by wire, within the country, has been fully re-established.

Table 2.4: **Evolution of restructured loans**

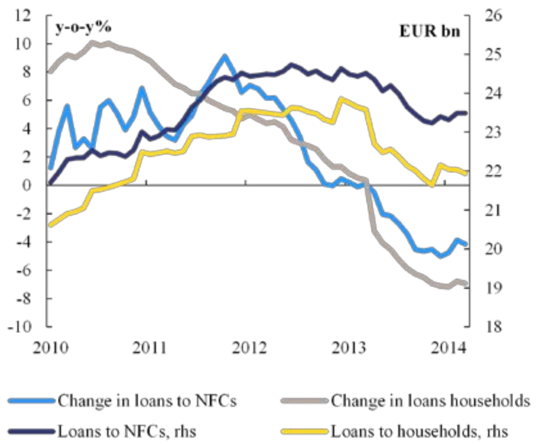
in % of total credit facilities	Restructured performing Jun-13	Restructured performing Feb-14	Restructured non-performing Jun-13	Restructured non-performing Feb-14
Banks	15.6	12.7	7.1	11.9
legal entities	16.1	13.5	9.0	13.4
private individuals	17.9	13.9	4.0	11.4
Coops	3.4	3.5	1.1	2.0
legal entities	2.9	3.3	1.5	2.3
private individuals	3.6	3.6	1.0	1.9

Source: Central Bank of Cyprus.

Domestic corporate deposits' annual decline decelerated from 26.1% in October 2013 to 17.1% in March. For the same period, the contraction in domestic household deposits abated from 7.2% to 6.4%. Non-resident deposits follow the same trend, with an even more pronounced improvement.

The correction of the excessive household and corporate indebtedness has slowed down. While the annual change in the loan stock suggests a continued contraction (Graph 2.9), the monthly dynamics shows that the stock of loans both for non-financial corporates and households has stabilised since September 2013.

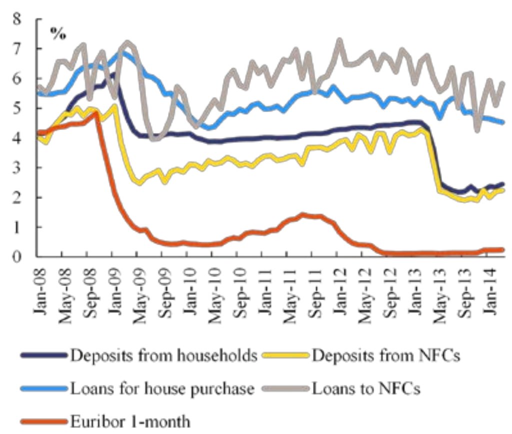
Graph 2.9: **Loan developments**



Source: Central Bank of Cyprus.

Despite CBC's successful regulatory effort to bring down deposit rates, the wide spread between interest rates on loans and deposits persists. The interest rate on new loans for house purchases declined by 14 basis points in the first quarter of 2014 (Graph 2.10). The cost of new corporate loans has been significantly more volatile, and increased by almost 60 basis points during the same period. Deposit rates have remained broadly unchanged.

Graph 2.10: **Interest rate developments**



Source: Central Bank of Cyprus

3. PROGRAMME IMPLEMENTATION

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

The Cypriot authorities have made further progress in implementing the programme. Fiscal targets for the first quarter of 2014 were met with a considerable margin, reflecting better than projected revenue performance and prudent budget execution. Progress has been made with the recapitalisation and consolidation of the cooperative credit sector, and banks are advancing with their restructuring plans. This has allowed for further liberalisation of domestic payment restrictions, in line with the government’s roadmap. The authorities have also taken steps toward implementing their ambitious structural reform agenda.

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

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

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

A summary assessment of compliance with programme conditionality is provided in Table 3.1, while the specific assessment on the implementation of individual elements of conditionality with deadlines for end-Q1 and April 2014 is found in Annex 1.

The authorities should maintain the (so far) good track record in policy implementation. Cyprus seems to continue performing well at this stage. In particular, over the first four quarterly reviews, Cyprus has been fully compliant with the vast majority of assessed policy conditions, as agreed in the Memorandum of Understanding. Although policy conditionality is gradually widening in scope and becoming more detailed, Cyprus' degree of compliance remains high. While the programme remains on track and the overall degree of compliance is high, there were some delays and partial compliance was observed in several areas, notably on structural reforms. There is a risk that partial compliance in important policy areas could become entrenched unless efforts are stepped up. The authorities should therefore continue to pursue their ambitious reform agenda

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

	Status
Financial sector reform	**Partially compliant:** Most deadlines for the first four months of 2014 were met, including the publication of the provisioning and disclosure directive, the external review of the new arrears management framework, the merger of the cooperative credit institutions and the set-up of a Task Force on the title deeds issue. Nevertheless, the implementation of some policy measures, especially in the area of regulation and supervision, was delayed or partially completed, which led to the postponement of several deadlines. The Central Bank of Cyprus (CBC) could not update its governance directive by end-April, and the deadline was shifted to end-June. The necessary legislative changes to the Resolution Law were reviewed by end-March, but the requirement to adopt them was shifted to end-June. Due to internal resource limitations, the CBC could not publish its first Financial Stability Report, which is now expected to appear at year-end. Progress with the management of legacy Laiki, and in particular with the appointment of advisors on the asset disposal process and on handling the voting rights in Bank of Cyprus, has been slow, and required a change in the deadlines. Despite these delays, the financial sector reform has been successful in completing the recapitalisation process of the Cypriot banks, which paved the way for further progress with relaxation of the restrictive measures. On Anti-Money Laundering (AML) the Cypriot authorities are continuing the implementation of the Action Plan. In some respects, however, compliance has been partial. CBC needs to fully implement appropriate enforcement actions as regards the remaining cases revealed by the external AML audit. Moreover, AML and Counter Financing of Terrorism (CFT) training programmes on, e.g., proper business profiles, sound and effective risk management systems, tax crimes, establishing the source of wealth for Political Exposed People (PEPs), enhanced ongoing monitoring for higher risk clients, etc. would need to be continued. Finally, the supervisory authorities are yet to fully finalise the development of risk-based tool(s) for offsite surveillance/monitoring and be able to demonstrate that the risk assessment methodology developed as a result is coherent with the development of a methodology for onsite activities.
Fiscal policy	**Compliant:** The fiscal performance until March 2014 is on track, and the Q1 quarterly target has been met with a significant margin. The annual 2014 budgetary targets remain within reach.
Fiscal-structural measures	**Partially compliant:** In public financial management, the mid-March deadlines concerning the Fiscal Council have been missed; the secondary legislation regarding the Fiscal Council staff and operations was adopted by 5 June (prior action), while the MoU on cooperation and exchange of information with the Minstry of Finance was signed 10 June. In revenue administration, most Q1-2014 deadlines have been missed. The legal amendments to support revenues in the short-term by enhancing collection powers and taxpayer compliance had been submitted to the House of Representatives as a package. The discussion on some of the amendments related to the increase of collection powers was subsequently reopened, which has blocked the entire package. Further, so far the authorities have not taken satisfactory steps to establish self-assessment for all income taxpayers, to prosecute tax fraud as criminal offence and the Inland Revenue Department has not made tax data available for risk analysis purposes. The enabling law to establish the new tax agency was approved 5 June (prior action). The follow-up report detailing actions addressing identified shortcomings to the OECD Global Forum was submitted to the OECD Global Forum by end-May (prior action). In the welfare system reform, all end-February and Q1-2014 deadlines have been missed. Core deliverables of the welfare reform system, namely the Guaranteed Minimum Income option to be pursued, the finalisation of the refined means-testing mechanism, and the adoption of the final design of the welfare reform by the Council of Ministers, have not materialised. The authorities provided information on the preferred Guaranteed Minimum Income option during the fourth review mission while work is ongoing on the finalisation of the welfare reform design. The majority of the remaining fiscal-structural Q1-2014 deadlines were either fully or partially observed by the time of the review mission. In particular: (i) the Head of the Privatisation Unit has been appointed, but interviews are ongoing for the Unit's staff and the work will get started in June (one month delay); (ii) the State-Owned Enterprises (SOEs) corporate governance law has not yet been agreed with programme partners and therefore not yet adopted (deadline being end-February); (iii) the first batch of reports in the public administration review has been shared with programme partners with one month delay, while presentations and discussions took place during the review mission;(iv) A basic roadmap of the National Health System has been shared with programme partners, which will be accompanied by a further detailed roadmap, to be agreed with programme partners by end-June 2014.
Labour market	**Partially compliant:** The deadline for the submission of the National Action Plan for Youth Employment and of a note summarising all active labour market measures has been missed. No progress has been registered with respect to pursuing a tripartite agreement with social partners for the application of the reformed wage indexation system in the private sector.
Goods/services market	**Partially compliant:** Some of the Q1-2014 deadlines have been missed. In particular, (i) in the housing market, the authorities have not yet defined deadlines for the issuance of building certificates and title deeds, ensuring also their enforcement; (ii) in competition, the authorities have not adopted the new mergers law; (iii) in tourism, the authorities delivered the first progress report on the implementation of the tourism action plan, but adjustments are still needed. The aeropolitical strategy was adopted, with a 1.5 month delay, during the mission (mid-May).
Data reporting	**Compliant:** The authorities comply with the data reporting requirements, as set in the MoU.

Source: Commission services.

and maintain its momentum. Continued full and timely policy implementation remains essential for the success of the programme.

3.1. FINANCIAL SECTOR

3.1.1. Maintaining liquidity in the banking sector

In May 2014, stage three of the roadmap was reached. Although the four milestones in Stage two were met already by end-January 2014, the full implementation of this stage was accomplished only in May as a prudent approach was followed. Restrictive measures relating to fixed-term deposits were abolished in March and the limits on transfers within Cyprus were lifted on 5 May. At this date, stage two of the roadmap can be considered officially closed (see Box 2.4). A few restrictions belonging to stage three have already been eliminated, notably the abolition of the restrictive measures relating to cash withdrawals in March and allowing the cashing of cheques in May. This occurred against the background of meeting one of the two milestones in stage three, namely the merger of cooperative banks.

With the opening of current accounts in end-May, payments within Cyprus are totally free, completing stage three. Before this last action, a newly opened account with cash could only be used as term deposit. Transfers to and from these accounts were not permitted, while the capacity to put money on them was also constrained by the banks' policy to impose cash withdrawal restrictions for liquidity management purposes and for costumers' security. This last domestic restriction on opening new current accounts was lifted end-May, leaving only the cross-border capital controls in place, covered by stage four of the roadmap. As recently evidenced with the large outflows from the cooperative sector, confidence is not yet fully restored. Further relaxations will be carefully assessed, taking into account the issue of overall financial stability.

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

The authorities have made progress in the implementation of the banking sector supervisory and regulatory reform. The new provisioning and disclosure directive, which will provide more information about the quality of bank assets and how they work out (Non-Performing Loans) NPLs, was published and became effective for the publication of the 2013 accounts for the cooperative sector. For the remaining banks, the provisioning and disclosure directive will be fully implemented by the time of the publication of the 2014 annual accounts. The Central Bank of Cyprus has stepped up its monitoring on the implementation of the restructuring plans by Bank of Cyprus and the coops, namely through the review of quarterly reports based on key performance operational and financial indicators, such as cost-income ratio, interest margin, loan-to-deposit ratio, etc. Staffing issues, in particular those related to the integration of the supervision of the cooperative sector, have been addressed. The assessment of the banks' operational capacity to work out NPLs has been finalised. The role of the Financial Ombudsman has been clarified, and the necessarily legal changes will soon be introduced.

Nevertheless, internal resource constraints have prevented the authorities from meeting all deadlines, some of which have been subsequently shifted. The Central Bank of Cyprus will develop options for the use of the credit register for supervisory purposes, e.g. for the determination of probabilities of default, and the additional data needed for that, by end-September, rather than end-May. The Central Bank Cyprus has to amend the governance directive, including, among others, the interaction between the banks' internal audit units and the bank supervisors. This amendment could not be done by end-April, for which the deadline had to be shifted to end-July. The necessary legislative changes to the Resolution Law were reviewed by end-March, but the requirement to adopt them has been shifted to mid-July. The CBC could not publish its first Financial Stability Report, which is now expected to appear at year-end. Progress with the management of legacy Laiki, and in particular with the appointment of advisors on the asset disposal process and on handling the voting rights in BoC, has been slow, and deadlines have therefore also been changed.

New commitments reflect the need for the CBC to comply with the new Single Supervisory Mechanism (SSM), as well as the policy priority

to improve the quality of bank assets. The CBC will request the internal audit departments of BoC and the coops to examine lending and loan restructuring practices in the past, and will require the institutions to take actions if these examinations find out that damaging decisions have been taken. The governance of the CBC will be reviewed further and amended by end-September in order to properly reflect new responsibilities related to the SSM.

3.1.3. Recapitalisation, resolution and restructuring

Bank of Cyprus

The level of Non-Performing Loans (NPLs) in Bank of Cyprus has reached about 55% of gross loans, or equivalently EUR 14.5bn, in the first quarter of 2014. While the bank has set up special work-out units to manage problem loans, material progress in reducing the level of NPLs has been modest. Moreover, the level of NPLs will contract only slowly. According to the new definition of NPLs, which was brought to European best practices, restructured NPLs remain classified as NPLs for at least 6 months after being restructured or until at least a significant part of the principal has been repaid, even if restructured loans respect the new terms and conditions.

Managing NPLs is the key priority for Bank of Cyprus in the next years. The units that have been created for managing NPLs of retail customers, SMEs, and mid- and large-sized corporates, are now up and running. A growing number of staff has been assigned to the work-out of problem loans and the volumes being managed by these units have more than doubled. Furthermore, Bank of Cyprus has appointed KPMG UK as an adviser to support the management of NPLs. Finally, the unit for mid- and large-sized corporates is broadening the target from the top 30 corporates and real estate developers to other large exposures. The amendment of the legal framework in relation to foreclosures and forced sales of mortgaged property could also support Bank of Cyprus' efforts to manage NPLs, in particular related to NPLs in the real estate sector,

The liquidity position of Bank of Cyprus has improved. This is mainly due to (i) the finalised sale of its subsidiary in Ukraine, for which half of the payment was received immediately, and the other half is expected by March 2015; and (ii) the sale of its equity stake in a bank in Romania. Furthermore, the sale of the assets of its subsidiary in the UK will also help support liquidity. As can be seen from the balance sheet of the Central Bank of Cyprus, this has allowed Bank of Cyprus to repay EUR 150m of ELA. The additional government guarantees for the issuance of bank bonds for a nominal value of up to EUR 2.9bn could be used as collateral to obtain liquidity, if necessary to safeguard financial stability, in line with State aid rules. At present, the liquidity position of Bank of Cyprus does not, however, require these guarantees to be issued. Against this background, the management of Bank of Cyprus decided to release one-third of the nine-month deposits (about EUR 300m) that were blocked until 30 April following the bail-in the summer of 2013. The two other thirds of the nine-month deposits will be released on 31 July and 31 October, respectively. The twelve-month deposits (about EUR 900m) that were frozen following the bail-in the summer of 2013 are due on 31 July, with the option to renew once for twelve months at most.

The capital position of Bank of Cyprus has remained stable with a core Tier 1 ratio at about 10%. The sale of its subsidiary in Ukraine had a slight negative impact, which was offset by the sale of its equity stake in Romania. Moreover, the bank has proceeded with the sale of a real estate loan portfolio in the UK, following the acquisition of certain operations of Cyprus Popular Bank Public in early 2013. This operation is expected to have strengthened BoC's capital position. The core Tier 1 ratio is expected to remain above 9% throughout the programme period, in accordance with the MoU, while the bank has been preparing for the ongoing Asset Quality Review and Stress Test organised by the ECB.

The Cooperative Credit Institutions

Upon approval of the restructuring plan for the cooperative sector by the EC on 24 February, the recapitalisation was finalised. EUR 1.5 billion of state funds, in the form of ESM notes, were injected into the Cooperative Central Bank (CCB) in exchange for common shares on 10

Box 3.1: The restructuring of the cooperative sector – state of play

The consolidation of the cooperative credit institutions (CCIs) into 18 new merged entities is expected to significantly improve supervision and deliver efficiency gains. The new institutions will have a standardised organizational structure and will implement a common Manual of Operations and Procedures. Each CCI will establish Internal Audit and Risk Management units, under the oversight of the Board of the Cooperative Central Bank (CCB) through its Internal Audit and Risk Divisions. The mergers will enable the CCIs to reduce their operating costs, notably by bringing the total number of branches from 417 as of December 2012 to 258 by the end of 2015. Eleven out of the 18 CCIs have already proceeded with the closure of 31 branches.

In an effort to mitigate the negative impact of the mergers in terms of liquidity, further closure of branches has currently been put on hold. As a result of the consolidation of accounts following the mergers, many individual clients' deposits exceeded the EUR 100,000 limit under the Deposit Guarantee Scheme. The staff reduction has led to the need to rebuild the relationship of confidence. In addition, rumours were spread that deposits will be put to contribution in the recapitalisation process, despite the sufficiently large envelope under the programme. These different factors led to an increase in deposit outflows which, in April, exceeded the average monthly outflow from the first quarter of the year. In reaction to this, the cooperative banks slowed down the closing of the branch network in an attempt to preserve the relationship with clients. Despite this negative impact of the restructuring process, the sector remains with a comfortable liquidity buffer without any borrowing from the Eurosystem.

The Restructuring Unit, in charge of monitoring the implementation of the restructuring plan and of providing ongoing support to the various Divisions of the CCB, was set up in March. Monitoring tables were designed, covering the four crucial areas of the Plan: arrears management, cost cutting, governance and non-core activities. Financial and operational Key Performance Indicators will provide quantitative guidance on progress. The monitoring tables will record all actions required, the responsibilities of each Division, and the timeframe of any action, and will be updated at least quarterly. Compliance with the restructuring plan will be ensured through regular meetings with each CCI management. The monitoring trustee (Grant Thornton), on behalf of the European Commission, will also supervise the implementation of the restructuring plan.

The set-up of the Shared Services Division (SSD), which will centralise and streamline NPL management, is a crucial milestone of the restructuring process. Oliver Wyman is advising the authorities on designing the most efficient structure for maximising value. The SSD at the CCB will include an Arrears Management and Restructuring unit, comprised of five regional teams, a Debt Recovery unit, also divided in five regional teams, and a Property Management unit. Specific criteria for the allocation and possible migration of the loan facilities have been determined, and the staffing needs of the division have been addressed. Expectations are high that the SSD delivers results quickly, given the magnitude of loan quality deterioration. The average NPL ratio across the sector reached close to 51% in end-March, with a substantial discrepancy between the geographical and the occupational CCIs, where the NPL ratio was only 10%.

Next to arrears management, improvements in operational efficiency and cost cutting are the other major priorities for the restructuring process. It is planned that the cost/income ratio should not exceed 47.5%, 50% and 62.5% for CCIs with assets above EUR1b, between EUR 500m and EUR 1b and below EUR 500m, respectively. This is to be achieved through the creation of common scales and pay harmonisation across all 18 CCIs and the CCB. The interest rate policy, with respect to both deposits and loans, also needs to be harmonised across the CCIs, also taking into account the interest rates practiced by the commercial banks. In the medium and long-term, operating costs are to be reduced through further sharing of services at group level.

Looking forward, the new executive and senior management will have to tackle a number of challenges. Problems with data quality and with the availability and analysis of financial statements for restructuring loans in arrears will have to be addressed first. The CCB will have to adequately integrate its new role and central functions so that the group starts to function as such. Finally, the autonomy of the CCIs will have to be contained in the new organisational set-up, without damaging the relationship with clients.

March 2014. After completion of the merger process into 18 consolidated institutions, the individual coops were recapitalised by the CCB in April in order to reach the minimum core Tier 1 ratio of 4% in each institution. As a result of these measures, the consolidated core Tier 1 ratio for the sector as a whole has strengthened significantly and lies well above the regulatory minimum.

The authorities are also proceeding with the other elements of the restructuring plan. The Restructuring Unit, in charge of monitoring overall implementation, was set up in March 2014. Key performance indicators that will assist the process and provide guidance have been agreed with the programme partners. In the area of governance, almost all executive and senior management positions have been filled, and a robust organisation structure, with an emphasis on internal audit and risk management, has been designed. Oliver Wyman is advising the CCB on the set up and operation of a Shared Services Department that will be in charge of working out non-performing loans. Cost-cutting measures have been undertaken, through a reduction in the total payroll by 15% and the closure of 31 branches in the first quarter of 2014. Looking ahead, arrears management remains the biggest challenge.

Hellenic Bank

In accordance with the MoU, the business plan of Hellenic Bank was submitted to the Central Bank of Cyprus in March 2014. While the programme conditionality only requires Hellenic Bank to submit a business plan and not a fully-fledged restructuring plan, future review missions will continue to monitor its implementation in light of the large size of the bank. The business plan, covering the period until 2016, has set as an important priority the coping with the deterioration in the quality of its loan book. The level of NPLs has reached 49% of gross loans in the first quarter of 2014. Although this is less than some of its Cypriot peers, in an international comparison this is very high. The main challenge is to prevent early arrears from becoming non-performing loans, and to actively manage the latter in order to maximise the value of the bank's assets.

The liquidity and capital situation of Hellenic Bank remains satisfactory. The core Tier 1 ratio had fallen to about 7%, below the regulatory minimum of 9%, at the end of 2013. This did not mean that the bank was facing an actual capital shortfall, because it had (and still has) a relatively large amount of Tier 1 instruments (CoCos) for which the trigger point is 9% core Tier 1. In order to fill the capital shortage, last March, EUR 86m of the CoCos were converted into equity and this raised the core Tier 1 ratio again to 9%. Hellenic Bank still has EUR 134m of CoCos left, and if they would be fully triggered, the core Tier 1 ratio would increase by three percentage points. However, the CoCos have been structured in such a way that they are not covered all at once upon breaching the 9% threshold, but only the amount necessary to bring back the core Tier ratio to exactly the minimum level of 9%.

3.1.4. Establishing the legal framework for private debt restructuring

The authorities established a steering committee and a project manager for the preparation of a comprehensive framework for reformed corporate and personal insolvency procedures. Their work regarding the design of the instruments of the insolvency framework is progressing and with regard to a corporate insolvency regime it does not only include improvements of the existing liquidation procedure but, more importantly, also the creation of modern rehabilitation tools for companies, which would allow them to develop a rescue plan and to continue their business activity.

With regard to the personal insolvency regime, a reform of the current judicial bankruptcy regime is being considered. This would aim at introducing a discharge from bankruptcy after a short number of years and under certain conditions for over-indebted vulnerable individuals with no ability to repay in order to allow them a fresh start. A negotiated debt settlement plan could be considered as an additional personal insolvency instrument in order to help facilitate debt restructuring of individuals in financial distress.

In parallel, the authorities are examining licencing and regulation options with regard to insolvency practitioners. Depending on their respective design, both private and corporate insolvency tools currently developed by the authorities may require the involvement of insolvency practitioners to facilitate the procedure.

The authorities have drafted legislation, which will facilitate the forced sales procedure by enabling mortgage creditors to conduct private auctions. This will help create an efficient foreclosure procedure, which will enhance the functioning of the insolvency framework, discourage strategic defaults and incentivise voluntary debt restructuring. The current draft still requires some improvements inter alia the exclusion of any interference from government agencies in the private auction procedure.

The authorities have established a Task Force, which is preparing a study assessing the magnitude of registered, but untitled, land sales contracts and underlying mortgages. On this basis, the Task Force, which comprises representatives of the CBC, the Ministry of Finance, the Law Office of the Republic and the Land Register, will develop recommendations, in particular with regard to the facilitation and acceleration of the transfer of title deeds to the purchaser, in cases where the sales contract did not require an immediate transfer of the property title.

3.1.5. Anti-Money Laundering

The Cypriot authorities have made further progress in addressing the commitments agreed in the Anti-Money Laundering (AML) action plan. After enhancing the legislative and regulatory AML framework, the focus has shifted towards effective implementation of AML rules. Identifying, assessing and mitigating money laundering and terrorist financing risks in practice forms an essential part of the agreed action plan. Most banks submitted by the first quarter of 2014 their annual risk assessment reports approved by their boards of directors to the CBC for review who committed to provide appropriate follow-up and feedback.

Following the third-party review of the functioning of the Companies' Registrar, the Cypriot authorities adopted a plan to reform the Department of Registrar of Companies. The reform plan lays out the various actions to be taken in nine areas (such as personnel roles and responsibilities, process and legislation, and compliance), and sets specific timelines for finalizing these actions. The relevant legislation in relation to the reforms indicated as high priority is foreseen to be implemented by Q4-2014, following adoption by the House of Representatives. In line with the reform plan, by end-January 2015, competent authorities should be able to access adequate and accurate current beneficial ownership information on all types of legal persons registered in Cyprus based on the information contained in the Companies' Registrar.

