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The Economic Adjustment Programme for Cyprus Third Review - Winter 2014

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The Economic Adjustment Programme for Cyprus

Third Review - Winter 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 29 January to 11 February 2014 for the third 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 2013 have been met with considerable margin, due to both continued prudent budget execution and a less severe recession than anticipated. Signs of stabilisation are emerging in the banking sector, although significant challenges remain. Despite some delays, structural reforms are also advancing. Given the prevailing substantial risks, continued full and timely policy implementation remains essential for the success of the programme.

The macroeconomic outlook remains challenging. While the recession has been less pronounced than expected in 2013, GDP is forecast to decline by broadly the same magnitude as expected in the last review (-4.8%) in 2014, despite continued improvements in business sentiment and consumer confidence indicators. The need for an adjustment of private and public sector debt from the current high levels will continue to act as a drag on growth. The economy is projected to return to modest growth next year. Nonetheless, risks to the outlook remain on the downside.

There has been further progress toward the restructuring of the financial sector, and dealing with the high level of non-performing loans is now a priority. The restructuring plan of Bank of Cyprus was approved by the Central Bank of Cyprus in November 2013. The consolidation process of the cooperative credit institutions has continued and their restructuring plan was approved by the Commission in February 2014, which enabled the recapitalisation with programme money. Deposit outflows have slowed and banks' liquidity buffers have strengthened. Reforms to supervision and regulation have also progressed satisfactorily. With key milestones in the authorities' roadmap now completed, the second phase of gradual relaxations of restrictions has started. Despite this progress, challenges remain, notably relating to the need to clean up banks' balance sheets and reduce of private sector indebtedness. Both are needed in order to restore credit and sustainable growth and require the establishment of an appropriate debt restructuring framework. Work also needs to continue on strengthening the implementation of banking sector regulation and supervision as well as of the anti-money laundering framework.

Fiscal performance has remained strong. The 2013 government deficit is estimated around at 2 percentage points lower than targeted, while the 2014 fiscal deficit is projected to be about 1 percentage point lower than anticipated earlier. 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 percent of GDP primary surplus, which is needed to place public debt on a sustainable downward path.

The implementation of structural reforms has also advanced, although some reforms need to be accelerated. Progress was notably observed in revenue administration reform, which aims to improve the efficiency of collection; in public financial management, with the adoption of the fiscal responsibility and budget systems law; in immovable property tax reform, with the objective of improving the fairness of the tax burden; and in improving labour market activation policies. However, a key priority is the adoption of a social welfare reform, which will introduce a guaranteed minimum income scheme, so as to provide adequate social protection for vulnerable households during the current downturn. Following the adoption of the privatisation law on 4 March, the privatisation plan must now be implemented without delay.

The review has now concluded, with all necessary decisions by the Eurogroup, the ESM Board of Directors, and the Executive Board of the IMF having been taken by early April. Its approval paves the way for the disbursement of EUR 150m 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, which was updated following the second review mission and agreed upon between the Cypriot authorities and the programme partners, i.e. the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF). On 24 April 2013, the European Stability Mechanism (ESM) Board of Governors approved the MoU. Vice President of the European Commission, responsible for economic and monetary affairs and the euro Olli Rehn signed the first MoU on 26 April 2013 and the updated MoU following the second review mission on 18 December 2013.

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

A joint EC/ECB/IMF staff mission visited Nicosia from 29 January to 11 February 2014 for the third quarterly mission and concluded that the economic adjustment programme remains on track.

By the time of publication, the two prior actions in the updated MoU for the granting of the fourth disbursement had been met. The two prior actions concerned the adoption of the Fiscal Responsibility and Budget System Law (FRBSL) and the Privatisation Law. The FRBSL is an umbrella law encompassing macro-fiscal policy-making, as well as budget formulation, approval and execution. It transposes the EU directives, notably the Two-Packs, and foresees the creation of a Fiscal Council. The Privatisation Law sets up the institutional framework for privatisation.

A successful completion of the third review should pave the way for the disbursement of EUR 150m by the ESM, and about EUR 86m by the IMF. This will bring the total amount authorised for disbursement under the programme to just above 50% of the overall international assistance of EUR 10bn.

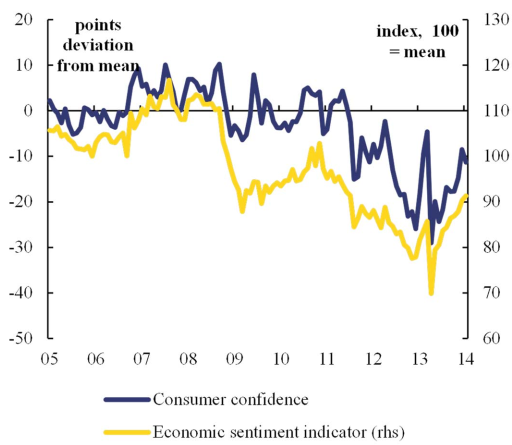
The report is organised as follows. Section 2 examines recent macroeconomic, fiscal and financial developments. A detailed assessment of compliance of programme conditionality is reported in Section 3. Section 4 looks at programme financing and debt sustainability, while Section 5 discusses risks to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

2. ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

The unwinding of macroeconomic imbalances continued and remained a drag on economic activity in 2013. ([1]) The macroeconomic environment remained difficult, notably due to the lack of credit intermediation, weakening corporate profits in most sectors of the economy, private and public deleveraging and worsening labour market conditions. While non-financial corporations are gradually reducing their debt, declining disposable income of households made the needed household deleveraging more challenging and slower than expected. Business sentiment and consumer confidence indicators continued to drift upward (Graph 2.1). Despite the difficult macroeconomic environment, some sectors such as tourism and professional business services have proved more resilient than previously foreseen.

Graph 2.1: **Economic sentiment and consumer confidence indicators**

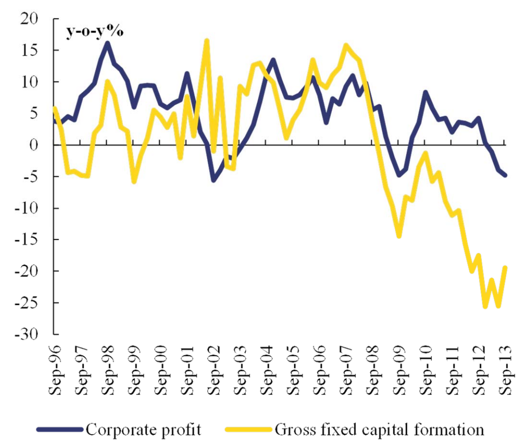


Source: DG ECFIN.

Real GDP continued its slide in the third quarter of 2013, although at a slower pace than in the second quarter and to a lesser extent than envisaged in the second review forecast. This better performance was largely due to less weak private consumption despite deteriorating labour market conditions. The resilience of private consumption reflects the effort of households to smooth consumption to sustain living standards, helped by, to some extent, the dissolution of some provident funds (see Box 2.3). The underlying weakness in gross fixed capital formation continued, while the annual decline in both imports and exports decelerated significantly, with still a positive contribution of external demand to GDP growth.

Most sectors displayed negative annual growth rates in third quarter of 2013. The contraction in construction, financial and insurance services was particularly pronounced and accelerated, while tourism showed some sign of improvement. Investment has declined sharply even though corporate profits (defined in terms of gross operating surplus) only recently have started to decline (Graph 2.2), supported by significant labour cost adjustments (see Box 2.1). Only in manufacturing and tourist oriented industries has the gross operating surplus held up relatively well, the latter reflecting a strong rebound in tourist arrivals in the second half of 2013. In the construction sector, however, the decline in value added has outpaced the adjustment in labour cost, and profit margins have been narrowing further.

Graph 2.2: **Corporate profits and real investment**



Source: Commission services.

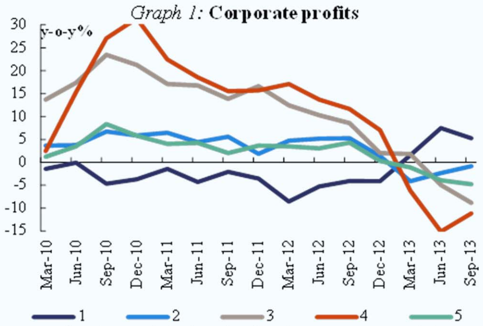
The current account adjustment continued in the third quarter of 2013 (Graph 2.3). This was largely due to a notable decline in import of goods, though at a lower rate than in the previous quarter, combined with better export performance,

([1]) While the forecast finalised at the end of the mission projected GDP to contract by -6.0% in 2013, the flash estimate suggest a decline of -5.4%, see footnote 2.

Box 2.1: Corporate profits from a sectoral perspective

The challenging operating environment has put corporate profits (measured in terms of gross operating profit) on a downward path (Graph 1). Nevertheless, the sectoral dispersion remains high at the current juncture. Corporate profits in manufacturing and in the more tourist-oriented industries (such as wholesale and retail trade, transport and food and accommodation services) have been holding up quite well. While in the latter, this is likely due to a strong rebound in tourist arrivals following the sharp decline in the first part of 2013, in manufacturing this reflects a sharp decline in labour cost. Corporate profits in the professional and administrative business service industries have also declined significantly. The fall is however smaller than in financial services, and the gross value added of this sector has been holding up quite well, reflecting the fact that foreign companies have, to a large extent, maintained their business activities in Cyprus. In the construction sector, however, corporate profits have been declining since 2009, and the decline has recently accelerated.

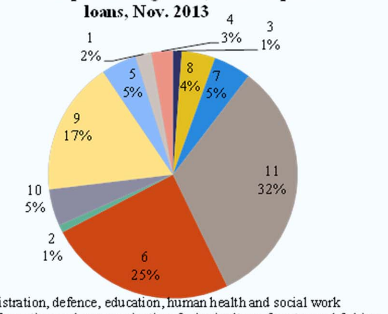
Graph 1: **Corporate profits**



1: manufacturing, 2: wholesale and retail trade, transport, accomodation and food services, 3: professional and administrative business services, 4: financial and insurance services, 5: total.
Sources: Eurostat

The adverse developments in corporate profits have pushed non-performing loans (NPLs) to elevated levels, most notably in the construction sector. The bursting of the housing bubble has left the construction sector as one of the most stressed industries in Cyprus. Half of corporate NPLs in the Cypriot banking system relate to the construction industry and real estate activities (Graph 2). In addition, close to 70% of the loan stock granted to construction firms were non-performing towards the end of 2013, while the industry is more leveraged than the others (Graph 3), making the prospects for this sector particularly dim.

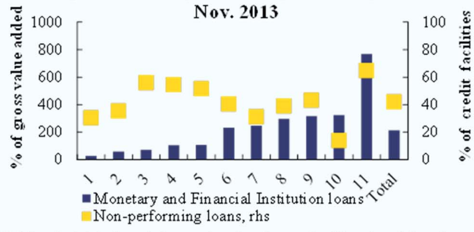
Graph 2: **Non-performing loans, % of corporate loans, Nov. 2013**



1:Public administration, defence, education, human health and social work activities, 2: Information and communication, 3: Agriculture, forestry and fishing, 4: Arts, entertainment and recreation, 5: Professional, scientific and technical activities administrative and support service activities, 6: Wholesale and retail trade, transport, accomodation and food service activities, 7: Manufacturing, 8: Industry (except manufacturing and construction), 9: Real estate activities, 10: Financial and insurance activities, and 11) construction.
Source: Central Bank of Cyprus and Eurostat

However, some of the industries that contributed significantly to growth prior to the crisis appear less leveraged. Notably, the ratio of loans to value-added in professional and administrative business services is relatively low, although the NPL ratio remains elevated. This suggests that deleveraging pressure could be more moderate in this sector, making it more able to support the economy once the confidence improves. Despite profits in tourist-oriented industries holding up relatively well, NPLs in these industries are relatively large (with a quarter of all non-performing loans having its origin in these industries). Nevertheless, the NPL ratio and level of indebtedness is among the lower in the economy. In line with the pick-up in the sector's corporate profits, the NPL ratio in manufacturing remains also comparatively low.

Graph 3: **Leverage and non-performing loans, Nov. 2013**

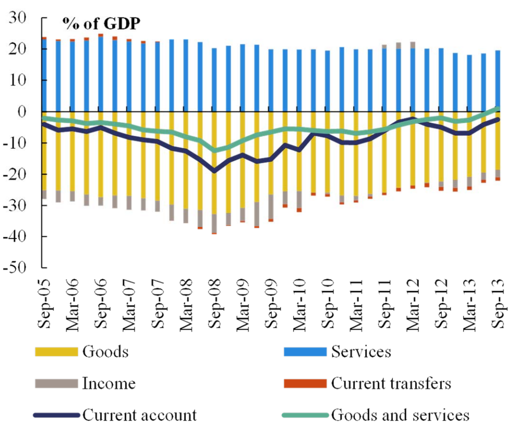


1:Public administration, defence, education, human health and social work activities, 2: Information and communication, 3: Agriculture, forestry and fishing, 4: Arts, entertainment and recreation, 5: Professional, scientific and technical activities administrative and support service activities, 6: Wholesale and retail trade, transport, accomodation and food service activities, 7: Manufacturing, 8: Industry (except manufacturing and construction), 9: Real estate activities, 10: Financial and insurance activities, and 11) construction.
Source: Central Bank of Cyprus and Eurostat

reflecting higher tourism receipts, which nevertheless was partly offset by further decline in export of financial and other business services. As a result, the current account recorded a deficit of

2.5% in the year up to Q3 of 2013 compared to a deficit of 5.0% of GDP in the corresponding period of 2012.

Graph 2.3: **Current account**

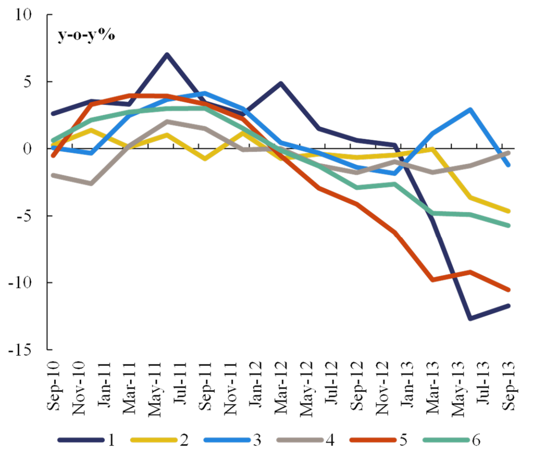


(1) 4 -quarter rolling sum. Negative values correspond to net imports/payments, while positive to net exports/receipts
Source: Eurostat.

The labour market has proved flexible and compensation per employee has adjusted further downwards. This has curbed the fall in employment and, together with migration outflows, served to help limit the increases in the unemployment rate, which nevertheless reached unprecedented levels at the end of 2013 (17.5%), with youth unemployment close to 40%. The annual decline in compensation of employees continued to gain speed in the Q3, accelerating the fall in unit labour costs (Graph 2.4).

The house prices decline intensified in the third quarter of 2013, with the trend likely to continue in 2014. Between the peak in mid-2008 and the third quarter of 2013, residential property prices were down by more than 22%, only partially reversing some of the increase since 2004. The fall in house prices reflects subdued demand for residential properties on the back of worsening income prospects and tight credit conditions, with the stock of MFI loans for house purchases continuing to slide. According to the Bank Lending Survey, further net tightening of credit supply for house purchases is expected in the beginning of 2014, while net demand of credit will remain as weak as at the end of 2013.

Graph 2.4: **Unit labour costs, selected industries.**



(1) Manufacturing, (2) Wholesale and retail trade, transport, accommodation and food service activities (3) Financial and insurance activities (4) Professional and administrative service activities (5) Public administration, etc., (6) total.
Source: Commission services.

HICP inflation continued to ease in the third quarter of 2013, and turned negative in October (Graph 2.5)**.** Amid a weak economic environment, core inflation fell further, with its two largest components (non-energy industrial goods, and services) in negative territory. The annual change for processed food remained positive, albeit small and moderating.

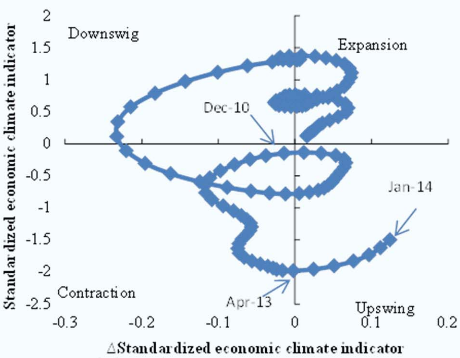
Real GDP was down by 5.3% y-o-y in the fourth quarter, according to the flash estimate, almost ½ pp less than in the previous quarter. This is broadly in line with what was suggested by a wide range of short term indicators (Box 2.2) and better than forecast at the end of the mission.(2) While the expenditure and supply breakdown is unavailable at the time of drafting, short term indicators suggest that the decline in GDP continues to be broad-based, with contractions in secondary sectors (construction and manufacturing), as well as in banking, transport, trade and other services. Tourism is likely to have held up well.

(2) The Q4 flash estimate was released on 14 February, after the finalisation of the macroeconomic forecast during the mission, and has therefore not been taken into consideration for the revised forecast.

Box 2.2: How to assess the short-term dynamics of the economy?

The business tracer for Cyprus suggests that the economy passed a trough in April 2013 (Graph 1). As GDP estimates are only released quarterly, higher frequency indicators are used to assess the underlying dynamics of the economy. One way of aggregating these indicators is to build a business tracer. According to the business tracer, the economy started to weaken towards the end of 2010 and a trough was reached in April 2013 when it crossed the vertical axis from the contractionary quadrant. Since then, some improvement has occurred, but it still remains below the horizontal axis, suggesting that expansion of economic activity is still somewhat ahead. While indicative for the cyclical position of the economy, the tracer does not provide any quantitative assessment of the quarterly dynamics going forward. In order to provide a quantitative assessment of what high frequency indicators imply for GDP growth in the short term horizon, bridge models for the Cypriot economy have been constructed.

Graph 1: **Business tracer**

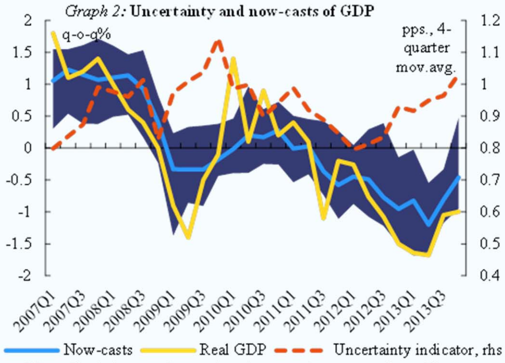


Source: Commission services

The bridge models for Cyprus, also known as now-cast models, seem to capture the underlying trend reasonably well, but are less reliable regarding the quarterly volatility (Graph 2). Bridge models are statistical models which relate short-term indicators with GDP growth. As seen in Graph 2, the models captured relatively well the significant downward movement in output between 2007 and 2009 as well as the underlying weakness that has been building up since the beginning of 2011. In line with the actual data and the climate tracer, the models also depict an improvement of the underlying trend since Q3 2013. Notably, the model forecasts a GDP growth of -0.5%q-o-q for Q4 2013, somewhat better than the flash estimate of -0.8%q-o-q.

However, the models usually underestimate the amplitude of large economic shocks. In recent quarters, the bridge models have pointed to less intense declines than the quarterly GDP estimates suggest. Similarly in 2008 and 2009, the bridge models underestimated the size of the GDP fall. In cases of large negative economic shocks, uncertainty increases, and therefore the dispersion in the forecasts produced by the bridge models is larger (as illustrated by the red dotted line in Graph 2). As in downturns, the models also seem to underestimate the size of the rebound. For instance, when the economy started recovering towards the end of 2009, the models were not able to capture the strong pick-up in quarterly GDP growth. This could suggest that when the currently elevated economic uncertainty abates, growth will pick up faster than suggested by short term indicators.

Graph 2: **Uncertainty and now-casts of GDP**



Note: Shaded area refers to the min-max of now-casts from 17 models.
Source: Commission services.

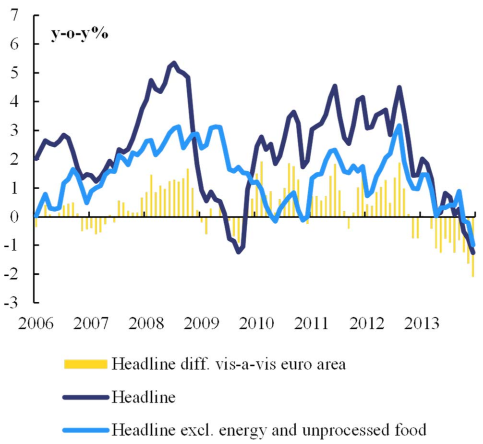
Both the business tracer and now-cast models suggest that the underlying weakness of the economy is likely to extend well into 2014. While some improvement in the sentiment indicators has been noted since mid-2013, it has been uneven and taken place from historical lows, with consumer confidence and construction sentiment still pointing to downside risks to economic activity. Although the now-cast models suggest that the economy reached a trough last year, it still predicts negative growth in the first quarter of 2014. Similarly, the business tracer still shows some distance to levels consistent with positive growth.