The CBC and the other supervisory bodies have reached further milestones in enhancing their risk-based approach to supervision. With technical assistance provided by the IMF, the CBC has developed a risk-based supervisory tool for onsite inspections, which includes examination procedures on corporate governance, risk assessment systems, policies and procedures, compliance functions, internal audit functions, training programmes, etc. Most of these examination procedures were used and tested in an onsite inspection of a credit institution in March 2014. Both the Cyprus Bar Association and the Institute of Certified Public Accountants of Cyprus have developed questionnaires to collect information relevant for their supervisory activities. These tools for offsite monitoring of lawyers, accountants and administrative service providers have been refined after pilot testing. All authorities should continue to use them in coherence with the development of a methodology for onsite activities and general risk-based assessment strategies. The Cyprus Securities and Exchange Commission has completed the first phase of the development of its offsite supervisory tool and is currently in the second phase of designing the methodology processes and procedures. In addition, the CBC and the other supervisory authorities shared anonymized information about their supervisory measures and enforcement actions applied for non-compliance and/or violations of laws and regulations.

The CBC has initiated some enforcement actions with regard to breaches of compliance with the relevant obligations under the AML regulations. In three cases, the CBC has sent letters, requiring banks to address the shortcomings identified in their systems and processes. In one case where the breaches were of a more systematic nature, the CBC has initiated the procedures to impose a sanction. The CBC committed to finalise these actions before the next review mission.

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

million euros unless otherwise stated			Fourth review forecast (May 2014)			Third review forecast (February 2014)		
	2012	2013	2014	2015	2016	2014	2015	2016
Total revenue	**6,974**	**6,656**	**6,626**	**6,544**	**6,820**	**6,528**	**6,479**	**6,800**
Taxes on production and imports	2,633	2,396	2,362	2,421	2,533	2,328	2,404	2,538
Current taxes on income and wealth	1,962	1,916	1,805	1,821	1,900	1,785	1,809	1,892
Social contributions	1,510	1,475	1,483	1,510	1,552	1,480	1,493	1,528
Sales and other current resources (1)	858	863	960	790	833	933	771	840
Capital transfers received	11	6	16	2	2	2	2	2
Total expenditure	**8,109**	**7,553**	**7,459**	**7,373**	**7,225**	**7,443**	**7,457**	**7,270**
Total current expenditure	7,425	6,937	6,897	6,889	6,730	7,001	7,004	6,802
of which								
Intermediate consumption	865	741	775	774	746	800	809	786
Compensation of employees	2,819	2,567	2,385	2,349	2,328	2,406	2,357	2,323
Social transfers	2,598	2,589	2,703	2,726	2,616	2,690	2,736	2,623
Interest	563	560	558	571	606	638	639	671
Subsidies	95	95	93	90	90	90	90	90
Other current expenditure	487	384	383	379	344	378	373	310
Total capital expenditure (2)	675	611	555	477	488	442	453	468
General government balance	**-1,135**	**-897**	**-833**	**-829**	**-405**	**-915**	**-978**	**-471**
% GDP	*-6.4*	*-5.4*	*-5.3*	*-5.1*	*-2.4*	*-5.8*	*-6.1*	*-2.8*
General government primary balance	**-572**	**-337**	**-275**	**-258**	**201**	**-277**	**-339**	**201**
% GDP	*-3.2*	*-2.0*	*-1.7*	*-1.6*	*1.2*	*-1.8*	*-2.1*	*1.2*

(1 The February projection for 2014 includes the expected increase in the distribution of dividends by the CBC compared to the previous year. The 2015 and 2016 numbers will be adjusted once decisions are taken by the CBC on dividends in these years. (2) 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.

In light of the recent changes to the AML rules, the Unit for Combating Money Laundering (MOKAS) conducted several seminars on preparing and submitting suspicious transaction reports. Knowledge- and awareness building of financial institutions, as well as some of the entities reporting to the other supervisory authorities, have all progressed. However, additional training would still be needed in order to cover the full range of reporting entities, inter alia on the duty to report issues relating to tax crimes, as well as the staff of the supervisory authorities themselves. In compliance with the MoU, MOKAS also continued to provide to the programme partners the breakdown of requests made and received to and by foreign financial intelligence units, including spontaneous disseminations.

3.2. FISCAL POLICY

The fourth review mission confirmed that Cyprus' fiscal performance is on track. Although a number of revenue and expenditure items performed better than expected in the first quarter of 2014, the higher-than-anticipated amount of government guarantees that were called or are expected by the authorities to be called offset the positive impact on the budget balance. ([2]) All major revenue categories were revised slightly upwards, in line with the better macroeconomic outlook for 2014 and the fiscal outcome in Q1. Total expenditure was also revised upwards, mainly due to the increased capital expenditure to service the higher-than-expected government guarantees due (amounting to about 0.5% of GDP). In addition, social transfers were also revised upwards, due to an accelerated processing of pending redundancy payments. The further deceleration of the public sector retirement wave partly compensates for these developments. All in all, increases in revenues and expenditure largely offset each other. The primary balance target for this year has been maintained.

([2]) The bulk of called government guaranteed loans relates to the Cooperative Central Bank. Further liabilities relate to the agreement with an international bank on the restructuring of government guaranteed loans, as well as to calls on a government guaranteed loan for Cyprus Airways. In order to reduce the fiscal risk coming from called government guarantees, a risk assessment unit has been established under the Public Debt Management Office, which is currently building a comprehensive database on government guarantees. The adoption of a medium-term debt management strategy is meant to facilitate further the monitoring and risk assessment of contingent liabilities stemming from government guarantees.

The projection of total revenue and expenditure over 2015-16 remains broadly stable compared to the last review. In spite of a slightly more protracted economic recovery in 2015-2016 than previously anticipated, total revenue is expected to remain in line with the earlier projection on the back of the positive carry-over due to the improved revenue forecast for 2014 and the impact on social security contributions of a slightly better labour market outlook compared to the last review. So far, the forecast does not include the additional dividends expected to be distributed by the CBC in 2015 and 2016. The projection of total expenditure has been moderately reduced for 2015, driven by the deceleration of the retirement wave in the public sector, some reduction in intermediate consumption and lower interest payments due to a downward revision in the assumed ESM interest rate. At the same time, the forecast for social transfers for 2015-2016 remains largely unchanged, reflecting the maturing GSIS pension system. Under the assumption that measures will be taken to close the fiscal gap in the outer programme years, the amount of consolidation measures to be specified for 2015-2016 has been revised slightly upwards to 1.7% of GDP (from 1.3% of GDP previously). This can partly be attributed to a slower economic recovery in 2015-2016 than previously anticipated.

The Cypriot authorities submitted to programme partners a first draft of their Fiscal Strategy Statement (FSS), which initiates the annual budget preparations. The FSS covers the period 2015-2017. In line with the MoU commitment, the updated programme fiscal targets and the underlying updated budgetary projection have been embedded in the draft FSS, which is expected to be adopted by the Council of Ministers in June this year.

Fiscal risks remain significant. The risks concern notably: 1) the government's large exposure to contingent liabilities; 2) downside risks related to adverse macroeconomic developments in the outer programme years; and 3). the requirement under the new Bank Recovery and Resolution Directive to transfer as of 2015 an annual amount of 0.1% of domestic insured deposits to its bank resolution fund, which in case the current bank levy is not increased would imply an annual fiscal cost of about 0.2% of GDP.

3.3. FISCAL-STRUCTURAL REFORMS

3.3.1. Pension and Healthcare System

Pension

The Cypriot authorities provided the necessary information to verify that all of the measures aimed at the Government Employees Pension Scheme (GEPS) apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees. Some pension schemes applying to hourly paid employees in the broader public sector are based on collective agreements and therefore fall outside the control of the executive and legislative powers of the authorities. The authorities issued a circular advising the concerned entities to undertake reforms in line with the GEPS reform. This is an on-going effort, which will be further monitored.

Healthcare

On healthcare reforms, efforts need to be stepped up to comply with the ambitious deadlines. The authorities remain committed to the full implementation of the national health system (NHS) by mid-2016, and have decided which parts of the NHS will be phased-in. The plan now foresees that primary care consultation services will be covered by mid-2015, which will be followed by outpatient specialist care and outpatient pharmaceutical care in January 2016, with full implementation by mid-2016. Against this background, the authorities have presented a basic roadmap, which should be followed by a detailed road map by end-June 2014. The approval by the House of Representatives of the healthcare framework bill, which will define among others the NHS budget, is foreseen for the end of 2014. The tendering process for the IT-infrastructure necessary for the NHS will be initiated by end-June 2014. The IT system is a crucial precondition for NHS implementation.

The NHS will be initially based on a single payer insurer, but could evolve into a multiple insurance system. As the government is keen on opening NHS towards health insurance competition on the basic benefits package, a study by an independent consultant will assess whether and when the necessary preconditions for

Box 3.2: Technical assistance to help deliver the healthcare system reform

The Cypriot authorities are undertaking important reforms to strengthen the sustainability of the funding structure and the efficiency of public healthcare provision. The introduction of a National Health System (NHS) is a core element in this regard. In line with the macroeconomic adjustment programme, the Cypriot authorities are committed to fully implementing a NHS system by mid-2016, with a first stage introduction by mid-2015.

In this context and following requests from the Cypriot authorities, the Support Group for Cyprus (SGCY) has been instrumental in channelling technical assistance to Cyprus across a broad range of areas, including:

(i) **preparing the technical requirements for a comprehensive IT system for the NHS with the help of national experts from Portugal**. The IT system will register all revenues and expenditures related to the NHS, monitor the quantity of medical services and goods provided, and will serve as a monitoring tool for health system performance. It is envisaged that such support will continue during the next phase involving the actual development and testing of the IT system (TBC);

(ii) **developing expertise in clinical guidelines and clinical audit**. Clinical guidelines are recommendations on the appropriate treatment and care of people with specific diseases and conditions, while clinical audit is a quality improvement process that seeks to improve patient care and outcomes through a systematic review of care provision against explicit criteria and the implementation of change, where needed;

(iii) **developing a Health Technology Assessment (HTA) process**. HTA is a multidisciplinary process that summarises information about the medical, social, economic and ethical issues related to the use of a health technology in a systematic, transparent, unbiased and robust manner. Its aim is to inform decision-makers on the formulation of safe and effective health policies that are patient-focused and seek to achieve best value for money; and

(iv) **helping to code patient cases using a system of diagnosis-related groups (DRGs)** under which hospitals will be paid a predetermined rate based on the patient's diagnosis to better control healthcare expenditure.

In addition to such specific technical assistance, a resident healthcare expert is being recruited to work in the areas of health systems and services and to coordinate -on behalf of the SGCY- the technical assistance provided to the Cypriot authorities in the area of healthcare.

achieving efficiency and affordability gains with a multiple insurance system can be ensured.

By end-June 2014, an organisational reform plan is foreseen to be approved by the Council of Ministers. It will cover the Ministry of Health, all public hospitals and other public health facilities, the Health Insurance Organisation and other associated facilities and organisations. A shadow budget for hospital inpatient activity, necessary for the transition to hospitals' financing based on their activity will be prepared by Q3-2014 and be extended to all hospital activities by end-2014.

3.3.2. Public Financial Management and Budgetary Framework

The adoption of secondary legislation to make the Fiscal Council operational was delayed and was therefore set as a prior action. An implementing text specifying further operational elements, including the legal status of the Fiscal Council staff, is needed to allow for the staffing of the Fiscal Council. Due to administrative delays, the draft of this legislation has been pending for adoption by the House of Representatives since end-February. Parliamentary approval was a mid-March deadline in the MoU and was set as a prior action. Furthermore, the Finance Committee of the House of Representatives needs to approve the nomination of the Fiscal Council Board members, as appointed by the Ministerial Council in April 2014. When approved, the Fiscal Council will be able to conclude a Memorandum of Understanding on the exchange of information between the Fiscal Council, Ministry of Finance, Central Bank of Cyprus, and University of Cyprus (also set as a prior action). Rapid adoption of these texts is needed in order for the Fiscal Council to undertake its tasks in the opening stages of the 2015 annual budgetary cycle.

In the field of public financial management, the MoU foresees actions to ensure proper recording and control of spending commitments, as well as monitoring of government guarantees. The authorities have put in place a system to ensure that spending commitments by the central government are subject to pre-commitment validation. Action was taken to ensure appropriate human resources at the Public Debt Management Office (PDMO) to carry out proper risk assessment of the outstanding stock of government guarantees. The PDMO has committed to submit the first quarterly risk assessment analysis of government guarantees to programme partners by mid-July. The programme also includes a new end-September deadline for the authorities to strengthen the institutional framework for managing guarantees.

3.3.3. Public Private Partnerships

The latest update of the Public Private Partnerships (PPPs) inventory reflects the respect of the moratorium until both the legal and the institutional frameworks are in place. The recently-adopted Fiscal Responsibility and Budget System Law (FRBSL) provides for an improved management of public investment, whether undertaken via traditional procurement of through PPPs. Guidelines for the management of public investment are expected to be implemented by June. They should include clear rules regarding the evaluation and approval of investment projects proposed by the line ministries and should provide guidance on the role played by the Minister of Finance. Once the guidelines are implemented, the PPPs moratorium will be lifted.

3.3.4. Privatisation and State-Owned Enterprises

While the Privatisation Law was adopted as a prior action on 4 March, the Privatisation Unit will only be fully operational by June. The Law provides the basis for the institutional framework and the regulation of the privatisation process. Required steps for the creation of the Privatisation Unit under the Ministry of Finance have been launched, including the appointments of its Head and two experts. The Head was appointed and approved by the Council of Ministers in early May, while the selection of the Unit's staff should be finalised by early-June.

The State-Owned Enterprises (SOEs)' Corporate Governance Law has not yet been adopted, as adjustments were needed to avoid inconsistencies with the FRBSL. This law is aimed at increasing the Ministry of Finance's monitoring and budgetary control powers over SOEs, entailing better coordination, control and supervision, thereby mitigating risks for the government's fiscal position. The law specifies clear auditing requirements and introduces a more rigorous approval procedure for the creation of new SOEs. The delay in the law's adoption is due to inconsistencies with the FRBSL, including different definitions for SOEs, the allocation of responsibilities and process of strategic planning. The creation of a specific SOEs Unit by law is also being questioned, as this could introduce an unnecessary rigidity in the organisation of the Ministry of Finance.

A SOEs Plan with a detailed roadmap for those SOEs under internal review is now underway. The Plan will set out the process and timelines for the review and restructuring of SOEs recording significant financial losses. Restructuring will be decided on the basis of the review, on a case-by-case basis.

3.3.5. Revenue administration

The short-term reforms to enhance efficiency and support tax collections have been further delayed and are currently assessed as non-compliant. The legal amendments to enhance the collection powers of the tax authorities and to establish self-assessment of income taxes were submitted to the House of Representatives (HoR)

Box 3.3: Public Private Partnerships in Cyprus

The literature and research on Public Private Partnerships (PPPs) has pointed to a number of potential benefits ([1]).A main argument supporting PPPs is the alleged greater experience and knowledge of the private sector in providing services in a cost-effective and efficient way. Furthermore, PPPs have been found to ensure a provision of services more on-time and on-budget than traditionally procured projects.

However, risks also exist. Fiscal risks arise from the long-term character of PPPs and their complex contractual arrangements that may not always reflect potential future contingencies for the State. PPPs may also involve inadequate sharing of benefits and risks, whereby the risks may tend to be largely borne by the State.

The overall importance of PPPs in Cyprus has so far been limited. There are no harmonised statistical data for PPPs at the European level, so a country comparison of the relative importance of PPPs is not available. In Cyprus, out of total public and private sector investment, around 5% was invested via PPPs in 2006-2013. This figure is an approximation with respect to the importance of PPPs in public investment, since no proper breakdown between public and private shares in PPPs has been obtained for the existing inventory. It is clear that the detailed share of public investment requires more detailed reporting.

Existing PPPs tend to be concentrated in particular sectors. According to the data provided by the Cypriot authorities (see table below), apart from the two international airports finished four years ago, marinas and desalination plants seem to attract most PPPs. The projects are generally sizeable and in some cases very large in comparison with the economy, pointing to the importance of a proper framework and risk assessment in order to prevent the occurrence of any contingent liabilities.

Table 1:
PPP contracts per Financial Reports 2006-2013

	Concession Name	Reference period	Capital Value of the Project EUR m
1	Larnaka and Paphos Airports	2006-2031	574.0
2	Larnaka Desalination Plant	2012-2039	47.5
3	Dhekelia Desalination Plant	2005-2027	27.3
4	Moni Desalination Plant*	2008-2011	9.7
5	Limassol Marina	2010-2062	351.0
6	Limassol Desalination Plant	2012-2032	45.8
7	Agia Napa Marina	2012-2067	220.0
	Total		1,275.3

* After the July 2011 naval base blast, the electricity power plant and the mobile desalination unit have been put out of action.
Source: Cyprus Treasury.

Already in mid-2013, the Cypriot authorities committed to establish a comprehensive PPPs strategy, including a stronger mandate for the Ministry of Finance for both the evaluation and the budgeting of projects, considering the need to manage fiscal risks. By putting in place an adequate legal and institutional framework for public investment including PPPs (through the recent adoption of the FRBSL and the guidelines to be distributed to line ministries later in June), the authorities aim to establish an effective gateway process verifying the economic and fiscal feasibility of projects, as well as the assessment and management of fiscal risks. Initially, the Cypriot authorities created an inventory including current and planned PPPs, contingent liabilities, as well as a three-year projection of the baseline revenue and expenditure impact of each PPP on the budget. This inventory has been shared with, and approved by, programme partners. It will be regularly updated and included in both the annual budget law and in the annual financial report, as of this year.

With the recent adoption of the FRBSL, a more predictable management of public investment, particularly via PPPs, can now be ensured. This legal basis should allow for more certainty when assessing the fiscal affordability of projects, better monitoring of public investment projects, as well as the development of financial reporting. Nonetheless, the current PPPs moratorium (whereby the Cypriot authorities committed not to enter into any new tendering process and not to sign any new PPP contract before the implementation of the legal and institutional

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([1]) Useful references to key empirical evidence on both potential benefits and risks:
http://ppp.worldbank.org/public-private-partnership/overview/ppp-objectives
http://www.oecd.org/gov/regulatory-policy/47377698.pdf

EIB EPEC Guide for public procuring authorities:
http://www.eib.org/epec/g2g/index.htm

EIB: Economic and Financial Report 2006/01
http://www.eib.org/attachments/efs/efr_2006_v01_en.pdf

Box (continued)

framework, excluding any projects that reached commercial close by end-October 2012) will not be lifted until new guidelines (to be adopted by the Council of Ministers) on public investment projects are implemented. In this context and in order to make sure there are no major fiscal risks involved, it is of essence that the Cypriot authorities specify the steps needed in order to establish PPPs that deliver value-for-money, while considering the possibility of having to renegotiate existing PPPs contracts, by making them more flexible, and under the strict monitoring of the Ministry of Finance.

as a package in March. Controversies around the procedures to be followed for the garnishing of bank accounts led the authorities to consider withdrawing the relevant legal amendments from the HoR. This has stalled the progress for the entire package. The key controversy pertained to the question of whether to require court approval prior to garnishing bank accounts of tax debtors. In the revised MoU, the authorities agreed that the garnishing of bank accounts should not require prior court approval, but that the taxpayer could be given a short appeal period. The new deadline for adoption of the legal amendments is end-June.

There is so far little progress to enhance the prosecution of tax fraud as a criminal offence. By law, the tax departments enjoy sufficient investigative powers, but there is a lack of investigation capacity (notably, skilled staff) and a risk-based prosecution case selection process is not made use of. As a result, the authorities have established a practice of settling cases by agreeing with the taxpayers on a penalty. Until recently, only the Customs and Excise Department has prosecuted tax fraud as a criminal offence, resulting in a small number of convictions each year. After some years without any prosecution activity, the Inland Revenue Department (IRD) is now pursuing one case, but no measures have been implemented to systematically enhance the prosecution of tax fraud. Thus the measure is currently assessed as non-compliant. Since there are no quick fixes to the underlying issues, the authorities agreed to propose a prosecution strategy by Q3-2014, which would be implemented by the new tax administration.

The enabling law to formally establish the new integrated tax agency was submitted to the HoR in early May, a few days after the MoU deadline. The law contains new rules vis-à-vis the Commissioner and deputy Commissioners of the new tax agency regarding their appointment, terms of office and accountability. It adopts key recommendations from the independent review of discretionary powers, which also issued specific recommendations on the accountability framework for these posts. The adoption of the law would mark a point of no return for the integration of the two existing tax departments into a new tax agency, and has been made a prior action. Accordingly, the unified Cypriot tax department would be formally established by 1 July 2014.

A data platform was created using data from all tax departments for risk analysis, but full access to the Inland Revenue Department (IRD) data has not yet been granted, resulting in only partial compliance. The development of a comprehensive compliance strategy has been launched under the guidance of technical assistance by the IMF, but the unwillingness of the IRD to provide full data access has strained the efforts. Other related work streams that depend on data access concern tax debt management, the cleansing of the tax registers, as well as the joint work programme for large and high risk taxpayers. Moreover, the preparation of the new single database for the new tax agency requires full data access. A revised deadline for IRD data access was set for end-June.

3.3.6. Public Administration Reforms

The results of the first batch of reports (Ministries of Health, Education and Agriculture, as well as local governments) are going in the right direction. Final reports reflect discussions held with the Cypriot authorities and the technical assistance experts from the World Bank and the UK since late 2013. The Cypriot authorities are currently working with the experts on a concrete reform plan for implementing the reports' recommendations. The Council of Ministers is expected to approve the public administration reform plan of these ministries by June 2014.

Preliminary conclusions point to reform challenges ahead. On *local governments*, the biggest challenge is to assess overall transition costs of far-reaching institutional reforms, including substantial reduction of municipalities and local authorities. This would be the first time for a reform on such a scale in Cyprus. Further decentralisation is also being considered. On *healthcare*, areas to be mainly affected include administration, network and hospital management, while involving stronger coordination between the Health Insurance Organisation and the Ministry of Health. Reform choices will be made in the context of the future implementation of the National Health System. On *education*, an excessively centralised system, together with a weak policy formulation and strategic planning, have led to a recommendation, inter alia, to establish a stronger inspectorate body, a more credible teachers' hiring and appraisal system and an increase in teaching hours. On *agriculture*, main challenges for the ministry include EU coordination and strategic planning.

3.3.7. Reform of the Welfare System

Despite further progress on the sequential steps foreseen for the adoption of the welfare plan, numerous delays have occurred, which pose risks for the full implementation of the welfare reform by July 2014. Based on an analysis of the social and fiscal impact of three possible options for the guaranteed minimum income scheme (GMI), the authorities retained one option, which is currently under consultation with social partners and political parties. The authorities also provided a common definition of income sources for the means-testing of all benefits and defined the level of additional allowances included in the GMI (housing allowances and the coverage of local municipal taxes). However, the Q1-2014 deadline for the adoption by the Council of Ministers of the final design of the reformed welfare system, the main deliverable of the reform, was missed. Also, work on reviewing other social benefits that fall outside the GMI (primarily relating to the child benefits and educational benefits) is not yet finalised. For this reason, it is not yet possible to confirm that the costing of the new GMI and other benefits that fall outside the GMI would still be within the agreed fiscal envelope. In order to ensure budget neutrality of the reform, the authorities committed to provide before the next review possible contingency measures, including a list of benefits outside the GMI for which the beneficiary profiles and eligibility will be streamlined if needed. Despite these delays, the authorities remained committed to implement the welfare reform by 1 July 2014. To that end, the adoption of the final design of the reform by the Council of Ministers and the adoption of the respective legislation by the House of Representatives are expected in June 2014.

Work is progressing with regard to the transfer of responsibilities to the Ministry of Labour, Welfare and Social Insurance (MLWSI) and on the design of an IT system to support the reformed welfare system. The authorities received TA from the Support Group for Cyprus for the IT project. The user requirement document, the analysis and design document, and the migration plan were delivered. The functionality of the IT system, including the registration of applications, has been presented. In parallel, proposals for the new administrative structure to administer the welfare system at the MLWSI were endorsed by the Public Works Department. Also, a tendering process was initiated on an appropriate building that could house the new benefit administration.

3.3.8. Other Fiscal-Structural Reforms

International tax cooperation

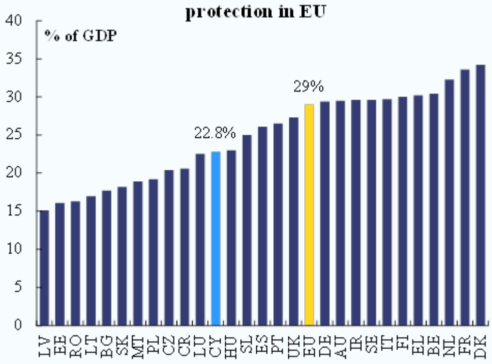
The authorities have provided an action plan to address the shortcomings identified by the OECD Global Forum peer review on Transparency and Exchange of Information for Tax Purposes. The four areas identified by the peer reviewers as non-compliant or only partially compliant concerned 1) the availability of ownership/identity information (Partially Compliant) and 2) of accounting records (Non-Compliant); 3) the insufficient enforcement of legally established rights to access certain information (Non-Compliant); and 4) delayed responses to information requests by foreign authorities (Partially Compliant). The authorities' action plan did not explicitly cover actions by the Department of the Companies' Registrar, which is

Box 3.4: **Enhancing the welfare system in Cyprus**

The reform of social welfare policy constitutes one of Cyprus' commitments under the economic adjustment programme. The need for enhancing the welfare system's effectiveness has become more prominent given the deterioration of the economic environment, which has increased the need to support people in high risk of poverty and social exclusion. On 26 July 2013, the Ministerial Council adopted a welfare reform plan, which aims at rationalizing and better targeting social benefits to those most in need, while avoiding dependence on benefits and promoting social inclusion. The reform also aims at improving the support for certain groups that under the current scheme may not be eligible for any support.

Cyprus ranks below the EU average regarding total expenditure for social protection, but welfare spending is rising fast. The financing of the social protection spending is covered primarily by contributions (e.g. for unemployment and sickness benefits, and social insurance pensions) with the remaining cost being tax-financed. The increased public spending in recent years has largely been driven by the increase in the unemployment rate, reflecting the deep economic crisis.

Graph 1: **Total expenditure on social protection in EU**



Source: Eurostat.

The current welfare system suffers from several weaknesses, which pose impediments to the equitable protection of vulnerable groups. These relate to: (i) fragmentation – i.e., benefits addressing the same objectives are often under the responsibility of different ministries; (ii) duplication – i.e. a single need is served by different administration entities; (iii) inequities – several benefits are largely insufficiently targeted; and (iv) disincentives for taking up work while receiving public assistance.

The reform of the welfare system is intended to address these inefficiencies and better support vulnerable households, while maintaining the social budget envelope unchanged. At the core of the new social welfare system is the existing unemployment benefit scheme combined with a reformed public assistance programme, the Guarantee Minimum Income (GMI). The new GMI will cover the basic needs defined on the basis of a new minimum consumption basket and additional allowances for housing cost and taxes. Both schemes will maintain work incentives through the benefit level, mandatory participation in active labour market policies (ALMP) (job search/clubs, interviews and public works), in-work benefits and earned income disregard. Both GMI and ALMP will be supplemented by other need-driven benefits, such as family, disability, and health benefits as well as education grants.

The planned refinement of the means-testing mechanisms and review of other benefits level should help generating a reallocation of resources within the agreed fiscal envelope. While the exact level and eligibility criteria of the need-driven benefits is not yet final, the aim of the reform is, within the total fiscal envelope, to increase the coverage under the GMI, expanding eligibility also to those not currently covered by the public assistance scheme (i.e., the working poor, the self-employed entering unemployment, and young unemployed graduates). The financing is foreseen by consolidating, streamlining or better targeting the need-driven benefits outside the GMI.

Provisional data show that the reform has the potential to significantly reduce the number of persons below the poverty line. At the time of the drafting this report, data on the level of the GMI allowance covering basic needs is still provisional. Whilst the level will only slightly improve compared to the existing public assistance benefit, bringing some beneficiaries above the poverty threshold (see Table 1), the main new element is that the GMI will have a wider coverage and will shift its focus towards the working poor and young unemployed. As a result, while the social spending envelope is to remain unchanged, the new GMI is

(Continued on the next page)

Box (continued)

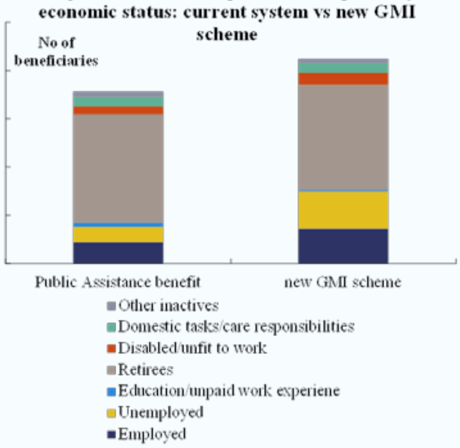
Table 1:
Level of GMI compared to current public assistance level

	Public Assistance benefit			new GMI scheme		
	Single person	+ dependent > 14	+ dependent < 14	Single person	+ dependent > 14	+ dependent < 14
Nominal amount[1] (EUR)	452	678	588	480	720	624
Equivalence scale[2]	1	0.5	0.3	1	0.5	0.3
Equivalent nominal amount (EUR)	452	226	136	480	240	144
as a % of poverty line[3]	0.53	0.53	0.53	0.56	0.56	0.56
as % of GDP per capita[4]	0.29	0.43	0.37	0.30	0.45	0.39

[1] At the time of drafting this report, the amount for the new GMI scheme is provisional
[2] In line with Eurostat, the equivalence scale used is the OECD modified equivalence that assigns the value of 1.0 to the first adult, 0.5 to each other household member aged 14 or over and 0.3 to each household member aged less than 14 years old.
[3] As per Ministerial Council decision of 10 April 2013, the poverty line is set at EUR 10,324.
[4] GDP per capita in 2013 is EUR 19,030
Source: Eurostat, Ministry of Labour, Welfare, and Social Insurance, and Commission services calculations.

projected to reduce poverty by around 3% as well as the intensity of poverty (i.e. the relative distance between the income of the poor and the poverty threshold) by around 17%, therefore helping bringing Cyprus closer to its EU 2020 poverty national target.

Graph 2: **Number and profile of recipients by economic status: current system vs new GMI scheme**



Source: Ministry of Labour, Welfare and Social Insurance.

relevant for at least the first three items. However, an overhaul of the Companies' Registrar is foreseen under the public administration reform and the AML action plan (see Section 3.1.5) and the Council of Ministers adopted end-April the relevant action plan, including actions which will help addressing the shortcomings identified. Given the large backlog in the Companies' Registrar, the time frame for the plan extends into early 2015, but with actions relevant for the Global Forum frontloaded to the extent possible. The authorities will outline all relevant actions and reforms in their follow-up report, which is due to the Global Forum end-May. In order to support the authorities" efforts to make rapid and comprehensive progress, the submission of the follow-up report has been made a prior action.

Earlier reforms had already led to the improvement in Cyprus' ability to respond to tax information requests by third countries. Notably, the implementation of the AML action plan, the staff reinforcement of the international tax liaison office (which has recently received three additional staff) and a change of practices in the Inland Revenue Department have helped to deliver more speedy responses. There is still, however, work to be done to reliably comply with the strict deadlines set by the international standards.

Progress with other MoU commitments in the field of international tax cooperation appears adequate, according to information currently available. The authorities are progressing with their large-scale examination in order to match information on savings income reported by the taxpayer with information received by other countries. They have also started to send out new tax assessments. The assessment of the correct transposition and implementation of Council Directive 2011/16/EU on administrative cooperation in the field of taxation is still on-going, while new performance statistics in relation to Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax are not yet available.

Immovable property tax

The General Valuation (GV) project on the update of the immovable property values, a major step of the Immovable Property Tax (IPT) reform, seems to be on track to implement the reform in 2014. Preliminary updated valuations will be submitted to the Inland Revenue Department (IRD) by end-May, while final data will be submitted by end-June, allowing the notification of imposition of IPT tax to taxpayers by early August.

The authorities are working on strategies to minimise operational risks. In order to ensure that the IRD will be able to send IPT assessments based on updated valuations to tax payers in time, a joint action plan has been produced including all the stakeholders of the IPT reform (Ministry of Finance, Department of Land and Surveys (DLS), and the Inland Revenue Department (IRD)). In addition, the authorities will prepare by mid-June 2014 a strategy to deal with possible citizens' complaints and another strategy for communicating the reform to the public audience.

The three studies aimed at strengthening the valuation procedures and reviewing property tax policy are progressing with technical assistance from the Central Statistics Office of Ireland and the Support Group for Cyprus. Preliminary results suggest that the valuation procedures used for the 2014 reforms are in line with international practice. The study on consolidating the collection and administration of the municipal property taxation and sewage tax, reviewing exemptions, and assessing the scope for shifting revenues from transaction to recurrent taxation will also provide an initial review of the tax regulations relevant for the foreclosure process, in order to minimise the cost of foreclosure.

3.4. STRUCTURAL REFORMS

3.4.1. Labour Market

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

Progress has been made in addressing the shortcomings of the current system of activation policies, while measures to tackle youth unemployment are about to be finalised. The authorities are expected to soon complete a comprehensive Action Plan for Youth Employment, which includes the establishment of a youth guarantee, In addition, a uniform monitoring and evaluation framework covering all active labour market measures is being developed. At the same time, various options to strengthen the capacity of public employment services within the constraints of the freeze on hiring are being devised, notably increased staff mobility and outsourcing. Finally, the cooperation, coordination, and exchange of information between public employment services and the social welfare administration have been strengthened.

3.4.2. Energy

To further develop a comprehensive strategy for the exploitation of Cyprus' domestic off-shore gas reservoirs and the transformation of

its energy sector, the programme foresees three interim commitments for Q2-2014: 1) submission of an update of the roll-out plan for the gas exploitation infrastructure; 2) submission of an advanced draft of specific legislation on the Sovereign Wealth Fund (SWF), which should *inter alia* define clear in- and outflow rules; 3) provision of an intermediate draft outline of the market organisation and regulatory regime for the energy sector and gas exports.

The submission of a revised roll-out plan can be considered to be achieved, although it will require updates for major new developments. While the plan is comprehensive and detailed, it is a living document that will require regular updates, taking into account the estimates of the size and quality of the gas available for commercial exploitation. Discussions during the mission focussed on potential major developments, including the prospects of (ad interim) imports of natural gas. In this regard, the tender procedure on a 10-year supply contract for imported natural gas appears to be on track. According to the tender timeline, a contract can be signed in the second half of 2014, and gas supply should start in 2016.

As regards gas export infrastructure, the Government Agreement (GA) is expected to be agreed in mid-2014, but the signing date is contingent on the government's actual approval to go ahead with the investment project(s)**.** The GA is foreseen to detail the terms and conditions of the Liquefied Natural Gas (LNG) plant project with the operator of the Aphrodite gas field, and eventually other energy companies. The authorities have designated an appropriate site for the project under a commercial rental contract. In line with the MoU requirement, the authorities have committed to evaluate in detail the potential financial and budgetary impact of the various options for developing an LNG plant and corresponding financing arrangements, prior to the finalisation of the GA and supplementary agreements.

Regarding the SWF, the inflow and outflow rules, already anchored in the FRBSL, will be provided for in the specific law on the resource fund and detailed in legislation implementing the FRBSL. Regarding the inflows, the FRBSL relies on a "net revenue" concept, which very broadly refers to taxes, dividends, fees and rights on the revenue side, netted off against "costs related to hydrocarbons". In order to ensure the SWF's credibility with respect to the rules governing inflows and outflows, the authorities remain committed to further clarify these definitions in specific legal documents.

Discussions on the institutional framework and the organisation of the electricity and gas markets continued. On the basis of reports that were received by programme partners prior to the mission, the focus was particularly on the future competitive regime of the electricity market, the future organisation of the gas market, and the timing and sequencing of the necessary reform measures. They include the possible use of the derogations available to Cyprus under the Third Energy Package, strengthening the regulator CERA, the unbundling of the electricity transmission and distribution networks, the privatisation of EAC and the start of gas imports and domestic supply.

3.4.3. Regulated Professions

The authorities have finalised the comprehensive review of requirements affecting the access and exercise of more than 100 regulated professions. The aim is to identify a number of requirements that are not justified or proportional, and which would need to be eliminated by law. The *full* elimination of such requirements cannot be done before Q3-2014, as all Member States are required, by this summer, to undergo an evaluation exercise on whether obstacles to access certain professions are or not justified and proportional.

3.4.4. Competition, Auditor General's Office and Sectoral Regulatory Authorities

Whilst the antitrust law was agreed and adopted end-March, the new mergers law has not yet been adopted. Finalisation of the mergers law took longer than initially planned. The final version of the law was agreed with the programme partners in early May. Adoption of the latter is expected by June.

Three chartered accountants will soon be transferred to the Competition Authority (CPC), while the latter is showing more pro-activeness in the area of advocacy. As soon as the new law on labour transfers and staff mobility

Box 3.5: **The Sovereign Wealth Fund – the inflows and outflows**

The establishment of a Sovereign Wealth Fund (SWF) is a useful policy tool for preventing a "resource curse". As is well established in the economics literature ([1]), large influx of resource revenues is prone to increase the risk of macro-economic imbalances.([2]) To tackle such problems, public resource revenues should flow through the budget into a SWF, with the aim of channelling the spending of these resources to well-defined destinations. The economic literature stresses that the success of a SWF critically depends on a sound legal footing as well as clear and credible rules (inter alia relating to inflows and outflows), which reflect a long-term consensus and are robust against political short-term pressures.

The creation of a resource fund in Cyprus and the rules regulating it are part of the programme conditionality. The MoU stipulates that the Cypriot authorities should establish "an institutional framework for the management of hydrocarbon resources, including a resource fund (…). The resource fund (…) 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 (…). The rules should be provided for in the FRBSL and the specific law on the resource fund and detailed in implementing legislation of FRBSL."

The FRBSL, adopted in February 2014, has established the SWF and provides for basic inflow and outflow rules. According to Article 74(4), the objectives of the SWF comprise: fiscal smoothing in order to safeguard public finances and the economy against fluctuations in the prices of hydrocarbons; the reduction of general government debt; and the investment of revenue surpluses in international financial assets, with the aim of providing security for future generations or achieving other long-term objectives. Article 73 of the FRBSL already anchors basic inflow- and outflow rules in the budgetary framework, relying however on a generic definition of "net revenues" which is reasonably precise with regard to gross revenue sources, but less precise with regard to the costs that will be subtracted before net revenues are deposited in the SWF.

While large-scale revenues can be expected only in the post-programme period, it is desirable to establish a clear legal framework already at this stage. In the run-up to the start of hydrocarbon exploitation, public hydrocarbon revenues are expected to be of a one-off nature, mostly consisting of signing fees for hydrocarbon exploration. However, establishing a clear framework at this stage, including concrete rules governing inflows and outflows, will help to ensure the SWF's credibility in terms of handling a more steady revenue stream once the exploitation of natural resources comes on steam.

Designing inflow rules is challenging in various respects. Costs and revenues are more easily defined for exploration and exploitation activities. For these activities, the Cypriot Government has signed with several energy companies "Exploration and Production Sharing Contracts" (EPSCs), which define the division of revenues and provide guidance on how to determine the costs. However, the legal framework should cover revenues from all segments of the hydrocarbon supply chain, notably also the downstream segment with a possible LNG plant and domestic distribution. In this regard, there are some main challenges. The rules should be simple, but able to cope with the shape of the hydrocarbon supply chain, which currently still is in the first stages of planning and development. Further, the rules should be coherent with those of the EPSC for reasons of transparency and consistency. In addition to that, while the aim should be to secure appropriate inflows to the SWF, not all taxes levied on the hydrocarbon supply chain should necessarily go into the SWF, in order to ensure that current non-hydrocarbon revenue sources continue to be captured by the central budget. Following this principle, the inflow rules should carefully determine which tax revenues from the hydrocarbon supply chain should go into the SWF.

In addition, the inflow rules will need to deal with a number of potential corporate governance challenges. Governance issues may arise from the possible indirect government involvement in many

(1) Van der Ploeg, F. (2011), Natural Resources: Curse or Blessing?" Journal of Economic Literature 49(2), p. 366–420.

(2) Such problems range from badly planned, uncontrolled and wasteful government spending to inflationary spending and the ensuing loss of competitiveness for the rest of the economy (known as the Dutch Disease phenomenon). Additional risks stem from the volatility of hydrocarbon revenues and the exhaustibility of hydrocarbon resources.

(Continued on the next page)

Box (continued)

activities of the hydrocarbon supply chain, namely through state-owned enterprises (SOEs) or "working companies" in which these SOEs have a stake. First, SOEs may have a reduced incentive to constrain their costs, given that a significant part of their revenues could not be used to their own benefit, but would flow to the SWF. Moreover, the incentives to closely monitor the cost performance of SOEs could be dented by the fact that the proceeds would flow through the annual budget into the SWF, thus impacting positively on the budget only in the long-term. Further, it will be necessary to ensure that the most appropriate investment projects are chosen. Investment decisions by these SOEs are in principle governed by the FRBSL procedures, but the governance issues as outlined above could probably increase the complexity of the process.

Withdrawals from the SWF should be rules-based and governed by a multi-stage procedure. Withdrawals in the first stage should focus on debt reduction, while sufficient asset accumulation should also be ensured. To allow sufficient asset accumulation, it will be crucial that withdrawals in the first stage are made on the basis of pre-determined rules which are adopted by the Council of Ministers. Further, these rules need to be in line with the above mentioned objectives as well as with the debt reduction rule specified in the Fiscal Compact. (3) The exact annual target for debt reduction would be set as part of an overall fiscal policy strategy, aiming at bringing debt down to 60% of GDP, i.e. the debt threshold determined by Protocol (No 12) on the Excessive Deficit Procedure. The second stage commences once this level is reached. The SWF will turn into a financing fund which would cover part of the non-hydrocarbon deficits, while accumulating financial assets for the benefit of future generations.

(3) Article 2b of Regulation (EC) No 1467/97 (as amended) states that "When it exceeds the reference value, the ratio of the government debt to gross domestic product (GDP) shall be considered sufficiently diminishing and approaching the reference value at a satisfactory pace in accordance with point (b) of Article 126(2) TFEU if the differential with respect to the reference value has decreased over the previous three years at an average rate of one twentieth per year as a benchmark, based on changes over the last three years for which the data is available."

from State-Owned Enterprises (SOEs) to ministries/independent regulatory authorities is adopted, CPC will benefit from three additional staff. CPC is currently working on the enhancement of its role in the area of advocacy, through the signature of a bilateral MoU with the Hellenic Competition Authority, involving exchanges on best practice. The publication of statements of objections is currently waiting for the opinion of the government's Legal Services.

The Auditor General's Office has changed Head and may prioritise its activities, whilst handling its shortage in human resources. The additional tasks allocated to the **Auditor General's** Office (AGO) by, *inter alia*, the FRBSL, privatisation and SOEs laws, and the public administration reforms, have increased pressure on the overall workload. Further prioritisation is expected for the collection of financial statements at all levels, including the totality of 380 villages, whereby data is rarely available. AGO may soon propose a legal amendment proposal to enhance their financial independence, as stipulated by the European Commission's Monitoring Report on the Accession Negotiations and the 2014 EU Anti-Corruption Report.

The Cyprus Energy Regulatory Authority (CERA) has reached an agreement with the Ministry of Finance in terms of staff allocation. After almost one year of discussions, CERA and the Ministry of Finance have agreed on the transfer of five additional staff to CERA, as earmarked in their 2014 budget. This would help increase the effectiveness of CERA.

3.4.5. Housing market and Immovable Property regulation

Progress has been slow with regard to improving the functioning of the housing market. While the authorities made efforts to engage all stakeholders (district and municipal authorities, building controls officers, etc.) in improving the process of the issuance of title deeds, deadlines for the issuance of title deeds and their enforcement were missed. The decision of the Department of Land and Surveys (DLS) to shift its human resources towards the finalisation of the General Valuation (GV) project partly explains the delay. To speed up progress, it was agreed to define binding administrative deadlines for the issuance of title deeds. An amending bill concerning the Street and Building Permit Law is to be submitted to the House of Representatives by Q3-2014. The bill provides for sanctions in case of delays in issuing certificates of completion.

With the finalisation of the GV project, the DLS will now put considerable effort into ensuring that the title deed issuance backlog will decrease. Available statistical data to date shows only slow progress in reducing this backlog. Internal transfers of DLS staff to increase the number of employees to existing sections at all District Offices dealing with the issuance of title deeds is expected to positively contribute to this process. In addition, the issuance of title deeds for units which are eligible for 'ex-officio' procedure are expected to proceed faster than before, as the GV project has helped in identifying these units.

Steps are being taken to improve the pace of court cases handling (MoU deadline in Q1-2016). The respective Code of the Civil Procedure Rules is under revision, while the legislation to establish an Administrative Court to take on board all first instance administrative cases should be enacted by end-2014. This would discharge the Supreme Court of this task, enabling it to carry out more expediently its second instance jurisdiction.

3.4.6. Tourism

The first progress report on the revised National Tourism Strategy needs further adjustment. The report outlines how the progress towards various targets in the Tourism Strategy 2013-2015 will be measured through horizontal actions. However, quantified figures illustrating strategic targets are still missing, which makes it difficult to assess whether the different actions of the tourism strategy have been successful. This shortage hampers the establishment of clear priorities for how Cyprus can make better use of its comparative advantage in this sector. Relevant stakeholders should be increasingly involved in the strategic thinking of this Strategy. A draft roadmap on how to best involve all stakeholders is now under preparation.

An aeropolitical strategy was adopted early May, with some delay. This strategy forms the basis for further development of Cyprus' external aviation policy, including a concrete action plan. The strategy implies that any airline wishing to operate in Cyprus needs to abide by concrete criteria, including profit maximisation and best aircraft utilisation. Other elements in an appropriate implementation of the strategy will require, *inter alia*, both in the short- and in the medium-term, a more flexible legal framework with all third countries and a more flexible airport cost structure.

4. PROGRAMME FINANCING AND DEBT SUSTAINABILITY

Out of the EUR 10bn of external assistance agreed on 25 March 2013, EUR 5.1bn have been released. EUR 4.75bn have been disbursed by the ESM in four tranches, of which EUR 1.5bn for the recapitalisation of the cooperative banking sector in the form of ESM notes. The IMF has disbursed four tranches of EUR 336m in total since the start of the programme.

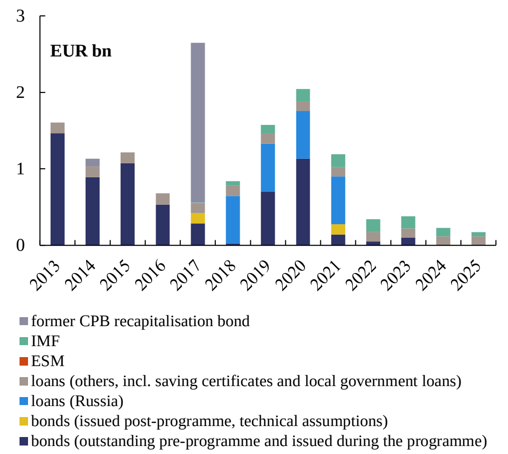
Total financing needs for the period Q2 2013-Q1 2014 were below the initial projection. Fiscal data suggest that total financing needs over the period Q2 2013-Q1 2014 amounted to EUR 4.1bn, of which EUR 1.5bn for financial sector recapitalisation, EUR 0.8bn for fiscal needs and EUR 1.9bn for medium- and long-term debt redemptions. The total financing needs were therefore well below the EUR 5.1bn initially projected. The difference, mainly due to better-than-expected fiscal performance, has allowed Cyprus to maintain a sizeable cash buffer.

Yields have further improved, mostly on bonds. Secondary market yields of Cyprus' outstanding foreign-law bonds have continued their downward path, with a significant decrease in April 2014. Despite very thin markets, yields have fallen to around 5% in April 2014 compared to 8% in January 2014 and peaks in March or July 2013 exceeding 25%. This is partially due to the generally improved financial market sentiment with regard to the European periphery and also to the yield of just under 5% achieved by Greece on its 5-year sovereign bond issue in April. However, the improvement in the T-Bill market is less pronounced. Yields remain high (at around 4.5%) and rolling-over of T-Bill holdings depends on relatively few domestic investors, while interest from other investors in Cyprus' T-Bills is still scarce. By the end of March 2014, the outstanding T-Bill stock stood at EUR 789m, somewhat lower than the EUR 970m at the inception of the programme.

After a break of three years, Cyprus returned to the international bond markets at the end of April 2014 by issuing a six-year Eurobond of EUR 100m via a private placement. Its coupon rate was set at 6.5%. However, after the issuance, its yield has decreased to around 5.5% in the secondary market. Moreover, on 2 June 2014, Cyprus started to issue six-year retail bonds of small amount (of up to EUR 10m per month) with an early redemption option to physical persons(3).

Financing needs during the second quarter of 2014 are assessed to be lower than in the preceding quarters. Based on the updated macro-fiscal projections, total financing needs for debt redemptions in Q2-2014 are estimated to amount to around EUR 0.1bn. No additional funds are required for fiscal needs since they are covered by revenues from the allocation of the Central Bank's profits of EUR 180m. The Ministry of Finance has requested an official ECB opinion on the transfer of the right to issue coins from the central bank to the government. This could provide an additional EUR 100m of financing, should the transfer of coinage rights be assessed to be in line with the provisions of the Treaty(4).The fiscal needs for Q2-2014 include the cost of already called state

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



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

(3) Given the small amounts involved and the possibility to redeem the bonds ahead of the maturity, this source of funding is at this stage not taken into account in the assessment of financing needs.

(4) Except for Cyprus, Estonia and Slovakia, the right to issue coins is in the hands of the government in all other euro area Member States.