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

	2012		Annual percentage change							
			Updated forecast					Second review forecast		
	Curr. prices (EUR m)	% of GDP	2011	2012	2013	2014	2015	2013	2014	2015
GDP	17,887	100	0.4	-2.4	-6.0	-4.8	0.9	-7.7	-4.8	0.9
Private consumption	12,087	67.6	1.3	-2.5	-7.5	-6.3	0.7	-10.7	-6.7	1.3
Public consumption	3,438	19.2	-0.2	-3.1	-6.0	-1.5	-2.7	-4.1	-5.2	-3.2
Gross fixed capital formation	2,430	13.6	-8.7	-19.6	-24.0	-18.1	1.3	-28.5	-14.0	1.2
Exports (goods and services)	7,710	43.1	4.5	-2.7	-4.8	-2.7	1.9	-5.8	-2.9	1.7
Imports (goods and services)	8,180	45.7	-0.1	-6.4	-14.7	-7.2	0.2	-16.0	-8.0	0.8
GNI (GDP deflator)	17,296	96.7	5.8	-7.3	-7.1	-5.7	3.8	-6.2	-6.1	0.2
Contribution to growth:	Domestic demand		-0.8	-5.6	-9.5	-6.6	0.1	-12.0	-7.0	0.4
	Inventories		-0.7	1.3	-1.2	0.0	0.0	-0.6	0.0	0.0
	Net exports		1.9	1.9	4.7	1.9	0.8	4.9	2.1	0.5
Employment			0.5	-4.2	-5.7	-4.4	0.8	-6.3	-4.4	0.8
Unemployment (1)			7.9	11.9	16.0	19.2	18.4	16.7	19.8	19.0
Compensation per employee			2.5	-0.9	-5.0	-3.0	0.9	-5.3	-5.6	-1.8
Unit labour costs, whole economy			2.5	-2.7	-4.7	-2.6	0.8	-3.9	-5.2	-1.9
Real unit labour costs			-0.3	-4.7	-2.4	-3.2	-0.7	-4.3	-6.2	-3.4
GDP deflator			2.8	1.9	-2.3	0.6	1.5	0.4	1.0	1.5
Harmonised index of consumer prices			3.5	3.1	0.4	0.4	1.4	0.7	1.0	1.4
Terms of trade			-0.2	-0.3	-1.1	0.0	-0.1	-0.5	-0.5	-0.6
Merchandise trade balance (2)			-24.2	-21.5	-18.3	-16.9	-16.7	-17.2	-15.4	-15.4
Current account balance			-4.5	-8.4	-1.7	0.0	0.4	-1.4	0.3	0.2

The table reflects information available prior to the cut-off date, 11 February 2014, and does not take into account the Q4 flash estimate which was released on 14 February, (1)Eurostat definition, % of labour force. (2) Percent of GDP.
Source: Commission services.

Graph 2.5: **HICP inflation**



Source: Eurostat.

The recession is expected to continue in 2014, with real GDP declining by 4.8% (Table 2.1). Domestic demand is expected to remain weak reflecting the significant, though more gradual than initially expected, deleveraging process in the private sector (following more robust consumption in 2013), together with further worsening of labour market conditions and wage adjustments. Unemployment is foreseen to increase further to close to 20% of the labour force, while HICP inflation will remain subdued.

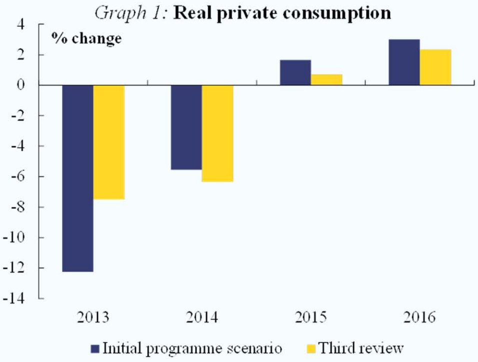
In 2015, GDP growth is forecast to return to positive territory alongside a strengthening of domestic demand. Domestic demand has been revised somewhat down, reflecting slower and more protracted than initially expected deleveraging by both households and corporates, which will gradually remove impediments to more balanced growth over time. This downward revision is offset by a more positive view on exports, driven by the tourist sector. 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 in 2015, the labour market will recover slowly and HICP inflation will accelerate, albeit remaining well below 2%.

Risks to the economic projections remain tilted to the downside. On the domestic front, slow resolution of non-performing loans and tight credit supply conditions could pose considerable risks to the real side of the economy. In addition, a slower household deleveraging could prolong the needed deleveraging process (Box 2.3). Moreover, a further worsening of labour market conditions could lead to a more prolonged weakness of business and consumer confidence. Upside risks for the Cypriot economy relate to possible

Box 2.3: Private consumption, savings and the medium-term outlook

Real GDP has contracted less in 2013 than initially expected when the programme was agreed in April 2013. This is mainly attributed to the resilience of households and their preferences to spend out of their savings and smooth consumption. The consumption smoothing has notably been supported by the dissolution of some provident funds. Following the bail-in about 650 provident funds were dissolved in 2013, which released about EUR 1.2bn of cash in the economy. Part of this money was used to repay loans, while the rest has presumably partially helped support consumption.

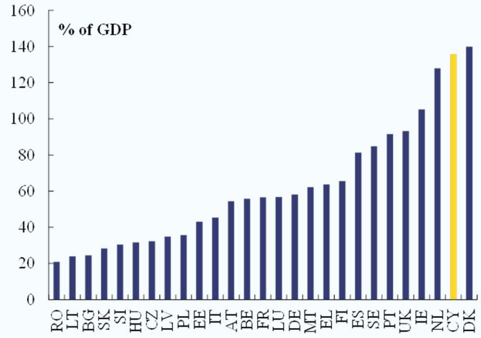
Graph 1: **Real private consumption**



Source: Commission services.

As a result, the savings rate of households is likely to have declined in 2013. This is contrary to the initial expectations of the programme, which had foreseen a sharp reduction of consumption (Graph 1) and an associated increase in precautionary saving as observed in other Members States during the initial phase of the financial crisis.

Graph 2: **Household indebtedness, 2012**



Source: Eurostat

The need to restore long-term savings and to reduce the high debt level is likely to weigh on consumption growth in future years. The loss of wealth due to the hair-cut and the use of some of households' long-term savings (notably savings from dissolved provident funds) may result in households' preference to restore their long-term savings by restraining consumption expenditures. In addition, the households need to honour their debt obligations and reduce their excessive indebtedness (Graph 2). More protracted household deleveraging accompanied by a simultaneous deleveraging in the other sectors of the economy (corporates, state, banks) would add to the risk of a potentially more-subdued-than-expected recovery.

improvements in the external outlook and a more competitive tourist sector.

2.2. FISCAL DEVELOPMENTS AND OUTLOOK

The general government budget deficit for 2013 is estimated to have reached 5.5% of GDP, compared to 7.8% of GDP projected in the second review. ([3]) This outcome largely reflects the significant fiscal consolidation measures undertaken in line with the MoU, tight expenditure control and a milder-than-expected recession. Despite weakening trends in the collection of certain taxes, and including the compensation of retirement funds that held deposits in Cyprus Popular Bank (CPB), the primary balance outcome for 2013 over-performed the November 2013 projection by around 1.8 pps.

Tight expenditure control significantly contributed to the 2013 outcome. With the exception of social transfer which has been negatively affected by adverse labour market developments, all main primary expenditure categories decreased, as compared to 2012. The early retirement wave in the public sector continued in 2013, although at a somewhat lower magnitude than in 2012. The corresponding high gratuity payments were however more than offset

([3]) 2013 data will be validated by Eurostat on 25 April 2014 and may be subject to revisions.

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

	2011	2012	2013	2014	2015	2016
Real GDP (1)	0.5	-2.4	-6.0	-4.8	0.9	1.9
Output gap (2)	0.5	-0.5	-4.0	-6.3	-3.5	-0.9
General government balance (3)	-6.3	-6.3	-5.5	-5.8	-6.1	-2.8
Primary balance (3)	-3.9	-3.2	-1.8	-1.8	-2.1	1.2
Cyclical-adjusted balance (4)	-6.5	-6.1	-3.7	-3.1	-4.5	-2.4
Structural balance (4)	-6.3	-6.5	-3.5	-4.1	-4.5	-2.4

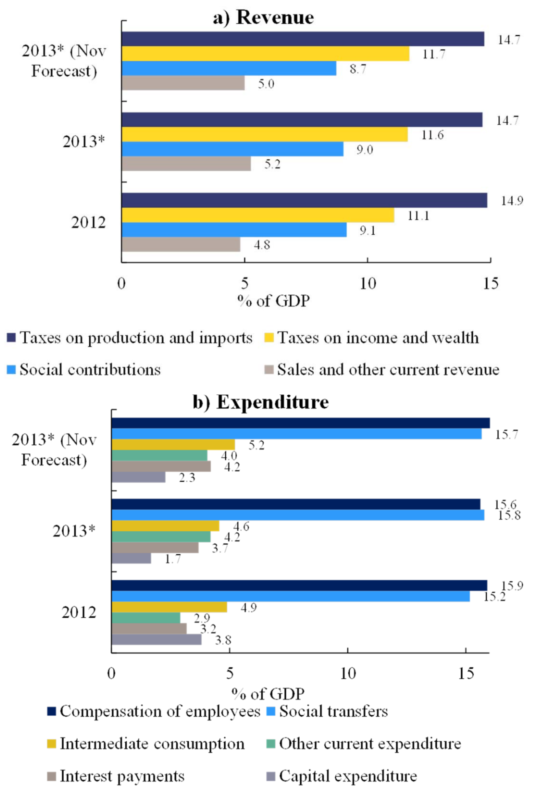
The table reflects information available prior to the cut-off date, 11 February 2014, and does not take into account the Q4 flash estimate which was released on 14 February, (1) Percentage change, (2) % of potential output, (3) incl. compensation of pension funds, estimated to amount to 1.8% of GDP, (4) % of GDP.
Source: Commission services.

by decreasing public sector employment and further measures to reduce the public sector wage bill. Even excluding the signing fees for gas exploration (1% of GDP), which have been statistically treated as negative capital expenditure, the fall in capital expenditure reached 33% y-o-y. This was mainly driven by the completion of a significant amount of investment projects in 2012 or their cancelation/suspension during 2013, together with a drop in construction prices. The interest bill ended up 0.5% of GDP lower than expected during the second review, largely due to the statistical treatment of the CPB bond yield (Box 2.4) and a lower than expected interest bill for foreign loans which are mostly based on the EURIBOR. The 30% y-o-y increase in other current expenditure was driven by the one-off compensation of provident and retirement funds in CPB (1.8% of GDP).

Tax revenue collection showed some weakening trend in 2013, while social contributions performed comparatively better. Revenue measures were implemented with determination and contributed to achieve tax revenues in line with last review's forecast. However, net of the effect of measures taken in 2012 and 2013, tax elasticities with respect to the tax base appear high, particularly for taxes on production and imports. On the other hand, social contributions exhibited a very low elasticity, thus decreasing less than initially expected.

During the third review, programme partners and the authorities agreed on an updated fiscal forecast, based on the updated macroeconomic projections and latest budgetary developments. The 2014 primary deficit is forecast to be 1.3 pps of GDP lower than projected in the second review. This is mainly due to the carry-over from the better-than-projected outcome in 2013 as well as high expected dividend income. In 2015 and 2016, the projections remain largely unchanged, in line with the broadly stable macroeconomic projections for these years. The carry-over from the better performance in previous years is absorbed by a decrease in unspecified measures by ¾% of GDP, compared to those included in the second review projections.

Graph 2.6: **Budget execution, general government 2013**



(*) The 2013 outturn includes the impact of permanent fiscal measures of 2.1% of GDP on the revenue side and 2.4% of GDP on the expenditure side.
Source: Ministry of Finance.

Box 2.4: Treatment of the costs of financial sector rescue operations in ESA95: the example of the CPB Bond

The on-going financial crisis has triggered an increased attention on how different forms of financial sector rescue operations should be treated in ESA95. If governments engage in financial sector rescue operations, one has to decide whether the transaction should be recorded as a budget neutral acquisition of equity or as a capital transfer with an impact on the government budget balance. The relevant Eurostat decision from 2009 and a subsequent clarification from 2013 provide a set of rules in this regard, ensuring consistency with ESA95. It should however be noted that each individual transaction has to be analysed by the national statistical institutions, based on the Eurostat rules.

The statistical treatment of equity recapitalisations depends on whether these are done via ordinary shares or preference shares. Recapitalisations via ordinary shares are treated as budget neutral financial transactions if they are considered to take place at market price. Any excess over the market price has to be recorded as a capital transfer. Recapitalisations in the form of preference shares are recorded as financial transactions if these are undertaken at an appropriate "non-contingent" rate of return. ([1]) If the return of the transaction is not deemed appropriate, the operation has to be split into a financial transaction and a capital transfer, in which the latter corresponds to the difference between the implicit rate of return and the non-contingent rate of return. ([2]) In case preference shares are converted into ordinary shares, a comparison needs to be made between the acquisition price and the market price at the time this acquisition price was fixed. Any excess of the acquisition price vis-à-vis the market value has to be recorded as a capital transfer.

In addition to equity recapitalisation, financial sector rescue operations can be carried out in other ways, such as debt injections, the issuance of guarantees, or the purchase of existing assets. Debt recapitalisations, i.e. loans to financial institutions, are recorded as financial transactions if there is no risk that the loan will not be repaid. If the loan is cancelled subsequently, it has to be recorded as capital expenditure. Guarantees have no direct impact on the government budget when they are granted. However, calls of guarantees have to be recorded as a capital transfer. Similar to equity recapitalisations, the purchase of assets is treated as a financial transaction if the assets are acquired at market price.

In June 2012, the Cypriot government issued a zero coupon bond to provide Cyprus Popular Bank (CPB) with sufficient funds for re-capitalisation needs. The CPB recapitalisation bond was issued by the Cypriot government to CPB at a nominal amount of EUR 1.89bn and an annual coupon rate of 5.15%, and the government got in exchange ordinary shares of CPB amounting to a value of EUR 1.8bn. ([3]) In light of the above considerations, it was decided by CYSTAT to treat the "bond yield" paid to CPB above the EUR 1.8bn share value (around EUR 93m) as a capital transfer and the acquisition of shares for EUR 1.8bn as financial transaction. The bond was shifted to Bank of Cyprus in March 2013 and rolled-over in July 2013. Consequently, capitalised interest for the second half of 2013 (amounting to about EUR 50m) was recorded in the interest bill. From 2014 onwards, the full amount of annual capitalised interest will be booked in the interest bill.

([1]) The non-contingent rate of return corresponds to the rate of return that would be appropriate to attract private investors. If shareholders participate in the transaction, it is therefore usually considered that the recapitalisation constitutes a budget neutral financial transaction.

([2]) Several special rules apply if the recapitalisation targets a public company which is already under the governments' control. In this case, the transaction is classified as a capital transfer if the company has run losses in the past or a sufficient rate of return is lacking. The risk adjusted rate of return expected by private investors on similar equity would be a minimum requirement to be deemed sufficient. Again, the recapitalisation could constitute a financial transaction if private investors contribute a significant share of the equity, given the perception that such investors would be seeking an appropriate return on their investment.

([3]) The bond was issued at an initial maturity of one year, but can be rolled–over up to four times, each time at a maturity of one year. The final redemption date hence is June 2017.

Table 2.3: **Fiscal accounts, projections for 2014 - 2016**

in million euros unless otherwise stated			February 2014 projection			November 2013 projection		
	2012	**2013**	**2014**	**2015**	**2016**	**2014**	**2015**	**2016**
Total revenue	**6,974**	**6,674**	**6,528**	**6,479**	**6,800**	**6,415**	**6,453**	**6,791**
Taxes on production and imports	2,633	2,412	2,328	2,404	2,538	2,346	2,415	2,564
Current taxes on income and wealth	1,962	1,911	1,785	1,809	1,892	1,795	1,810	1,899
Social contributions	1,510	1,482	1,480	1,493	1,528	1,439	1,424	1,455
Sales and other current resources (1)	858	863	933	771	840	833	802	870
Capital transfers received	11	6	2	2	2	2	2	2
Total expenditure	**8,109**	**7,575**	**7,443**	**7,457**	**7,270**	**7,541**	**7,434**	**7,263**
Total current expenditure	7,434	7,300	7,001	7,004	6,802	7,051	6,937	6,753
of which						0	0	0
Intermediate consumption	865	750	800	809	786	868	861	839
Compensation of employees	2,819	2,567	2,406	2,357	2,323	2,450	2,402	2,373
Social transfers	2,606	2,595	2,690	2,736	2,623	2,658	2,620	2,508
Interest	563	605	638	639	671	643	641	673
Subsidies	95	95	90	90	90	85	85	85
Other current expenditure (2)	487	688	378	373	310	347	327	275
Total capital expenditure (3)	675	275	442	453	468	490	497	510
General government balance	**-1,135**	**-901**	**-915**	**-978**	**-471**	**-1,126**	**-980**	**-472**
% GDP	*-6.3*	*-5.5*	*-5.8*	*-6.1*	*-2.8*	*-7.1*	*-6.1*	*-2.8*
General government primary balance	**-572**	**-296**	**-277**	**-339**	**201**	**-483**	**-339**	**201**
% GDP	*-3.2*	*-1.8*	*-1.8*	*-2.1*	*1.2*	*-3.1*	*-2.1*	*1.2*

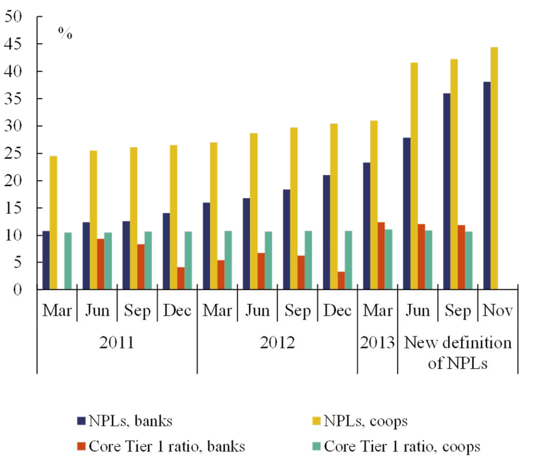
(1) The February projection for 2014 includes the expected increase in the distribution of dividends by the CBC compared to the previous year. The 2015 and 2016 numbers will be adjusted once decisions are taken by the CBC on dividends in these years, in line with its duties under the Treaties and the Statute. (2) For 2013, this includes compensation of pension funds amounting to 1.8% of GDP in 2013. (3) For 2013, this includes signing fees for gas exploration amounting to 1.1% of GDP, which are treated as negative capital expenditure (disposal of non-produced assets).
Source: Ministry of Finance.

The estimated debt-to-GDP ratio for 2013 is about 2pps lower than expected in November 2013, reflecting the lower deficit. The second disbursement of EUR 100m took place in December 2013. The debt-to-GDP ratio is expected to have reached 112% of GDP in 2013. It is projected to peak at 126% in 2015, and to gradually decline towards 104% in 2020.

2.3. FINANCIAL MARKETS AND FINANCIAL SECTOR DEVELOPMENTS

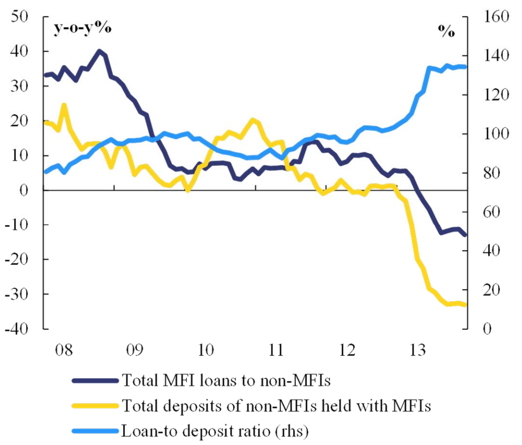
The stabilisation of the financial sector has progressed further, even though the quality of bank assets continued to deteriorate. The moderation of deposit outflows helped banks improve their liquidity buffers. The approval in November 2013 by the Central Bank of Cyprus of the restructuring plan of Bank of Cyprus and the submission at end-January 2014 of the restructuring plan of the Cooperative Central Bank to the European Commission as well as their strong commitment for quick and ambitious realisation have likely supported the regain in confidence in the banking sector. Nevertheless, financial stability warrants further monitoring, in light of the undercapitalisation risks posed by the increasing non-performing loans, with arrears' management posing the strongest challenge for banks to maintain an adequate capital level.

Graph 2.7: **Financial soundness indicators**



Source: Central Bank of Cyprus

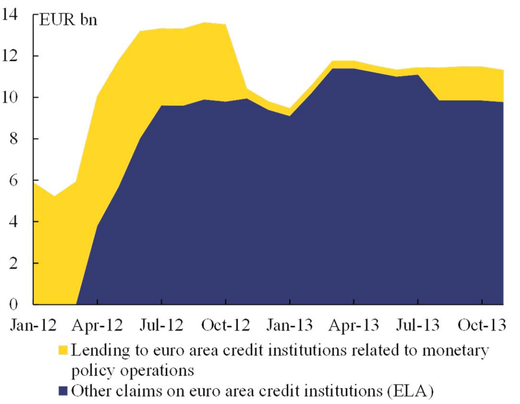
Graph 2.8: **Loans and deposits**



Source: Central Bank of Cyprus

Despite continued deterioration in the quality of banks' assets, the sector remains sufficiently capitalised. Towards the end of 2013, non-performing loans (NPLs) on local operations reached, according to the newly introduced definition since June 2013, 38% and 44% of total credit facilities granted by banks and cooperative credit institutions, respectively (Graph 2.7). Despite this significant increase, banks' aggregate core Tier 1 ratio was just below 12% in September 2013, reflecting the successful recapitalisations of Bank of Cyprus and Hellenic Bank. For the coops, and prior to the injection of capital by the state in the Cooperative Central Bank planned for March 2014, this ratio stood at 10.7%.

Graph 2.9: **Eurosystem lending to MFIs in Cyprus**

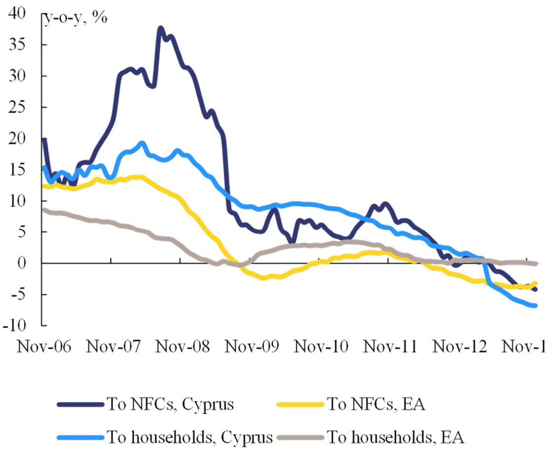


Source: Central Bank of Cyprus.