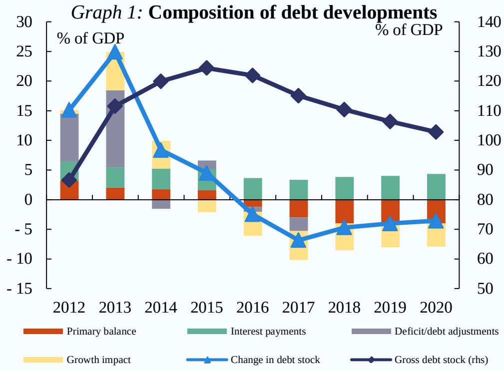
Box 4.1: Debt sustainability assessment

The revised macro-fiscal projection and the subsequent changes to the financing needs leave the baseline public debt projections broadly unchanged. The peak of the debt trajectory is expected at 124% of GDP in 2015, slightly lower than expected in February 2014. The current scenario projects a decline to 103% of GDP in 2020, driven notably by the economic recovery and the return to primary surpluses as from 2016.

The interest bill for 2014-2016 is expected to be lower than projected during the third review. This is largely explained by a significantly lower than expected ESM interest rate for 2013, which has resulted in a significant but prudent revision of the ESM interest rate assumption for the programme period. After the programme horizon, the interest bill is projected to be influenced by higher market interest rates compared to those charged on ESM and IMF loans.

There are few changes to the composition of the deficit/debt adjustments for 2014. The conclusion of the EUR 1bn loan-asset swap between the CBC and the Ministry of Finance was rescheduled to Q3-2014 (as compared to previous expectation that it would be implemented in Q2-2014). Deficit-debt adjustments also include the expected profit distribution by the CBC of about EUR 0.1bn in

Graph 1: **Composition of debt developments**

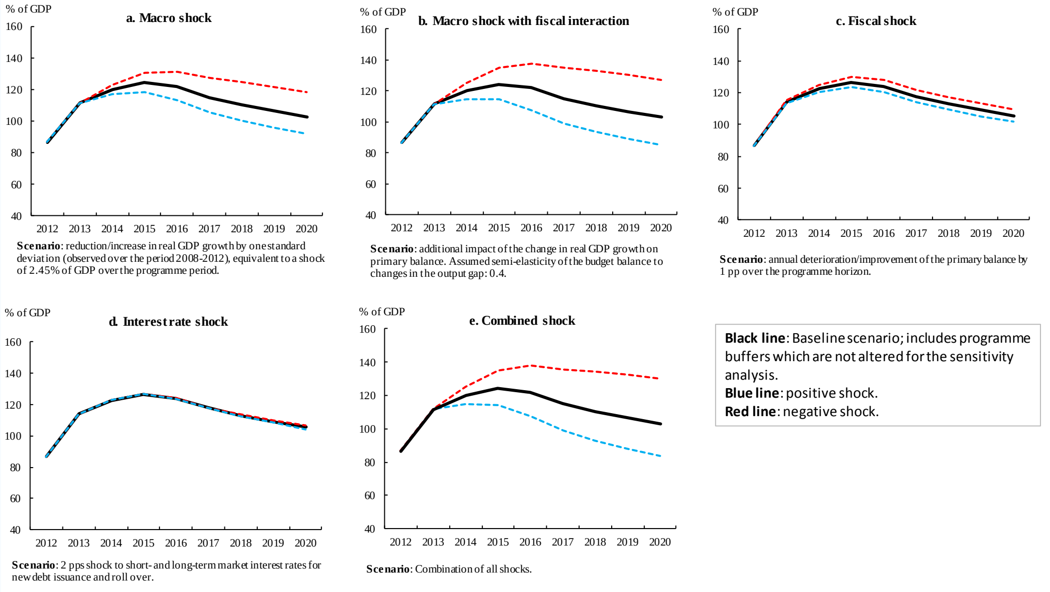


Source: Commission services.

both 2015 and 2016. While the ECB assessment on the operation is still pending, the transfer of coin in circulation amounting to EUR 0.1bn in 2014, would be debt neutral if accompanied by a decrease in government liabilities. The desired debt reduction will be achieved by redemption of the CPB bond of the same amount. Privatisation proceeds are as in earlier reviews projected to materialise over a three-year horizon from 2015 onwards, amounting to a total of EUR 1.4bn.

The debt trajectory continues to be vulnerable to the macroeconomic and fiscal performance. Graph 2 shows that a reduction (increase) in real GDP growth by one standard deviation (calculated

Graph 2 : Programme scenario sensitivity analyses



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Box (continued)

over the period 2008-2012, equivalent to a shock of 2.44% of GDP) over the programme period would drive the debt trajectory sharply upwards (downwards) until 2020. An additional effect of a lower (higher) real GDP growth on primary balance would aggravate the impact of the shock.([1]) An isolated fiscal shock to the primary balance of 1 pp over the programme horizon would have a more limited effect on the debt-to-GDP ratio until 2020. Changes in higher (lower) short- and long-term market interest rates (by 2 pps, respectively) appear to have only a small effect on the debt trajectory until 2020.

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

guarantees and a buffer against the possibility that an additional amount would need to be settled upfront (the baseline assumption is that the amounts due will be disbursed within three to five years).

Based on current assumptions, the third quarter financing needs are expected to be higher than in the second quarter mainly due to the redemption in mid-July of a foreign-law bond of EUR 0.5bn. Over the third quarter, total debt redemptions are estimated to amount to around EUR 650m and fiscal needs to around EUR 350m.

A successful fourth programme review would unlock the disbursement of the ESM's fifth tranche to finance needs arising until the end of the second quarter and most of the debt service needs in the third quarter. In addition of covering the financing needs in the second quarter, the fifth ESM disbursement has to cover the financing need stemming from the redemption of a bond of EUR 0.5bn. The latter falls on 15 July 2014, which is too early to be covered by the Q3 2014 programme disbursement and cannot be paid out of Cyprus' cash reserves, if adequate cash levels are to be maintained. As a result, the fifth ESM disbursement would amount to EUR 600m. In addition, the IMF would disburse EUR 83m. After the disbursement by the ESM and the IMF and the mid-July redemption of EUR 500m, the government's cash balance is estimated to amount to around EUR 1bn.

Following the fifth ESM and IMF disbursements, around EUR 4.2bn of programme funds will remain available. Following the disbursement of this tranche, the ESM will have disbursed 60% of its programme envelope of EUR 9bn. The IMF, spreading disbursements equally over the programme horizon and not participating in the recapitalisation of the financial sector, will have disbursed a total of EUR 0.4bn, i.e. around 40% of the IMF funds allocated to the economic adjustment programme for Cyprus.

5. RISKS TO THE PROGRAMME

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

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

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

- negative spillovers emerging from the geopolitical tensions between Russia and Ukraine, which could weigh on economic activity;

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

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

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

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

ANNEX 1
Compliance Table

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

	Actions for the fourth review (deadlines for Q1 and end-April 2014)	Assessment - Comment
1	**FINANCIAL SECTOR REFORM**	
1.A.	**REGULATION AND SUPERVISION**	
	Maintaining liquidity in the banking sector	
1.1	The Cypriot authorities commit to continue implementing the roadmap for the gradual relaxation of restrictive measures which was published on 8 August 2013. This roadmap identifies a series of milestones for the gradual liberalisation of the restrictions also taking into account indicators of investor confidence in the banking system and financial stability indicators, including the liquidity situation of credit institutions. A joint CBC-Ministry of Finance task force will be set up **by end-February** to design a well-targeted communication strategy aiming to regularly communicate to market participants, information regarding the roadmap and the progress already made in the implementation of the banking sector strategy.	**Compliant with delay** The joint CBC-Ministry of Finance task force was set up on 21 March 2014.
1.2	Furthermore, the CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector. The CBC will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules. In this respect, and in order to safeguard financial stability, approval has been obtained from the House of Representatives for the issuance of additional government guarantees of up to EUR 2.9 billion on 27 January 2014 as contingency collateral in case of need, in line with State aid rules.	**Compliant** The current scheme of guarantees is available until end-June 2014 and is being renewed every six months. No new guarantees have been issued yet.
1.3	The Bank of Cyprus and the Cooperative Central Bank submitted their first capital and funding plans in November 2013 **and January 2014**, respectively. The CBC will continue to receive the updated plans on a quarterly basis and will transmit them to the ECB, the EC, the ESM and the IMF. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector, the gradual easing of restrictive measures, and reduction of borrowing from the central bank, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario are provided by the CBC, in coordination with the ECB.	**Compliant** The updated capital and funding plans for Bank of Cyprus were received by the CBC in late April 2014. Cooperative Central Bank submitted its first plans in January 2014 and is expected to submit the March update by end-May 2014.
	Regulation and supervision for banks and cooperative credit institutions	
1.5	Having reviewed its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning, the CBC started introducing regulatory amendments. A new loan origination directive was adopted in October 2013. The new provisioning and disclosure directive will be finalised **by end-February** and will become effective for the publication of the 2013 financial statement concerning disclosure requirements. The CBC will require banks to submit **by end-March** an action plan for the full implementation of these guidelines starting from their 2014 annual accounts. Furthermore, with the aim to ensure timely implementation of newly introduced and upcoming EU rules on capital requirements and NPLs, the CBC has instructed banks to submit **by end-April** estimates of its potential impact on capital and **by end-June** profitability and coverage ratio.	**Compliant** Work is in progress to meet the end-June deadline.
1.6	Banks with restructuring plans will be required to submit, starting from **April 2014** and with reference date end-December 2013, **quarterly** reports describing the progress with the implementation of the restructuring plans. The reports will contain a set of key performance indicators including selected operational and financial targets developed by the CBC and communicated to the banks. The CBC units responsible for the supervision of BoC and coops will assess **on a quarterly basis** these reports. The first assessment of these reports will be submitted to the CBC Board by **end-May**.	**Partially compliant** for end-April deadline. Bank of Cyprus submitted its progress report on time, while the coop sector is expected to submit its report by mid-May 2014.
1,7	The CBC (i) has put in place a work plan for 2014, including thematic on-site inspections and off-site reviews on loan restructuring and risk management, operations, and governance issues for the supervisory units responsible for BoC and the coop sector; and (ii) will provide them with sufficient resources to contract necessary technical support from banking and troubled debt restructuring experts. In addition, CBC will clarify the allocation of tasks and responsibilities in the governance structure of the CBC to effectively carry out the supervisory tasks of the central bank in line with SSM requirements.	**Compliant**
1,8	The CBC will integrate stress-testing into regular off-site bank supervision, taking into account the entry into force of CRD IV and CRR and the related developments and timelines in the Single Supervisory Mechanism.	**Compliant**
1.9	Following the legal integration of the supervision of the cooperative credit institutions into the CBC, the operational integration will be completed **by end-March 2014** in line with the action plan of September 2013. This action plan includes steps to recruit experienced staff and to apply the CBC supervisory and regulatory model for the effective monitoring of the entire cooperative credit sector.	**Compliant**
1.10	By **end-April**, the governance directive will be revised specifying, among others, the interaction between banks' internal audit units and bank supervisors, in line with best practices.	**Non-compliant** Due to resource constraints, the deadline was shifted to end-July.
1.11	The accounts of cooperative credit institutions are subject to an independent annual audit by an external, recognised and independent auditing firm. The CBC has the right to overturn the selection of an auditor by any cooperative credit institution. The consolidated accounts of the cooperative credit institutions will be published beginning from 2013 annual accounts.	**Compliant**

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Table (continued)

1.12	The CBC will have sufficient staff to carry out its functions-in full independence as stipulated by the Treaties. Taking into account the imminent increase in the tasks of the CBC, owing in particular to the requirements imposed on the banking supervision department, recruitment will be accelerated and additional resources, with sufficient qualifications, will be allocated without delay.	**Compliant**
1.13	The authorities will, in consultation with EC, ECB and IMF and informing the ESM, review the effectiveness of the Resolution Authority, including its composition and governance, with a view to adopting legislative and operational changes **by end- March**.	**Non-compliant** The legislative changes to the Resolution Law were reviewed by end-March, and the deadline for their adoption was shifted to mid-July.
	Monitoring of corporate and household indebtedness	
1.14	The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. Data from surveys will be used until the credit register becomes fully operational. The annual Financial Stability Report, to be published at year-end will include an extended analysis on corporate and household indebtedness. Exceptionally to the year-end timing of the publication, the first report will be published by **end-April**. In addition, quarterly monitoring reports will continue to be submitted and their scope and content will be further enhanced.	**Non-compliant for the end-April deadline** Due to internal resource constraints, the publication of the first annual Financial Stability Report was shifted to end-December. **Compliant** for the quarterly monitoring reports.
	- In order to ensure compliance with the new framework for the management of arrears, **by end-March 2014**, the CBC, with external technical support, will complete an assessment of the operational capacity of the commercial banks' loan workout units, including with respect to early arrears. Following the completion of the merger process for the cooperative credit institutions, the corresponding deadline will be end-May.	**Compliant** for the end-March deadline.
	- Banks will be required to report quarterly on restructuring progress and management of NPLs, with reference date **end-March** and submitted **by end-May**, using specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.), which were approved by the CBC in consultation with EC, ECB and IMF and informing ESM. Furthermore, banks will report monthly on early arrears (e.g. number and amount of past due loans within 1-90 days, type of actions taken, and number and amount of cured or uncured loans).	**Compliant** for requiring a progress report on restructuring and managing NPLs. Banks will submit reports by end-June 2014.
	- The role of the Financial Ombudsman with regard to hearing complaints on compliance with the arrears management process will be clarified **by end-March**.	**Compliant**
	- The Cypriot authorities, in view of financial stability considerations and on-going bank restructuring, commit not to introduce any new administrative measures which would interfere with the setting of bank lending rates. In particular no ceilings on bank lending rates would be introduced.	**Compliant**
	Increasing financial transparency	
1.B.	**RECAPITALISATION AND RESTRUCTURING**	
	Restoring adequate capital buffers	
1.17	The CBC increased the minimum Core Tier 1 capital ratio from 8% to 9% in December 2013. The CBC is assessing the impact of the entry into force of the Common Equity Tier 1 capital definition laid down in the CRDIV and CRR. On the basis of that assessment the CBC will define, **by end-March** and in consultation with the EC, ECB, IMF and informing ESM, the minimum capital requirements taking into account the parameters of the balance sheet assessment and the EU-wide stress test. In no circumstances will this revision lead to any distribution of capital by the banks which were found in the PIMCO exercise to face a capital shortfall.	**Compliant with delay** The authorities determined the minimum capital requirement at 8% in terms of Common Equity Tier 1 after the end-March deadline.
	Management of legacy Laiki	
1.18	In order to enhance the recovery value from the disposal of the assets of Laiki, the Resolution Authority will instruct the Special Administrator to appoint **by end-March** a well-recognised and independent consulting or auditing firm(s) or international institution(s) to provide services associated with the management of the disposal process, and be entrusted with the voting rights associated with Laiki's shares participation in BoC. As part of the terms of reference for the appointment of the consultants agreed in consultation with the EC, ECB and IMF and informing the ESM, a revised roadmap for the full disposal of the assets will be developed by **end-April** with a view to maximize value for creditors.	**Non-compliant** The deadline for appointing a consultant for handling the voting rights was shifted to end-September. The deadline for appointing an advisor on the asset disposal was shifted to end-June. The deadline for developing an action plan based on the roadmap was fixed at end-July.
	Restructuring of Bank of Cyprus	
1.19	To strengthen confidence in the bank, by **end February** the CBC agreed with BoC on the quarterly operational and financial indicators that will be communicated to the public on progress being made in the implementation of the restructuring plan.	**Compliant** The first publication of the quarterly performance indicators will be in May 2014 along with the results for Q1 of 2014.
	Restructuring and recapitalisation of Hellenic Bank	
1.21	Following the successful recapitalisation of Hellenic Bank with privately raised funds, the CBC has required Hellenic Bank to submit **by end-March** a business plan covering the period up to end-2015.	**Compliant**

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Table (continued)

	Restructuring and recapitalisation of cooperative credit institutions	
1,22	The CBC assessed the capital needs of individual cooperative credit institutions, indicating a total capital shortfall of EUR 1.5 billion for which funds were deposited in a securities account with the CBC to boost confidence in the system. This ensures that there will be no contribution required from depositors to achieve the recapitalisation of the sector. Following a fair value assessment of the CCB and CCIs' assets and after the approval of the restructuring plan by the EC, these EUR 1.5 billion of state funds will be injected in the Cooperative Central Bank in exchange for common shares.	**Compliant** The recapitalisation of the Cooperative Central Bank took place on 10 March 2014.
1,23	To this end, the restructuring plan for the cooperative sector was submitted to the EC in January 2014. The terms and remuneration of the public support will comply with the EU state aid rules with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections, will be subject to specific management rules and restrictions and to a restructuring process, which will be scrutinised by an external monitoring trustee to assume his tasks immediately after the approval of the recapitalisation aid and associated restructuring plan and commitments by the EC under state aid rules. The monitoring trustee will submit quarterly reports on governance and operations, as well as ad-hoc reports as needed and will work under the direction of the EC. In line with the EU state aid rules the trustee will be responsible for overseeing the implementation of the restructuring plan. This includes, inter alia, verifying proper governance and the use of commercial-basis criteria in key policy decisions and assessing the soundness of strategies to deal with loan arrears. The monitoring trustee will closely follow the bank' operations and shall have access to Board meeting minutes, and be observer at the executive committees and other critical committees, including risk management and internal audit functions.	**Compliant** The monitoring trustee (Grand Thornton) was appointed and is verifying the monitoring commitments.
1.24	In line with the strategy for the restructuring and recapitalising of the sector that was published in July 2013, the individual cooperative credit institutions will be merged into a maximum of 18 entities **by end-March**. These mergers are designed to achieve viability, efficiency and profitability. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones. Following the completion of the merger process and the establishment of the final governance structure of the sector, the CBC will review its affiliation directive by **end-July**.	**Compliant** for the end-March deadline.
1.25	Upon completion of legal mergers of affiliated credit cooperative institutions, the Cooperative Central Bank will inject sufficient capital into them to take a 99% stake and ensure compliance with the 4% individual core tier 1 ratio. These operations will be finalised by **end-April**, with the view to speed up the appointment of the Board of Directors of each institution and the implementation of the new governance guidelines. At the consolidated level, the sector is still subject to the general minimum core tier 1 capital requirement of 9% or the new minimum capital requirement to be determined as per paragraph 1.17.	**Compliant**
1.26	Based on the new legal framework for the management of the stake of the State in the cooperative sector, a relationship framework between the State and the Central Cooperative Bank was established, to ensure that the Central Cooperative Bank adopts sound policies and restructuring measures to enhance the viability of the cooperative sector, but without interfering in commercial business decisions and undue political interference. Compliance with the relationship framework will be reviewed **on a quarterly basis** by the monitoring trustee, who will also report any breaches of the framework to the EC. The authorities will inform the ECB, the ESM, and the IMF of the conclusions of that report.	**Compliant** The quarterly review process of the relationship framework between the State and the Cooperative Central Bank is ongoing.
1.27	As part of the implementation of the restructuring plan, the Cooperative Central Bank will leverage on external expertise. In particular such expertise will be drawn upon to develop policies and practices in the areas of arrears management and corporate restructuring. In addition, it will ensure that the recruitment of executive and senior management of the CCB and CCIs take place in line with international best practices and will be completed by **end-May**. The selection criteria for the CCB will be established by the Cooperative Central Bank and consulted by the Ministry of Finance with the EC, ECB and IMF and informing the ESM. As part of the relationship framework the CBC and CCB, in consultation with the Ministry of Finance management unit, will agree by **end-April** on quantitative indicators to allow for an adequate monitoring of the implementation of the coops' restructuring plan. In addition, main indicators and conclusions used in the monitoring exercise will be released as part of the quarterly public reporting in order to enhance confidence.	**Partially compliant** for the end-April deadline. Key performance indicators for monitoring implementation of the restructuring plan were agreed end-March. Indicators for external communication are in the process of being determined.
1.C.	**LEGAL FRAMEWORK FOR PRIVATE DEBT RESTRUCTURING**	
1.29	All unnecessary legal, administrative or other hurdles currently constraining the seizure and sale of loan collateral shall be removed so that the assets pledged as collateral can be recovered within a reasonable period deemed to be a maximum time-span of 1.5 years from the initiation of the relevant proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. The authorities commit not to introduce any further impediments to the seizure of assets pledged as collateral. Furthermore, they will establish a Task Force (comprising representatives of CBC, Ministry of Finance, the Law Office of the Republic and the Land Register) **by end-March** to prepare a study assessing the magnitude of registered, but untitled land sales contracts and underlying mortgages and develop recommendations **by end-June**.	**Compliant** with the end-March deadline. The Task Force on preparing a study on the title deeds issue was established in mid-March 2014.
2.	**FISCAL POLICY**	
	Fiscal Policy in 2014	

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Table (continued)

	Based on the programme's current macroeconomic and fiscal projection and reflecting the 2014 Budget, the Cypriot authorities will achieve a deficit of the general government primary balance of EUR 277 million (1.8% of GDP) in 2014 , respecting the EDP recommendation of a headline deficit of no more than 8.4% in 2014. To this end, Cyprus will fully implement the permanent measures included in the 2014 Budget, amounting to at least EUR 270 million in 2014 (Annex 1).	**Compliant** The updated programme projection shows a deficit of the general government primary balance of 1.7% of GDP. The headline deficit is estimated at 5.3% of GDP.
	Based on the programme's updated budgetary projection, the Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 340 million (2.1% of GDP) in 2015 and a surplus of at least EUR 201 million (1.2% of GDP) in 2016, respecting the EDP recommendation of a headline deficit of no more than 6.3% of GDP in 2015 and 2.9% of GDP in 2016.	**Compliant** The updated programme projection for 2015 shows a deficit of the general government primarily balance of 1.6% of GDP. The headline deficit is estimated at 5.1% of GDP. For 2016 the updated projection shows a primary balance surplus of 1.2% of GDP and a headline deficit of 2.4% of GDP.
3.	**FISCAL STRUCTURAL MEASURES**	
3.1	**Pension Reforms**	
3.1	The Cypriot authorities have agreed to provide **by February 2014** all information necessary to verify that, to the extent it falls under the control of their executive and legislative powers, all of the measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees.	**Compliant**
3.2	**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:	
3.2	c) taking into account the economic conditions, the implementation of the necessary complimentary reforms, the results of the updated actuarial study and after consultation with the programme partners, implement a National Health System (NHS), to be fully in place by mid-2016. The NHS will ensure its financial sustainability while providing universal coverage. By mid-2015, a first stage of NHS, e.g. primary care, will be put into place. This first stage will be defined and adopted with the full roadmap to NHS **by April 2014**, which will also clarify the role of Ministry of Health and the HIO. The amending bill to NHS will be submitted to the House of Representatives by Q2-2014. The policies of the Ministry of Health on pricing and reimbursement of medical goods and services, including those related to pharmaceutical expenditure, will be revised in agreement with programme partners to contain projected spending levels under NHS.	**Compliant** A basic roadmap of the NHS has been shared with programme partners, which will be accompanied by a further detailed roadmap, to be agreed with programme partners by end-June 2014.
3.3	**Budgetary Framework and Public Financial Management**	
3.3	The Cypriot authorities will:	
3.3	• provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in the FRBSL, including an implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance by **mid-March 2014**;	**Compliant with delay** The secondary legislation that would enable the staffing of the Fiscal Council was adopted by the House of Representatives 5 June (prior action). The signing of a MoU on exchange of information between the Fiscal Council, Ministry of Finance, Central Bank of Cyprus, Statistical Services, and the University of Cyprus took place 10 June (also part of the prior action).
3.3	As regards expenditure controls in the state budget, which shall avert the risk of overspending against existing appropriations and/or accumulating arrears, the Cypriot authorities will: • remove the risk of overspending by making sure that spending commitments, as these will be defined in the FRBSL, of the central government are subject to pre-commitment validation **by Q1-2014**. All outstanding commitments should be timely and properly recorded and reported, on a quarterly basis, in the accounting system.	**Compliant**
3.4	**Public private partnerships (PPPs)**	
3.4	The Cypriot authorities will:	
3,4	• regularly update the inventory of PPPs, including contingent liabilities and include it both in the annual budget law and in the annual financial report	**Compliant** The first update was submitted during the review mission.
3.4	• put in place an adequate legal and institutional framework for public investment projects, including PPPs, to assess fiscal risks and to monitor their execution through: (i) establishing an effective gateway process that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Minister of Finance and his services (i.e. the Ministry, the Directorate General for European Programmes, Coordination and Development and the Treasury) in reviewing and approving public investment projects and in particular PPPs at critical points in the gateway process; and (iii) developing financial reporting and accounting rules that ensure timely and transparent communication of public investment project and PPP related obligations. The legal basis for managing public investment and specifically PPPs will be included in the FRBSL;	**Compliant** The FRBSL was adopted on 13 February.