Banks' liquidity has improved on the back of normalising deposit movements. Domestic banks continued to experience deposit outflows, but at a much lower rate. Foreign banks benefitted from significant non-resident deposit growth of about 10% in the fourth quarter of 2013. As a result, total monthly deposits outflows slowed to EUR 77min December, from EUR 971m in September. The loan-to-deposit ratio with reference to resident non-MFIs has stayed stable during the second half of 2013 at around 135% (Graph 2.8). Nevertheless, the continued reduction in banks' assets, notably related to the repayment of loans, helped banks to improve their liquidity buffers, despite the decline in deposits. As a result, the sector's overall reliance on borrowing from the Eurosystem declined from EUR 11.5bn in July to EUR 11.3bn in November 2013 (Graph 2.9).

The correction of the excessive household and corporate indebtedness has continued. The contraction of loans to households has accelerated and reached -6.8% y-o-y in December 2013 (Graph 2.10). Credit to non- financial corporates also further declined, reaching -4.2% in December, although at a slower pace than loans to households.

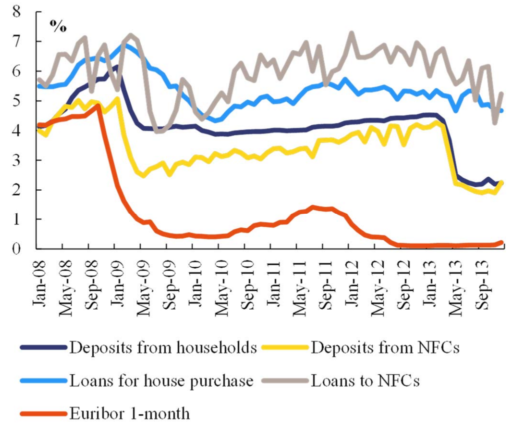
Graph 2.10: **Bank loans in Cyprus and the euro area**



Source: Central Bank of Cyprus

The cost of new credit remains high relative to deposit remuneration. The Central Bank of Cyprus' regulatory effort to bring down deposit rates has produced the expected result since the second half of 2013 (Graph 2.11). While the cost of new lending has shown signs of moderation, especially with respect to corporate loans, the decline in lending rates has been less pronounced and more volatile than the fall of deposit rates. As a result, banks' interest margins have improved, most noticeably in the households' segment, where they have jumped from around 1% at the beginning of 2013 to above 2.5% most recently.

Graph 2.11: **Interest on new loans and deposits**



Source: Central Bank of Cyprus.

3. PROGRAMME IMPLEMENTATION

The third 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. Financial sector restructuring and reforms are progressing well, although with a few delays. The fiscal policy remains well on track, with fiscal targets for 2013 being met with a considerable margin, due to both continued prudent budget execution and a less severe recession than expected. Structural reforms are also advancing in all key areas, although some of the reforms need to be accelerated.

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

Ambitious reforms of the tax revenue and public administration are envisaged in the programme and aim at improving tax compliance, fight tax 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 the programme conditionality is provided in Table 3.1, while the specific assessment on the implementation of the individual elements of conditionality with an end-Q4 deadline is found in Annex 1.

The authorities should continue to pursue their ambitious reform agenda and maintain its momentum. While the programme remains on track, Cyprus still faces significant risks. 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

The milestones for moving to stage two of the roadmap were met. The authorities, in consultation with the programme partners reviewed the milestones and liquidity position of the Cypriot banks to assess whether moving

Table 3.1: **Summary of compliance with policy conditionality for the third review (end-Q4 2013)**

	Status
Financial sector policy	**Partially compliant.** There was a concentration of deadlines for the last quarter of 2013 and January 2014 of which several were met, including the issuance of government guarantees, the submission of banks 'restructuring plans and approval of key performance indicators for reporting to the CBC, creation of a credit register, loan origination directive, supplementary information on the Code of Conduct in arrears management as well as banks' implementation plans of the matter, the supervisory programme of the CBC, a legal review on impediments to debt restructuring, the increase of the CT1 ratio from 8% to 9% and the publication of a roadmap with key actions by the new board of the cooperative banks. The publication of the NPL series according to the new definition and the approval of performance indicators for NPL management were achieved with a delay. In the delicate matters of the provisioning and disclosure directive, Resolution Law, the Financial Ombudsman and Laiki's voting rights in BoC, the deadlines were not met and shifted to later in the new MoU. Partially for operational reasons, the publication of the Financial Stability Report and the survey on market conditions are delayed as well as the definition of the new minimum capital requirement under CRDIV. On AML, the Cypriot authorities are continuing the implementation of the Action Plan and met most of the deadlines which expired at the end of 2013 or January 2014, albeit in some cases with delay. While CBC followed up on all the cases revealed by Deloitte, it is about to initiate the procedure for the appropriate enforcement actions. Thus, AML Action Plan 5.5.1 has been partially complied with. CBC issued guidance on proper business profiles, sound and effective risk management systems, tax crimes, establishing the source of wealth for PEPs, enhanced ongoing monitoring for higher risk clients and adequate AML/CFT training programs (AML 1.1.1, 1.2.1- 1.2.3, 1.3.1. and 2.2) at the beginning of February 2014, i.e. with slight delay compared to the end-2013 deadline; the same is true for the guidance by the other supervisory authorities on tax crimes as predicate offence for money laundering.
Fiscal policy	**Compliant.** Budgetary developments are on track vis-à-vis the targets set in the MoU and remain comfortably within margins. In 2013, budget execution over-performed vis-a-vis end-year targets, mainly on the back of strong expenditure control, rigorous implementation of adjustment measures, a robust collection of social contributions, and more favourable macro developments. The 2013 general government deficit is estimated at 5.5% of GDP, significantly better than the programme target of 7.8% of GDP. Budgetary targets for 2014 have been adjusted accordingly, standing at 5.8% of GDP (almost 1¼ percentage points better than targeted in the previous review).
Fiscal-structural measures	**Partially compliant.** The authorities are continuing their work in the areas launched some months ago, including public financial management and budgetary frameworks, social benefit reforms and tax administration. Most fiscal structural reforms deadlines were observed by the conclusion of the review mission, while the fiscal responsibility and budget system law was adopted by the House of Representatives three days after the mission ended. However, some reforms are still delayed or partially compliant: (a) the adoption of the privatisation law was set as a prior action and was endorsed by the House of Representatives on 4 March, while the adoption of the State-Owned Enterprises (SOEs) corporate governance law was expected to be adopted by end-February but has not yet happened; (b) there have been delays in the adoption of the legislation improving the collection enforcement powers of the revenue administration and enhance voluntary compliance by taxpayers; (c) there has been insufficient progress to pursue the sequential steps in the welfare plan reform with a Q4-2013 deadline, albeit work is ongoing. In particular, the definition of the level and costing of the GMI, and the refinement of the means-testing mechanism for all benefits have not yet been finalised.
Labour market	**Compliant.** Q4-2103 deadlines have been met, except for the tripartite agreement for the application of the reformed wage indexation in the private sector, which has not been concluded yet and negotiations are still ongoing.
Goods and services market	**Partially compliant.** The authorities complied with most structural reforms by the time the review mission was over. There are, however, some measures that are still partially or non-compliant, namely: (a) the comprehensive review of all regulated professions needs further fine-tuning; (b) the PAPD report on the CPC is incomplete and not yet implemented. Amendments to the antitrust and mergers laws have not yet been adopted. CPC still needs a more active role in the area of advocacy; (c) the amendments of the forced sales procedures (private auctions) were not adopted, as these will be aligned with the new insolvency framework.
Data reporting	**Compliant.** The authorities comply with the data reporting requirements, as set in the MoU.

Source: Commission services.

to stage two of the roadmap could be considered. The four important milestones have been accomplished: (i) Hellenic Bank was successfully recapitalised by private means already in October, (ii) the Central Bank of Cyprus (CBC) approved the restructuring plan of Bank of Cyprus in November, (iii) funds for the recapitalisation of the Cooperative sector were disbursed on a dedicated account at the central bank and (iv) the Cooperative credit sector officially submitted its restructuring plan to the European Commission end-January. Furthermore, the authorities and the commercial banks presented an analysis of deposit outflows and the liquidity situation, which led to the conclusion, in consultation with Cyprus' programme partners, that Cyprus was ready for further relaxation of administrative measures.

Capital controls will gradually be relaxed along stage two of the roadmap. A gradual move to stage two has so far entailed the unlocking of the restrictions on fixed-term deposits, which have become entirely available upon their maturity with the caveat that early termination, even with paying a penalty, is not possible. Nevertheless this remains a big step forward, as during stage one, upon maturity, deposits were rolled over into a 1-month term, except for 20% of the deposit amount. The full implementation of stage two of the roadmap would also entail the liberalization of transfers between domestic banks and the abolishment of limits of EUR 15,000 for natural and EUR 75,000 for legal persons, which so far have been further increased to EUR 20,000 and 100,000, respectively.

Further relaxations of capital restrictions will depend on developments in Bank of Cyprus and the Cooperative sector. According to the roadmap, moving to stage three depends on the completion of the mergers in the Cooperative sector and on progress made with the implementation of the restructuring plan of Bank of Cyprus, subject to an assessment of overall financial stability, banks' liquidity position and market confidence. Stage three will bring two major relaxations. First, restrictions related to cash withdrawals and the cashing of checks will be abolished, and second, opening accounts without any restrictions will be allowed.

3.1.2. Regulation and supervision of banks and cooperatives credit institutions

The authorities advanced further with the implementation of the regulatory and supervisory conditionality. The loan origination directive was issued on 4 December 2013, and the legal framework for setting up the credit register was created. The CBC published in November 2013 supplementary information on the Code of Conduct for dealing with troubled borrowers. In the area of arrears' management, banks also submitted their implementation plans in January, in compliance with the MoU deadline.

However, in some areas, delays occurred. The time series of non-performing loans (NPLs) according to the new definition introduced in June 2013 were published at the end of January only, a month later than initially foreseen. Because of delayed availability of data due to the heavy restructuring of Bank of Cyprus, the Financial Stability Report could not be published in December 2013. The updated MoU requires this publication to occur before April 2014. In the regulatory field, the directive on provisioning and disclosure requirements has been finalised and issued on 17 February 2014, as opposed to end-2013 in the previous MoU.

The revised financial sector conditionality addresses the pressing issues of managing arrears and limiting the deterioration of bank assets' quality. The updated MoU strengthens the CBC monitoring of banks' active management of existing NPLs and the preventive steps taken with respect to early arrears. On the basis of a review to be completed by end-June 2014, the CBC will revise by end-July, as needed, the arrears management directive in order to ensure that banks successfully maximise the value of their assets. The role of the Financial Ombudsman with regard to hearing complaints on compliance with the arrears management process will be clarified by end-March 2014. Last, but not least, the legal framework for personal and corporate insolvency will be strengthened (Box 3.1 and Section 3.4.5). The updated MoU recognizes the relevance of this issue by grouping policy requirements related to private debt restructuring in a separate sub-section.

Box 3.1: Policy initiatives addressing private sector debt restructuring

Improving private debt restructuring requires a comprehensive approach of the problem. Legal uncertainties and deficiencies as well as procedural shortcomings are impeding loan restructuring by slowing the process, reducing the incentives for voluntary debt restructuring and encouraging strategic defaults. Various initiatives have been, or will be, launched to address several inter-related issues. In particular, improvements are envisaged for handling the complex multi-creditor relationships and the rehabilitation of borrowers.

As a first step, the Directive on Arrears Management of the Central Bank of Cyprus gives guidance to banks for negotiating debt restructuring with borrowers. The Framework on Arrears Management requests banks to offer viable and cooperative borrowers a range of fair and sustainable restructuring options, tailored to the specific situation. Where multiple creditors are involved, the framework advises a cooperative approach.

Second, the Cypriot insolvency regime would benefit from a reform which provides for better tools to rehabilitate troubled borrowers. A steering committee consisting of representatives of the authorities involved has been set up in order to draft new insolvency legislations, both for private and corporate insolvencies. It is intended to establish a number of modern features tailored to the needs of Cyprus and in line with international best practices. The aim would be to include practical tools to deleverage over-indebted individuals and firms, while also having in mind banks' interests. The comprehensive reform of insolvency law and procedures in Cyprus can play an important role in reintegrating both entrepreneurs and consumers into full participation in the economy and contributing to future growth which will also be beneficial to credit institutions.

The reform of the corporate insolvency regime should aim at establishing a modern rehabilitation procedure for companies. Currently, the Cypriot insolvency regime for corporates only permits the liquidation of firms but does not offer modern rehabilitation tools for companies, which would allow them to continue their business activity. A rehabilitation procedure for corporates should include a stay on all creditors' actions and on debtor's unauthorised transfers allowing continued business operations, as well as sufficient time and protection to develop a rescue plan for the company. Such restructuring plan could be proposed by the insolvency administrator and approved by a majority creditors' vote. The specific needs of the Cypriot economy will have to be taken into account, and notably the large portion of small and medium-sized enterprises. Additional measures such as the regulation of the profession of insolvency practitioners may also have to be considered.

A reform of the personal insolvency regime would help facilitate debt restructuring of individuals. First, a new personal regime should be developed to permit debtors to use their "best efforts" to repay their debt. This would involve a negotiated debt settlement plan, which would be of particular use in regard to secured credit, such as mortgages. A stay on all actions for a defined period of time, including on both creditor collection and debtor transfers would permit the development of a repayment plan. Once agreed, such a plan should be validated by the court and have a duration of a number of years.

Second, the reform of the current judicial bankruptcy regime should also be considered. This would aim at introducing an automatic discharge from bankruptcy after a short number of years for over-indebted individuals in order to allow them a fresh start. In this regard, on adjudication of bankruptcy, debtors would surrender ownership of all of their assets and be freed from of all debts. A discharge from bankruptcy will need to be subject to strong safeguards to ensure an adequate balance between debtor and creditor interests. Those safeguards would notably require a "look-back" period in respect of potentially fraudulently transferred assets and the full and honest cooperation of the bankrupt. The bankrupt person may also be required to make, for a period of time, regular debt repayments for the benefit of creditors (after allowance for reasonable living expenses for the debtor and dependents).

Finally, there is a need to eliminate the administrative hurdles and inefficiencies of the legislative framework, which are currently constraining the seizure and sale of loan collaterals. The foreclosure process in Cyprus is

(Continued on the next page)

Box (continued)

extremely long, usually a number of years. This is largely due to the possibility of repeated valuation procedures concerning the property and also of repeated legal challenges (by debtors and third party creditors) within the foreclosure process. Efficient foreclosure processes will enhance the functioning of the insolvency framework and incentivise voluntary debt restructuring. As a first step, the authorities have submitted a draft legislation, which will facilitate the forced sales procedure by limiting the role of the Land Register in the auction process and enabling mortgage creditors to conduct private auctions. Further streamlining of administrative processes at the Land Registry and relevant civil procedures of the courts will also be considered to ensure the smooth functioning of both foreclosure and insolvency processes.

3.1.3. Recapitalisation, resolution and restructuring

Bank of Cyprus

In accordance with the MoU, the restructuring plan of Bank of Cyprus was approved by the Central Bank of Cyprus in early November 2013. The restructuring plan covers the period until 2017, including how to downsize its balance sheet and to refocus its core business on the Cypriot economy. The successful implementation of the plan would help restoring depositors' and investors' confidence in the Bank of Cyprus and the banking sector as a whole.

The implementation of the restructuring plan is now progressing further. About 77 branches and 5 International Banking Units (in which the international operations are concentrated) have been closed, and the plan is to finalize the process of rationalising branches and International Banking Units by March 2014 and June 2014, respectively. As far as the IT operations are concerned, the plan foresees the full migration of the IT system of Cyprus Popular Bank into Bank of Cyprus by June 2014.

The level of NPLs in Bank of Cyprus reached about 50% of gross loans in the fourth quarter of 2013 ([4]). This is partly because of the introduction of the new definition of non-performing loans. While the management of NPLs is now progressing, the results will not become apparent immediately since according to the new definition of NPLs adopted by the Central Bank of Cyprus, restructured loans that at the time of restructuring presented arrears of over 60 days remain classified as NPLs for at least 6 months after being restructured, even if restructured loans respect the new terms and conditions.

Managing NPLs is the key priority for Bank of Cyprus for the next years. A new Head of Restructuring & Recoveries has been appointed and three units have been created for managing NPLs, one for retail, one for SMEs and one for mid- and large-sized corporates, with the latter targeting the top 30 corporates and real estate developers. The "Special Projects Division", which was launched in October 2013, is now integrated into this unit.

Concerns regarding the subsidiaries of Bank of Cyprus and Cyprus Popular Bank in Ukraine have been addressed. The resolution of Cyprus Popular Bank and the restructuring of Bank of Cyprus included the sale of the foreign subsidiaries. The specific judicial procedures in Ukraine, involving a claim on the assets of the subsidiary, have been stopped, allowing Bank of Cyprus to proceed with the finalisation of the sale of this subsidiary.

The liquidity position of Bank of Cyprus is expected to improve. This is mainly due to the agreed sale of its subsidiary in Ukraine and the sale of the assets of its subsidiary in the UK. As a contingency measure, the House of Representatives approved the issuance of government guarantees for a value of up to EUR 2.9bn, which, if needed and in line with State aid rules, could be used as collateral to obtain liquidity. At present, the liquidity position of Bank of Cyprus does, however, not require these guarantees to be issued. Against this background,

([4]) http://www.bankofcyprus.com/Documents/Investor%20Relations/Press%20Releases/ENG/FinancialResultsFY2013ENG.pdf

Box 3.2: Enhanced monitoring of banks' restructuring and arrears' management

The main challenge ahead for all banks in Cyprus is to maximise the value of their assets in the current economic environment. In practice, this refers to the need for banks to implement a strict policy of managing arrears. The Central Bank of Cyprus (CBC) has already established a specific legal framework for dealing with troubled borrowers. Now, it pertains to commercial banks and cooperative credit institutions themselves to implement this framework. Non-performing loans (NPLs) will have to be actively restructured in order to significantly improve their likelihood of becoming performing again. Early arrears, i.e. loans with delays on payments of less than 90 days, should also be addressed soon enough with a pro-active remedial policy in order to avoid them becoming non-performing. The management of arrears becomes naturally more complicated in the context of a full-fledged restructuring of those financial institutions that must regain viability.

The authorities, in consultation with the programme partners, have developed an enhanced monitoring process of banks' restructuring process and their management of arrears. An extensive set of key performance indicators (KPIs) has been developed for following the main parameters of the restructuring process, with respect to capital levels, liquidity developments, management of NPLs, and business efficiency. Expected regulatory changes have been taken into consideration. Institutions are expected to report both the operational and financial targets as well as the latest quarterly values of the same quantitative indicators. A system of internal reporting will inform the Central Bank of Cyprus about a more extended range of variables, including balance sheet and profit and loss items. The banks subject to restructuring plans are required to submit the progress reports, starting as of April 2014 with a reference date end-December 2013. These regular reports will then be assessed by the respective supervisory units from the CBC in order to inform the CBC Board within a month from the submission by the banks (par. 1.6 of the MoU).

The supervision of banks' arrears management policy will be stepped up. The banks' operational capacity to deal with arrears will be assessed by the CBC by end-March 2014 (end-April for the coops, after completion of the consolidation process by end-March). Starting from end-March, banks will be required to submit quarterly reports on NPLs management, as well as monthly reports on dealing with early arrears. Specific quantitative performance indicators (number of loans restructured, cash collection, cure rates, etc.) will be used. Furthermore, with the assistance of an external expert, the CBC will review banks' arrears management policies and practices by end-June 2014. Based on the findings of this review, the CBC will revise, as needed, the Arrears Management Directive by end-July. In addition, the CBC will instruct, by end-June, the external auditors of the banks on agreed-upon procedure reports about the effectiveness of banks' debt restructuring arrangements and strategies. These reports will cover six-month periods, starting from December 2014. Generally speaking, the MoU foresees a much closer cooperation between banks' external auditors and the CBC supervisory units.

Banks subject to restructuring plans will be required to regularly communicate on progress with the implementation of their restructuring plans. Both Bank of Cyprus and the cooperative sector are required to communicate to the large public about their restructuring process, inter alia by means of key performance indicators. In addition, the CBC will complete by end-February 2015 a comprehensive technical assessment of Bank of Cyprus restructuring plan with the aim to identify areas that require further strengthening and review. This communication and review strategy is integral part of the policy actions aiming at a return to confidence in the banking system.

the management of Bank of Cyprus decided not to roll-over the six-month deposits that were blocked until 31 January following the bail-in the summer of 2013.

The upfront recognition of expected losses resulted in a lower capital ratio. The core Tier 1 ratio of Bank of Cyprus declined to about 10%, which is below the 12% indicated in the KPMG report. Nevertheless, the ratio is in line with the restructuring plan of Bank of Cyprus, which includes the front-loading of the losses as expected by PIMCO (the consultant estimating the capital needs) and the sale of the subsidiary in Ukraine, which also impacts negatively on capital. The core Tier 1 ratio is, however, expected to remain above

9% throughout the programme period, in accordance with the MoU, as the frontloading of the losses is foreseen to be offset by higher profitability at the end of the programme.

The Cooperative Credit Institutions

The restructuring and recapitalisation of the cooperative credit institutions (coops) has been progressing according to the plan. The consolidation process through legal and operational mergers continued, and the sector will consist of 18 coops by end-March. A new General Manager of the Cooperative Central Bank (CCB) was appointed in December 2013 and the nomination of senior line managers is progressing. The external asset valuation was finalised and confirmed that, upon completion of the capitalisation process, government ownership of the CCB will reach 99%. The restructuring plan was submitted to the European Commission in end-January 2014, in full compliance with the MoU. The key challenge for the cooperative banks is to deal with the high level of non-performing loans for which an arrears management framework is being set up. Following the completion of the merger process, the CBC will review its affiliation directive. An assessment will be made by January 2015 of the local risk management tools of the Cooperative Credit Institutions.

Hellenic Bank

After the successful completion of its recapitalisation by private funds, Hellenic Bank is facing the challenge of coping with the risk of falling quality of its loan book. The private investors have reiterated their readiness to support the business of the bank. The liquidity situation of the bank is satisfactory, and could allow the granting of new credit to the economy once demand resumes. In the immediate present, however, 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. While the programme conditionality only requires Hellenic Bank to submit a business plan, future review missions will continue to monitor its condition in light of its systemic importance.

3.1.4. Anti-Money Laundering

The Cypriot authorities continue with the implementation of the Anti-Money Laundering (AML) action plan. In early December 2013, the CBC issued the fourth edition of the AML Directive. The updated directive ([5]) included a requirement for banks to obtain a copy or other evidence of the registration of a trust as part of their customer verification procedure, thereby aligning the AML Directive with the law on "Regulating Companies Providing Administrative Services and Related Matters".

The customer due diligence (CDD) framework was further enhanced, though with a slight delay. The CBC issued a circular at the beginning of February 2014 that provided further guidance to the obliged financial institutions on a number of CDD related issues, such as the identification of the Political Exposed Persons (PEPs) and the new provisions on the introduction of tax crimes as predicate offenses. The other supervisory authorities have also circulated similar guidance on tax crimes to the non-financial corporates (lawyers, accountants and administrative service providers).

A third-party review of the functioning of the Companies' Registrar was finalised. The Cypriot authorities will address the identified shortcomings and are working with the technical assistance teams to design a strategy for implementing the report's recommendations.

The supervisory capacity of the supervisory bodies has been enhanced. The AML unit of the CBC was complemented by additional human resources (3 additional employees), while further re-enforcements (2 additional employees) are expected by the end of 2014. In addition, the development of risk-based supervisory tools for offsite and onsite surveillance is progressing with the IMF technical assistance. The other supervisory authorities have enhanced their AML monitoring capacity by restructuring the supervisory department (Cyprus Securities and Exchange Commission), increasing the human resources (Cyprus Bar Association) or strengthening the outsourced monitoring function

([5]) http://www.centralbank.gov.cy/media/pdf/EN_AML_DIRECTIVE_4th_2013.pdf

(Institute of Certified Public Accountants of Cyprus). 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 finalised the follow-up on the cases revealed by the Deloitte report. Small teams of AML officers carried out targeted onsite inspections during which they met with the Money Laundering Compliance Officers of the banks in question, reviewed customer files and account transactions, as well as alerts and documentary evidence. Where the financial institutions had not complied with their obligations under the AML regulation, the CBC requested remedial actions, such as the filing of suspicious transaction reports or the reclassification of customers as higher risk. Further, the CBC will send warning letters to several banks, requiring them to address the shortcomings identified in their systems and processes. In cases where breaches are of a systemic nature or of greater importance, the CBC will initiate the procedures to impose administrative fines. As the completion of the supervisory measures was not finalized by end-January 2014, the deadline was shifted to end-March 2014.

The Unit for Combating Money Laundering (MOKAS) continued to provide statistical data on the exchange of information with other financial intelligent units (FIUs). In compliance with the MoU, MOKAS provided to the programme partners the breakdown of requests made and received, including spontaneous disseminations, to and by foreign FIUs. The annual data are also available in MOKAS' annual report for 2012 ([6]).

3.2. FISCAL POLICY

The third review mission confirmed that Cyprus met the 2013 fiscal targets with considerable margin. This is largely due to prudent budget execution, notably related to intermediate consumption. On the revenue side, non-tax revenues performed above expectations, on the back of more benign labour market developments and increased revenues from EU funds.

In compliance with the MoU, the Cypriot authorities aligned the 2014 Budget Law with the revised projections of the second review. The House of Representatives approved the 2014 Budget Law in December 2013. To advance some of the fiscal effort foreseen in 2015 and 2016, the budget introduced fiscal measures amounting to around ⅓% of GDP, in addition to those specified in the original MoU at the start of the programme.

The 2014 fiscal target has been revised down by 1.3 pps compared to November 2013 (see Table 2.3)**.** Against the background of the significant consolidation effort undertaken in 2013 in line with the MoU requirements, the general government primary deficit is expected to stay flat at 1.8% of GDP in 2014. The improvement compared to the previous forecast is mainly driven by the positive carry-over from 2013 as well as a reduction in expenditure for 2014. Revenue developments largely reflect the continued recession, partly offset by the implementation of significant consolidation measures, and the expected increase in central bank profit allocations to the government by about EUR 100m. On the expenditure side, the lower public employment resulting from the high number of retirements in 2013, combined with the hiring freeze in the public sector and further measures to reduce the public sector wage bill, are projected to outweigh the increase in social transfers connected to adverse labour market developments.

The projections for 2015 and 2016 assume that any remaining fiscal gaps to the programme targets will be closed by yet-to-be-specified measures. The cumulative fiscal gap for 2015 and 2016 is now estimated at 1.3% of GDP, ¾pp less than expected in November 2013. Total revenue in 2015 and 2016 is expected to recover in line with the improving macroeconomic situation. The forecast does so far not include the additional dividends expected to be distributed by the CBC in 2015 and 2016, in line with the CBC's duties under the Treaties and the Statute, but will be adjusted once the decision is taken. Total expenditure is projected to stay broadly unchanged in 2015, with

([6]) http://www.law.gov.cy/law/mokas/mokas.nsf/B6860BF4E952069AC2257BDD0042692F/$file/MOKAS%202012-ENG.pdf higher pension payments in the general social insurance scheme, largely offset by a deceleration of the retirement wave in the public sector leading to lower pension gratuity payments. Total expenditure is projected to decrease in 2016, in line with the assumption that the fiscal gap will be closed.

Fiscal risks remain subject to careful monitoring. Over the programme horizon, risks related to macroeconomic developments continue to be on the downside. Further, revenue developments are fragile. Tax collection points to a weakening performance of key revenue items and high tax elasticities may have an adverse effect on budgetary performance should growth surprise on the downside.

3.3. FISCAL-STRUCTURAL REFORMS

3.3.1. Pension and Healthcare System

In line with the MoU requirement, all aspects of the public sector pension reform also apply to pension schemes in the broader public sector. However, a few entities in the broader public sector run provident funds that offer defined benefit schemes, which do not follow the reformed rules. These funds were established based on collective agreements. The authorities have therefore issued a circular advising the relevant entities to undertake reforms of their provident funds. As far as the programme requirement is concerned, the authorities are compliant.

Effort needs to be increased to comply with the agreed healthcare reforms. Reforms aim at strengthening the funding structure and the efficiency of the healthcare system to deliver universal and high quality care. Full implementation of a National Health System (NHS) has been postponed from end-2015 to mid-2016 to allow sufficient time for setting up the IT system as well as the restructuring of public hospitals. However, one part of NHS, such as e.g. primary care, will be phased-in already mid-2015. The strategy regarding phasing-in will be adopted with the full roadmap to NHS in April this year. Also, the amending bill on NHS will be submitted to the House of Representatives by Q2-2014. The submission of the report on a review of income thresholds for free public health care has been postponed to Q2-2014 to take into account changes related to the guaranteed minimum income scheme.

Several work streams aim at improving patient throughput in public hospitals and optimizing the use of hospital resources. Related to this, full coding of all hospital inpatient cases based on an activity-based payment system (diagnosis related groups) has been achieved. This will allow for installing a shadow budget for hospital inpatient activity by mid-2014, to be extended to all hospital activities by end-2014, which is necessary for the transition to hospitals' financing based on their activity.

The results of the working groups on improving the efficiency of healthcare delivery are broadly satisfactory and are being monitored continuously. The Ministry of Health (MoH) established a pilot project for family doctors acting as gate-keepers for access to further levels of care. The MoH is also working on the framework of health technology assessments to increase the cost-effectiveness of the basket of publicly reimbursed products. Technical assistance projects, financed by the European Commission, support the various reforms. The World Bank's functional review has proposed significant organisational changes for the MoH and hospital restructuring. Its implications for the path towards achieving hospital autonomy (both managerial and financial) will be examined until the next review mission. Moreover, the framework for pricing and reimbursement of goods and services according to Directive 201/24/EU has been transposed on time and will be assessed by the European Commission in the coming months. Finally, the regular working times have been adjusted to reduce overtime and the related wage costs.

3.3.2. Public Financial Management and Budgetary Framework

The House of Representatives adopted the high-level umbrella law, the Fiscal Responsibility and Budget System Law (FRBSL), on 13 February 2014, thus with some delay compared to the Q4-2013 deadline as envisaged by the MoU. As the FRBSL was not adopted at the time of the review, its enactment had been set as a prior action for the disbursement of the fourth instalment of financial assistance. Enforcement of the umbrella law is to take place soon after its adoption, upon its publication in the official gazette.

The enforcement of the FRBSL is expected to provide a comprehensive and transparent legal framework to the Public Financial Management (PFM) practices applicable to the entire general government, while ensuring compliance with the EU requirements. The latter derive from the Two-Pact Regulation 473/2013/EU (particularly, for the establishment of an Independent Fiscal Institution) and the Council Directive 2011/85/EU, as there was a genuine need to deepen existing provisions in Cyprus' legal framework. The later adoption of the law caused a delay in the establishment of a Cypriot Fiscal Council. The implementing text specifying further operational elements, including the legal status of the Fiscal Council staff (in the form of secondary legislation) and the draft Memorandum of Understanding between the Fiscal Council and the Ministry of Finance regarding the exchange of statistical information was finalised and should be adopted by the Council of Ministers after the FRBSL has entered into force and at the latest by mid-March 2014.

Action was taken to ensure proper recording and control of spending commitments, and appropriate monitoring of government guarantees. The Accountant General issued a circular specifying the procedures, the authorisations, and proper recording of commitments for the central government on 31 December, while a second circular setting the single framework for the general government was issued on 14 January 2014. Regarding the monitoring of government guarantees, the Public Debt Management (PDM) Law was amended to allow for better monitoring of the existing and new government guarantees. The PDM office received technical assistance from the IMF on the monitoring and assessment of risks stemming from government guarantees in October 2013. A decision was taken for a secondment of a qualified auditor to join the PDM office at the latest by 1 March.

3.3.3. Public Private Partnerships

A more predictable management of public investment, particularly via Public Private Partnerships (PPPs), will be ensured with the recent adoption of the FRBSL. This legal basis should allow for higher levels of certainty in the fiscal affordability of projects, better monitoring of public investment projects, as well as the development of financial reporting and accounting rules. The PPPs inventory will be regularly updated and will be included in both the annual budget law and in the annual financial report.

3.3.4. Privatisation and State-Owned Enterprises

As the privatisation law had not yet been adopted at the time of the review mission, its enactment was agreed as a prior action. The law was enacted on 4 March. It creates an institutional framework for the privatisation process and sets out the decision-making process and the chain of accountability. The framework includes a privatisation unit, responsible to a dedicated inter-ministerial committee, to manage the process. The next step is to appoint the head and staff of this unit.

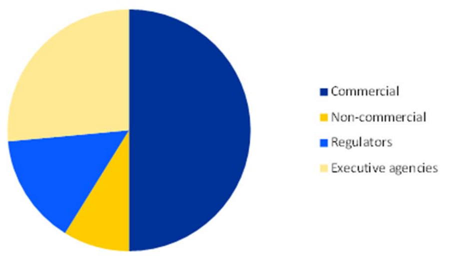
The Ministry of Finance submitted a more detailed privatisation plan before the review mission, in line with the Minister's commitment letter of December 2013. The revised plan contains asset-specific timelines and intermediate steps for all SOEs identified for privatisation and the strategy envisaged for each asset. It also draws on the analysis and recommendations of the technical documentation from which the plan is derived. Nonetheless, the schedule for the real estate sales should be developed further once advisors are appointed. The plan will continue to be revised as privatisation progresses.

The law on SOEs corporate governance was submitted to programme partners within the MoU deadline. The law increases the Ministry of Finance's monitoring and budgetary control powers over SOEs, with specific articles introducing better coordination, control and supervision. It specifies clear auditing requirements and introduces a more rigorous approval procedure for the creation of new SOEs. This law complements the FRBSL in improving financial management in the public sector. Submission to the House of Representatives was delayed, but the authorities agreed that the law would be submitted by the end of February 2014.

Box 3.3: Cyprus' commercial state-owned enterprises

Cyprus has over 60 state-owned enterprises (SOEs). Half of these operate in a commercial environment, while the rest, known locally as semi-governmental organisations (SGOs), perform functions such as implementing government policy and regulating the economy. This box focuses only on the commercial SOEs. These operate in a variety of sectors from telecoms to theatre. All but four ([1]) are 100 per cent owned by the government.

Graph 1: Categorisation of Cyprus' SOEs

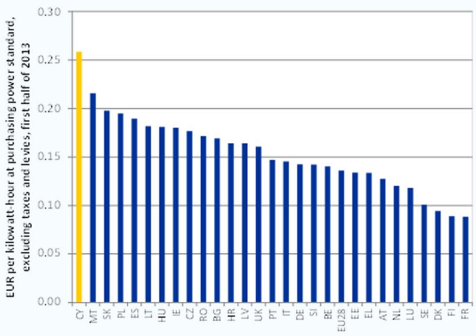


The need for reform is demonstrated by the poor financial state of many of the commercial SOEs. At least 16 showed signs of distress in 2012: seven had net debt more than four times operating earnings (EBITDA); three had negative EBITDA and positive debt; and another six had lower net debt, but overall losses. This financial situation makes them vulnerable to changes in interest rates or interruptions to cash flow.

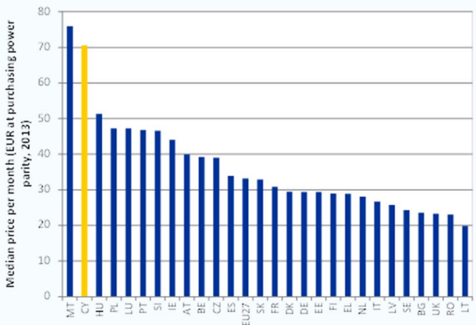
This vulnerability creates large contingent liabilities for the government. The SOEs have accumulated large and growing debts. In 2012, commercial SOEs' net debts amounted to over EUR 1bn, or 6 per cent of GDP, up 9 per cent on the previous year. Commercial SOEs have also received EUR 1.1bn of government guarantees, the equivalent of 14 per cent of annual government expenditure. The fragile financial state of some SOEs creates significant risks for the government's fiscal position, should these debts not be honoured or the guarantees be called. Governance reform should allow the government to exert stronger control over SOEs' finances, mitigating these risks.

Cyprus' SOEs have considerable scope to improve their performance. Although mobile call costs are relatively low in Cyprus, Graphs 2 and 3 show that electricity and broadband prices are among the highest in the EU. ([2]) This could partly reflect inefficiencies in the SOEs. A stronger corporate governance structure is one way to help incentivise efficiency. This can support lower prices for consumers when combined with a strong regulatory framework to limit monopoly power.

Graph 2: Domestic electricity prices



Graph 3: Broadband costs



The Cypriot authorities have committed to introduce a new law to regulate the creation and functioning of SOEs. The law will establish a central unit monitoring SOEs' performance. This new framework should help the government improve SOEs' operating efficiency and manage the impact on the country's finances. The reform complements the government's privatisation plan, which considers the privatisation of some commercial SOEs, including the telecoms company (CyTA), the energy company (EAC), and the commercial activities of the ports authority (CPA). The government has also identified some SOEs for restructuring or liquidation, with the remainder subject to review to improve their efficiency or to consider the potential for privatisation.

([1]) Cyprus Forest Industries, Cyprus Pipes Industries, Pancyprian Company of Bakers and Cyprus Airways.

([2]) Eurostat; European Commission Digital Agenda Scoreboard

A list of SOEs to be restructured or liquidated was approved by the Council of Ministers with some delay. Supplementary information about the termination of some SOEs was submitted during the mission. Further work is needed to clarify the process and timelines for the review and restructuring of the remaining SOEs, particularly those that have been identified for internal review. A roadmap is now being developed.

Cyprus has completed an inventory of all SOEs, real estate and land. Information about the various assets will be better accessible, allowing for a more efficient decision-making process. It will also allow greater transparency, making it easier to hold stakeholders and the authorities accountable.

3.3.5. Revenue Administration

With a minor delay, a reform plan for the establishment of the new integrated tax agency and flanking reforms was approved by the government. The reform plan was drawn up with the support of technical assistance by the IMF and the Commission, and was given approval by programme partners. Intense technical assistance support is foreseen over the course of 2014, and will be provided in close collaboration with the project team on the authorities' side.

The next step will be the adoption of the enabling legislation to formally establish the new integrated tax agency by July 2014. The integration plan foresees a "phoenix approach". First, the shell of the new agency, replacing the existing Inland Revenue Department (IRD) and VAT Services (VS), will be created together with the appointment of senior management. In a second step, the integrated units will be put into operation progressively, starting in the second half of 2014.

Some of the Q4-deadlines concerning short-term measures to improve revenue collection were not met. In particular, important legal amendments to enhance tax collection and voluntary compliance and to establish full self-assessment have not yet been enacted. After a prolonged period of legal vetting, some of the amendments were deemed to need adjustments in order to ensure constitutionality. Moreover, the authorities have so far not demonstrated that tax fraud is systematically prosecuted. Finally, the independent review of discretionary powers available to tax administration management, assigned to an external expert, is at the stage of finalisation but not yet completed. All related deadlines were shifted to Q1-2014.

On the positive side, a first version of the joint IRD and VS work programme for conducting audits and enhancing voluntary compliance was submitted on time. The work programme is a living document which is expected to benefit from further technical assistance, with the aim to base it more firmly on risk-analysis and appropriate treatment strategies. Another important achievement concerns the enhanced possibilities for data exchange within the tax administration but also with other relevant authorities, which will facilitate integral performance reporting and risk analysis. Finally, to facilitate payments by taxpayers, the pilot project on the immovable property tax that introduced payments through a bank agent will be expanded to other taxes. E-payments will be possible in the entire public domain by Q3-2014.

As required, work on the compliance risk analysis was launched at the end of 2013. Initially progress with the risk analysis has been slow. It has now gained momentum, fostered by technical assistance and after the responsible team was given access to the data required for the analysis. Next milestones toward, ultimately, a comprehensive compliance management strategy were agreed with the authorities. The authorities notably committed to take measures to cleanse the tax payer registers by Q3-2014, an important prerequisite to manage compliance risks. Substantial technical assistance toward establishing the new Cypriot tax department including on the compliance management work stream will be provided, to support the implementation of the integration plan to establish the new tax agency.

3.3.6. Public Administration Reforms

New working times in the public service have been established in compliance with the MoU. The starting time of regular working hours has been shifted to 7.30 (from 8.00 before), with a possibility to start and to finish one hour later. Working time in the period from 7.00 to 17.00

(and 19.00 in the health sector) is now remunerated as regular working allowing for a more substantial reduction of overtime costs. The Ministry of Health, which showed significant implementation problems in the last review mission, has also complied.

The Cypriot authorities have shared with programme partners the technical assistance reports on three ministries (Education, Health, Agriculture), human resource management, local governments and the Companies' Registrar. These reports, produced by the World Bank and the UK TA experts, are a useful first step in understanding how to improve the efficiency of Cyprus' public administration. The Cypriot authorities are working with the technical assistance teams to design a strategy for implementing the reports' recommendations.

3.3.7. Reform of the Welfare System

Work on the sequential steps foreseen for the adoption of the welfare plan has progressed, yet delays have occurred. The authorities presented to programme partners their work on the definition and level of the minimum consumption basket covering basic needs, which was based on a budget standard method and checked against a normative budget standard approach (as requested by programme partners). The authorities formulated different alternative design options for the Guaranteed Minimum Income (GMI) in terms of eligibility conditions and benefits levels, and conducted micro-simulations to test the social and fiscal impact of these options. Consultation with social partners on these GMI options should take place soon, while the Legal Services provided preliminary legal scrutiny for the incorporation of the GMI provisions into a legislative framework. Given the initial tight timeframe for complying with this major reform, the deadline for a final proposal of the definition, level and financing of the GMI taking into account the fiscal envelope has been extended to end-February, while the date for the final implementation of the reform remains unchanged (1 July 2014).

Work has been initiated for the reform of the rest of the social benefits that fall outside the GMI, albeit with delay. This primarily relates to the child benefits and educational benefits, and would eventually lead to the refinement of the means-testing mechanism for all benefit schemes. The authorities identified all available electronic database connections and data exchange arrangements and are currently consulting with the Central Bank of Cyprus and the Cooperative Central Bank to finalise procedures for the verification of applicants' financial assets. Given the large amount of work required, the deadline for the finalisation of the work on the criteria and mechanism for the means-testing has been extended to end-February.

Work streams with deadlines by April and May are also ongoing, notably the transfer of competencies and responsibilities to the Ministry of Labour and Social Insurance (MLSI) and the design of an IT system to support the reformed welfare system. Currently, the authorities are receiving TA from the Support Group for Cyprus for the IT project and a first progress report was delivered on 20 January. In parallel, with the help of experts, the MLSI proceeded with a study and developed a proposal on the organisational structure of the services that will undertake the administration and provision of social benefits within the MLSI.

3.3.8. Other Fiscal-Structural Reforms

International tax cooperation

Abidance with EU laws in the area of international tax cooperation appears adequate. The provisions in Cyprus' domestic law seem to be broadly in line with the Council Directive 2011/16/EU. A full-fledged conformity assessment is, however, still pending. Regarding deadlines on information exchange established in Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of VAT, updated performance data will become available only later in the year.

Efforts are undertaken to improve the follow-up on information that Cyprus receives from other Member States under the Savings Directive (2003/48/EC). Notably, the authorities have progressed with the large-scale examination launched last year, which matches the information received on savings income with the information reported by the identified taxpayers. Overall, further work is needed to ensure the systematic follow-up on information received from other countries. In the long-term, the new integrated administration of direct taxes and VAT is expected to further enhance the ability to make proper use of the information obtained (see 3.3.5).

Cyprus has recently received a non-compliance rating by the OECD regarding the application in practice of its legal framework and standards of transparency and exchange of information for tax purposes. The OECD Global Forum on Tax Cooperation and Transparency focussed on implementation issues over the period 07/2009-06/2012. Out of ten areas, it rated two areas as non-compliant and another two as partially compliant, leading to its overall non-compliance judgment. The four identified areas of non-compliance or partial compliance concern: the availability of ownership/identity information (Partially Compliant) and of accounting records (Non-Compliant); the insufficient enforcement of legally established rights to access certain information (Non-Compliant); and delayed responses to information requests by foreign authorities (Partially Compliant).