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Table (continued)

3.5	**State-owned enterprises and privatisation**	
3.5	As regards extra-budgetary funds and entities, in particular the State-Owned Enterprises (SOEs) and other state-owned assets:	
3.5	• the Cypriot authorities will submit to the House of Representatives the law regulating the creation and the functioning of SOEs at the central and local levels, in order to enhance the monitoring powers of the central administration, while including reporting on SOEs in the context of the annual budgetary procedure **by end-February 2014**. No additional SOEs will be created until the legal framework has been adopted.	**Non-compliant** The draft law has not yet been agreed with the programme partners, as consistency with the FRBSL needs fine-tuning, and the SOEs Unit will no longer appear explicitly in the law. Agreement and adoption by the HoR are expected by mid-June.
3.5	• the Head of the new SOEs Unit and the Unit's supporting staff will start their work **by end-March 2014**;	**Non-compliant** The work will get started after adoption of the SOEs corporate governance law in mid-June.
3.7	**Revenue administration, tax compliance and international tax cooperation**	
3.7	The Cypriot authorities will reform the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection capacity and the fight against tax fraud and evasion, with a view to increasing fiscal revenue. The reform will comprise of a programme of short-term measures to enhance compliance, efficiency and effectiveness as well as a comprehensive long-term reform covering risk management and the establishment of a new integrated function-based tax administration structure, integrating the existing IRD and VAT services. Most of the short-term programme has been implemented. However, the following actions will be completed by **Q1-2014**:	
3.7	(1) attributing personal responsibility for payment of company taxes to those, who -in the case of non-listed companies- truly and effectively control a company and to the responsible manager for fraudulent filing of company taxes;	**Non-compliant** This is not yet approved because it was part of a package of amendments that went to the HoR and which suffered delays rooted in the other amendments, not this one (see 3.7(3)). New deadline is Q2-2014.
3.7	(2) harmonising the legislation among tax types so that not paying withholding taxes is a criminal offence and taking the necessary steps to ensure tax fraud is prosecuted as a criminal offence;	**Non-compliant** Criminalising non-payment of withholding taxes: This is not yet approved because it was part of a package of amendments that went to the HoR and which suffered delays rooted in the other amendments, not this one (see 3.7(3)). New deadline is Q2-2014. Prosecution of tax fraud: While the authorities have intensified effort somewhat, there is the need to arrive at a more strategic approach. New conditionality in this respect is inserted in the new MoU.
3.7	(3) strengthening powers by the tax authorities to ensure payment of outstanding tax obligations, including by providing authority to garnish assets or prohibiting the alienation or use of assets, including property and bank accounts, by the taxpayer;	**Non-compliant** The relevant draft bills had been approved by programme partners, but the discussion was opened again on the procedures for the garnishment of bank accounts and the role of courts. Programme partners have emphasized the importance of not requiring the tax authorities to obtain court approval prior to each garnishment. The authorities are working on a revised draft for this, but a number of important procedural details need to be worked out. The deadline was shifted to Q2-2014.
3.7	(4) enacting the necessary legislation to establish self-assessment for all income taxpayers by changing from a pre-assessment verification of income tax returns to post assessment audits selected on the basis of risk; and	**Non-compliant** This is not yet approved because it was part of a package of amendments that went to the HoR and which suffered delays rooted in the other amendments, not this one (see 3.7(3)). New deadline is Q2-2014.
3.7	(5) conducting an independent formal review to recommend changes to legislation to determine the appropriate level of discretion available to the tax administration management and how it is exercised.	**Compliant**

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Table (continued)

3.7	(6)(i) make the data from the IRD, VAT Services and Customs and Excise Department available to selected staff by the tax administrations via one platform, to be used for integral risk identification and analysis **by Q1-2014**;	**Partially compliant** Selected staff was given full access to data from VAT Service and Customs & Excise, but not yet from the IRD. The deadline for the IRD was shifted to Q2-2014.
3.7	(7) The full integration of the two tax departments, based on the adopted integration implementation plan. As next steps, the authorities will, amongst others:	
3.7	(7) 1. submit to the House of Representatives the enabling legislation to establish the new tax agency **by April-2014**; and	**Compliant with delay** On 5 June, the enabling law was adopted by the HoR (prior action).
3.8	(1) fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;	**Compliant** The assessment by the EC of the implementation of DIR 2011/16 is on-going. The time-frames of Regulation 904/2010 have been largely respected up to now. New performance statistics will be available in due course.
3.8	(4) submit **by end-February 2014** to programme partners a comprehensive action plan to address the shortcomings identified in Phase 2 of the peer review by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, with a view to achieve full compliance with the OECD supplementary review. The action plan shall be implemented by Q2-2014. In addition, the authorities will monitor closely further progress in responding timely to tax information requests by third countries and, **starting from end-March 2014**, submit to the programme partners quarterly performance updates.	**Compliant** An action plan was submitted in February. The plan lacked in scope as it predominantly covered actions taken by the tax authorities, not detailing the relevant actions underway in the context of the reform of the Department of the Registrar of Companies or under the AML action plan. The authorities will comprehensively outline these actions in their follow-up report to the OECD Global Forum. This report was submitted on 30 May (prior action). Performance statistics were received on time.
3.8	(5) In the context of an effective implementation of Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the EUSD), the Cypriot authorities will continue to provide to the EC all necessary and available information/statistics extracted from the data exchanged under the FISC153. In addition, on an annual basis and starting from the tax year ending 31 December 2013, the Cypriot authorities will provide to the EC a breakdown of the information provided under the EUSD by sector of activity of the paying agents, including possible sanctions actually claimed of paying agents for their application of the EUSD.	**Compliant**
3.9	**Immovable Property Tax Reform**	
3.9	The Department of Lands and Surveys (DLS) and the Inland Revenue Department will prepare **by Q1-2014** a joint action plan outlining the required intermediate steps and deadlines, which will ensure a smooth and timely implementation of the new immovable property tax.	**Compliant** The joint action plan was submitted in March 2014.
3.10	**Public Administration Reform**	
3.10	• the first batch is undertaken by the World Bank and the UK public administration and covers the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies. The results of the first batch will be presented by Q1-2014. Based on the findings of this review, the Cypriot authorities will agree on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers by Q2-2014. The relevant legislation in relation with the reforms indicated as high priority will be adopted by the House of Representatives by Q3-2014. The reform will start to be implemented by Q4-2014, in accordance with the reform plan.	**Compliant with delay** All reports were submitted and presented to the programme partners with one month delay and during the review mission.
3.11	**Welfare System** *(Reforms must be consistent with the fiscal targets defined in this MoU)*	
3.11	To this end, the Cypriot authorities will take the following steps:	
3.11	• on the basis of the level of the minimum consumption basket covering basic needs in order to achieve a decent standard of living, define the level, the composition and the eligibility criteria of the new guaranteed minimum income scheme (GMI) which will replace the existing public assistance scheme and estimate its overall costing **by end-February 2014;**	**Compliant with delay** The CY authorities provided information on three different options for the composition, level, and costing of the GMI during the 3rd review mission. The final composition, level, and costing of the preferred GMI scheme was presented to programme partners on 08 May 2014.
3.11	• refine the means testing mechanism by introducing a common definition of income sources, financial assets and movable and immovable property, so as to ensure the consistency of eligibility criteria across different benefit schemes **by end-February 2014;**	**Partially compliant** The CY authorities provided information on common definition of income by end-April 2014. However, no information was provided on how means-testing mechanisms will be revised.

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Table (continued)

3.11	• adopt the final design of the reformed welfare system by the Council of Ministers **by Q1-2014** after consultation with social partners, followed by consultation and review by programme partners. The adopted reform would define all benefits, their respective level, and eligibility criteria, as well as the overall costing of the system;	**Non-compliant** Deadline shifted from end-March to mid-June 2014.
3.11	• transfer all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour and Social Insurance, which should be appropriately equipped in terms of financial and human resources, the latter being reassigned from other departments of the public administration **by April-2014**, except the benefits to be provided by the Ministry of Education and Culture (education benefits) and the Ministry of Interior (benefits to displaced people).	**Non-compliant** Deadline shifted from end-April to end-June 2014.
4.	**LABOUR MARKET**	
4.1	**Cost of Living Adjustment (COLA) of wages and salaries**	
4.1	To ensure that wage growth better reflects developments in labour productivity and competitiveness, in both expansions and recessions, the Cypriot authorities are reforming the wage-setting framework for the public and private sector in such a way as to improve real wage adjustment. To this end, the effective application of the reform of the wage indexation system (COLA) applicable to the broader public sector, as determined in the budget of 2013 and embedded in the Medium-Term Budget, must be ensured. ../.. A tripartite agreement will be pursued with social partners for the application of the reformed system in the private sector by **Q2-2014**.	**Non-compliant** No meeting between the Ministry of Labour, Welfare and Social Insurance and private sector labour unions took place since the last review. The deadline to reach a tripartite agreement in the private sector has been extended to Q4-2014.
4.2	**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.	**Compliant**
	Activating the unemployed and combating youth unemployment	
4.4	In their assessment of current activation policies, the Cypriot authorities have identified a series of challenges. These include: difficulties faced by the Public Employment Services in serving an increased number of unemployed people; lack of a coherent and homogeneous framework for continuous monitoring and evaluation of different schemes, which impedes proper evaluation of the activation system as a whole; need for increased coordination across different ministries and departments of the administration and need to reduce fragmentation; and absence of a data warehouse, which impedes an automatic and immediate processing and exchange of information. Therefore, the Cypriot authorities will ensure the implementation of a set of agreed measures to address the identified shortcomings and weaknesses. These will include:	
4.4	• ensuring an effective integration of the different schemes by centralising the administration of all activation programmes and by enhancing the coordination across the different departments responsible for the various programmes;	**Compliant**
4.5	With one of the steepest increases in the youth unemployment rate in the EU and with the rapid rise of young people not in employment, education or training (NEETs), Cyprus needs to take swift action to create opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will present **by April 2014** the revised National Action Plan for Youth Employment, which will include, inter alia, measures envisaged for support under the Youth Employment Initiative aimed at establishing a Youth Guarantee, in line with the conclusions of the European Council of June 2013. The design, management and implementation of these measures targeted to youth shall be well integrated within the broader system of activation policies (section 4.3) and be coherent with the reform of the social welfare system (section 3.11) and the agreed budgetary targets.	**Non-compliant** Pending the finalisation of the daft Operational Programme for the ESF, the deadline was shifted to end-May.
	For this purpose, the authorities will submit by **April 2014** a comprehensive note summarising the full list of all active labour market policies (existing and envisaged) with the relevant intended aims, recipients, budgetary allocations and sources of financing.	**Non-compliant** Pending the finalisation of the daft Operational Programme for the ESF, the deadline was shifted to end-May.
5.	**GOODS AND SERVICES MARKET**	
5.1	**Services Directive and regulated professions**	
5.1	The Cypriot authorities will further improve the functioning of the regulated professions sector (such as lawyers, engineers, architects) by carrying out a comprehensive review of requirements affecting the access and exercise of activity. The Cypriot authorities will finalise their review by **Q1-2014**. Following completion of the review, the requirements that are not justified or proportional will be eliminated by Q3-2014.	**Compliant with delay** The full and comprehensive review of 115 professions was submitted to the programme partners with one month delay.
5.3	**Competition, transparency and sectoral regulatory authorities**	
	The Cypriot authorities will	

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Table (continued)

5.2 • enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers and antitrust, including the power to conduct sector enquiries **by end-March 2014**; and	**Partially compliant** The new antitrust law was adopted within the deadline, while the new mergers law has been agreed with the programme partners, but has not yet been adopted.

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Table (continued)

5.4 Housing market and immovable property regulation	
The Cypriot authorities will:	
5.3 define deadlines for the issuance of building certificates and title deeds and ensure their enforcement **by Q1-2014;**	**Non-compliant** The deadline for defining administrative deadlines for the issuance of title deeds shifted to Q2-2014. The submission of amending legislation of the Street and Building Permit law, which aims to guarantee that the certificate for the completion of works (building certificate) is enforced, is now expected by Q3-2014.
5.3 • every three months, publish quarterly progress reviews, including executive commentaries on developments related to the issuance of building and planning permits, certificates, title deeds, title deed transfers and related mortgage operations;	**Compliant**
5.5 Tourism	
5.4 Since tourism is one of Cyprus' largest economic sectors and a potential driver of future growth and employment, a reinvigoration of its competitiveness is necessary. To that end, the Cypriot authorities will:	
5.4 • present a progress report on the implementation of the action plan twice per year including an assessment of its implementation based on performance indicators, **by Q1 and Q3 every year, starting from 2014.**	**Partially compliant** The first progress report was submitted with delay and now needs further fine-tuning. The revised progress report is expected by mid-June.
5.4 • start implementing an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, taking into account the EU external aviation policy and the EU aviation agreements, while ensuring sufficient air connectivity. This strategy, which will include a concrete action plan, will be adopted **by Q1-2014.**	**Compliant with delay** The aeropolitical strategy was adopted by the Council of Ministers on 14 May.
5.6 Energy	
6. TECHNICAL ASSISTANCE	

Source: Commission services.

ANNEX 2

Macroeconomic Projections

Table A2.1: Selected economic indicators

	2010	2011	2012	2013	2014	2015	2016
Real economy			*(percent change)*				
Real GDP	1.3	0.4	-2.4	-5.4	-4.2	0.4	1.6
Domestic demand incl. inventories	1.9	-1.4	-3.8	-9.8	-6.1	-0.5	0.9
Total consumption expenditure	2.6	3.0	0.8	-3.9	-5.8	-0.9	1.7
Private consumption expenditure	1.5	1.3	-2.0	-5.7	-5.1	-0.2	1.5
Government consumption expenditure	1.0	-0.2	-3.8	-5.0	-2.7	-2.4	-3.2
Gross fixed capital formation	-4.9	-8.7	-18.3	-21.6	-17.0	1.3	3.9
Exports of goods and services	3.9	4.5	-2.5	-4.2	-2.7	1.9	2.9
Imports of goods and services	4.8	-0.1	-5.4	-14.1	-6.9	-0.1	1.3
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	0.2	-0.8	-5.1	-7.9	-6.0	-0.5	0.9
Foreign trade	-0.6	1.9	1.5	4.8	1.8	0.9	0.8
Changes in inventories	1.8	-0.7	1.2	-2.2	0.0	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	1.9	2.3	1.6	-1.5	0.2	1.3	1.7
HICP	2.6	3.5	3.1	0.4	0.2	1.1	1.7
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	6.3	7.9	11.9	15.9	18.6	18.0	16.8
Total employment	-0.2	0.4	-4.2	-5.2	-4.0	0.4	1.5
Compensation per employee	2.6	2.5	-0.9	-6.0	-3.0	0.4	1.5
Labour productivity	1.5	0.0	1.8	-0.2	-0.2	0.0	0.1
Unit labor costs	1.1	2.5	-2.7	-5.8	-2.8	0.4	1.3
Public finance			*(percent of GDP)*				
General government balance	-5.3	-6.3	-6.4	-5.4	-5.3	-5.1	-2.4
Total revenue	40.8	39.9	39.3	40.3	41.7	40.5	40.8
Total expenditure	46.2	46.3	45.8	45.8	47.1	45.7	43.3
General government primary balance	-3.0	-4.0	-3.2	-2.0	-1.7	-1.6	1.2
Gross debt	61.3	71.5	86.6	111.5	119.9	124.4	121.9
Balance of payments			*(percent of GDP)*				
Current external balance	-9.0	-4.5	-8.3	-1.9	-0.1	0.2	0.6
Ext. bal. of goods and services	-6.2	-4.4	-3.2	1.5	3.6	4.4	5.1
Exports goods and services	42.0	43.5	43.5	45.0	46.1	46.7	47.2
Imports goods and services	48.2	47.9	46.7	43.5	42.5	42.3	42.1
Balance of services	20.6	20.0	18.6	19.5	20.1	20.7	21.2
Balance of goods	-26.8	-24.3	-21.8	-18.0	-16.5	-16.2	-16.0
Balance of primay income	-3.1	0.7	-4.2	-2.9	-3.1	-3.6	-3.9
Net current transfers	0.3	-0.9	-0.9	-0.5	-0.5	-0.6	-0.7
Memorandum item			*(EUR bn)*				
Nominal GDP	17.4	17.9	17.7	16.5	15.8	16.1	16.7

Source: Commission services.

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

percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	1.5	1.3	-2.0	-5.7	-5.1	-0.2	1.5
2. Government consumption expenditure	1.0	-0.2	-3.8	-5.0	-2.7	-2.4	-3.2
3. Gross fixed capital formation	-4.9	-8.7	-18.3	-21.6	-17.0	1.3	3.9
4. Domestic demand excl. inventories	0.2	-0.8	-4.9	-7.8	-6.0	-0.5	0.9
5. Changes in inventories (contr. to growth)	1.8	-0.7	1.2	-2.2	0.0	0.0	0.0
6. Domestic demand incl. inventories	1.9	-1.4	-3.8	-9.8	-6.1	-0.5	0.9
7. Exports of goods and services	3.9	4.5	-2.5	-4.2	-2.7	1.9	2.9
7a. - of which goods	12.2	22.6	1.0	0.5	0.7	1.3	1.8
7b. - of which services	2.4	1.1	-3.2	-5.2	-3.5	2.0	3.2
8. Final demand	2.5	0.2	-3.4	-8.1	-5.0	0.3	1.5
9. Imports of goods and services	4.8	-0.1	-5.4	-14.1	-6.9	-0.1	1.3
9a. - of which goods	7.3	-3.6	-10.0	-17.4	-8.2	-0.3	1.1
9b. - of which services	-0.4	7.7	3.9	-8.5	-4.9	0.1	1.6
10. GDP at market prices	1.3	0.4	-2.4	-5.4	-4.2	0.4	1.6
(Contribution to change in GDP)							
11. Final domestic demand	0.2	-0.8	-5.1	-7.9	-6.0	-0.5	0.9
12. Changes in inventories	1.8	-0.7	1.2	-2.2	0.0	0.0	0.0
13. Net exports	-0.6	1.9	1.5	4.8	1.8	0.9	0.8

Source: Commission services.

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

percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	3.7	4.7	0.6	-6.0	-4.9	1.0	3.2
2. Government consumption expenditure	2.6	3.0	-4.9	-9.7	-4.3	-1.3	-1.9
3. Gross fixed capital formation	-3.7	-10.7	-17.0	-22.4	-15.3	3.7	6.7
4. Domestic demand excl. inventories	2.0	1.6	-3.2	-9.0	-6.0	0.8	2.6
5. Changes in inventories (contr. to growth)	0.1	0.0	0.2	-0.2	-0.2	-0.2	-0.2
6. Domestic demand incl. inventories	3.8	0.9	-2.0	-11.1	-6.0	0.9	2.7
7. Exports of goods and services	6.1	6.6	-0.9	-3.6	-1.8	3.3	4.5
7a. - of which goods	13.6	24.1	2.0	0.9	1.2	2.2	2.8
7b. - of which services	4.8	3.4	-1.6	-4.7	-2.5	3.5	4.9
8. Final demand	4.5	2.5	-1.7	-8.9	-4.7	1.6	3.3
9. Imports of goods and services	7.0	2.1	-3.3	-13.2	-6.2	1.3	2.9
9a. - of which goods	9.6	-0.7	-8.1	-16.5	-7.5	0.7	2.4
9b. - of which services	1.6	8.4	6.3	-7.3	-4.2	2.2	3.7
10. Gross national income at market prices	5.4	6.7	-5.7	-5.6	-4.3	1.3	3.1
11. Gross value added at basis prices	3.8	3.2	-0.7	-6.4	-4.0	1.7	3.4
12. Gross domestic product at market prices	3.3	2.7	-0.9	-6.9	-4.0	1.8	3.4

Source: Commission services.

Table A2.4: **Implicit deflators**

percent change	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	2.1	3.3	2.6	-0.3	0.2	1.2	1.6
2. Government consumption expenditure	1.6	3.2	-1.1	-4.9	-1.6	1.1	1.3
3. Gross fixed capital formation	1.2	-2.2	1.6	-1.0	2.0	2.4	2.7
4. Domestic demand incl. inventories	1.9	2.4	1.8	-1.4	0.1	1.4	1.8
5. Exports of goods and services	2.2	2.0	1.6	0.6	0.9	1.3	1.5
6. Final demand	2.2	2.0	1.6	0.6	0.9	1.3	1.5
7. Imports of goods and services	2.1	2.2	2.2	1.1	0.8	1.4	1.6
8. Gross domestic product at market prices	1.9	2.3	1.6	-1.5	0.2	1.3	1.7
HICP	2.6	3.5	3.1	0.4	0.2	1.1	1.7

Source: Commission services.

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

Percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Labour productivity	1.5	0.0	1.8	-0.2	-0.2	0.0	0.1
2. Compensation per employee	2.6	2.5	-0.9	-6.0	-3.0	0.4	1.5
3. Unit labour costs	1.1	2.5	-2.7	-5.8	-2.8	0.4	1.3
4. Total population	2.6	2.6	1.5	0.4	1.0	1.0	0.8
5. Population of working age (15-64 years)	3.1	2.9	1.5	1.0	1.0	0.2	0.2
6. Total employment	-0.2	0.4	-4.2	-5.2	-4.0	0.4	1.5
7. Unemployment rate (1)	6.3	7.9	11.9	15.9	18.6	18.0	16.8

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

Table A2.6: **External balance**

EUR bn unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Exports of goods (fob)	1.1	1.4	1.4	1.5	1.5	1.5	1.5
2. Imports of goods (fob)	5.8	5.8	5.3	4.4	4.1	4.1	4.2
3. Trade balance (goods, fob/fob) (1-2)	-4.7	-4.3	-3.9	-3.0	-2.6	-2.6	-2.7
3.1 p.m. (3) as % of GDP	-26.8	-24.3	-21.8	-18.0	-16.5	-16.2	-16.0
4. Exports of services	6.2	6.4	6.3	6.0	5.8	6.0	6.3
5. Imports of services	2.6	2.8	3.0	2.8	2.6	2.7	2.8
6. Service balance (4-5)	3.6	3.6	3.3	3.2	3.2	3.3	3.5
6.1 p.m. 6 as % of GDP	20.6	20.0	18.6	19.5	20.1	20.7	21.2
7. External balance of goods and services (3+6)	-1.1	-0.8	-0.6	0.2	0.6	0.7	0.9
7.1 p.m. 7 as % of GDP	-6.2	-4.4	-3.2	1.5	3.6	4.4	5.1
8. Balance of primary incomes and current transfer	-0.5	0.0	-0.9	-0.6	-0.6	-0.7	-0.8
8.1. - of of which, balance of primary income	-0.5	0.1	-0.7	-0.5	-0.5	-0.6	-0.6
8.2 - of which, net current transfers	0.0	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1
8.3 p.m. 8 as % of GDP	-2.8	-0.2	-5.1	-3.4	-3.7	-4.2	-4.5
9. Current external balance (7+8)	-1.6	-0.8	-1.5	-0.3	0.0	0.0	0.1
9.1 p.m. 9 as % of GDP	-9.0	-4.5	-8.3	-1.9	-0.1	0.2	0.6
10. Net capital transactions	0.0	0.0	0.0	0.0	0.0	0.1	0.1
11. Net lending (+)/net borrowing (-) (9+10)	-1.5	-0.8	-1.5	-0.3	0.0	0.1	0.2
11.1 p.m. 11 as % of GDP	-8.8	-4.3	-8.2	-2.1	0.1	0.8	1.2

Source: Commission services.