Much of the negative rating can be attributed to bottlenecks in the Registrar of Companies and low compliance with the submission of tax returns. These two issues had already been recognised within the programme, notably through the AML action plan and by requiring Cyprus to develop a comprehensive compliance strategy in the context of its revenue administration reform.

Cyprus appears strongly committed to address the shortcomings identified by the OECD. The authorities have already elaborated an action plan steered by the tax authorities and started its implementation. However, discussions revealed that the plan lacks actions on the issues related to the Registrar of Companies, which will undergo a reform within the Public Administration Reform (see 3.3.6). As a consequence, the authorities agreed to submit a revised plan that unifies all relevant actions. They also committed to swift implementation of the plan and close monitoring of their performance in responding to new information requests in order to achieve full compliance in the OECD supplementary review.

Immovable property tax

The reform of the immovable property tax (IPT) has further progressed, also taking into account the recommendations from IMF and SGCY technical assistance (TA). In September 2013, the Cypriot authorities officially initiated a General Valuation (GV) project to update the tax base for the immovable property, which benefitted from TA support. The TA contained a number of recommendations for the successful conclusion of the General Valuation project, which were taken on board in the revised MoU. The GV project is advancing. The capturing of building characteristics is progressing satisfactorily, while an analysis of the transaction values in small municipalities or communities has been initiated. The latter serves also as a small scale assessment and testing of the Computer Assisted Mass Appraisal System (CAMAS). The aim remains to publish updated values in the summer of 2014.

The deadlines for the implementation of the recommendations of some studies on IPT were slightly extended. In order to allow the studies aimed at refining the GV model and at further improving the property tax efficiency to benefit from the updated property values based on the GV project, the deadlines for the implementation of these studies' recommendations were extended to mid-2015. The tender procedure of the study on the scope of consolidating the collection and administration of the various taxes levied on property was finalised with a slight delay at the end of January 2014.

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. The application of the Cost of Living Allowance (COLA) in the private sector is currently suspended until end-2014. The key element in the discussion with social partners on the possible application of the reformed COLA to the private sector appears to be the change from full indexation to partial indexation (at 50% of inflation). The authorities will keep programme partners informed on the progress of negotiations both at technical and political level, with an aim for a reform to be agreed upon mid-2014.

Progress has been registered with respect to the implementation of measures to tackle youth unemployment and to address the shortcomings of the current system of activation policies. A draft plan for the implementation of a Youth Guarantee has been submitted to the Commission while the full employment action plan is expected by April 2014. In addition, a uniform monitoring and evaluation framework is going to be applied to all active labour market measures, and a common database is being established, to be shared by all the different implementing bodies. This is envisaged as a transitional solution, until a common data warehouse becomes fully operational in 2015. Measures to strengthen the capacity of public employment services within the constraints of the current freeze on hiring are being devised, relying primarily on a revision of tasks, increased staff mobility and outsourcing. The cooperation, coordination, and exchange of information between public employment services and the social welfare administration is being strengthened.

3.4.2. Energy

Cyprus faces significant policy challenges as regards to the exploitation of its domestic off-shore gas reservoirs and the ensuing transformation of its energy sector. The programme foresees interim steps for the development of a comprehensive strategy to address these challenges. As intermediate commitments to be fulfilled by Q4-2013 Cyprus had committed to: 1) submit a revised draft roll-out plan for the gas exploitation infrastructure, 2) provide an intermediate draft outline of the market organisation and regulatory regime for the energy sector and gas exports, and 3) anchor within the budgetary framework clear in- and outflow rules for the Resource Fund that will manage future gas revenues.

A revised version of the roll-out plan has been received, incorporating further comments by programme partners. Compared to the previous version, the revised plan provides a much better basis for discussions on the best way forward in relation to domestic gas exploitation and gas export. In particular, it provides an analytical comparison of different infrastructure and export options in scenarios covering a range of possible reservoir sizes of commercially exploitable natural gas and a range of gas prices. However, the plan is considered as a living document: the authorities agreed to provide regular updates of the roll-out plan in order to take account of new and changed information, notably regarding the size and quality of the gas available for export. As the Government Agreement on the Liquefied Natural Gas (LNG) project is not close to finalisation, the authorities have not yet submitted an analysis of its financial and budgetary impact.

Initial discussions on market organisation and the energy regulatory regime took place on the basis of a first outline submitted in early January. Various feasible options and their economic and legal aspects (as mentioned in the MoU) were discussed. An important issue is the possible use of the derogations from the provisions of the Third Energy Package available to Cyprus as regards their domestic electricity and gas markets. This issue is closely related to the on-going assessment of the implementation of the Third Energy Package and to the issue of possible import of natural gas for domestic use in the short term (for which a new tendering procedure has been launched), as well as the privatisation prospects for the state-owned incumbent electricity company (EAC), which has a de-facto monopoly. The authorities have commissioned a number of studies on the institutional framework and the organisation of the electricity and gas markets, which will become available progressively and feed into the outline. An advanced intermediate version of the outline will be available by Q2-2014 with a view to a final version by Q4-2014.

The budgetary framework law (FRBSL, see 3.3.2), adopted in mid-February, has established the resource fund. Basic inflow rules and objectives of the resource fund are anchored in this law, while its governance structure, as well as more concrete inflow and outflow rules will be determined in a specific law, informed by technical assistance from the IMF.

3.4.3. Services and Regulated Professions

The necessary amendments to the legislation of specific sectors were adopted as a prior action in December 2013. The legislation on construction services, travel agencies and car rental services was adopted in late 2013. With regard to the law on tourism services on beaches, the President instructed then the Attorney General to refer to the Supreme Court the question whether the newly adopted law is repugnant to, or inconsistent with, the relevant provisions of EU law. The Cypriot authorities have confirmed their intention to re-submit to the House of Representatives a proposal for a legal framework on tourism services on beaches, provided that the Supreme Court rules that the law is consistent with EU. The Supreme Court's hearing is expected for mid-March.

The review of the requirements on the access and exercise of specific regulated professions was finalised, albeit with some delay. A first review of 20 priority professions took place before the review mission, while the Cypriot authorities have now finalised a second-stage review of the remaining professions (more than 100). Throughout the first and second reviews, the authorities have identified a number of requirements that are not justified or proportional, which need to be eliminated. The review is to be finalised by Q1-2014. The *full* elimination of requirements that are not justified or proportional has been back-loaded by two quarters (by Q3-2014), considering the on-going transparency exercise, which is applicable to all Member States. Finally, the bans on the advertising of veterinarians were abolished in late 2013.

3.4.4. Competition and Sectoral Regulatory Authorities

The Competition Authority and the Attorney General's legal services have proposed amendments to the legislation on the mergers and antitrust laws, including the power to conduct sector enquiries. Whilst the amendments on the antitrust law have been agreed, fine-tuning on the mergers law is still needed. The authorities have confirmed that all amendments will be adopted by end-March 2014.

The Office of the Auditor General plays an important role in ensuring that public money is spent responsibly. The authorities have agreed to ensure that the Office has sufficient financial means to carry out its functions. This reflects the additional tasks allocated to it by, *inter alia*, the FRBSL, privatisation and SOEs laws.

The National Regulatory Authorities (NRAs, mainly energy and telecoms) are subject to budget and staff approval from the Ministry of Finance. Although the National Regulatory Authorities have an agreement with the Ministry of Finance that it will not interfere with the regulatory parts of their budgets, their legal independence seems challenged, as staffing needs that had been previously earmarked in their budgets are not being covered. The government has however not judged it necessary to make any amendments to the existing legislation, while it has committed to continuously ensure that powers and independence of the NRAs are effective in accordance with the EU regulatory framework.

3.4.5. Housing Market and Immovable Property Regulation

The housing market and immovable property regulation reform is advancing, but further efforts are needed. The abolition of the requirements on the proof of legal interest for access to the Department of Land Surveys (DLS) data by monetary financial institutions was adopted in late 2013. Since then, only a small number of financial institutions have applied for a license that allows access to the DLS data. The Cypriot authorities have continued to publish data and review progress on the issuance of building and planning permits ([7]), certificates, title deeds and title deeds transfers, and related mortgage operations ([8]). The issuance of title deeds is progressing, but further efforts are required for the expeditious elimination of the backlog.

Following the IMF's technical assistance on the current insolvency and bankruptcy framework, the authorities are currently engaged in its detailed revision (see Box 3.1). The private auction procedures are an integral element of this framework. The authorities prepared a draft legislation for private auction that was shared with programme partners before the Q4-2013 deadline.

([7]) http://www.moi.gov.cy/moi/moi.nsf/All/93A053FB23A64321C2257BDD0039FFF9

([8]) http://www.moi.gov.cy/moi/DLS/dls.nsf/dmldata_en/dmldata_en?OpenDocument

However, in order to ensure full alignment and compliance with the comprehensive reform of the insolvency regime, the introduction of the private auction procedures are now foreseen to be adopted by end-June 2014. In compliance with the MoU, 12 new judges were appointed to the 4 district courts to expedite the processing of cases under commercial and immovable property laws.

3.4.6. Tourism

Tourism has the potential to drive growth in the Cypriot economy. The first progress report on the revised National Tourism Strategy will be completed by March this year; subsequent reports will be prepared every six months. Priorities should be set such to allow Cyprus to make better use of its comparative advantage in this sector. In line with the framework that was adopted by the Council of Ministers in October 2013, the hotels' legislation and relevant regulations were amended, though with a small delay. The amended legal framework makes it easier to combine different types of activity – tourism, residential and other uses – in a single development.

Air services agreements, on the basis of current and future needs, have been assessed and analysed in a strategy report. This will form the basis for further development of Cyprus' external aviation policy. The report provides also a solid starting point for a concrete action plan on air connectivity that is expected to be launched within the next three months.

4. PROGRAMME FINANCING AND DEBT SUSTAINABILITY

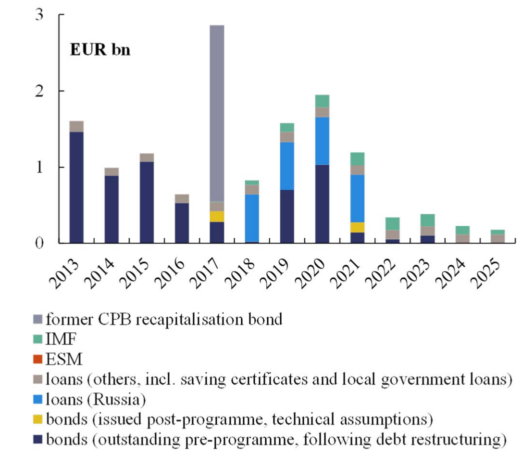
Out of the EUR 10bn of external assistance agreed on 25 March 2013, EUR 4.9bn have already been released. EUR 4.6bn have been disbursed by the ESM in three tranches, of which EUR 1.5bn for the recapitalisation of the cooperative banking sector in the form of ESM notes. The IMF has disbursed three tranches of EUR 86m each since the start of the programme.

Total financing needs for the period Q2-Q4 2013 were below the initial projection. Preliminary 2013 fiscal data suggest that total financing needs over the period Q2-Q4 2013, excluding the financial sector recapitalisation of EUR 1.5bn, amounted to about EUR 2.4bn (of which slightly less than EUR 0.8bn for fiscal needs and EUR 1.6bn for medium- and long-term debt redemptions).

Yields have further improved, mostly on bonds. Secondary market yields of Cyprus' outstanding foreign-law bonds have continued their downward path. Despite very thin markets, yields have fallen to below 8% in January 2014 compared to peaks in March or July 2013 exceeding 25%. However, the improvement in the T-Bill market is less pronounced. Yields remain high (around 4.7%) and the interest of domestic banks in rolling-over their T-Bill holdings is low. By the end of December 2013, the outstanding T-Bill stock decreased to EUR 750m compared to EUR 970m at the end of March 2013.

Financing needs during the first quarter of 2014 are assessed to be limited. Based on the updated macro-fiscal projections, total financing needs for 1Q2014 are estimated to amount to somewhat less than EUR 0.6bn, of which more than EUR 0.3bn for fiscal needs and around EUR 0.2bn for debt redemptions that took place already in January 2014. Estimated fiscal needs also include a buffer against the possibility that state guarantees for local government loans and loans of other borrowers might be called.

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.

Based on current assumptions, the second quarter financing needs might even be lower. Debt redemptions are small and – more importantly – central bank profits of pertaining to the fiscal year 2013 are expected to be disbursed in early April, based on an independent decision on profit distribution in line with the CBC's duties under the Treaties and the Statute. In the course of Q2 2014, the transfer of the right to issue coins from the central bank to the Ministry of Finance will provide EUR 100m.([9])

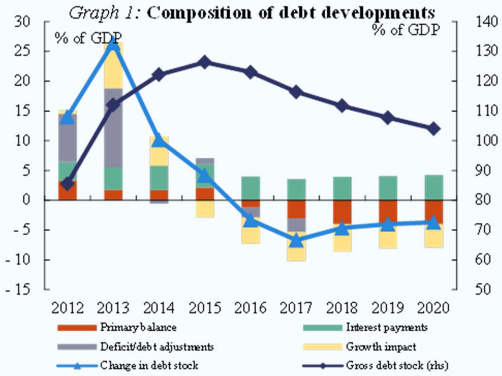
The successful third programme review would unlock the disbursement of the ESM's fourth tranche to meet debt service and fiscal needs arising until the end of the second quarter of 2014. In light of the government's still comfortable cash position and the limited financing needs, the third ESM disbursement, which would come on top of the IMF's disbursement of EUR 86m, will not exceed EUR 150m. At the end of Q1 2014, the government's cash balance is thus estimated to amount to around EUR 0.6bn.

([9]) 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 baseline public debt projections remain broadly unchanged. The changes to the macro-fiscal scenario and the subsequent changes to the financing needs have somewhat lowered the debt trajectory compared to the December 2013 DSA. The debt level is expected to peak in 2015 at 126% of GDP, and to decline to around 104% of GDP in 2020, driven notably by the economic recovery and the return to primary surpluses in outer years.

Graph 1: **Composition of debt developments**

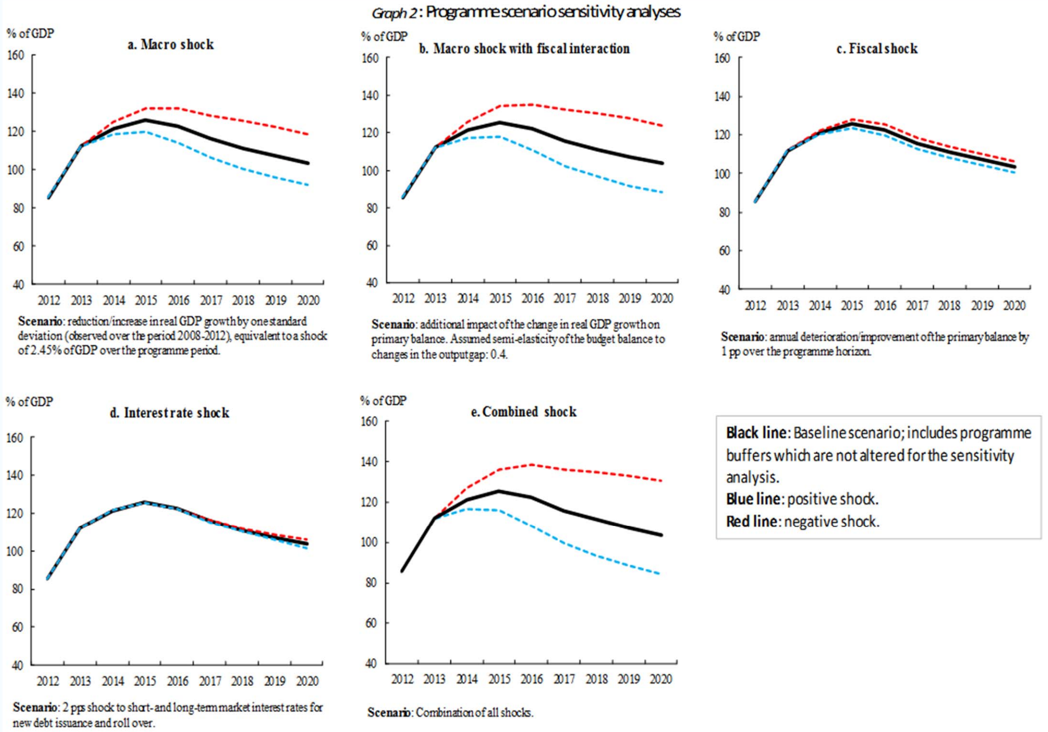


Source: Commission services.

The interest bill for 2013 is expected to be lower than projected during the second review. The downward revision is largely explained by the statistical treatment of the CPB bond yield, and favourable interest rate developments on variable interest loans. After the programme horizon, higher market interest rates compared to those charged on ESM and IMF loans will have an impact on the interest bill.

There are no critical changes to the composition of the deficit/debt adjustments. The EUR 1bn loan-asset swap between the CBC and the Ministry of Finance is scheduled to be concluded by Q2 2014 and therefore reduces debt in 2014. Deficit-debt adjustments also include the expected profit distribution by the CBC of about EUR 100m in both 2015 and 2016 in line with the duties under the Treaty and the Statute as well as the transfer of accumulated coin seigniorage income in 2014, amounting in total to EUR 0.3bn until 2016. Privatisation proceeds are projected to materialise over a three-year horizon from 2015 onwards, amounting to a total of EUR 1.4bn.

Graph 2: **Programme scenario sensitivity analyses**



(Continued on the next page)

Box (continued)

The debt trajectory continues to be vulnerable to macroeconomic and fiscal performance. As shown in Graph 2, a reduction (increase) in real GDP growth by one standard deviation (calculated over the period 2008-2012, equivalent to a shock of 2.44% of GDP) over the programme period would drive the debt trajectory sharply upwards (downwards) until 2020. Also the effect of a lower (higher) real GDP growth on primary balance would aggravate the impact of the shock.([1]) An isolated fiscal shock resulting in an annual improvement (deterioration) of the primary balance by 1 pp over the programme horizon would have a more limited effect on the debt-to-GDP ratio until 2020. The sensitivity of the debt trajectory to changes in higher (lower) short- and long-term market interest rates (by 2 pps, respectively, until 2020) is small.

([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.

Taking into account the fourth ESM and IMF disbursements, around EUR 4.9bn of programme funds remain available. Following the disbursement of the fourth tranche, including the cash-less second tranche for the recapitalisation of the financial sector, the ESM has disbursed more than half of its share of the agreed programme envelope of EUR 9bn. The IMF, spreading disbursements equally over the programme horizon and not participating in the recapitalisation of the financial sector, has disbursed a total of EUR 0.3bn, i.e. around one third of the funds allocated to the Cypriot adjustment programme.

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 the recapitalisation and restructuring ;
- 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 a 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 and potentially leading to lower-than-expected privatisation proceeds; and
- lack of success in regaining market access at a reasonable borrowing cost, once the programme is coming towards its conclusion.

ANNEX 1

Compliance Table

Table A1.1: Assessment of compliance: monitoring table

	Actions for the third review (to be completed by end January 2014)	Assessment - Comment
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 number of restrictions have already been relaxed or lifted according to the roadmap. By **end-January 2014** the CBC will study current market conditions, including through well-targeted surveys and focus groups, in order to ensure that further relaxations during the second stage of the roadmap remain consistent with financial stability.	**Compliant** for the implementation of the roadmap. **Partially compliant** - The market survey is ongoing and planned to be finalised by end-February.
1.2	Furthermore, the CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector. The CBC will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules. In this respect, the Cypriot authorities stand ready to consider to issue additional government guarantees in line with State aid rules, if and as needed to safeguard financial stability.	**Compliant** - The Parliamentary Committee adopted the issuance of government guarantees on 27 January.
1.3	The authorities will request domestic banks relying on central bank funding or receiving State aid to submit medium-term funding and capital plans to the CBC at the end of each quarter. These plans will be transmitted to the ECB, the EC, the ESM and the IMF. The Cooperative Central Bank and the Bank of Cyprus will submit their first plans together with their final restructuring plans. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector and reduction of borrowing from the central bank, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario are provided by the CBC, in coordination with the ECB.	**Compliant** - BoC in November 2013. Coops end-January 2014
	Regulation and supervision for banks and cooperative credit institutions	
1.6	A new definition of non-performing loans has entered into force on 1 July 2013. The time series for non-performing loans will be published **by end-December 2013**, including historical observations reaching as far back as possible.	**Compliant with delay** (delay due to missing data for BoC, the biggest bank and in heavy restructuring) - The series was published in end-January 2014.
1.7	The CBC will also create a central credit register listing all borrowers and beneficial owners, from both commercial banks and cooperative credit institutions, to enable these institutions to check new loan applications against the register. The credit register will identify the borrowers who are or were in arrears and will help monitor credit risk and large exposures. Following the establishment of the legal framework for the credit register **by mid-December 2013**, the central credit register will be operational **by end-September 2014**.	**Compliant**
1.8	After analysis of the results from the due diligence exercise and taking into account best practices in the implementation of the International Financial Reporting Standards, the CBC reviewed its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Taking into account the conclusions of this review, the CBC will introduce regulatory amendments, with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will be finalised **by 31 December 2013** and will become effective for the publication of the 2013 financial statement concerning disclosure requirements. The CBC will require banks to submit **by end-February 2014** an action plan for the full implementation of these guidelines starting from their 2014 annual accounts.	**Compliant** for the review (October 2013) and loan orignation directive (4 December 2013). **Non-compliant** for provisioning and disclosure requirements (deadline shifted from December 2013 to February 2014 in new MoU) - The banks are late with their action plan (deadline shifted from February to March in new MoU).
1.10	The CBC will issue **by end-November 2013** mandatory disclosure requirements to banks submitting restructuring plans. Starting with reference date **end-December 2013**, these banks will be required to publish quarterly reports describing the progress with the implementation of the restructuring plans. These reports will contain a set of key performance indicators to be developed by the CBC and communicated to the banks, in advance of the forthcoming quarterly report.	**Compliant** for CBC instruction - The preparation of the quarterly (external publication) publication is ongoing.
1.13	**By end-January 2014**, the CBC will complete its annual supervisory program detailing its main objectives and activities for 2014, including a tentative timeframe to gradually resume regular on-site inspection of commercial and cooperative banks (which will also include review and implementation of provisioning requirements), staffing, cost and budget assigned to each activity, and main training programs. The CBC will clarify the allocation of tasks and responsibilities in the governance structure of the CBC to effectively carry out the supervisory tasks of the central bank in line with SSM requirements. Also **by end-January 2014**, the CBC will require banks to submit the 2014 work program of their internal audit departments.	**Compliant.**
1.16	The authorities will, in consultation with EC, ECB and IMF and informing the ESM, review the effectiveness of the Resolution Authority, including its composition and governance, with a view to adopting legislative and operational changes **by end-January 2014**.	**Non-compliant** (difficult governance issue). Deadline shifted from January to March in new MoU.
	Monitoring of corporate and household indebtedness	
1.17	The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. Data from surveys will be used until the credit register becomes fully operational. The Financial Stability Report, to be published on a yearly basis **as of December 2013**, will include an extended analysis on corporate and household indebtedness. The first quarterly monitoring report has been received in the beginning of July 2013 and its scope and content will be further enhanced.	**Non-compliant** (due to missing data for BoC, the biggest bank and in heavy restructuring) - deadline for publication of Financial Stability Report is moved from December 2013 to April 2014 in new MoU.
	· In line with the framework for the management of arrears, and in accordance with the strategies they are required to develop, banks will submit to the CBC their revised strategies (including pre-packaged programs, and general policies to deal with small and large troubled borrowers, respectively) and plans for their internal implementation **by end-January 2014**. **By end-March 2014**, the CBC, with external technical support, will complete an assessment of the operational capacity of the banks' loan workout units to implement their plans. Banks will also be required to report quarterly on restructuring progress and management of NPLs, beginning **end-March 2014**, using specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.), which will be determined **by end-November 2013** by the CBC in consultation with EC, ECB and IMF and informing ESM.	**Compliant** for submission- banks submitted arrears management implementation plans. **Compliant with delay** for performance indicators - The CBC approved in January 2013 the performance indicators for NPL management to be used in the quarterly reporting.
	· **By end-November 2013**, the CBC will publish supplementary information on the Code of Conduct (CoC) in order to further enhance public awareness and facilitate its implementation. **By end-May 2014** the CBC will complete a second round of inspections to verify banks' compliance with the CoC and impose sanctions as needed.	**Compliant.**
	· Building on recent work to identify and address impediments for private debt restructuring, **by end-December 2013** the authorities will perform a legal review of the relevant legislation with technical assistance as needed. On this basis, legislation will be passed to expand the role of the Financial Ombudsman **by end-January 2014** to achieve fair debt restructuring, while ensuring adequate resources for the service given the expected case load.	**Compliant** (legal review) - **Non-compliant** for role of Financial Ombudsman as it is a difficult policy issue (end-January deadline is shifted to March in new MoU).
	Increasing financial transparency	
1.19	The Cypriot authorities are committed to further enhancing the AML framework and to ensuring its implementation, under the timetable set out in the agreed AML Action Plan (see Annex 2) and in particular by taking the following measures:	

(Continued on the next page)

Table (continued)

	· Strengthen preventive measures of obliged entities with regard to customer due diligence, use of introduced business and reporting of suspicious transactions (Action Plan – sections 1, 2 and 3).	**Compliant with delay** - CBC and the other supervisory authorities issued the required guidances and circular with delay, in early Feb. 2014.
	· Ensure transparency and timely access to information on beneficial ownership of trusts (Action Plan – section 4). The programme partners take note of the Cypriot authorities' commitment to establish trust registers with the supervisory authorities (Action Plan – section 4.3.1)	**Compliant** - CBC published the fourth edition of the AML Directive in early December 2013, while the third party review of the Companies' Registrar was delivered by end-December 2013.
	· The supervisory competent authorities will review their off-site and on-site supervisory procedures and further implement a risk-based approach to AML supervision for financial and non-financial (lawyers, accountants and TCSPs) institutions (Action Plan – sections 5 and 6).	**Partially compliant** - Six out of seven Action Plan commitments due to be completed in Q4 201/Jan. 2013 have been complied with. One commitment was partially compliant as the CBC followed up on the cases revelead by Deloitte and is about to initiate the procedure for the appropriate enforcement actions . However, the procedure is expected to be finalised by Q1-2014.
	On a quarterly basis, in the context of the programme review starting **Q4 2013**, the supervisory competent authorities will, on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.	**Compliant** - The programme partners reviewed a sample of the enforcement actions that competent supervisory authorities have made.
	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.	**Compliant** - MOKAS provided, within the specified deadline, the programme partners with the breakdown of requests made and received, including spontaneous disseminations, to and by foreign FIUs. The annual data are also available in MOKAS' annual report for 2012.
1.B.	**RECAPITALISATION AND RESTRUCTURING**	
	Restoring adequate capital buffers	
1.20	The CBC will increase the minimum Core Tier 1 capital ratio from the present level of 8% to 9% **by end-December 2013**. By the same date, the CBC will assess the impact of the entry into force of the Common Equity Tier 1 capital definition laid down in the CRDIV and CRR. On the basis of that assessment the CBC will define, by **end-February 2014** and in consultation with the EC, ECB, IMF and informing ESM, the minimum capital requirements taking into account the parameters of the balance sheet assessment and the stress test of the Single Supervisory Mechanism. In no circumstances will this revision lead to a decrease in the minimum amount of capital held by the banks. In the interim period until the revised requirements enter into force, the CBC will prohibit any release of capital by the banks which were found in the PIMCO exercise to face a capital shortfall.	**Compliant** for increase of CT1 ratio - **Non-compliant** for calibration of new minimum capital requirement under CRR/CRDIV as this is a complex policy issues (February deadline is shifted to March in the new MoU).
	Management of legacy Laiki	
1.21	By **end-January 2014**, the Resolution Authority will present a detailed roadmap for the full disposal of legacy Laiki's assets, while maximizing the value for the creditors. Pending disposal of legacy Laiki's shares in BoC and to ensure their adequate management, the Resolution Authority will instruct the Special Administrator to entrust **by end-January 2014,** the voting rights of these shares to a well-recognised and independent consulting or auditing firm(s) or an international institution(s).	**Compliant** for roadmap - **Non-compliant** for entrusting voting rights of Laiki's shares in BoC as this is a complex policy issue (January deadline is shifted to March in new MoU).
	Restructuring of Bank of Cyprus	
1.22	The CBC will instruct BoC to publish selected features of its restructuring plan before end-2013. On the basis of the plan, **prior to the granting of the third disbursement of financial assistance**, the CBC will approve BoC's proposed set of quarterly targets for the next 12 months for key financial and operational indicators in critical areas and the terms of a quarterly report on progress relative to above-mentioned targets. This report will be submitted to the CBC **by end-March 2014**. A CBC team has been appointed to closely monitor BoC's compliance with the above-mentioned targets, assess any deviations, and define remedial actions if warranted. The report of the team on its main activities will be submitted quarterly to the CBC Board, starting with **end-2013**.	**Compliant** - The preparation of the quarterly (internal) publication is ongoing.
	Restructuring and recapitalisation of Hellenic Bank	
	Restructuring and recapitalisation of cooperative credit institutions	
1.25	To this end the restructuring plan for the cooperative sector will be submitted to the EC **by end-January 2014**. The terms and remuneration of the public support will comply with the EU State aid rules with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process, which will be scrutinised by an external monitoring trustee.	**Compliant.**
1.27	Upon completion of each legal merger of affiliated credit cooperative institutions, the Cooperative Central Bank will inject sufficient capital into them to take a 99% stake and ensure compliance with the 4% individual core Tier 1 ratio. These operations will be finalised by end-March 2014, with the view to speed up the appointment of the Board of Directors of each institution and the implementation of the new governance guidelines. At the consolidated level, the sector is still subject to the general minimum core tier 1 capital requirement of 9%.	**Compliant** - The merger process is ongoing.
1.29	With the view to decisively restructure the sector, the CBC has required the new board of the CCB to publish, **by end-November 2013**, a roadmap agreed with the CBC specifying key interim actions for the next three months, including: (i) the appointment of the new CEO, (ii) measures to bolster the independence and qualification of CCI Boards, (iii) actions to retain customers, (iv) measures to impede further asset deterioration, and (v) measures to prepare the transfer of NPLs to specialized units within the sector.	**Compliant.**
1.30	As part of the implementation of the restructuring plan, the Cooperative Central Bank will leverage on external expertise, in particular in the areas of arrears management and corporate restructuring. In addition, it will ensure that the recruitment of executive and senior management of the CCB and CCIs take place in line with international best practices. The selection criteria will be established by the Cooperative Central Bank and consulted by the Ministry of Finance with the EC, ECB, ESM and IMF. Compliance with the requirements of this paragraph will be assessed in the quarterly progress reports of the Cooperative Central Bank on the implementation of the restructuring plan.	**Compliant** - The recruitment process is ongoing.
2.	**FISCAL POLICY**	
	Fiscal policy in 2013	
2.1	2.1. The Cypriot authorities will achieve a budgetary outcome in line with the Council Recommendation of 16 May 2013, with a view to bringing an end to the situation of an excessive government deficit, taking into account the Commission's assessment of effective action of 6 September 2013. To this end, the Cypriot authorities will rigorously implement the 2013 Budget Law (as amended) and the agreed consolidation measures, amounting to at least EUR 351 million.	**Compliant** - The general government budget execution data is estimated to show a headline deficit of 5.5% of GDP, significantly better than recommended by the Council on 16 May (6.5% of GDP). The amount of implemented measures is assessed to exceed EUR 351 million.
	Fiscal Policy in 2014	
	Based on programme's current macroeconomic and fiscal projection and reflecting the draft 2014 Budget, the Cypriot authorities will achieve a deficit of the general government primary balance of EUR 483 million (3.1% of GDP) in 2014 , respecting the EDP recommendation of a headline deficit of no more than 8.4% in 2014. To this end, Cyprus will fully implement permanent measures for 2014, amounting to at least EUR 270 million in 2014 (Annex 1). The total amount of fiscal policy measures to underpin the 2014 budgetary targets, will be included in the 2014 Budget Law.	**Compliant** - The 2014 Budget Law has been aligned to the macro- and fiscal projections agreed during the 2nd review mission and was approved by the House of Representatives on 19 December 2013.
3.	**FISCAL STRUCTURAL MEASURES**	
3.1	**Pension Reforms**	

(Continued on the next page)

Table (continued)

3.1 The Cypriot authorities have implemented/agreed to implement the following measures:	
3.1 • ensure that all of the measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees by Q4-2013, to enter into force on 1 January 2014.	**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 b) restructure public hospitals according to the action plan as approved by the Council of Ministers at end-June 2013 and aim at full implementation by Q2-2015;	**Compliant**
3.2 c) taking into account the results of the updated actuarial study and after consultation with the programme partners, implement without further delay a National Health System (NHS), to be in place by end-2015, ensuring its financial sustainability while providing universal coverage and considering the possibility of implementation in stages by end-2015. To this end, the government will present its detailed plan **by January 2014**;	**Non-compliant** - Submission of roadmap shifted to April; full NHS implementation shifted to mid-2016 with phase in mid-2015; overall high implementation risks.
3.2 f) review income thresholds for free public health care in comparison to to the eligibility criteria for social assistance while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures by Q4 2013.	**Non-compliant** - Submission of report shifted to Q2-2014 to align with review of guaranteed minimum income scheme.
3.2 h) introduce a coherent regulatory framework for pricing and reimbursement of goods and services based on the actual level of costs incurred in accordance with Article 7 of Directive 2011/24/EU of the European Parliament and of the Council of 9 March 2011. An interim report will be ready by Q4-2013;	**Compliant**
3.2 i) continue to code inpatient cases by the system of diagnosis-related groups (DRGs) achieving full coding of all inpatient cases in public hospitals by January 2014; and,	**Compliant**
3.2 j) (i) adjust back by half an hour the regular starting and ending working times in the Health Service (to 7:30/8:30 – 15:00/16:00) and further reduce overtime and related costs to the wage bill, by making working time more flexible so as to cover - as a minimum - service hours from 7:00 to 19:00 under regular working time (see 3.10.).	**Compliant**
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 high-level Fiscal Responsibility and Budget System Law (FRBSL), which will be adopted by Q4-2013 (including an implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance);	**Compliant with delay** - The establishment of the Fiscal Council is embedded in the FRBSL, the adoption of which was set as a prior action in the updated MoU. The deadline for the adoption of implementing text and the MoU on exchanges of information moved to mid-March 2014. The FRBSL was adopted by the House on February 13; the implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance still pends.
3.3 Enact a FRBSL applicable to the entire general government sector. The umbrella law will encompass, inter alia, macro-fiscal policy-making, and budget formulation, approval and execution. It will take on-board and deepen existing provisions transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and implementing the Two-Pack EU Regulation 473/2013 and the Fiscal Compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts (on budget documentation and statistics) ensuring that adopted measures are fully effective by Q4-2013.	**Compliant with delay** - The FRBSL was adopted by the Council of Ministers in December 2013; the House of Representatives adopted the FRBSL on February 13. In the updated MoU, adoption of the FRBSL by the HoR was set as 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 Q4-2013, and of the general government by Q1-2014. All outstanding commitments should be timely and properly recorded and reported in the accounting system. • Improve the monitoring of government guarantess through a risk assessment analysis. To this end, amend the Public Debt Management Law, by end-December 2013, in order to ensure a proper risk assessment of the outstanding stock of government guarantees and ensure appropriate human resources to that end.	**Compliant** - the authorities set requirments for pre-commitment controls applied to the central government in December 2013. To improve the monitoring of government guarantess, the law of the PDMO was amended in December 2013.
3.4 Public private partnerships (PPPs)	
3.4 The Cypriot authorities will:	
3.4 • update the inventory of PPPs, including contingent liabilities, as of 1 January 2014, and include it both in the annual budget law and in the annual financial report;	**Partially compliant** - January not being a deadline, as process gets started as of then. Data request sent to line ministries; full update to be ready mid-March 2014.
3.4 • put in place an adequate legal and institutional framework for public investment projects, including PPPs, to assess fiscal risks and to monitor their execution through: (i) establishing an effective gateway process that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Minister of Finance and his services (i.e. the Ministry, Planning Bureau and Treasury) in reviewing and approving public investment projects and in particular PPPs at critical points in the gateway process; and (iii) developing financial reporting and accounting rules that ensure timely and transparent communication of public investment project and PPP related obligations. The legal basis for managing public investment and specifically PPPs will be included in the FRBSL, which will enter into force on 1 January 2014; and	**Compliant with delay** - The FRBSL was adopted by the Council of Ministers in December 2013; the House of Representatives adopted the FRBSL on February 13. In the updated MoU, adoption of the FRBSL by the HoR was set as prior action.
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 • by Q4-2013, the Council of Ministers will examine a list of SOEs to be restructured or liquidated;	**Partially compliant** - The list is not complete, as it lacks concrete timelines for the SOEs under internal review. New deadline for submission of plan with detailed timelines for SOEs under internal review by Q2-2014.
3.5 • the Cypriot authorities will complete the full inventory of real estate and land assets by Q4-2013, specifying which ones are ready for privatisation; and	**Compliant**
3.5 • submit to the House of Representatives a draft law to regulate the creation and the functioning of SOEs at the central and local levels and enhance the monitoring powers of the central administration, including reporting on SOEs in the context of the annual budgetary procedure by Q4-2013. No additional SOEs will be created until the legal framework has been adopted	**Non-compliant** - the adoption of the law was expected to be adopted by the end of February.
3.6 • The privatisation plan will be adopted by the Council of Ministers prior to the granting of the third disbursement of financial assistance, after consultation with programme partners, and will include asset-specific timelines and concrete intermediate steps ;	**Compliant**
3.6 • In parallel, the specific legal and institutional framework for the privatisation process will be implemented by January 2014, after consultation with programme partners;	**Compliant** - the adoption of the privatisation law was set as a prior action and was endorsed by the House of Representatives on 4 March.
3.7 Revenue administration, tax compliance and international tax cooperation	

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3.7 The Cypriot authorities will reform the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection capacity and the fight against tax fraud and evasion, with a view to increasing fiscal revenue. The reform will comprise of a programme of short-term measures to enhance compliance, efficiency and effectiveness as well as a comprehensive long-term reform covering risk management and the establishment of a new integrated function-based tax administration structure, integrating the existing IRD and VAT services. The short-term programme will be implemented by Q4-2013 and include the following sets of measures:	
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** - After a long procedure of legal vetting, the Cypriot legal services have voiced concerns. To address these the bill has been redrafted and will be submitted to the HoR shortly. Deadline shifted to Q1-2014.
3.7 (2) harmonising the legislation among tax types so that not paying taxes is a criminal offense regardless of the type of tax and ensure tax fraud is prosecuted as a criminal offense; and	**Non-Compliant** - After a long procedure of legal vetting, the Cypriot legal services have voiced concerns. To address these the bill has been redrafted and will be submitted to the HoR shortly. Deadline shifted to Q1-2014.
3.7 (3) strengthening powers by the tax authorities to ensure payment of outstanding tax obligations, e.g. by having authority to seize corporate assets, prohibiting alienation or use of assets, including property and bank accounts, by the taxpayer;	**Non-Compliant** -After a long procedure of legal vetting, the Cypriot legal services have voiced constitutionality concerns. The bills and seizing procedures are being redrafted to address these. Submission to the HoR is expected within the month of March. Deadline shifted to Q1-2014.
3.7 (4) ensuring staff mobility between different tax administration entities in order to ensure appropriate staffing of entities with high revenue collection capacities;	**Compliant** -However, in practice, opportunities for staff mobility within the tax administration entities are slim at the moment as staffing needs have increased in all entities.
3.7 (5) optimising the use of IT systems in the tax administration based on: (i) facilitating information exchange between tax administration entities and with other relevant authorities, taking into account legal provisions for data protection; and (ii) enhancing the use of e-filling of tax returns and e-payment (e.g. by allowing payment through bank transfers);	**Compliant** - (i) Government-wide data exchange has been made possible. Work to further facilitate it in practice is on-going. (ii) Payment modalities have been enhanced. Further work is on-going to allow for full e-payment still within 2014.
3.7 (6) 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;	**Non-Compliant** - After a long procedure of legal vetting, the bill is now expected to be submitted to the HoR shortly. Deadline shifted to Q1-2014.
3.7 (7) deciding on a joint audit programme for large taxpayers, to be conducted in 2014;	**Compliant** -The programme has been submitted on time. It includes selection criteria and an explanation of joint (income taxes and VAT) risks. First audits have been initiated.
3.7 (8) developing a joint work programme for conducting targeted audits and enhancing voluntary compliance of known high-risk groups; and	**Compliant** - The programme has been submitted on time. It includes selection criteria and an explanation of joint risks. First audits have been initiated. The programme needs more work on the voluntary compliance element. TA on the subject is being provided.
3.7 (9) conduct an independent formal review to recommend changes to legislation to determine the appropriate level of discretion available to the tax administration management and how it is exercised.	**Non-Compliant** - The review has been conducted by an external expert. A report was sent to the authorites for comments and its finalisation is expected within February. Deadline shifted to Q1-2014.
3.7 (10) A comprehensive compliance strategy that will be put in place by Q2-2015. The strategy will be firmly based on analytical work on risk identification and analysis and on an evaluation of different risk treatment strategies. Work for the risk identification and analysis will begin in Q4-2013.	**Compliant** - Work on the risk analysis has started, inter alia in the context of creating the joint programmes (see (7), (8) above). TA is being provided and work is planned to further progress in the next months.
3.7 (11) 1. develop a reform plan that reflects the recommendations of the TA received in February 2013 and further recommendations derived from future TA. The reform plan will be agreed with program partners and approved by the government by Q4-2013; and	**Compliant with delay** - A comprehensive plan centred around the creation of a function-based integrated tax agency but also covering all aspects of tax administration has been agreed with programme partners approved by the government in early January.
3.8 (1) fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation[3] 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; Footnote 3: The Cypriot authorities have submitted Law N. 205(I)/2012 (enacted on 28 December 2012), transposing	**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.
3.8 (2) ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States; and	**Compliant** - See under (3) below. Further, the authorities have launched a large-scale examination to compare the information they received with information reported by the respective taxpayers.
3.8 (3) improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer; and	**Compliant** - Wide access to databases has been granted. The establishment of the integrated tax agency will further enhance the capacity to follow-up on tax information obtained.
3.8 (4) implement the recommendations put forward in the in-depth review of Cyprus' legal and regulatory framework under the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and commit to address any shortcomings to be identified in the forthcoming evaluation of implementation issues	**Compliant** - The recommendations of the Phase I review have been implemented. Work on the Phase II review is underway. The authorities agreed to submit an action plan by end-February.
3.9 Immovable Property Tax Reform	
3.9 • a study on the scope of consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope of shifting revenues from transaction fees and taxes to recurrent taxation. The tender procedure and the assignment of the study to the successful bidder shall be concluded by Q4-2013.	**Compliant with delay** - The tender procedure was finalised end-January 2014.
3.10 Public Administration Reform	
3.10 The public sector represents a large share of public expenditures in Cyprus. To ensure an efficient use of government resources, while delivering a quality service to the population; the Cypriot authorities will :	
3.10 By December 2013, adjust back by half an hour the regular starting and ending working times, to 7:30 - 8:30 and to 15:00 – 16:00and further reduce overtime and related costs to the public sector wage bill, by making working time more flexible so as to cover - as a minimum - service hours from 7:00 until 17:00 in the entire public sector and service hours from 7:00 to 19:00 for public sector services with extended operating hours (including, but not limited to, healthcare and security), under regular working time (see 3.2).	**Compliant** - Adjustment made in December 2013.
3.11 Welfare System*(Reforms must be consistent with the fiscal targets defined in this MoU)*	
3.11 The Cypriot authorities will ensure that the reform will be achieved through:	
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 (Q4-2013);	**Partially compliant** - The authorities finalised their work on the definition and level of the minimum consumption basket and progressed on their work on the GMI. The final definition, level and costing of the GMI still pends.