Table A2.7: **Fiscal accounts**

	2010	2011	2012	2013	2014	2015	2016
			levels, EUR m				
Taxes on production and imports	2,679	2,612	2,633	2,396	2,362	2,421	2,533
Taxes on income and wealth	1,926	2,098	1,962	1,916	1,805	1,821	1,900
Social contributions	1,552	1,566	1,510	1,475	1,483	1,510	1,552
Other current resources (1)	948	851	858	863	960	790	833
Total current revenue	7,106	7,127	6,963	6,650	6,610	6,542	6,818
Capital transfers received	10	12	11	6	16	2	2
Total government revenue	7,116	7,139	6,974	6,656	6,626	6,544	6,820
Compensation of employees	2,758	2,875	2,819	2,567	2,385	2,349	2,328
Intermediate consumption	978	945	865	741	775	774	746
Social transfers	2,479	2,617	2,598	2,595	2,710	2,733	2,623
Interest payments	391	426	563	560	558	571	606
Subsidies	62	85	95	95	93	90	90
Other current expenditure	436	500	487	384	383	379	344
Total current expenditure	7,103	7,449	7,425	6,937	6,897	6,889	6,730
Total capital expenditure (2)	911	811	675	611	555	477	488
Total expenditure	8,036	8,272	8,109	7,553	7,459	7,373	7,225
General government balance, EDP	-920	-1,132	-1,135	-897	-833	-829	-405
			% of GDP				
Taxes on production and imports	15.4	14.6	14.9	14.5	14.9	15.0	15.2
Taxes on income and wealth	11.1	11.7	11.1	11.6	11.4	11.3	11.4
Social contributions	8.9	8.8	8.5	8.9	9.4	9.4	9.3
Other current resources (1)	5.4	4.8	4.8	5.2	6.1	4.9	5.0
Total current revenue	40.8	39.9	39.3	40.3	41.7	40.5	40.8
Capital transfers received	0.1	0.1	0.1	0.0	0.1	0.0	0.0
Total government revenue	40.9	39.9	39.4	40.3	41.8	40.5	40.8
Compensation of employees	15.8	16.1	15.9	15.6	15.1	14.6	14.0
Intermediate consumption	5.6	5.3	4.9	4.5	4.9	4.8	4.5
Social transfers	14.4	14.7	14.7	15.7	17.1	16.9	15.7
Interest payments	2.2	2.4	3.2	3.4	3.5	3.5	3.6
Subsidies	0.4	0.5	0.5	0.6	0.6	0.6	0.5
Other current expenditure	2.5	2.8	2.7	2.3	2.4	2.4	2.1
Total current expenditure	40.9	41.7	42.0	42.1	43.6	42.8	40.4
Total capital expenditure (2)	5.2	4.5	3.8	3.7	3.5	3.0	2.9
Total expenditure	46.2	46.3	45.8	45.8	47.1	45.7	43.3
General government balance, EDP	-5.3	-6.3	-6.4	-5.4	-5.3	-5.1	-2.4
Nominal GDP	17.4	17.9	17.7	16.5	15.8	16.1	16.7

(1) The projection for 2014 includes the expected increase in the distribution of dividends by the CBC compared to the previous year. The 2015 and 2016 numbers will be adjusted once decisions are taken by the CBC on dividends in these years.
(2) 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**

	2010	2011	2012	2013	2014*	2015	2016**
EDP deficit (% of GDP)	-5.3	-6.3	-6.4	-5.4	-5.3	-5.1	-2.4
EDP gross debt (% of GDP)	61.3	71.5	86.6	111.5	119.9	124.4	121.9
			levels, EUR bn				
EDP deficit	-0.9	-1.1	-1.1	-0.9	-0.8	-0.8	-0.4
Gross debt	10.7	12.8	15.3	18.4	19.0	20.1	20.3
Change in gross debt	0.8	2.1	2.6	3.1	0.6	1.1	0.3
Nominal GDP	17.4	17.9	17.7	16.5	15.8	16.1	16.7
Real GDP	15.1	15.2	14.8	14.0	13.4	13.5	13.7
Real GDP growth (% change)	1.3	0.4	-2.4	-5.4	-4.2	0.4	1.6
			% of GDP				
Gross debt ratio	61.3	71.5	86.6	111.5	119.9	124.4	121.9
Change in gross debt ratio	2.8	10.1	15.1	24.9	8.4	4.5	-2.5
			Contribution to change in gross debt				
Primary balance	3.0	3.9	3.2	2.0	1.7	1.6	-1.2
Snow-ball effect	0.4	0.8	3.8	9.9	8.2	1.4	-0.4
of which							
Interest expenditure	2.2	2.4	3.2	3.4	3.5	3.5	3.6
Real growth effect	-0.7	-0.2	1.7	5.0	4.9	-0.5	-2.0
Inflation effect	-1.1	-1.4	-1.1	1.4	-0.2	-1.6	-2.1
Stock-flow adjustments	-0.6	5.5	8.1	13.0	-1.5	1.5	-0.8

* Stock-flow adjustments also reflect the transfer of coinage rights from the CBC to the government. ** Projected privatisation proceeds of EUR 500m are spread evenly over the four quarters of 2016.
Source: Commission services.

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

cash data unless states otherwise *million euros, negative = surplus / revenue*	2013				2014				2015				2016	Programme period (2013Q2-2016Q1)	2013	2014	2015	2016	2017	2018	2019	2020
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1									
Amortisation of existing market debt excl. short-term	3.5	1,435.9	123.7	43.5	249.4	124.6	643.6	113.1	146.9	78.5	61.4	928.3	340.0	4,289.0	1,606.6	1,130.8	1,215.2	680.7	2,507.4	782.7	1,463.8	1,883.7
among which:																						
domestic- (GRDS), foreign-law (EMTN) & CPB recap bond:	*0.0*	*1,416.9*	*47.0*	*1.0*	*243.9*	*90.0*	*600.0*	*55.2*	*141.1*	*42.8*	*17.6*	*871.4*	*332.4*	*3,859.4*	*1,464.8*	*989.2*	*1,073.0*	*530.6*	*2,376.5*	*19.6*	*703.1*	*1,132.5*
loans	*0.0*	*17.8*	*76.1*	*24.2*	*0.0*	*28.7*	*37.7*	*52.0*	*-0.2*	*29.8*	*38.1*	*51.4*	*1.8*	*357.6*	*118.1*	*118.5*	*119.2*	*127.2*	*108.0*	*740.0*	*737.7*	*730.1*
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	134.5	0.0	0.0	0.0
Amortisation of offical lenders	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.1	56.0	111.4	160.0
ESM	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
IMF	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*7.1*	*56.0*	*111.4*
Financial sector recapitalisation	0.0	0.0	1,500.0	0.0	0.0	0.0	0.0	300.0	0.0	200.0	0.0	200.0	300.0	2,500.0	1,500.0	300.0	400.0	300.0	0.0	0.0	0.0	0.0
of which contingency buffer	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*300.0*	*0.0*	*200.0*	*0.0*	*200.0*	*300.0*	*1,000.0*	*0.0*	*300.0*	*400.0*	*300.0*	*0.0*	*0.0*	*0.0*	*0.0*
Fiscal financing needs	10.9	154.5	85.9	538.4	2.4	12.2	364.7	797.4	160.2	441.4	120.5	429.1	-50.4	3,056.3	789.8	1,176.8	1,151.1	-122.1	-346.4	-41.5	-8.3	51.5
memo items:																						
primary balance (in ESA terms)	*-153.4*	*104.1*	*-80.1*	*466.4*	*-103.8*	*150.7*	*-48.0*	*276.2*	*-88.8*	*327.5*	*-187.0*	*206.0*	*-220.5*	*802.5*	*337.0*	*275.0*	*257.7*	*-200.7*	*-521.5*	*-724.2*	*-751.9*	*-780.8*
interest (in ESA terms)	*158.7*	*105.4*	*173.0*	*122.8*	*135.4*	*48.8*	*291.3*	*82.4*	*133.8*	*64.0*	*278.4*	*95.0*	*147.1*	*1,677.3*	*559.9*	*557.9*	*571.1*	*605.6*	*580.9*	*688.2*	*756.8*	*851.0*
Programme financing needs	14.4	1,590.4	1,709.6	581.9	251.8	136.8	1,008.3	1,210.6	307.0	719.9	181.9	1,557.4	589.5	9,845.3	3,882.0	2,607.5	2,766.3	589.5	-	-	-	-
memo: total annual financing needs															*3,896.4*	*2,607.5*	*2,766.3*	*858.6*	*2,302.7*	*797.1*	*1,566.9*	*2,095.2*

Source: Commission services.

ANNEX 4

Programme Documents

Memorandum of Understanding on Specific Economic Policy Conditionality

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

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

- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit by 2016, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and
- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

1. Financial sector reform

Key Objectives

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

Progress since February

The authorities continued to implement the reform of the financial sector. With respect to the regulatory and supervisory framework, the operational integration for the supervision of cooperative credit institutions by the Central Bank of Cyprus was completed. The directives on loan origination and on provisioning were implemented and banks submitted their action plans for complying with the provisioning and disclosures directive. The assessment of the operational capacity of financial institutions to work-out non-performing loans was carried out, in the context of rising arrears. Due to internal resource constraints, the publication of the first Financial Stability Report had to be rescheduled for end-December 2014.

Restructuring of the financial sector has progressed well. The Cooperative Central Bank was effectively recapitalised by the State with the ESM notes on 10 March 2014. The merger of the individual coops into 18 institutions was completed as envisaged by end-March and the capital injections in the individual institutions have been completed in April. The appointment of qualified executive and senior management and the improvement of governance are ongoing. Bank of Cyprus is proceeding with implementing its restructuring plan and has agreed upon the key performance indicators to be communicated to the public on the restructuring plan implementation progress. Hellenic Bank submitted to the CBC its business plan in March. Banks have established specialised units to effectively deal with non-performing loans. The significant banks are participating in the on-going Comprehensive Assessment of the ECB, due to be completed by the end of October 2014. Further progress was achieved with the liberalisation of restrictive measures.

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. The Cypriot authorities commit to continue implementing the roadmap for the gradual relaxation of restrictive measures which was published on 8 August 2013. This roadmap identifies a series of milestones for the gradual liberalisation of the restrictions also taking into account indicators of investor confidence in the banking system and financial stability indicators, including the liquidity situation of credit institutions. The Cypriot authorities will ensure, in timely consultation with the EC, ECB, IMF and informing the ESM, that the relaxation of remaining domestic payment restrictions is consistent with financial sector stability and in line with the agreed strategy. Further progress under the program is needed before considering actions related to restrictions on the capital account.

1.2. Furthermore, the CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector. The CBC will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules. The additional government guarantees for the issuance of bank bonds of up to EUR 2.9 billion in nominal value could be used as collateral against liquidity, if necessary to safeguard financial stability, in line with State aid rules.

1.3. The Bank of Cyprus and the Cooperative Central Bank submitted their capital and funding plans in April 2014. The CBC will continue to receive the updated plans **on a quarterly basis** and will transmit them to the ECB, the EC, the ESM and the IMF. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector, the gradual easing of restrictive measures, and the reduction of borrowing from the central bank, with the objective to avoid asset fire sales and a credit crunch.

Regulation and supervision of banks and cooperative credit institutions

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

1.5. Having reviewed its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning, the CBC introduced regulatory amendments. A new loan origination directive was adopted in October 2013, though implementation has so far been hindered by lack of financial information to enable an effective assessment of the repayment capacity of borrowers. The new provisioning and disclosure directive will be fully implemented by the time of the publication of the 2014 annual accounts. For the co-operative credit institutions, the requirements of the new provisioning and disclosure directive will be fully applied in their 2013 annual accounts. Following a request by the CBC, banks will report on the potential impact of newly introduced and upcoming EU rules on their profitability and coverage ratios **by end-June**.

The authorities will present an action plan to improve the enforcement of the requirement that the corporate financial statements are prepared on a regular and timely basis by end-September, with a view to introducing any necessary amendments to the legal framework **by end-November**.

1.6. BoC and the coops submitted in April and May 2014, respectively, a quarterly report describing the progress with the implementation of the restructuring plans. The reports contain a set of key performance indicators including selected operational and financial targets developed by the CBC and communicated to these banks. The CBC units responsible for the supervision of BoC and coops will assess these and subsequent reports **on a quarterly basis** and submit their conclusions and proposed actions to the CBC Board within four weeks of the receipt of the reports.

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

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

1.9. The independently audited consolidated accounts of the cooperative credit institutions for the year 2013 will be published **by end-June**.

1.10. The CBC will have sufficient staff to carry out its functions in full independence as stipulated by the Treaties. The current recruitment of experienced staff should be finalised **by end-June**. The CBC will further assess the need to increase its staff, taking into account the new tasks undertaken under this Memorandum of Understanding and the tasks imposed by the creation of the Single Supervisory Mechanism **by end-October,** and address the identified needs **by end-December**.

1.11. In light of the new responsibilities taken on by the CBC, the revision of the Resolution Law and the transition to the Single Supervisory Mechanism, the Authorities will review the governance of the CBC **by end-June** and adopt the necessary legislative amendments **by end-September**.

1.12. The authorities, in consultation with EC, ECB and IMF and informing the ESM, reviewed the effectiveness of the Resolution Authority, including its composition and governance, in March 2014. The amendments to the Resolution Law are to be adopted **by mid-July**.

Monitoring of corporate and household indebtedness

1.13. The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. Data from surveys will be used until the credit register becomes fully operational. The annual Financial Stability Report, to be published **at year-end**, will include an extended analysis on corporate and household indebtedness. In addition, quarterly monitoring reports will continue to be submitted and their scope and content will be further enhanced.

1.14. Measures will be taken to strengthen the management of non-performing loans and to deal with troubled borrowers. A framework for targeted private-sector debt restructuring is being established.

- Following the completion of the merger process for the cooperative credit institutions, an assessment of the operational capacity of the CCB's loan workout unit will be completed **by end-May**.
- Banks will be required to report **quarterly** on restructuring progress and management of NPLs. The first report, with reference date end-March, will be submitted **by end-June**, using specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.), which were approved by the CBC in consultation with EC, ECB and IMF and informing ESM. Furthermore, banks will report monthly on early arrears (e.g. number and amount of past due loans within 1-90 days, type of actions taken, and number and amount of cured or uncured loans).

- The CBC will, with assistance of an external expert, review banks' arrears management policies and practices, taking into account international best practices. The preliminary findings of this review will be presented to the EC, ECB and IMF, and informing the ESM, **by mid-July.** The review will be completed **by end-July** and serve as a basis for further policy recommendations on the arrears management processes in credit institutions. Following the review, revisions of the Arrears Management Directive and of the Code of Conduct will be introduced as needed, taking into account the developments and timelines in the Single Supervisory Mechanism, **by end-September.** The responsible CBC supervisory units will examine the implementation of the banks' action plans to correct deficiencies identified by the external expert and submit the main findings and recommendations to the CBC Board **by end-November**.
- **By end-June**, the CBC will introduce requirements for banks and coops to submit agreed-upon procedure reports prepared by their external auditors on banks' effectiveness of debt restructuring arrangements and strategies for the periods ending in December 2014, June 2015, December 2015, and June 2016.
- The role of the Financial Ombudsman with regard to handling complaints on compliance with the arrears management process was clarified by end-March. The necessary legal amendments to the Law on the Financial Ombudsman are to be adopted, in consultation with the EC, ECB and IMF and informing the ESM, **by end-June**.
- The Cypriot authorities, in view of financial stability considerations and on-going bank restructuring, commit not to introduce any new administrative measures which would interfere with the setting of bank lending rates. In particular no ceilings on bank lending rates would be introduced.
- The Cypriot authorities will prepare, **by mid-July**, an action plan for removing impediments for lenders to obtain adequate updated information on the financial situation of delinquent borrowers, under sufficient safeguards. These impediments will be fully removed **by end-December.**
- In order to encourage a market for distressed assets, the Cypriot authorities will prepare, **by end-June**, a report identifying impediments to transfer individual loans to third parties.

<u>Increasing financial transparency</u>

1.15. Based on the findings of the April 2013 audit undertaken by MONEYVAL and an independent auditor, the Cypriot authorities have progressed in enhancing the anti-money laundering (AML) framework in line with best practices and are committed to ensuring its implementation, under the timetable set out in the agreed AML Action Plan (see Annex 2) and in particular by taking the following measures:

- Strengthen preventive measures of obliged entities with regard to customer due diligence, use of introduced business and reporting of suspicious transactions (Action Plan – sections 1, 2 and 3).
- Ensure transparency and timely access to information on beneficial ownership of trusts (Action Plan – section 4). The programme partners take note of the establishment by the Cypriot authorities' of trust registers with the supervisory authorities (Action Plan – section 4.3.1)

- The supervisory competent authorities are reviewing their off-site and on-site supervisory procedures and further implement a risk-based approach to AML supervision for financial and non-financial (lawyers, accountants and TCSPs) institutions (Action Plan – sections 5 and 6). In carrying out its onsite supervisory program, the CBC will build on its follow-up work on the April 2013 audit regarding individual financial institutions.
- On a quarterly basis, in the context of the programme review starting **Q4-2013**, the supervisory competent authorities will, on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.

To address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have revised the legal framework so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts related to money laundering and tax matters.

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

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

B. Recapitalisation and restructuring of financial institutions

Restoring adequate capital buffers

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

Management of legacy Laiki

1.17. In order to enhance the recovery value from the disposal of the assets of Laiki, the Resolution Authority instructed the Special Administrator to appoint a well-recognised and independent consulting or auditing firm(s) or international institution(s) to be entrusted with the voting rights associated with Laiki's shares participation in BoC. This appointment will be completed **by end-September.** The finalisation of the appointment of an advisor to provide services associated with the management of the disposal process shall be completed

by end-June. As part of the terms of reference for the appointment of the advisor agreed in consultation with the EC, ECB and IMF and informing the ESM, an action plan for the full disposal of the assets will be developed **by end-July,** with a view to maximize value for creditors.

Restructuring of Bank of Cyprus

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

1.19. Going forward, the CBC will complete **by end-February 2015** a comprehensive technical assessment of BoC's restructuring plan with the aim to identify areas that require further strengthening and review, and with due consideration to the establishment of the Single Supervisory Mechanism.

Restructuring and recapitalisation of cooperative credit institutions

1.20. The final restructuring plan for the cooperative sector was submitted to the EC in January 2014. . On the basis of that plan and the commitments submitted by the Cypriot authorities, the Commission approved restructuring aid for the cooperative credit institutions as compatible with the internal market on 24 February 2014. The cooperative credit institutions that benefited from public capital injections are subject to specific management rules and restrictions and to a restructuring process, which is being scrutinised by an external monitoring trustee. The monitoring trustee will submit quarterly reports on governance and operations, as well as ad-hoc reports as needed and is working under the direction of the EC. In line with the EU State aid rules, the trustee will, inter alia, verify proper governance and the use of commercial-basis criteria in key policy decisions and assessing the soundness of strategies to deal with loan arrears. The monitoring trustee shall have access to Board meeting minutes, and be observer at the executive committees and other critical committees, including risk management and internal audit functions.

1.21. The merger of individual cooperative credit institutions into 18 entities was completed in March. These mergers were designed to achieve viability, efficiency and profitability. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones. Following the completion of the merger process and the establishment of the final governance structure of the sector, the CBC will review its affiliation directive **by end-July**.

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

1.23. As part of the implementation of the restructuring plan, the Cooperative Central Bank has utilised external expertise to develop and implement policies and practices in the areas of arrears management and corporate restructuring. The recommendations made and deemed necessary by the authorities will be implemented. In addition, it will be ensured that the recruitment of executive and senior management of the CCB and CCIs takes place in line with international best practices and the established selection criteria, and will be completed **by end-May**. Moreover, to strengthen confidence in the sector, the CBC agreed with the CCB and the Ministry of Finance Management unit on the operational and financial indicators on progress with implementing the restructuring plan that will be communicated **quarterly** to the public.

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

C. Legal framework for private debt restructuring

1.25. All legal, administrative or other hurdles currently constraining the seizure and sale of loan collateral shall be removed so that the assets pledged as collateral can be recovered within a reasonable period deemed to be a maximum time-span of 1.5 years from the initiation of the relevant proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. The authorities commit not to introduce any further impediments to the seizure of assets pledged as collateral.

1.26. The authorities established a Task Force to prepare a study assessing the magnitude of registered, but untitled, land sales contracts and underlying mortgages and to develop recommendations **by end-June**.

1.27. The authorities will, in consultation with EC and IMF and informing the ECB and ESM, prepare a comprehensive reform framework to be endorsed by the Council of Ministers **by end-July**, establishing appropriate corporate and personal insolvency procedures. A draft of the reform framework as well as an impact assessment of various options on lenders will be completed **by end-June**, and shared with the EC, ECB, IMF and the ESM. On the basis of that framework, corporate and personal insolvency legislation will be adopted, which will include licensing and regulation of insolvency practitioners **by end-December**.

1.28. The legal framework in relation to foreclosures and the forced sales of mortgaged property will be amended in consultation with the EC and the IMF and informing the ECB and the ESM, and adopted **by end-June,** with immediate effect for all mortgaged properties except primary residences (for which provisions will enter into effect **by end-December**, in line with the adoption of the insolvency legislation), to allow for private auctions to be conducted by mortgage creditors, without interference from government agencies.

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

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

2. Fiscal policy

Key objectives

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

In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation in order to achieve a 3% of GDP primary surplus in 2017, 4% of GDP in 2018 and maintain at least such a level thereafter; (2) to achieve the annual budgetary targets as set out in this Memorandum of Understanding (MoU) through high-quality permanent measures, and additional measures in the outer years, in particular to reduce the growth in expenditure on the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on vulnerable groups; (3) to this end, to fully implement the fiscal consolidation measures for 2014, listed in Annex 1; (4) to correct the excessive general government deficit by 2016; and (5) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see Section 3), including the implementation of a Medium-Term Budgetary Framework designed in accordance with EU specifications.

The Cypriot authorities adopted a number of fiscal measures for 2012-2014 and have progressed in relation to fiscal-structural reforms. The authorities commit to the full implementation of these measures (see Annex 1) and to regularly monitor the budgetary effect of the measures taken. Any deviation from the projected budgetary effect of the measures will be evaluated and addressed accordingly in the quarterly programme reviews, taking into account macroeconomic developments. In the event of underperformance of revenues or higher social spending needs, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the programme period, cash revenues above programme projections, including any windfall gains,[5] 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 3.5 of this Memorandum, will not be undertaken over the course of the programme period. The government will modify **by mid-June 2014** the bill amending the road vehicles and traffic law so that it will not include the provision for a tax amnesty for the payment of annual road tax.

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

[5] 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

the European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD and EFF/EMFF) in the framework of the 2007-2013 and 2014-2020 programming periods, while taking into account available EIB funding. The authorities will ensure that the institutional capacity to implement current and future programmes is improved and the appropriate human resources of Managing Authorities and implementing bodies are available.

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

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

Fiscal policy in 2014

Based on the programme's current macroeconomic and fiscal projection and reflecting the 2014 Budget, the Cypriot authorities will achieve a deficit of the general government primary balance of EUR 275 million (1.7% of GDP) in 2014[6] corresponding to a headline deficit of 5.3% of GDP (respecting the 16 May 2013 Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Cyprus). To this end, Cyprus will fully implement the permanent measures included in the 2014 Budget, amounting to at least EUR 270 million in 2014 (Annex 1).

Fiscal policy in 2015-16

Based on the programme's updated budgetary projection, the Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 258 million (1.6% of GDP) in 2015, corresponding to a headline deficit of 5.1% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus). In 2016 the Cypriot authorities will achieve a general government primary balance surplus of at least EUR 201 million (1.2% of GDP), corresponding to a headline deficit of 2.4% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus)[7]. These targets and the underlying updated budgetary projection will be embedded in the 2015-2017 Fiscal Strategy Statement, which will be adopted by the Council of Ministers **by Q2-2014**.

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

The 2014-2016 expenditure ceilings will be updated for the period 2015-2017 and will accompany the 2015 Budget Law document. Any deviation from the budgetary objectives

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

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

contained in the 2014-2016 framework will be properly documented and reasons for such deviations will be provided to the programme partners. In **Q2-2016**, the Cypriot authorities will present the programme partners with a provisional list of measures to attain a primary surplus of 3% of GDP in 2017 and 4% of GDP in 2018. The measures required will be included in the draft 2017 Budget Law.

3. Fiscal-structural measures

Key objectives

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

Pension reform

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

Health care reform

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

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

b) taking into account the findings of the functional review of the Ministry of Health, carry out health sector reforms, including restructuring all public hospitals/public health facilities, the Ministry of Health, the HIO, and other associated facilities/organisations based on a Reform Plan to be approved by the Council of Ministers **by Q2-2014**. The reform plan will provide for the autonomization of all public hospitals/public health facilities. All necessary legislative changes to be approved by the House of Representatives **by end-November 2014** aiming at full implementation **by Q2-2015**; Public hospitals complete the shadow-budgeting for all inpatient cases on diagnoses-related groups **by Q3-2014** and for all in- and outpatient activities **by Q4-2014**;
c) taking into account the economic conditions, the implementation of the necessary complementary reforms, the results of the updated actuarial study, and after consultation with the programme partners, implement a National Health System (NHS), to be fully in place **by mid-2016**.