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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 (Q4-2013);	**Non-compliant** - The authorities initiated their work on refining the means-testing mechanism, primarily on the child and education benefits. The finalisation of the work on the criteria and mechanism for the means-testing mechanism of all benefits schemes still pends.
3.11 The reformed welfare system must be consistent with the fiscal targets defined in this MoU	
4. LABOUR MARKET	
4.1 Cost of Living Adjustment (COLA) of wages and salaries	
4.1 A tripartite agreement will be pursued with social partners for the application of the reformed system in the private sector [by end-2013]. Furthermore, based on the current economic outlook, wage and salary indexation is foreseen not to be applied in the private sector until 2014.	**Partly compliant** -negotiations still on-going. Preliminary agreement reached on 2 out of 3 elements of the reform.
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 prepare detailed policy proposals to address the identified shortcomings and weaknesses, to be submitted to the programme partners by end-2013 for review and consultation. These will include:	**Compliant**
4.4 • the development of a coherent methodology for the continuous monitoring and evaluation of activation programmes, to be applied consistently across the different schemes, thereby enabling the assessment of their performance and effectiveness;	**Compliant**
4.4 • the development of the appropriate IT infrastructure so as to automatize better and more comprehensive collection (see 3.11), processing and exchange of data across the various schemes as well as with the administration of social welfare services;	**Compliant**
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**
4.4 • enhancing staff mobility to support the administrative capacity of the public employment services so as to enable them to better respond to the increased demand for their services; and	**Compliant**
4.4 • reviewing and enhancing the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed.	**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 Q4-2013 a draft action plan for the implementation of measures envisaged for support under the Youth Employment Initiative, in line with the conclusions of the European Council of June 2013. The design, management and implementation of these measures targeted to youth shall be well integrated within the broader system of activation policies (section 4.3) and be coherent with the reform of the social welfare system (section 3.11) and the agreed budgetary targets.	**Compliant**
5. GOODS AND SERVICES MARKET	
5.1 Services Directive: Sector-specific legislation	
5.2 Reform of Regulated professsions	
The authorities will:	
5.2 • complete the comprehensive review of the requirements affecting access and exercise of all regulated professions by Q4-2013. Following completion of the review, the requirements that are not justified or proportional will be eliminated by Q1-2014; and	**Partially compliant** - Deadline shifted to Q1-2014 for the completion of the final review.
5.2 • eliminate any existing total bans on the use of a form of commercial communication (advertising) in the veterinarians profession, as required by the Services Directive by November 2013.	**Compliant**
5.3 Competition and sectoral regulatory authorities	
The Cypriot authorities will	
5.3 The Cypriot authorities will strengthen the independence and the effectiveness of the Commission for the Protection of Competition (CPC) by:	
• guaranteeing sufficient and stable financial means and qualified personnel to ensure its effective and sustained operation by Q4-2013;	**Partially compliant** - PAPD report incomplete and not yet implemented.
• enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers and antitrust, including the power to conduct sector enquiries by Q4-2013;	**Non-compliant** - Deadline shifted to end-March.
• promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition by Q4-2013;	**Partially compliant** - CPC has developed a plan and has requested technical assistance to help implement it.
5.3 The Cypriot authorities will increase competition by ensuring that powers and independence of the National Regulatory Authorities (NRAs) remain effective, by enabling them to have the necessary resources in line with their duties and in accordance with the EU Regulatory Framework. Any necessary legislative amendments will be adopted by Q4-2013.	**Compliant** - No legal amendments were identified as necessary, but follow-up has been agreed.
5.4 Housing market and immovable property regulation	
5.4 Any requirements on the proof of legal interest for access to these data by these bodies shall be abolished prior to the granting of the third disbursement of financial assistance;	**Compliant** - The legal amendment was enacted in early December 2013.
5.4 • amend the procedure on the forced sale of mortgaged property (see 1.5) to allow for private auctions by amending the relevant legislation and rules in relation to the forced sales of mortgaged property either by adopting similar principles of the rules for immovable property recovery in bankruptcy regulations or by enacting new legislation by Q4-2013; and	**Non-Compliant** - This commitment is now incorporated in the Insolvency Framework part of the revised MoU (article 1.31). A new deadline, aligned with the insolvency framewrok timline, was agreed.
5.4 • improve the pace of court case handling, in order to eliminate court backlogs by Q1-2016 and provide for specialized judges by Q4-2013, with instructions for the expeditious processing of cases under commercial and immovable property laws.	**Compliant** - Three judges per disctrict (12 in total) were appointed with instructions to assign priority to cases under commercial and immovable property law.
5.5 Tourism	
5.5 Since tourism is one of Cyprus' largest economic sectors and a potential driver of future growth and employment, a reinvigoration of its competitiveness is necessary. To that end, the Cypriot authorities will:	
5.5 • present a progress report on the implementation of the action plan twice per year (every March and September until the end of the programme), starting in Q4-2013, including an assessment of its implementation based on performance indicators.	**Compliant** - The structure and content of the report (to be submitted in March) have been agreed.
5.5 • amend the current hotel and and other relevant legislation (eg. the immovable property law and town planning policies), in order to facilitate mixed-use developments, by Q4-2013;	**Compliant with delay** - The legislative amendments were adopted end-January 2014.

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5.5 Provide a report on the analysis and assessment of concrete needs based on the existing and the future air services agreements by Q4-2013.	**Compliant with delay** - The report was submitted mid-January 2014.
5.6 Energy	
The Cypriot authorities will:	
5.6 • formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy, constitutes a living document to be developed under the full authority of the Cypriot Government. It should include at least the following three key elements, which should be presented to the programme partners for consultation according to the timeline specified below:	
5.6 1. a roll-out plan for the infrastructure required for the exploitation of natural gas, taking into account possible technical and commercial uncertainties and risks. The plan should cover: the required investments, associated costs, financing sources and methods, related ownership structure; related major planning risks and bottlenecks; and a projection of the revenue streams over time; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues; updated version by Q4-2013.	**Compliant:** The authorities have submitted an updated and revised roll-out plan. The plan does not yet sufficiently cover financing sources and methods and the related ownership structure, but the authorities have agreed to provide regular updates in the future as the information situation (notably on the amount of gas) is still dynamic.
5.6 2. a comprehensive outline of the regulatory regime (CERA) and market organisation for the restructured energy sector, with a view to introducing open, transparent, competitive energy markets, and taking explicitly into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, and the EU targets for energy efficiency, renewable energy and carbon emissions.	
5.6 Specifically, the outline should include the following elements: a description of the envisaged institutional framework (the various government and private actors with their respective functions); the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the sequence and envisaged timing of the major actions and changes; the potential for setting-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; and full unbundling of gas suppliers and customers, in particular electricity companies; by Q4 2013, with a view to a final outline by Q2 2014; and	**Compliant** - A first version, covering the institutional framework and the regulatory regimes of the gas and electricity market, was received and discussed during the mission. The situation is complex and dynamic. In addition, a number of background workstreams to feed into the outline need to be finalised. A more advanced version is expected for Q2-2014.
6. TECHNICAL ASSISTANCE	
6.1 Given the nature of the structural challenges Cyprus is facing, including a lack of specific skills in some areas and scarcity of resources, the Cypriot authorities will provide an updated request for technical assistance needs during the programme period, including the on-going technical assistance projects by end-2013. This request will identify and specify the areas of technical assistance or advisory services, which the Cypriot authorities consider essential for the implementation of the MoU and where they intend to seek such technical assistance services, in coordination with the programme partners. All technical assistance provided by the European Commission, other than technical assistance provided directly under the Structural and other EU funds, will be coordinated by the Support Group for Cyprus.	**Compliant**

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	-6.0	-4.8	0.9	1.9
Domestic demand incl. inventories	1.9	-1.4	-4.1	-10.5	-6.8	0.0	1.3
Total consumption expenditure	2.6	3.0	0.6	-5.7	-6.3	0.3	2.5
Private consumption expenditure	1.5	1.3	-2.5	-7.5	-6.3	0.7	2.3
Government consumption expenditure	1.0	-0.2	-3.1	-6.0	-1.5	-2.7	-3.7
Gross fixed capital formation	-4.9	-8.7	-19.6	-24.0	-18.1	1.3	3.9
Exports of goods and services	3.9	4.5	-2.7	-4.8	-2.7	1.9	2.8
Imports of goods and services	4.8	-0.1	-6.4	-14.7	-7.2	0.2	1.6
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	0.2	-0.8	-5.6	-9.5	-6.6	0.1	1.3
Foreign trade	-0.6	1.9	1.9	4.7	1.9	0.8	0.6
Changes in inventories	1.8	-0.7	1.3	-1.2	0.0	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	1.9	2.8	1.9	-2.3	0.6	1.5	1.8
HICP	2.6	3.5	3.1	0.4	0.4	1.4	1.7
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	6.3	7.9	11.9	16.0	19.2	18.4	17.0
Total employment	-0.2	0.4	-4.2	-5.7	-4.4	0.8	1.7
Compensation per employee	2.6	2.5	-0.9	-5.0	-3.0	0.9	1.5
Labour productivity	1.5	0.0	1.8	-3.0	-0.5	-0.1	-0.1
Unit labor costs	1.1	2.5	-2.7	-2.1	-2.5	1.0	1.8
Public finance			*(percent of GDP)*				
General government balance	-5.3	-6.3	-6.3	-5.5	-5.8	-6.1	-2.8
Total revenue	40.8	39.6	38.9	40.6	41.5	40.2	40.7
Total expenditure	46.2	46.0	45.3	46.1	47.3	46.3	43.5
General government primary balance	-3.0	-3.9	-3.2	-1.8	-1.8	-2.1	1.2
Gross debt	61.3	71.5	85.5	112.0	121.5	125.8	122.5
Balance of payments			*(percent of GDP)*				
Current external balance	-9.0	-4.5	-8.4	-1.7	0.0	0.4	0.6
Ext. bal. Goods and services	-6.2	-4.3	-2.6	1.7	3.8	4.5	5.0
Exports goods and services	42.0	43.3	43.1	44.9	46.1	46.6	46.9
Imports goods and services	48.2	47.6	45.7	43.1	42.3	42.1	41.9
Balance of services	20.6	19.9	18.9	20.1	20.7	21.2	21.6
Balance of goods	-26.8	-24.2	-21.5	-18.3	-16.9	-16.7	-16.6
Balance of primay income	-3.1	0.7	-4.2	-3.1	-4.6	-3.3	-3.4
Net current transfers	0.3	-0.9	-1.6	-0.4	0.7	-0.9	-1.0
Memorandum item			*(EUR bn)*				
Nominal GDP	17.4	18.0	17.9	16.4	15.7	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	-2.5	-7.5	-6.3	0.7	2.3
2. Government consumption expenditure	1.0	-0.2	-3.1	-6.0	-1.5	-2.7	-3.7
3. Gross fixed capital formation	-4.9	-8.7	-19.6	-24.0	-18.1	1.3	3.9
4. Domestic demand excl. inventories	0.2	-0.8	-5.4	-9.5	-6.7	0.1	1.3
5. Changes in inventories (contr. to growth)	1.8	-0.7	1.3	-1.2	0.0	0.0	0.0
6. Domestic demand incl. inventories	1.9	-1.4	-4.1	-10.5	-6.8	0.0	1.3
7. Exports of goods and services	3.9	4.5	-2.7	-4.8	-2.7	1.9	2.8
7a. - of which goods	12.2	22.6	1.0	0.5	0.5	1.0	1.6
7b. - of which services	2.4	1.1	-3.5	-6.0	-3.5	2.2	3.1
8. Final demand	2.5	0.2	-3.7	-8.8	-5.5	0.7	1.8
9. Imports of goods and services	4.8	-0.1	-6.4	-14.7	-7.2	0.2	1.6
9a. - of which goods	7.3	-3.6	-10.0	-17.0	-8.6	0.2	1.6
9b. - of which services	-0.4	7.7	0.9	-10.5	-4.8	0.2	1.6
10. GDP at market prices	1.3	0.4	-2.4	-6.0	-4.8	0.9	1.9
(Contribution to change in GDP)							
11. Final domestic demand	0.2	-0.8	-5.6	-9.5	-6.6	0.1	1.3
12. Changes in inventories	1.8	-0.7	1.3	-1.2	0.0	0.0	0.0
13. Net exports	-0.6	1.9	1.9	4.7	1.9	0.8	0.6

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	-0.2	-7.4	-5.8	2.2	4.0
2. Government consumption expenditure	2.6	3.0	-4.1	-10.7	-1.9	-1.4	-2.4
3. Gross fixed capital formation	-3.7	-10.7	-18.3	-25.5	-17.5	3.1	5.9
4. Domestic demand excl. inventories	2.0	1.6	-3.8	-10.5	-6.3	1.5	3.0
5. Changes in inventories (contr. to growth)	0.1	0.0	0.2	0.1	0.1	0.1	0.1
6. Domestic demand incl. inventories	3.8	0.9	-2.5	-11.2	-6.3	1.6	3.2
7. Exports of goods and services	6.1	6.6	-0.9	-4.4	-1.5	3.5	4.3
7a. - of which goods	13.6	24.1	2.0	0.9	0.9	1.8	2.4
7b. - of which services	4.8	3.4	-1.6	-5.6	-2.1	3.9	4.8
8. Final demand	4.5	2.5	-2.0	-9.2	-4.8	2.2	3.5
9. Imports of goods and services	7.0	2.1	-4.5	-13.3	-6.1	1.8	3.2
9a. - of which goods	9.6	-0.7	-8.1	-15.6	-7.8	1.5	2.9
9b. - of which services	1.6	8.4	3.1	-9.2	-3.1	2.2	3.7
10. Gross national income at market prices	5.4	7.3	-5.4	-7.1	-5.7	3.8	3.5
11. Gross value added at basis prices	3.8	3.2	-0.7	-10.6	-4.3	2.3	3.4
12. Gross domestic product at market prices	3.3	3.3	-0.5	-8.1	-4.2	2.4	3.7

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	2.4	0.2	0.6	1.5	1.6
2. Government consumption expenditure	1.6	3.2	-1.1	-5.0	-0.4	1.3	1.3
3. Gross fixed capital formation	1.2	-2.2	1.7	-2.0	0.7	1.8	1.9
4. Domestic demand incl. inventories	1.9	2.4	1.7	-0.8	0.5	1.6	1.8
5. Exports of goods amd services	2.2	2.0	1.8	0.4	1.2	1.5	1.5
6. Final demand	2.2	2.0	1.8	0.4	1.2	1.5	1.5
7. Imports of goods and services	2.1	2.2	2.1	1.6	1.2	1.6	1.6
8. Gross domestic product at market prices	1.9	2.8	1.9	-2.3	0.6	1.5	1.8
HICP	2.6	3.5	3.1	0.4	0.4	1.4	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	-3.0	-0.5	-0.1	-0.1
2. Compensation per employee	2.6	2.5	-0.9	-5.0	-3.0	0.9	1.5
3. Unit labour costs	1.1	2.5	-2.7	-4.7	-2.6	0.8	1.4
4. Total population	2.6	2.6	1.5	1.0	1.0	1.0	0.8
5. Population of working age (15-64 years)	3.1	2.9	1.7	1.0	1.0	0.2	0.2
6. Total employment	-0.2	0.4	-4.2	-5.7	-4.4	0.8	1.7
7. Unemployment rate (1)	6.3	7.9	11.9	16.0	19.2	18.4	17.0

(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	4.5	4.1	4.2	4.3
3. Trade balance (goods, fob/fob) (1-2)	-4.7	-4.3	-3.9	-3.0	-2.7	-2.7	-2.8
3.1 p.m. (3) as % of GDP	-26.8	-24.2	-21.5	-18.3	-16.9	-16.7	-16.6
4. Exports of services	6.2	6.4	6.3	5.9	5.8	6.0	6.3
5. Imports of services	2.6	2.8	2.9	2.6	2.5	2.6	2.7
6. Service balance (4-5)	3.6	3.6	3.4	3.3	3.3	3.4	3.6
6.1 p.m. 6 as % of GDP	20.6	19.9	18.9	20.1	20.7	21.2	21.6
7. External balance of goods and services (3+6)	-1.1	-0.8	-0.5	0.3	0.6	0.7	0.8
7.1 p.m. 7 as % of GDP	-6.2	-4.3	-2.6	1.7	3.8	4.5	5.0
8. Balance of primary incomes and current transfer	-0.5	0.0	-1.0	-0.6	-0.6	-0.7	-0.7
8.1. - of of which, balance of primary income	-0.5	0.1	-0.7	-0.5	-0.7	-0.5	-0.6
8.2 - of which, net current transfers	0.0	-0.2	-0.3	-0.1	0.1	-0.1	-0.2
8.3 p.m. 8 as % of GDP	-2.8	-0.2	-5.7	-3.4	-3.8	-4.1	-4.4
9. Current external balance (7+8)	-1.6	-0.8	-1.5	-0.3	0.0	0.1	0.1
9.1 p.m. 9 as % of GDP	-9.0	-4.5	-8.4	-1.7	0.0	0.4	0.6
10. Net capital transactions	0.0	0.0	0.0	0.3	0.2	0.1	0.1
11. Net lending (+)/net borrowing (-) (9+10)	-1.5	-0.8	-1.5	0.0	0.2	0.2	0.2
11.1 p.m. 11 as % of GDP	-8.8	-4.3	-8.3	0.2	1.0	1.3	1.5

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	2,412	2,328	2,404	2,538
Taxes on income and wealth	1,926	2,098	1,962	1,911	1,785	1,809	1,892
Social contributions	1,552	1,566	1,510	1,482	1,480	1,493	1,528
Other current resources (1)	948	851	858	863	933	771	840
Total current revenue	7,106	7,127	6,963	6,668	6,526	6,477	6,798
Capital transfers received	10	12	11	6	2	2	2
Total government revenue	7,116	7,139	6,974	6,674	6,528	6,479	6,800
Compensation of employees	2,758	2,875	2,819	2,567	2,406	2,357	2,323
Intermediate consumption	978	945	865	750	800	809	786
Social transfers	2,500	2,630	2,606	2,595	2,690	2,736	2,623
Interest payments	391	426	563	605	638	639	671
Subsidies	62	85	95	95	90	90	90
Other current expenditure (2)	436	500	487	688	378	373	310
Total current expenditure	7,124	7,460	7,434	7,300	7,001	7,004	6,802
Total capital expenditure (3)	911	811	675	275	442	453	468
Total expenditure	8,036	8,272	8,109	7,575	7,443	7,457	7,270
General government balance, EDP	-920	-1,132	-1,135	-901	-915	-978	-471
			% of GDP				
Taxes on production and imports	15.4	14.5	14.7	14.7	14.8	14.9	15.2
Taxes on income and wealth	11.1	11.7	11.0	11.6	11.3	11.2	11.3
Social contributions	8.9	8.7	8.4	9.0	9.4	9.3	9.1
Other current resources (1)	5.4	4.7	4.8	5.3	5.9	4.8	5.0
Total current revenue	40.8	39.6	38.9	40.6	41.5	40.2	40.7
Capital transfers received	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Total government revenue	40.9	39.7	39.0	40.6	41.5	40.2	40.7
Compensation of employees	15.8	16.0	15.8	15.6	15.3	14.6	13.9
Intermediate consumption	5.6	5.3	4.8	4.6	5.1	5.0	4.7
Social transfers	14.4	14.6	14.6	15.8	17.1	17.0	15.7
Interest payments	2.2	2.4	3.1	3.7	4.1	4.0	4.0
Subsidies	0.4	0.5	0.5	0.6	0.6	0.6	0.5
Other current expenditure (2)	2.5	2.8	2.7	4.2	2.4	2.3	1.9
Total current expenditure	40.9	41.5	41.6	44.4	44.5	43.4	40.7
Total capital expenditure (3)	5.2	4.5	3.8	1.7	2.8	2.8	2.8
Total expenditure	46.2	46.0	45.3	46.1	47.3	46.3	43.5
General government balance, EDP	-5.3	-6.3	-6.3	-5.5	-5.8	-6.1	-2.8
Nominal GDP	17.4	18.0	17.9	16.4	15.7	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, in line with its duties under the Treaties and the Statute. (2) For 2013, this includes compensation of pension funds amounting to 1.8% of GDP in 2013. (3) For 2013, this includes signing fees for gas exploration amounting to 1.1% of GDP, which are treated as negative capital expenditure (disposal of non-produced assets).
Source: Commission services.