1. The NHS will be developed and implemented based on the fundamental principles of free choice of provider, social equality and solidarity, financial sustainability and universal coverage of a minimum benefit basket.
2. Implementation will be carried out in three stages. **By mid-2015**, in the first stage of NHS, primary care consultation services will be covered. **By 1 January 2016**, outpatient specialist care and outpatient pharmaceuticals will be added to the benefits covered. Full implementation of NHS will be achieved **by mid-2016**.
3. NHS will be initially based on a single payer agency. The system may evolve into a multiple insurance system provided that the necessary preconditions for achieving efficiency and affordability gains (i.e. consumer information and transparency, contestable markets, freedom to contract, fiscal viability of insurance agencies, competition regulation and risk-adjustment) can be ensured.
4. The detailed road map for the implementation of the NHS will be agreed with programme partners **by Q2-2014**. The amended bill of NHS will also determine and clarify the respective role, governance and responsibilities (notably concerning the strategic policy, budget control, monitoring, audit and regulation) of the Ministry of Health and the HIO and will be approved by the House of Representatives **by Q4 2014**.
5. The policies of the Ministry of Health on pricing and reimbursement of medical goods and services, including those related to pharmaceutical expenditure, will be revised in agreement with programme partners to contain projected spending levels under NHS.
6. An Implementation Advisory Team will be established **by end-June 2014**, drawing on national and international expertise, to assist the Ministry of Health with the implementation of NHS and health sector reforms. A study by an independent consultant, to be chosen in consultation with programme partners, will be undertaken to evaluate the functional and financial sustainability of the NHS operated by single or multi payer agencies; the study will also assess how and when the precondition mentioned in paragraph c)3 (ie consumer information and transparency, contestable markets, freedom to contract, fiscal viability of insurance agencies, competition regulation and risk-adjustment) can be achieved.

d) secure adoption by the Council of Ministers of a binding set of contingency measures (e.g. revision of the basket of publicly reimbursable medical services and products, cuts in tariffs for medical products and providers of medical services, limits to the volume of reimbursable products and services, capacity planning) **by Q4-2014**, in order to ensure that the agreed budget limits of public health expenditure are not exceeded;
e) initiate the tendering of the IT-infrastructure necessary for implementing the NHS **by Q2-2014**;
f) review income thresholds for free public health care in comparison to the eligibility criteria for social assistance, while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures **by Q2-2014**;
g) continue to publish clinical and prescription guidelines and to audit their implementation; continue to establish the system for health-technology assessment. Periodic reviews of the basket of publicly-reimbursable medical services will be conducted, based on objective, verifiable, criteria, including cost-effectiveness criteria (health technology assessment will contribute when feasible); prepare quarterly reports on the results of the respective workstreams;

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

<u>Public financial management</u>

3.3. The Cypriot authorities will:

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in the Fiscal Responsibility and Budget System Law (FRBSL), including an implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance **prior to the granting of the fifth disbursement of financial assistance**;

- improve the risk-assessment analysis associated with government guarantees. To this end, submit for consultation with programme partners **by mid-July 2014** an advanced draft of the risk assessment report prepared by the Public Debt Management Office, with a view to a final version **by Q3-2014**. The report shall identify guarantees that are expected to result in calls in the current and following year;

- adopt a comprehensive medium-term debt-management strategy, **by end-October 2014,** aimed at: (i) smoothing the debt redemption profile and reducing refinancing risk; (ii) diversifying across instruments and types of investors; (iii) ensuring a smooth functioning of the domestic Treasury bill market; and (iv) enhancing risk-assessment of contingent liabilities from government guarantees. This will help paving the way for a sustainable return to market access in due time.

- implement guidelines for public investment management, including project appraisals in line with the FRBSL provisions **by Q2-2014**. The authorities commit not to enter into any new tendering process and not to sign any public private partnership (PPP) contract before the implementation of the guidelines for public investment management; and

- regularly update the PPPs inventory, including contingent liabilities and include it both in the annual budget law and in the annual financial report.

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 HoR **by mid-June 2014**. The law will enhance the monitoring powers of the central administration, while including reporting on SOEs in the context of the annual budgetary procedure. No additional SOEs will be created until the law has been adopted;

- the Cypriot authorities will submit for consultation with programme partners a plan with detailed timelines for the review of those SOEs that are under internal review **by Q2-2014**; and

- each SOE will submit a strategic plan to the competent minister for approval, in consultation with programme partners, and in line with the FRBSL and SOEs Law provisions **by Q4-2014.**

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

An appropriate regulatory framework is a prerequisite for the privatisation of natural monopolies. The provision of basic public goods and services by privatised industries will be fully safeguarded, in line with the national policy goals and in compliance with the EU Treaty and the relevant secondary legislation.

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

- establish the Privatisation Unit through the appointment of its Head and its experts, in line with the provisions of the Privatisation Law; the Unit will be fully operational **by June 2014**;

- appoint independent advisors for the CPA privatisation **by Q2-2014**, in accordance with the privatisation plan;

- appoint independent advisors for the privatisation of CyTA and EAC **by Q3-2014**, in accordance with the privatisation plan;

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

- appoint independent advisors with relevant expertise and develop a plan with detailed intermediate steps and timings for disposing of the identified real estate assets **by Q3-2014**.

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

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

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

In order to complete the agreed short-term measures, the following actions will be undertaken without delay and in no case later than **by Q2-2014**:

- attributing personal responsibility for payment of company taxes to those, who - in the case of non-listed companies - truly and effectively control a company and to the responsible manager for fraudulent filing of company taxes;
- harmonising the legislation among tax types so that not paying withholding taxes is a criminal offence;
- strengthening powers by the tax authorities to ensure payment of outstanding tax obligations, including by providing authority to garnish assets or prohibiting the alienation or use of assets, including property and bank accounts, by the taxpayer. The garnishing of bank accounts will not require prior court approval, but may allow for a short appeal period for the tax payer during which the relevant amount remains frozen; and
- enacting the necessary legislation to establish self-assessment for all income taxpayers by changing from a pre-assessment verification of income tax returns to post assessment audits selected on the basis of risk.

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

- A comprehensive compliance strategy that will be put in place **by Q2-2015**. The strategy will be firmly based on analytical work on risk identification and analysis, as well as on an evaluation of different risk treatment strategies. To further progress, the authorities will
    - o make the data from the IRD available to selected staff by the tax administrations via one platform, to be used for integral risk identification and analysis **by Q2-2014**;
    - o cleanse the income tax registers **by Q2-2014** and VAT registers **by Q4-2014**, by removing inactive cases and put in place a process to maintain the registers up-to-date;
    - o further improve the joint work programme for large and high risk taxpayers and provide a progress report **by Q2-2014** and finalise the compliance risk management module for large taxpayers **by Q3-2014**, with a view to setting up the integrated large taxpayer unit of the new tax department (see below) **by Q4-2014**; and

  - **by Q3-2014**, elaborate an integral strategy for the prosecution of tax fraud as a criminal offence, including an evaluation of the required investigative and legal resources needed in the new tax department.

- The establishment of a new integrated function-based tax administration, integrating the existing Inland Revenue Department and VAT Service, based on the adopted integration plan. As next step, the authorities will, **prior to the fifth disbursement of financial assistance**, enact the enabling legislation for establishment of the new tax agency **by 1 July 2014**. The legislation should include provisions for a fixed term of office for the new Commissioner of Taxation and sound principles for rotation in occupying the office of the Commissioner of Taxation.

In addition, the authorities will reinforce the tax unit in the Ministry of Finance that is responsible for tax policy formulation and for monitoring the implementation of tax policy and the revenue performance (including by measuring the VAT gap) **by Q2-2014.**

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

- fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;

- ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States;

- improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer; and

- **prior to the fifth disbursement of financial assistance,** the authorities will submit to the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes the follow-up report detailing the actions to address the shortcomings identified, with a view to achieve full compliance. The authorities will continue with the swift implementation of the commitments taken to reverse the negative opinion by the OECD Global Forum and provide a progress report to programme partners **by Q2-2014.**

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

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

Immovable property tax reform

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

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

Necessary legislative changes should be adopted by the House of Representatives **by early July 2014,** following consultation with programme partners. Legislation specifying the frequency of the mandatory update of the values in line with international best practices should be enacted by **Q1-2015**, following consultation with programme partners.

In order to ensure a smooth and timely implementation of the new immovable property tax and to minimise the operational risks, the authorities will present to the programme partners **by end-June 2014**:

- a communication strategy aiming at informing of the goals of the property tax reform, the implications for citizens and the procedures of the new reform;
- a comprehensive objections' management strategy to effectively and timely deal with possible valuation complaints.

The strategies need to be clear and practical, explicitly defining the required steps and resources, and the envisaged timelines.

In addition, the authorities will:

- **by Q4-2014,** conduct an assessment of the relevance of the parameters used in the Computer Assisted Mass Appraisal (CAMA) model for the GV and identify possible missing parameters. Refine, if needed, the CAMA in light of this assessment **by Q2-2015;**
- conduct an assessment of the variance between GV assessed values and market price **by Q4-2014;** and
- implement **by Q2-2015** the recommendations of a study on the scope for consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope for shifting revenues from transaction fees and taxes to recurrent taxation. The study will also provide an initial

review of the tax regulations relevant for the foreclosure process, with a view to minimising the cost of foreclosure and subsequent sale of foreclosed property **by Q2-2014**.

Public administration reform

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

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

- the appropriate system of remuneration and working conditions/conditions of employment in the public sector (e.g. annual vacation leave, sick leave, maternity leave, working time), in relation to the private sector and to other EU countries and based on best practices; and

- the introduction of a new performance based appraisal system in the public sector, for development and promotion purposes, linking performance with the remuneration system/ increments.

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

The sectoral element will examine:

- the role, competences, organisational structure, size and staffing of relevant ministries, services and independent authorities;

- the possibility of abolishing, merging or consolidating non-profit organisations or companies and state-owned enterprises; and

- the possibilities for the re-organisation and re-structuring of local government,

and comprises two batches:

- the first batch is undertaken by the World Bank and the UK public administration and covers the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies. Based on the findings of this first batch, the Cypriot authorities will agree on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers **by Q2-2014.** The relevant legislation in relation with the reforms in Agriculture, Education, local government indicated as high priority will be adopted by the House of Representatives **by Q3-2014**. The relevant legislation indicated as high priority on the Companies Registrar will be adopted **by October-2014.** The reform will start to be implemented **by Q4-2014**, in accordance with the reform plan.

- the second batch will cover all remaining Ministries (Labour, Welfare and Social Insurance, Communications and Works, Energy, Commerce, Industry and Tourism, Interior, Defence, Justice and Public Order, Foreign Affairs), and the Ministry of Finance, including the Treasury and the Directorate General for European Programmes, Coordination and Development (ex Planning Bureau) being covered under the PFM. It will also include all SOEs (subject to the decisions taken under the provisions of 3.4 and 3.5 regarding privatisation, restructuring or liquidation). Finally, it will cover the President's Office and the Council of Ministers, as well as the Constitutional and Independent Services (see Annex 3 for a detailed list). The results of the second batch will be presented **by Q4-2015.** They will include cost estimates and implementation timelines with detailed intermediate steps. Based on the findings of this review, the Cypriot authorities will agree on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers **by Q1-2016.** The relevant legislation in relation with the reforms indicated as high priority will be adopted by the House of Representatives **by Q2-2016**. The reform will start to be implemented **by Q3-2016**, in accordance with the reform plan.

- In addition, the authorities will review the impact of the changes to the public sector working hours and will present their findings to the programme partners **by Q4 2014.**

Welfare system

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

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

- consolidating the existing social benefits by streamlining, and, inter alia by merging some benefits and phasing out others, and integrating them under the Ministry of Labour, Welfare and Social Insurance;

- improving the targeting of benefits; and

- providing work incentives to avoid welfare dependency.

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

- adopt the final design of the reformed welfare system by the Council of Ministers **by mid-June 2014** after consultation with social partners, followed by consultation and review by programme partners. The adopted reform would define all benefits, their respective level, and eligibility criteria, as well as the overall costing of the system, along with provisions on the mandatory participation of beneficiaries to active labour market programmes;

- **by end-June 2014** establish a monitoring unit to assess the GMI outcomes (ie. number of applications and costs, targeting accuracy, coverage and impact on poverty);

- provide for consultation with the programme partners **by end-June 2014** a list of social benefits outside the GMI of which the beneficiary profiles and eligibility will be examined and **by mid-July 2014,**contingency measures to ensure fiscal neutrality of the reform in 2014.

- By **Q3-2014,** on the basis of an assessment of the possible fiscal impact of the welfare reform and as part of the budgetary process for 2015, update the costing of the GMI, and identify possible additional rationalization of social benefits outside the GMI in order to achieve fiscal neutrality of the reform;

- ensure that a comprehensive database and the necessary IT requirements, including all required interfaces with different databases to allow for the comprehensive verification of eligibility criteria, are in place to support the administration of the reformed welfare system **by end-June 2014**; and

- transfer all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour, Welfare and Social Insurance, which should be appropriately equipped in terms of financial and human resources, the latter being reassigned from other departments of the public administration **by Q2-2014**, except the benefits to be provided by the Ministry of Education and Culture (education benefits) and the Ministry of Interior (benefits to displaced people).

The reformed welfare system must be consistent with the fiscal targets defined in this MoU. Draft legislation providing for the new guarantee minimum income scheme (GMI) will be submitted for review to the programme partners before submission to the House of Representatives. The law will be adopted **by Q2-2014**.

4. Labour market

Key objectives

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

Cost of living adjustment (COLA) of wages and salaries

4.1. To ensure that wage growth better reflects developments in labour productivity and competitiveness, in both expansions and recessions, the Cypriot authorities are reforming the wage-setting framework. A tripartite agreement will be pursued with social partners **by Q4-2014** for the suspension of wage indexation in the private sector until 2016 and the application thereafter of the reformed wage indexation system (COLA) applicable to the public sector (lower frequency of adjustment, suspension at times of recession and partial indexation).

Minimum wage

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

Activating the unemployed and combating youth unemployment

4.3. The increase in unemployment underlines the need for an overall assessment of activation policies and available instruments for income support after the expiration of unemployment insurance benefits. The planned reform of public assistance should ensure that social assistance serves as a safety net to ensure a minimum income for those unable to support a basic standard of living, while safeguarding incentives to take up work, ensuring consistency with the reform of the welfare system as described in section 3.10.

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

i. the development of a coherent methodology for the continuous monitoring and evaluation of activation measures, to be applied consistently across the different ALMP. A comprehensive report will be presented **by Q3-2014** and as of then the new methodology will be applied, thereby enabling the assessment of the performance and effectiveness of all measures;

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

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

4.5. With one of the steepest increases in the youth unemployment rate in the EU and with the rapid rise of young people not in employment, education or training (NEETs), Cyprus needs to take swift action to create employment opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will submit **by end-May 2014** the National Action Plan for Youth Employment, which will include, *inter alia*, measures envisaged for support under the Youth Employment Initiative including also the implementation of the Youth Guarantee, in line with the conclusions of the European Council of June 2013. The design, management and implementation of these measures targeted to youth shall be well integrated within the broader system of activation policies and be coherent with the reform of the social welfare system (section 3.10) and the agreed budgetary targets. For this purpose, the authorities will submit **by end-May 2014** a comprehensive note summarising the full list of all active labour market policies (existing and envisaged) with the relevant intended aims, recipients and budgetary allocations.

5. Goods and services markets

Key objectives

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

Services Directive and regulated professions

5.1. The Cypriot authorities stand ready to adopt any further necessary amendments towards the full implementation of the Services Directive. Rules that refer to the calculation of fees for professional services (including those adopted by professional bodies) need to be assessed before adoption for compliance with internal market and competition principles, except as otherwise agreed with programme partners. To this end, the opinion of the Cypriot Commission for the Protection of the Competition (CPC) and of programme partners is required.

On the basis of the comprehensive review of requirements affecting the access and exercise of activity of the regulated professions sector (such as lawyers, engineers, architects), the Cypriot authorities will eliminate by law the requirements that are not justified or proportional **by Q3-2014**.

Competition, transparency and sectoral regulatory authorities

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

- continuing to provide sufficient and stable financial means, as well as qualified personnel in order to enhance its effective and on-going operation **by Q2-2014;**
- enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers. The amended law will be adopted by the HoR **by June 2014, at the latest**; and
- promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition **by Q2-2014**. The CPC may seek technical assistance to achieve this objective.

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

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

Housing market and immovable property regulation

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

The Cypriot authorities will:

- define binding administrative deadlines for the issuance of title deeds upon receipt of the certificate of final approval **by Q2-2014**. Moreover to ensure the enforcement of the deadlines for issuance of certificates of completion by the supervisor engineers, an amending bill concerning the Street and Building Permit Law will be submitted to the House of Representatives **by Q3-2014**, after consultation with the programme partners;
- prepare a joint action plan to streamline the processes within the DLS and between the DLS, the Local and District Authorities and the Ministry of Interior Technical Services **by Q2-2014**; This plan should detail the resources required across authorities, streamlined processes if needed, set clear deadlines for any consultations required for issuing a certificate of final approval, as well as means to enforce those deadlines;
- ensure that the title deed issuance backlog drops to less than 2,000 cases of immovable property units with title deed issuance pending for more than one year **by Q4-2014** (backlog refers to (i) applications, (ii) units that are eligible for the "ex-officio" issuance of title deeds, required certificates and permits). The ex-officio cases will automatically be counted in the backlog from the date the certificate of final approval is being issued by the respective Local or District Authority. To that end, **by mid-July,** provide to programme partners granular data on the stock of backlogs of permits, deeds, and certificates and a strategy identifying ways to reduce this backlog and continue publishing the quarterly progress reviews, starting **in Q3-2014**;
- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the monetary financial institutions and for all government services **by Q4-2014**; and
- improve the pace of court case handling, in order to eliminate court backlogs **by Q1-2016**. To that end, provide detailed statistics on court backlogs and duration of court proceedings to programme partners on a quarterly basis starting **in Q4-2014**, submit a draft action plan for the elimination of court backlogs, including the electronic filing of new documents **by end-October 2014,** and enact legislation to establish an Administrative Court **by Q4-2014.**

Tourism

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

- present a progress report on the implementation of the tourism action plan twice per year, including an assessment of its implementation based on performance indicators, **by Q1** and **Q3** every year, starting from 2014. An update of the first progress report will be presented to the programme partners **by Q2-2014**.
- present a plan enhancing the coordination of the various tourism stakeholders and relevant authorities **by Q2-2014**. The plan shall include concrete actions and a roadmap leading to an effective mechanism for coordination.
- start implementing an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, taking into account the EU external aviation policy and the EU aviation agreements, while ensuring sufficient air connectivity.. The action plan approved by the Council of Ministers in May 2014 will be implemented **as of Q3-2014** and will be reviewed annually by the Cypriot authorities, in consultation with the programme partners.

Energy

5.5. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package is fully and correctly implemented;
- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy will be developed and updated under the full authority of the Cypriot Government and should include at least the following three key elements, to be presented to the programme partners for consultation according to the timeline specified below:
    1. a *roll-out plan* for the infrastructure required for the exploitation of natural gas. This plan should take into account the relevant technical and commercial uncertainties and risks and should cover: the required investments, associated costs, financing sources and methods, ownership structure; major planning risks and bottlenecks; a projection of the revenue streams over time; and an appropriate sales framework for the off-shore gas supply for both exports and domestic markets aimed at maximising revenues. Next update **by Q2-2014.**

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

2. *a comprehensive outline of the regulatory regime and market organisation* for the restructured energy and gas sector, with a view to introducing open, transparent, competitive energy markets. The outline should take into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, the prospects of privatisation of SOEs in the energy sector, and the EU targets for energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include a description of the sequence and timing of the major changes envisaged: the institutional framework; the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the setting-up of wholesale markets for gas and electricity; the customer's free choice of supplier; and the full unbundling of gas suppliers and customers,. The Cyprus authorities will in this context consider the intended use and duration of the available 'isolated market' and 'emergent market' derogations. An advanced intermediate draft will be provided **by Q2-2014,** with a view to a final outline **by Q4-2014**; and

3. an institutional framework for the management of hydrocarbon resources, including a *resource fund*, which should receive and manage various types of public revenues from offshore gas exploitation and sales. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices. The resource fund, established in the FRBSL (see 3.3), should be based on clear rules governing inflows and outflows, coupled with clear rules regarding dividends, fees and costs of government entities and stakes in the energy sector. These rules should be provided for in the FRBSL and the specific law on the resource fund and detailed in implementing legislation of FRBSL. An advanced draft of the specific law will be submitted to programme partners for consultation **by Q2-2014,** before its submission to the House of Representatives.

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

6. Technical assistance

6.1. Given the nature of the structural challenges Cyprus is facing, including a lack of specific skills in some areas and scarcity of resources, the Cypriot authorities will provide an updated request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-June 2014**. This request will identify and specify the areas of technical assistance or advisory services, which the Cypriot authorities consider essential for the implementation of the MoU and where they intend to seek such technical assistance services, in coordination with the programme partners. All technical assistance provided by the European Commission, other than technical assistance provided directly under the Structural and other EU funds, will be coordinated by the Support Group for Cyprus.

7. Growth Strategy

7.1 The Cypriot authorities will develop a comprehensive and coherent growth strategy that will help the economy to move to a sustainable growth path. The growth strategy will take into account the on-going public administration reform, public financial management reform, the commitments in the Cyprus Economic Adjustment Programme and relevant Union initiatives. The growth strategy will aim at, inter alia, creating a more attractive business environment, addressing administrative complexity, implementing more streamlined and simpler procedures, and it will also take into account the Partnership Agreement for the implementation of the European Structural and Investment Funds.

By **Q3-2014**, the Cypriot authorities will assign a single body to develop, coordinate, and enforce this growth strategy. Also **by Q3-2014**, the authorities will provide, in consultation with the programme partners, an action plan for the development, and implementation of the growth strategy. The Cypriot authorities may request technical assistance to further develop this strategy.

Annex 1

Budgetary measures adopted by Cyprus in or after December 2012

Fiscal measures with effect in 2012

Expenditure measures

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

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

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

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

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

Revenue measures

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

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

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

Fiscal measures with effect in 2013

Expenditure measures

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

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

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

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

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

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

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

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

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

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

i. freeze public sector pensions;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

<u>Fiscal measures with effect in 2014</u>

Expenditure measures

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

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

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

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

I.36 Ensure additional expenditure savings by a further reduction of public sector allowances and streamlining of overtime compensation, including by revising the formula for calculating overtime compensation on weekdays and in weekends for state officers and apply the revision pro rata in the case of hourly paid employees;

I.37 A further targeting of social pensions;

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

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

Revenue measures

I.40 Extend the application of the temporary contribution on gross earnings and pensions of public and private sector employees up to 31 December 2016 as follows: EUR 0 – 1,500: 0%; EUR 1,501 – 2,500: 2.5%; EUR 2,501 – 3,500: 3.0%; and > EUR 3,501 - : 3.5%.

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

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

I.42 Increase excise duties on energy, i.e., on oil products, by increasing the tax rate on motor fuels (petrol and gasoil) by EUR 0.05.

I.43 Increase the contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point on pensionable earnings, i.e. 0.5 of a percentage point from employees and 0.5 of a percentage point from employers and 1 percentage point in the case of self-employed persons.

I.44 A reform of the tax system for motor vehicles with effect from budget year 2014, based on environmentally-friendly principles, with a view to raising additional revenues in the medium-term, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.

I.45 An introduction of a contribution of 3% on salaries of casual employees servicing on a contract basis, who receive gratuity including volunteers of 5 years services and police constables.

Annex 2

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

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

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 CBC to reiterate and clarify the obligation under the CBC directive that obliged entities are required to establish adequate AML/CFT training programs for all staff responsible for establishing business relationships and/or opening customer accounts and updating customer information. CBC to ensure that training programs are implemented and include information on current ML and TF techniques, methods and trends, and clear explanations of all aspects of the AML/CFT laws, regulations. In particular, this should include requirements concerning CDD, suspicious transaction reporting and sanctions for non-compliance.	Ongoing
	Mechanisms for coordination with supervisors of introducers	2.3 CBC to establish co-operation mechanisms with CySEC, the Cyprus Bar Association and ICPAC (for accountants) for exchanging information and ensuring supervisory coordination.	Compliant
3	**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.	Partially compliant Q2 - 2014
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[1] and nominee shareholders to disclose the identity of their nominator to the company and to the company register; or b) require that all nominee directors and nominee shareholders be authorised or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs).	Compliant
4.2	**Company Registry**		
	Efficiency of Companies' Registrar as an important aid to CDD.	4.2.1 Carry out a third party review of the functioning of the Companies' Registrar and communicate results to the programme partners. 4.2.2 Ensure the department of the registrar is appropriately resourced.	Compliant 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	**Supervision of financial institutions**		
5.1	**Revise the AML/CFT supervisory structure within the CBC, ensuring it is adequately resourced**	5.1.1 Revise and/or establish organisation structure and management within the CBC's Banking Supervision and Regulation Department (BSRD) to address AML/CFT matters,[2] in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Compliant

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

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

		5.1.2 CBC to ensure adequate human resources and technical capacity to undertake effective AML/CFT supervision. The level of resources should be commensurate with the size, complexity, and risk profiles of the financial institutions operating in the system.[3] To meet this objective, if deemed necessary by the CBC, hire AML/CFT experts with the necessary professional skills and experience (e.g. foreign supervisors retired or on leave) – subject to necessary confidentiality restrictions.[4]	Ongoing
5.2	**Develop risk-based supervisory tool(s) for offsite surveillance/monitoring activities prior to implementation**	5.2.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas,[5] and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - institutional risk profiles; - specific AML/CFT supervisory strategies (adapted to institutional risk profiles).	Compliant
5.3	**Develop risk-based supervisory tool(s) for onsite inspections prior to implementation**	5.3.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: -Corporate Governance; -Risk Assessment Systems; -Policies & Procedures; -Compliance Function; -Internal & External Audit Functions; -Training Program.	Partially compliant Q2 – 2014
5.4	**Establish Formal AML/CFT Training Program**	5.4.1 Establish a formal AML/CFT training program for CBC staff to ensure adequate implementation of the offsite and onsite tools. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools; - customer acceptance policies;	Q2 – 2014

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

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

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

Annex 3

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

The Public Administration Review: Second Batch of Studies

The second batch of studies to be carried out in accordance to paragraph 3.9 will cover the following areas:

Ministries and the Departments/Services falling under each Ministry

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

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

Constitutional Powers /Services

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

Independent Services/Authorities

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

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

i. Office for the Commissioner of State Aid Control [8]
ii. Authority for the Supervision of Cooperative Societies [9]
iii. Competition Protection Commission

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

Cyprus: Letter of Intent

Nicosia, June 16, 2014

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) of April 29, 2013, as supplemented and modified by previous MEFPs, we describe progress and policy steps towards meeting the objectives of the economic program of the Cypriot government, which is being supported by an arrangement under the Extended Fund Facility (EFF).

We have made progress with policy implementation under the program. Fiscal performance through end-March continued to exceed expectations, and, as a result, we have met all end-March and continuous performance criteria (PCs). Despite some delays, we have made progress toward complying with the requirements of structural conditionality. We have met two structural benchmarks (SBs) related to the consolidation of the coop sector and the assessment of its operational capacity. We have achieved the requirements of a third SB partially and those for two SBs with a delay. We expect to complete fully or partially the requirements of another two SBs in June.

Looking forward, we remain fully committed to our program's objectives to restore the health of the financial system, strengthen the sustainability of public finances, and adopt structural reforms to support public finances and long-run growth, while protecting the welfare of the population:

- In the financial sector, the key challenge is to address non-performing loans (NPLs). We will intensify the supervisory monitoring of banks' progress with debt restructuring and advance preparations for the implementation of the reform of the debt restructuring legal framework. At the same time, we are relaxing domestic payment restrictions, being mindful of the need to safeguard financial stability. Finally, we remain committed to strengthening bank supervision and to the implementation of the AML /CFT framework.

- Having modestly revised our primary fiscal deficit targets in line with the improved 2014 growth outlook, we remain committed to maintaining prudent budget execution, especially in light of still high macroeconomic uncertainty.

- We are advancing with our ambitious structural reform agenda. We remain committed to implementing a welfare reform protecting vulnerable groups this year. We are also taking steps to reform the revenue administration and to fight tax evasion and non-compliance. At the same time, we plan to strengthen the management of public debt and of fiscal risks related to government guarantees. Finally, we are advancing with preparatory steps to privatize state-owned enterprises.

Financing of our program remains adequate. The central bank has transferred last year's profits to the budget and we are making progress toward reducing public debt through a debt-to-asset swap with the CBC.

Based on the above, we request the following:

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

- Modification of the end-June 2014 PCs on: (i) the general government primary balance, general government primary expenditure; and the stock of general government debt (Table 1).

- Establishment of new quantitative PCs for end-September 2014 (Table 1).

- Establishment of new or modified SBs on the following: (i) a strategy to reform the debt restructuring legal framework (end-July); (ii) quarterly CBC report on coops' progress with restructuring targets (end-July); (iii) entrusting the management of Laiki's voting rights in BoC to an independent third party (end-September); (iv) CBC assessment of banks' and coops' action plans to address deficiencies in debt management capacity and practices (end-November); (v) approval of a new debt management strategy (end-October); (vi) adoption of legislation to modernize personal and corporate insolvency procedures and regulate insolvency practitioners (end-December 2014); and (vii) assessment of governance issues related to bank preferential lending practices (end January-2015) (Table 3).

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

Sincerely,

/s/	/s/
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

Our economy continues to adjust to correct large imbalances accumulated before the crisis. As a result, GDP contracted by 5.4 percent last year, reflecting significant declines in financial and construction sectors, which had grown at unsustainable levels in the past. Our tourism and service sectors helped to cushion the adjustment, and the overall contraction was less than 6 percent expected at the time of the third review. Still, the recession is taking a heavy toll on our economy and society, with the unemployment rate rising to very high levels and disposable incomes falling. This has led to an increase in non-performing loans (NPLs), now close to 140 percent of GDP for the core domestic banking sector, which are constraining banks' ability to provide liquidity to the economy, further hampering the ability of businesses to create jobs.

1. **We have revised our macroeconomic framework to reflect a less deep but more prolonged economic adjustment.** In light of the better-than-expected outturn in 2013 and available data for the early months of 2014, we revised our projection for GDP growth in 2014 to -4.2 percent (from -4.8 percent). However, we expect the adjustment to take more time and the recovery to be weaker, as domestic demand, especially private consumption, is weighed down by the need to reduce very high levels of private sector debt. As a result, growth is projected to reach only 0.4 percent in 2015, increasing to 1.6 percent in 2016. Risks to the outlook remain significant. On the external front, increased geopolitical tensions related to the Ukraine conflict could affect our service and tourism sectors negatively. Domestically, delays in dealing with the large NPLs could exacerbate negative feedback between the economy and the banks, further hampering the recovery.

B. Financial Sector Policies

Restructuring private sector debt

2. **Ensuring that banks are effectively addressing the high level of NPLs is a key priority.** Having recapitalized the banking sector and met our end-March **structural benchmark** on consolidating the coop sector, achieving progress in reducing NPLs—now about half of total loans—is essential to restore confidence and resume the provision of credit to the economy. To this end, the CBC has intensified its supervisory monitoring of banks' efforts with debt restructuring, which focuses on three key areas:

- ***Assessment of debt restructuring capacity, policies and compliance with the Code of Conduct***: The CBC has completed the in-situ assessment of the operational capacity of banks' and coops' units to deal with NPLs (existing **structural benchmarks**, one achieved with delay, the other on time). Deficiencies have already been identified in the case of banks, related to building up capacity and training, IT systems, independence of arrears management units, and performance monitoring against quantitative targets. Despite some delays due to capacity constraints, the CBC is also committed to finalizing the verification of the banks' compliance with the code of conduct and the assessment of arrears management policies and practices of banks and coops by end-July. On this basis, banks and coops will be required to submit to the CBC their action plans to address: (i) operational deficiencies (by end-June), and (ii) potential shortcomings related to compliance with the code of conduct and arrears management policies and practices (by end-September). The responsible CBC supervisory units will examine the implementation of these plans and submit the main findings and recommendations to the CBC Board by **end-November** (**new structural benchmark**).

- ***Monitoring of progress toward restructuring targets***: In April, BoC submitted to the CBC first quarterly reports on the implementation of their restructuring plan and on progress related to a set of key performance indicators on selected operational and financial targets. The coops have done so in May. The responsible CBC supervisory units are assessing these quarterly reports regularly. They have reported their findings on the first report to the CBC Board for BoC and remains committed to do so for the coops by **end-July** (**modified structural benchmark**).

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

3. **The reform of the debt restructuring legal framework is critical to ensure adequate incentives for debt restructuring**. To this end, we have established a project group and have conducted consultations with stakeholders on reform proposals. Given the complexity of the task and the need to consult widely, we will need additional time to prepare a reform strategy to be approved by the Council of Ministers by end-July **(new structural benchmark)**. In developing the insolvency law strategy, by end-June we will conduct an impact assessment of various options on lenders. We remain committed to amend foreclosure legislation by end-June, with immediate effect for all mortgaged properties except primary residences (for which provisions will enter into effect by end-December in line with the adoption of the insolvency law). The new foreclosure legislation will allow for the sale of loan collateral through private auctions to be conducted by mortgage creditors, without interference from government agencies. By end-December, we will adopt legislation on household and corporate insolvency in line with international best practices and establish procedures for the licensing and regulation of insolvency practitioners (**modified structural benchmark**).

Normalizing financial flows

5. **We continue to relax remaining domestic payment restrictions consistent with preserving financial sector stability**. We have substantially relaxed restrictions, in line with our roadmap published in August 2013, fully liberalizing domestic transfers and abolishing restrictions on term deposits and cash withdrawals, as key milestones on restructuring and recapitalizing the financial sector had been reached. Looking forward, we will continue to monitor market and bank liquidity conditions closely and ensure that remaining relaxations of domestic payment restrictions envisaged in our roadmap remain consistent with financial sector stability. Further progress under the program is needed before considering actions related to restrictions on the capital account.

We remain committed to ensuring adequate banking system liquidity. The Central Bank of Cyprus (CBC) stands ready to take appropriate measures to maintain sufficient liquidity in the system, following the procedures and rules of the Eurosystem. Additionally, we stand ready to provide additional government guarantees in line with state aid rules, amounting to up to €2.9 billion, for the issuance of bank bonds that can be used as collateral against liquidity, if necessary to safeguard financial stability.

Strengthening supervision and regulation

4. **We are strengthening banking regulation and supervision ahead of the establishment of the pan-European Single Supervisory Mechanism (SSM)**. We have increased resources in line with the CBC's intense supervisory work program, and are working with the banks to prepare for the ongoing ECB Comprehensive Assessment. Building on these efforts we will work on three fronts:

- ***Capital***: With the entry into force of the new capital definition in CRD_IV and CRR and in line with the harmonized benchmark in the comprehensive assessment, the CBC will set the minimum bank capital requirement at 8 percent CET1 under Pillar I by end-June. In line with CRD_IV, the CBC will request significant banks to maintain capital buffers in excess of minimum Pillar I requirements based on conservative assumptions and take prompt action if needed. In addition, the CBC has instructed banks to submit by end-June estimates of the potential impact of upcoming NPL and provisioning EU rules on domestic banks' profitability and coverage ratios.

- ***Bank resolution***: Legacy Laiki remains under resolution, and will need to be wound down. In this regard, we remain committed to transfer the management of its voting rights in BoC to independent and reputable firms or international institutions by **end-September** (**modified structural benchmark**). In addition, we will appoint a reputable advisory firm to manage the disposal of the assets of Laiki by end-June (existing **structural benchmark**). The firm will be tasked with finalizing, by end-July, an action plan for the disposal of the assets. Separately, we remain committed to strengthen the independence and effectiveness of the Resolution Authority through the adoption of amendments to the resolution law by mid-July, aiming to ensure that decision makers are isolated from conflicts of interest.

- ***Bank internal audit and credit register***: Despite some delays, the CBC stands ready to complete: (i) the revision of the governance directive on the interaction between banks' internal audit units and CBC bank supervisors, in line with best practices (by end-July); and (ii) the operationalization of the credit register, the development of options to use it for supervisory purposes, in line with best European supervisory practices, and the finalization of the content of the additional data to be collected by the credit register (by end-September).

Strengthening the AML framework

5. **We remain committed to strengthening the implementation of the AML/CFT framework**. We are working on two fronts:

- ***AML bank supervision***: After having strengthened the AML/CFT supervisory function for financial institutions, the CBC has resumed inspections of banks. Under the new supervisory plan, one onsite inspection has been completed and the CBC will inspect three additional banks by end-June, and another seven by end-December. The CBC remains committed to apply appropriate supervisory and enforcement measures in case of deficiencies and non-compliance with the AML/CFT legal framework.

- ***Registrar of Companies***: We are in the process of making available free basic information on all companies registered in Cyprus and will complete this process by end-June. By end-October, we will amend the company law with the aim to modernize it by, inter alia, streamlining the process of registration and strengthening the enforcement powers of the Registrar to ensure adequate updating of information and de-registration of non-compliant companies. Subsequently, by end-January 2015, in line with the action plan approved by the Council of Ministers also addressing the Global Forum requirements, competent authorities will be able to access adequate, accurate and current beneficial ownership information on all types of legal persons registered in Cyprus based on the Registrar of Companies' information.

C. Fiscal Policy

6. **We have adjusted the 2014 primary fiscal deficit target to 1.6 percent of GDP on a cash basis**. This implies a modest tightening of 0.4 percent of GDP, reflecting the upward revision in the growth projection for 2014, expected to result in an improved revenue performance. Already, higher-than-projected tax revenues, along with continued prudent budget execution of discretionary spending, have helped to meet the end-March fiscal targets with a comfortable margin (0.6 percent of GDP). Our revised fiscal forecast remains conservative and takes into account additional needs resulting from the materialization of contingent liabilities associated with called loan guarantees (also see below). Our medium-term fiscal strategy aims to gradually reduce our primary deficit to 1 percent of GDP in 2015, a surplus of 1.8 percent of GDP in 2016, so as to attain a surplus of 4 percent of GDP by 2018, which is needed to place public debt on a sustained downward path.[10] This guides the budget ceilings in our fiscal-strategy statement, which was finalized in May.

D. Structural Fiscal Reforms

7. **A key priority is to strengthen our social safety net to protect vulnerable groups during the downturn.** To this end, we will introduce a new Guaranteed Minimum Income

[10] These targets are consistent with the respective ESA95 targets presented in the MoU between the EC and the authorities. These targets include expected dividends of €100 million per year in 2015-16, to be distributed by the CBC in line with CBC's duties under the Treaties and the Statute.

scheme (GMI) aiming to cover all those in need and to reduce poverty in our society, while preserving work incentives. We remain committed to implementing the reform following its approval by the Council of Ministers at mid-June (existing end-March **structural benchmark**), the completion of the IT testing phase, and adoption of the welfare law by end-June (**existing structural benchmark**). We will do so in a budget-neutral manner:

- ***For 2014***: Financing included in the 2014 budget is estimated to fully cover GMI costs in the second half of 2014, as public assistance and other benefits will be incorporated into the GMI. To prepare for potential additional costs this year, by mid-July, we will identify (i) a list of social benefits outside the GMI, for which we will review the beneficiary profiles and eligibility, (ii) other contingency measures, to ensure budget neutrality in 2014. Moreover, by end-June, we will establish a monitoring unit to assess the GMI outcomes (i.e. number of applications and costs, targeting accuracy, coverage, impact on poverty) and be in a position to further evaluate the costing of the GMI.

- ***For 2015 and beyond***: On the basis of an impact assessment of the welfare reform and as part of the budgetary process of 2015, by end-September, we will update the costing of the GMI and, if needed, we will rationalize other benefits outside the GMI to ensure that the reform remains consistent with 2015 and medium-term fiscal targets.

8. **We are also taking steps to strengthen our revenue administration**. This is key to enhancing revenue collections so as to preserve the sustainability of our public finances.

- ***Short-term measures to increase collections***: Taxes owed but not paid are high, amounting to an estimated 6 percent of GDP. To help recover these, as a **prior action** for the review, new legislative amendments will be adopted by parliament and regulations finalized to establish self-assessment and provide the revenue administration with the authority to prohibit the alienation of immovable assets, seize movable assets, and garnish bank accounts. Such actions will be taken after other procedures have been exhausted and the tax debt is undisputable. Powers related to garnishing bank accounts would not require a court order but could allow a short appeal period, so as to safeguard taxpayer interest.

- ***Revenue administration reform***: The enabling law consolidating the existing two tax authorities into a single Department of Taxation was submitted to Parliament with a slight delay on May 8 (existing end-April **structural benchmark**) and was adopted on June 5. As a next step, we will appoint the new management team of the new department by end-July. To ensure a unified view of the taxpayer we will implement a common taxpayer database by end-September and complete the single registration process by end-December. Also by end-December, we will establish an integrated unit for large taxpayers in the new department (existing **structural benchmark**).

- ***Monitoring***: To mitigate the risk of revenue loss during the integration process, we will intensify the monitoring of monthly performance indicators (including registration, filing and payment, auditing and debt collection), which has been delayed. In this regard, the revenue administration reform project team will prepare by end-June an assessment of performance for the first 5 months of the year with remedial actions as needed. At the same time, we are conducting two joint pilot field audits for large taxpayers, which we will complete by end-

June. Regarding the planned eight field audits for high-risk taxpayers, we have finalized four and will complete the rest by end-June. We will initiate collection procedures following these assessments, as needed.

9. **We are working to enhance the management of fiscal risks arising from government guarantees.** The stock of government guarantees is large, at €3 billion (20 percent of GDP) and is not systematically monitored. To address associated risks, we have increased the resources of the Public Debt Management Office (PDMO), which, by mid-July, will complete a comprehensive database of guarantees, crosschecked with financial institutions and purged of called guarantees. In this regard, we have already concluded an agreement between the government and a foreign bank for the restructured payment of one set of called guarantees (1 percent of GDP) and are working to finalize the restructuring process for the payment to a domestic bank of an additional set of called guarantees(0.5 percent of GDP) by mid-July. Looking forward, the PDMO will prepare quarterly risk-assessment reports on the stock of guarantees; the first report will be finalized by end-September and will be included in the fiscal risk statement in the 2015 budget. Also by end-September, we will put in place institutional arrangements, including clear responsibilities within the Ministry of Finance and between it and line ministries, and procedures to manage guarantees and to deal with debt restructuring and recovery of costs associated with called guarantees. These procedures will be described in a manual and/or guidelines to be prepared by end-January 2015.

10. **We are developing a medium-term debt strategy aimed at paving the way for a sustainable return to market access.** Significant official financing (€10 billion) at favorable conditions meet most of our financing needs during the program period. However, the debt maturity profile is not sufficiently smooth and exhibits a relatively high concentration of debt repayment obligations amounting to €8 billion following the end of the program in May 2016 and until end-2020, of which €2.7 billion is in 2017 alone. In this context, and taking into account market conditions (yields have been on a declining trend since the program was approved), we are preparing to re-access capital markets in due time. In this regard, we will establish an investor relation function within the PDMO by end-July. Moreover, the PDMO will develop of comprehensive medium-term debt-management strategy aimed at: (i) smoothing our debt redemption profile and reducing refinancing risk; (ii) diversifying across instruments and types of investors; (iii) ensuring a smooth functioning of the domestic Treasury bill market; and (iv) enhancing monitoring and the risk assessment of contingent liabilities from government guarantees (see above). The Council of Ministers will adopt the updated strategy by **end-October (new structural benchmark).**

11. **We remain committed to privatizing state-owned enterprises.** This is expected to improve economic efficiency, reduce our public debt, and encourage foreign direct investment. To this end, we have appointed the head of the privatization unit and are working on hiring additional staff, with the aim to have a fully operational unit by end-June. By end-September, we will complete the selection process for strategic and financial advisors for the commercial activities of the ports administration (CPA), the telecommunications company (CyTA), and the electricity company (EAC). We remain committed to privatizing CyTA and the commercial activities of CPA before the end of our program. In this regard, the regulatory framework for CPA will be updated by end-December via parliamentary approval of the respective legislation. Also by end-December, legislation will be adopted to convert CyTA into a limited liability company.

We are also committed to complete the privatization process for EAC by mid-2018, after unbundling its activities and other preparatory steps.

E. Program Financing and Monitoring

12. **We are making progress with measures which provide additional financing for our program and lower public debt.** The CBC transferred €180 million of central bank profits to the government in April, and an additional €200 million is expected to be transferred during 2015-16, in line with CBC duties under the Treaties and the Statute. In line with practice in other European countries, we also plan to transfer the rights and liabilities associated with issuing coins from the CBC to the Treasury, which is expected to contribute €100 million in additional financing. To this end, we will amend the Central Bank Bill, expected to be approved by Parliament by end-June, when a MoU between the CBC and Ministry of Finance will also be signed. Finally, we remain committed to finalizing a debt-to-asset swap, which will reduce our public debt by €1 billion (about 6 percent of GDP), to be conducted in accordance with the CBC rules and the Treaties by end-July. To facilitate the transfer, the government has completed a valuation of the assets, and, to ensure compliance with the Treaty, a second valuation on behalf of the CBC will be completed before end-July.

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

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

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

	Performance criteria					Indicative targets	
	Mar-14			Jun-14	Sep-14	Dec-14	Mar-15
	Target	Adjusted target 4/	Actual				
Floor on the general government primary balance 2/	-22	-23	90	6	40	-253	116
Ceiling on the general government primary expenditure 2/	1,504	1,505	1,476	3,158	4,784	6864	1520
Ceiling on the stock of general government debt	18,399		18,203	18,697	18,172	18994	19139
Ceiling on the accumulation of new general government guarantees 2/	0		-53	127	207	312	0
Ceiling on the accumulation of external arrears 2/ 3/	0		0	0	0	0	0
Ceiling on the accumulation of domestic arrears 2/	0		0	0	0	0	0
Ceiling on the accumulation of tax refund arrears by the general government 2/	10		-39	10	10	10	10

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since January of the corresponding year.
3/ Continuous performance criterion.
4/ The primary balance and primary spending targets were adjusted down and up respectively by 0.6 million reflecting compensation payments to pension funds in Q1 2014.

Table 2. Cyprus: Revenue Administration Indicative Targets 1/
(Cumulative number of audits since January 2014)

	Indicative targets			
	Mar-14	Jun-14	Sep-14	Dec-14
Number of comprehensive field audits of large taxpayers 1/	0	2	4	6
Number of comprehensive field audits of high risk taxpayers 2/	0	8	16	24

1/ Large taxpayers are defined as those with annual turnover above a certain threshold as defined by the tax administration procedures.
2/ High risk taxpayers are defined as those that meet selection criteria set by internal tax administration procedures.

Table 3. Cyprus: Existing and Proposed Conditionality

Measures	Timing
Prior Action for the Fourth Review	
Adoption of legislation and regulations to fight tax evasion	Before Board Meeting
Proposed New and Modified Structural Benchmarks	
Approval by Council of Ministers of the strategy for reforming the debt-restructuring legal framework	End-July 2014
CBC supervisory units to submit to the CBC Board the first quarterly report regarding the coops' performance against selected operational and financial targets	End-July 2014 (modified SB)
Appointment of an independent firm and/or international institution to be entrusted with the voting rights of legacy Laiki in BoC	End-September 2014 (modified SB)
Approval by Council of Ministers of the debt-management strategy	End-October 2014
CBC submission of assessment of banks and coops implementation of action plans to address operational deficiencies and potential shortcomings related to compliance with the Code of Conduct and arrears management policies and practices	End-November 2014
Adoption by parliament of legislation to modernize personal and corporate insolvency procedures and to regulate insolvency practitioners assisting in the restructuring process	End-December 2014 (modified SB)
CBC assessment of internal audit on governance of bank debt restructuring	End-January 2015
Existing Structural Benchmarks	
Implementation of a new social welfare system	End-June 2014
Establishment of an integrated large taxpayers unit	End-December 2014

Cyprus: Technical Memorandum of Understanding

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

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

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

A. Quantitative Performance Criteria and Indicative Targets

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

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

- *The central government*. Includes the Constitutional Powers, the Constitutional Services, the Independent services, the Independent offices, the Ministries and the departments, services, and other bodies they supervise, 21 special purpose funds, and 14 semi government organizations.
- *The local governments*. Comprise 39 municipalities, 356 village authorities, and all agencies and institutions attached thereto which are classified as local governments according to ESA 95.
- *The social security funds*. These include the medical treatment scheme, the regular employees' provident fund, the social insurance fund, the holiday fund, the redundancy fund, and the protection of the rights of employees' fund.
- *Any newly created institution defined as general government under ESA 95*. This includes any new budgetary institution, special fund, social security fund, semi-government organization, municipality, village authority, and any other entity created during the program period to carry out operations of a fiscal nature. The government will inform the

IMF, European Commission and ECB staff of the creation or any pending reclassification of any such new funds, programs, or entities immediately. The general government, as measured for purposes of the program monitoring, for a given year shall not include entities that are re-classified from outside general government into general government during that year.

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

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

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

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

- The 2014 targets will be adjusted downwards by the payments to compensate pension funds for the losses related to the resolution of Laiki Bank up to €78 million.

- The 2014 targets will be adjusted upwards by the dividends received from the CBC in excess of €180 million and in excess of €40 million from the semi-government organizations.

- The 2014 targets will be adjusted downwards by the dividends received from the CBC below €180 million and below €40 million from the semi-government organizations.

Ceiling on the General Government Primary Expenditure (performance criterion)

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

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

20. The 2014 ceilings on the GGPE will be adjusted upwards by the payments to compensate pension funds for the losses related to the resolution of Laiki bank up to €78 million.

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

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

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

- Upwards (downward) by the amount of any upward (downward) revision to the stock of end-March 2013 general government debt.
- Upwards (downwards) by the amount of any increase (decrease) to the disbursement of the Cyprus Entrepreneurship fund EIB loan, currently projected at €100 million.
- Upwards, by debt arising from payments for bank restructuring carried out under the program's banking sector support and restructuring strategy. These payments may include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.
- Upwards by the amounts disbursed under the EIB loan to finance projects authorized in the 2014 budget under the National Strategic Reference Framework.

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

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

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

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

- Upwards (downwards) by the amount of any increase (decrease) of the disbursement of EIB and/or Council of Europe Development Fund loans to be guaranteed by the government in 2014 relative to the amounts presented in Table 1 of the MEFP. The annual provision of guarantees cannot exceed €312 million.

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

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

Ceiling on the Accumulation of Domestic Arrears (performance criterion)

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

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

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

B. Monitoring of Prior Actions, Structural Benchmarks and MEFP Commitments

28. Adoption of measures to fight tax evasion (prior action)

Specification. The measures will include the following:

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

- Legislation and regulations to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to prohibit the alienation of immovable, seize movable assets and garnish bank accounts Powers related to garnishing bank accounts would not require a court order but could allow a short appeal period.

AML supervision's implementation:

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

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

Exchange of financial intelligence:

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

C. Reporting Requirements

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

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

Table 1. Cyprus: Reporting Requirements (Concluded)

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

1/ Reporting requirements for cooperative banks will be revisited after the CBC becomes their supervisor.

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