Table A2.8: **Debt developments**

	2010	2011	2012	2013	2014*	2015	2016**
EDP deficit (% of GDP)	-5.3	-6.3	-6.3	-5.5	-5.8	-6.1	-2.8
EDP gross debt (% of GDP)	61.3	71.5	85.5	112.0	122.2	126.4	123.1
			levels, EUR bn				
EDP deficit	-0.9	-1.1	-1.1	-0.9	-0.9	-1.0	-0.5
Gross debt	10.7	12.9	15.3	18.4	19.1	20.3	20.5
Change in gross debt	-0.8	2.2	2.4	3.1	0.7	1.1	0.2
Nominal GDP	17.4	18.0	17.9	16.4	15.7	16.1	16.7
Real GDP	15.1	15.2	14.8	14.0	13.3	13.5	13.7
Real GDP growth (% change)	1.3	0.4	-2.4	-5.4	-4.8	0.9	1.9
			% of GDP				
Gross debt ratio	61.3	71.5	85.5	112.0	122.2	126.4	123.1
Change in gross debt ratio	2.8	10.2	14.0	26.5	10.2	4.2	-3.3
			Contribution to change in gross debt				
Primary balance	3.0	3.9	3.2	1.8	1.8	2.1	-1.2
Snow-ball effect	0.4	0.8	3.5	11.4	9.0	1.1	-0.4
of which							
Interest expenditure	2.2	2.4	3.1	3.7	4.1	4.0	4.0
Real growth effect	-0.7	-0.2	1.7	5.6	5.6	-1.0	-2.3
Inflation effect	-1.1	-1.4	-1.4	2.1	-0.7	-1.8	-2.2
Stock-flow adjustments	-0.6	5.5	7.3	13.3	-0.6	1.0	-1.7

* 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. shc	3.5	1,435.9	123.7	43.5	249.9	101.4	543.8	100.3	147.0	60.7	61.6	910.5	340.1	4,118.5	1,606.6	995.4	1,179.9	645.5	2,715.4	769.5	1,463.8	1,783.7
among which:																						
domestic- (GRDS), foreign-law (EMTN) & CPB	*0.0*	*1,416.9*	*47.0*	*1.0*	*243.9*	*85.0*	*500.0*	*60.2*	*141.1*	*42.8*	*17.6*	*871.4*	*332.4*	*3,759.4*	*1,464.8*	*889.2*	*1,073.0*	*530.6*	*2,597.6*	*19.6*	*703.1*	*1,032.5*
loans	*0.0*	*17.8*	*76.1*	*24.2*	*0.0*	*10.5*	*37.9*	*34.2*	*0.0*	*12.0*	*38.3*	*33.6*	*2.0*	*286.7*	*118.1*	*82.6*	*83.9*	*91.9*	*94.8*	*726.9*	*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	136.8	0.0	0.0	0.0
Amortisation of offical lenders	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.2	57.4	114.8	165.0
ESM	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
IMF	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*7.2*	*57.4*	*114.8*
Financial sector recapitalisation	0.0	0.0	1,500.0	0.0	0.0	0.0	0.0	300.0	0.0	200.0	0.0	200.0	300.0	2,500.0	1,500.0	300.0	400.0	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	144.1	93.7	515.3	343.4	263.9	229.8	522.9	112.4	435.7	66.7	455.2	-16.8	3,166.2	763.9	1,360.0	1,070.0	-48.6	-310.8	-22.1	2.6	37.0
memo items:																						
primary balance (in ESA terms)	*-153.4*	*104.1*	*-80.0*	*425.4*	*12.5*	*148.9*	*-168.3*	*284.0*	*-88.8*	*327.5*	*-187.0*	*287.4*	*-220.5*	*845.1*	*296.1*	*277.1*	*339.0*	*-200.5*	*-522.7*	*-725.8*	*-753.6*	*-782.5*
interest (in ESA terms)	*158.7*	*115.1*	*193.3*	*138.2*	*151.0*	*71.1*	*314.1*	*102.2*	*156.9*	*81.6*	*282.6*	*117.7*	*171.5*	*1,895.3*	*605.3*	*638.4*	*638.8*	*671.2*	*620.2*	*711.3*	*763.6*	*825.1*
Programme financing needs	14.4	1,579.9	1,717.4	558.8	593.3	365.3	773.6	923.2	259.4	696.5	128.3	1,565.7	623.3	9,784.7	3,856.1	2,655.4	2,649.9	623.3	-	-	-	-
memo: total annual financing needs															*3,870.5*	*2,655.4*	*2,649.9*	*896.9*	*2,548.6*	*804.7*	*1,581.2*	*1,985.7*

Source: Commission services.

ANNEX 4

Programme Documents

Memorandum of Understanding on Specific Economic Policy Conditionality

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

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

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

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

1. Financial sector reform

Key Objectives

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

Progress since November

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

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

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. The Cypriot authorities commit to continue implementing the roadmap for the gradual relaxation of restrictive measures which was published on 8 August 2013. This roadmap identifies a series of milestones for the gradual liberalisation of the restrictions also taking into account indicators of investor confidence in the banking system and financial stability indicators, including the liquidity situation of credit institutions. A joint CBC-Ministry of Finance task force will be set up **by end-February** to design a well-targeted communication strategy aiming to regularly communicate to market participants, information regarding the roadmap and the progress already made in the implementation of the banking sector strategy.

1.2. Furthermore, the CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector. The CBC will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules. In this respect, and in order to safeguard financial stability, approval has been obtained from the House of Representatives for the issuance of additional government guarantees of up to EUR 2.9 billion on 27 January 2014 as contingency collateral in case of need, in line with State aid rules.

1.3. The Bank of Cyprus and the Cooperative Central Bank submitted their first capital and funding plans in November 2013 and January 2014, respectively. The CBC will continue to receive the updated plans **on a quarterly basis** and will transmit them to the ECB, the EC, the ESM and the IMF. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector, the gradual easing of restrictive measures, and reduction of borrowing from the central bank, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario are provided by the CBC, in coordination with the ECB.

Regulation and supervision of banks and cooperative credit institutions

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

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

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

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

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

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

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

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

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

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

Monitoring of corporate and household indebtedness

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

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

- In order to ensure compliance with the new framework for the management of arrears, **by end-March 2014**, the CBC, with external technical support, will complete an assessment of the operational capacity of the commercial banks' loan workout units, including with respect to early arrears. Following the completion of the merger process for the cooperative credit institutions, the corresponding deadline will be **end-May**.

- Banks will be required to report quarterly on restructuring progress and management of NPLs, with reference date **end-March** and submitted **by end-May**, using specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.), which were approved by the CBC in consultation with EC, ECB and IMF and informing ESM. Furthermore, banks will report monthly on early arrears (e.g. number and amount of past due loans within 1-90 days, type of actions taken, and number and amount of cured or uncured loans).
- The CBC will, with assistance of an external expert, review banks' arrears management policies and practices, taking into account international best practices. This review will be completed **by end-June** and serve as a basis for further policy recommendations on the arrears management processes in credit institutions. Following the findings of the review, as needed, revisions of the Arrears Management Directive and of the Code of Conduct will be introduced by **end-July.**
- By **end-June**, the CBC will introduce requirements for banks and coops to submit agreed-upon procedure reports prepared by their external auditors on banks' effectiveness of debt restructuring arrangements and strategies for the periods ending in December 2014, June 2015, December 2015, and June 2016.
- The role of the Financial Ombudsman with regard to hearing complaints on compliance with the arrears management process will be clarified **by end-March**.
- The Cypriot authorities, in view of financial stability considerations and on-going bank restructuring, commit not to introduce any new administrative measures which would interfere with the setting of bank lending rates. In particular no ceilings on bank lending rates would be introduced.

<u>Increasing financial transparency</u>

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

- Strengthen preventive measures of obliged entities with regard to customer due diligence, use of introduced business and reporting of suspicious transactions (Action Plan – sections 1, 2 and 3).
- Ensure transparency and timely access to information on beneficial ownership of trusts (Action Plan – section 4). The programme partners take note of the establishment by the Cypriot authorities' of trust registers with the supervisory authorities (Action Plan – section 4.3.1)
- The supervisory competent authorities are reviewing their off-site and on-site supervisory procedures and further implement a risk-based approach to AML supervision for financial and non-financial (lawyers, accountants and TCSPs) institutions (Action Plan – sections 5 and 6). In carrying out its onsite supervisory program, the CBC will build on its follow-up work on the April 2013 audit regarding individual financial institutions.

- On a quarterly basis, in the context of the programme review starting **Q4-2013**, the supervisory competent authorities will, on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.

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

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

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

B. Recapitalisation and restructuring of financial institutions

Restoring adequate capital buffers

1.17. The CBC increased the minimum Core Tier 1 capital ratio from 8% to 9% in December 2013. The CBC is assessing the impact of the entry into force of the Common Equity Tier 1 capital definition laid down in the CRDIV and CRR. On the basis of that assessment the CBC will define, **by end-March** and in consultation with the EC, ECB, IMF and informing ESM, the minimum capital requirements taking into account the parameters of the balance sheet assessment and the EU-wide stress test. In no circumstances will this revision lead to any distribution of capital by the banks which were found in the PIMCO exercise to face a capital shortfall.

Management of legacy Laiki

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

Restructuring of Bank of Cyprus

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

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

Restructuring and recapitalisation of Hellenic Bank

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

Restructuring and recapitalisation of cooperative credit institutions

1.22. The CBC assessed the capital needs of individual cooperative credit institutions, indicating a total capital shortfall of EUR 1.5 billion for which funds were deposited in a securities account with the CBC to boost confidence in the system. This ensures that there will be no contribution required from depositors to achieve the recapitalisation of the sector. Following a fair value assessment of the CCB and CCIs' assets and after the approval of the restructuring plan by the EC, these EUR 1.5 billion of state funds will be injected in the Cooperative Central Bank in exchange for common shares.

1.23. To this end, the restructuring plan for the cooperative sector was submitted to the EC in January 2014. The terms and remuneration of the public support will comply with the EU state aid rules with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections, will be subject to specific management rules and restrictions and to a restructuring process, which will be scrutinised by an external monitoring trustee to assume his tasks immediately after the approval of the recapitalisation aid and associated restructuring plan and commitments by the EC under state aid rules. The monitoring trustee will submit quarterly reports on governance and operations, as well as ad-hoc reports as needed and will work under the direction of the EC. In line with the EU state aid rules the trustee will be responsible for overseeing the implementation of the restructuring plan. This includes, inter alia, verifying proper governance and the use of commercial-basis criteria in key policy decisions and assessing the soundness of strategies to deal with loan arrears. The monitoring trustee will closely follow the bank' operations and shall have access to Board meeting minutes, and be observer at the executive committees and other critical committees, including risk management and internal audit functions.

1.24. In line with the strategy for the restructuring and recapitalising of the sector that was published in July 2013, the individual cooperative credit institutions will be merged into a maximum of 18 entities **by end-March**. These mergers are designed to achieve viability, efficiency and profitability. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones. Following the completion of the merger process and the establishment of the final governance structure of the sector, the CBC will review its affiliation directive by **end-July**.

1.25. Upon completion of legal mergers of affiliated credit cooperative institutions, the Cooperative Central Bank will inject sufficient capital into them to take a 99% stake and ensure compliance with the 4% individual core tier 1 ratio. These operations will be finalised by **end-April**, with the view to speed up the appointment of the Board of Directors of each institution and the implementation of the new governance guidelines. At the consolidated level, the sector is still subject to the general minimum core tier 1 capital requirement of 9% or the new minimum capital requirement to be determined as per paragraph 1.17.

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

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

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

C. Legal framework for private debt restructuring

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

1.30. The authorities will, in consultation with EC and IMF and informing the ECB and ESM, prepare a comprehensive reform framework to be endorsed by the Council of Ministers **by end-May**, establishing appropriate corporate and personal insolvency procedures. On the basis of that framework, legislation will be prepared and submitted to the House of Representatives **by December 2014**.

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

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

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

2. Fiscal policy

Key objectives

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

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

The Cypriot authorities adopted a number of fiscal measures for 2012-2014 and have progressed in relation to fiscal-structural reforms. The authorities commit to the full implementation of these measures (see Annex 1) and to regularly monitor the budgetary effect of the measures taken. Any deviation from the projected budgetary effect of the measures will be evaluated and addressed accordingly in the quarterly programme reviews, taking into account macroeconomic developments. In the event of underperformance of revenues or higher social spending needs, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the programme period, cash revenues above programme projections, including any windfall gains,[10] will be saved or used to reduce debt. To the extent that over-performance is deemed permanent, this can reduce the need for additional measures in the outer years. Measures, such as tax amnesties, that could have an adverse impact on tax compliance and foster tax fraud and evasion, thereby counteracting efforts in line with paragraph 3.7 of this Memorandum, will not be undertaken over the course of the programme period.

Sound fiscal policy and expenditure prioritisation should contribute to preserving the good implementation of Structural and other EU funds, in respect with the programme's budgetary targets. In the light of Cyprus' economic challenges, EU funds will be targeted to those areas that deliver the most important economic and social impact, in accordance with the priorities to be set in the relevant EU regulatory framework. In order to ensure the effective implementation of EU funds, the Government will ensure that the necessary national funds remain available to cover national contributions, including non-eligible expenditure, under the European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD and EFF/EMFF) in the framework of the 2007-2013 and 2014-2020 programming periods, while

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

taking into account available EIB funding. The authorities will ensure that the institutional capacity to implement current and future programmes is improved and the appropriate human resources of Managing Authorities and implementing bodies are available.

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

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

Fiscal policy in 2014

Based on the programme's current macroeconomic and fiscal projection and reflecting the 2014 Budget, the Cypriot authorities will achieve a deficit of the general government primary balance of EUR 277 million (1.8% of GDP) in 2014[11], respecting the EDP recommendation of a headline deficit of no more than 8.4% in 2014. To this end, Cyprus will fully implement the permanent measures included in the 2014 Budget, amounting to at least EUR 270 million in 2014 (Annex 1).

Fiscal policy in 2015-16

Based on the programme's updated budgetary projection, the Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 340 million (2.1% of GDP) in 2015 and a surplus of at least EUR 201 million (1.2% of GDP) in 2016[12], respecting the EDP recommendation of a headline deficit of no more than 6.3% of GDP in 2015 and 2.9% of GDP in 2016.

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

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

3. Fiscal-structural measures

Key objectives

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

[12] These targets need to be adjusted for expected dividends of EUR 0.2 billion, to be distributed by the CBC in line with CBC's duties under the Treaties and the Statute.

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

Pension reform

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

The Cypriot authorities have agreed to provide **by February 2014** all information necessary to verify that, to the extent it falls under the control of their executive and legislative powers, all of the measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees.

Health care reform

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

a) preserve and implement all fiscal measures relating to compulsory health-care contribution for public servants and public servant pensioners to be reviewed **by Q2-2014** with the programme partners and all co-payments for using public health care services;
b) restructure public hospitals according to the action plan as approved by the Council of Ministers at end-June 2013 and aiming at full implementation **by Q2-2015**;
c) taking into account the economic conditions, the implementation of the necessary complimentary reforms, the results of the updated actuarial study and after consultation with the programme partners, implement a National Health System (NHS), to be fully in place **by mid-2016**. The NHS will ensure its financial sustainability while providing universal coverage. By **mid-2015**, a first stage of NHS, e.g. primary care, will be put into place. This first stage will be defined and adopted

with the full roadmap to NHS **by April 2014**, which will also clarify the role of Ministry of Health and the HIO. The amending bill to NHS will be submitted to the House of Representatives **by Q2-2014**. The policies of the Ministry of Health on pricing and reimbursement of medical goods and services, including those related to pharmaceutical expenditure, will be revised in agreement with programme partners to contain projected spending levels under NHS.

d) secure adoption by the Council of Ministers of a binding set of contingency measures (e.g. revision of the basket of publicly reimbursable medical services and products, cuts in tariffs for medical products and providers of medical services, limits to the volume of reimbursable products and services) **by Q4-2014**, in order to ensure that the agreed budget limits of public health expenditure are not exceeded;
e) complete the design of the IT-infrastructure necessary for implementing the NHS, explore all options for improving the IT-infrastructure via the most cost-effective web-based applications as an alternative to the currently-defined IT tender **by Q1-2014**;
f) review income thresholds for free public health care in comparison to the eligibility criteria for social assistance, while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures **by Q2-2014**;
g) continue to publish clinical and prescription guidelines and to audit their implementation; continue to establish the system for health-technology assessment. Periodic reviews of the basket of publicly-reimbursable medical services will be conducted, based on objective, verifiable, criteria, including cost-effectiveness criteria (health technology assessment will contribute when feasible); prepare quarterly reports on the results of the respective workstreams;

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

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

3.3. The Cypriot authorities will:

- enact a Fiscal Responsibility and Budget System Law (FRBSL applicable to the entire general government sector**, prior to the granting of the fourth disbursement of financial assistance.** The umbrella law will encompass, inter alia, macro-fiscal policy-making, and budget formulation, approval and execution. It will take on-board and deepen existing provisions transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and implementing the Two-Pack EU Regulation 473/2013 and the Fiscal Compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts on budget documentation and statistics ensuring that adopted measures are fully effective;

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in the FRBSL, including an implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance **by mid-March 2014**;

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

- remove the risk of overspending by making sure that spending commitments, as these will be defined in the FRBSL, of the central government are subject to pre-commitment validation **by Q1-2014**. All outstanding commitments should be timely and properly recorded and reported, on a quarterly basis, in the accounting system.
- improve the monitoring of government guarantees through a risk assessment analysis. To this end, ensure appropriate human resources at the Public Debt Management Office to carry out proper risk assessment of the outstanding stock of government guarantees.

Public private partnerships (PPPs)

3.4. The Cypriot authorities will:

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

State-owned enterprises and privatisation

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

- the Cypriot authorities will submit to the House of Representatives the law regulating the creation and the functioning of SOEs at the central and local levels, in order to enhance the monitoring powers of the central administration, while including reporting on SOEs in the context of the annual budgetary procedure **by end-February 2014.** No additional SOEs will be created until the legal framework has been adopted.
- the Head of the new SOEs Unit and the Unit's supporting staff will start their work **by end-March 2014**;

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

- each SOE will submit a strategic plan to the competent minister for approval, in consultation with programme partners, as set out in Part V of the SOEs Law **by Q3-2014.**

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

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

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

- enact the Privatisation Law, **prior to the granting of the fourth disbursement of financial assistance**;

- establish the Privatisation Unit through the appointment of its Head and its experts, in line with the provisions of the Privatisation Law; the Unit will be fully operational **by mid-May 2014**. The terms of reference for the appointments will be prepared in consultation with programme partners;

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

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

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

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

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

3.7. The Cypriot authorities will reform the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection capacity and the fight against tax fraud and evasion, with a view to increasing fiscal revenue. The reform will comprise of a programme of short-term measures to enhance compliance, efficiency and effectiveness as well as a comprehensive long-term reform covering risk management and the establishment of a new integrated function-based tax administration structure, integrating the existing IRD and VAT services. Most of the short-term programme has been implemented. However, the following actions will be completed **by Q1-2014**:

- attributing personal responsibility for payment of company taxes to those, who - in the case of non-listed companies - truly and effectively control a company and to the responsible manager for fraudulent filing of company taxes;
- harmonising the legislation among tax types so that not paying withholding taxes is a criminal offence and taking the necessary steps to ensure tax fraud is prosecuted as a criminal offence;
- strengthening powers by the tax authorities to ensure payment of outstanding tax obligations, including by providing authority to garnish assets or prohibiting the alienation or use of assets, including property and bank accounts, by the taxpayer;
- enacting the necessary legislation to establish self-assessment for all income taxpayers by changing from a pre-assessment verification of income tax returns to post assessment audits selected on the basis of risk; and
- conducting an independent formal review to recommend changes to legislation to determine the appropriate level of discretion available to the tax administration management and how it is exercised.

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

- A comprehensive compliance strategy that will be put in place **by Q2-2015**. The strategy will be firmly based on analytical work on risk identification and analysis, as well as on an evaluation of different risk treatment strategies. To further progress, the authorities will
    - make the data from the IRD, VAT Services and Customs and Excise Department available to selected staff by the tax administrations via one platform, to be used for integral risk identification and analysis **by Q1-2014**;
    - cleanse the income tax registers **by Q2-2014** and VAT registers **by Q3-2013**, by removing inactive cases and put in place a process to maintain the registers up-to-date;
    - further improve the joint work programme for large and high risk taxpayers and provide a progress report **by Q2-2014**; and
    - finalise the compliance risk management module for large taxpayers **by Q3-2014.**
- The full integration of the two tax departments, based on the adopted integration implementation plan. As next steps, the authorities will, amongst others:
    1. submit to the House of Representatives the enabling legislation to establish the new tax agency **by April-2014**; and
    2. set up the integrated large tax payer unit **by Q4-2014**.

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

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

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

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

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

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

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

Immovable property tax reform

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

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

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

In addition, the authorities will:

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

Public administration reform

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

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

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

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

The sectoral element will examine:

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

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

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

and comprises two batches:

- the first batch is undertaken by the World Bank and the UK public administration and covers the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies. The results of the first batch will be presented **by Q1-2014.** Based on the findings of this review, the Cypriot authorities will agree on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers **by Q2-2014.** The relevant legislation in relation with the reforms indicated as high priority will be adopted by the House of Representatives **by Q3-2014**. The reform will start to be implemented **by Q4-2014**, in accordance with the reform plan.

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

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

Welfare system

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

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

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

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

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

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

4. Labour market

Key objectives

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

Cost of living adjustment (COLA) of wages and salaries

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

i. a lower frequency of adjustment, with the base period for calculating the indexation (COLA) being lengthened from the current period of six months to twelve months. Indexation would take place on 1st January each year;

ii. a mechanism for automatic suspension of application and derogation procedures during adverse economic conditions, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation would be effected for the following year; and

iii. a move from full to partial indexation, with the rate of wage indexation being set at 50% of the rate of increase of the underlying price index over the previous year.

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

A tripartite agreement will be pursued with social partners for the application of the reformed system in the private sector **by Q2-2014**.

Minimum wage

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

Activating the unemployed and combating youth unemployment

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

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

Therefore, the Cypriot authorities will ensure the implementation of a set of agreed measures to address the identified shortcomings and weaknesses. These will include:

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

ii. completing the process of harmonisation, automatic collection, processing and exchange of data across the various schemes and between all implementing bodies **by Q1-2014**;

iii. ensuring an effective integration of the different schemes by centralising the administration of all activation programmes and by enhancing the coordination across the different departments responsible for the various programmes;

iv. measures to enhance the administrative capacity of the public employment services via increased staff mobility and/or outsourcing of specific tasks **by Q2-2014**; and

v. measures to enhance the cooperation between the public employment services and the benefit-paying institutions in the activation of the unemployed.

4.5. With one of the steepest increases in the youth unemployment rate in the EU and with the rapid rise of young people not in employment, education or training (NEETs), Cyprus needs to take swift action to create opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will present **by April 2014** the revised National Action Plan for Youth Employment, which will include, *inter alia*, measures envisaged for support under the Youth Employment Initiative aimed at establishing a Youth Guarantee, in line with the conclusions of the European Council of June 2013. The design, management and implementation of these measures targeted to youth shall be well integrated within the broader system of activation policies (section 4.3) and be coherent with the reform of the social welfare system (section 3.11) and the agreed budgetary targets. For this purpose, the authorities will submit **by April 2014** a comprehensive note summarising the full list of all active labour market policies (existing and envisaged) with the relevant intended aims, recipients, budgetary allocations and sources of financing.

5. Goods and services markets

Key objectives

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

Services Directive and regulated professions

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

The Cypriot authorities will further improve the functioning of the regulated professions sector (such as lawyers, engineers, architects) by carrying out a comprehensive review of requirements affecting the access and exercise of activity. The Cypriot authorities will finalise their review **by Q1-2014**. Following completion of the review, the requirements that are not justified or proportional will be eliminated **by Q3-2014**.

Competition, transparency and sectoral regulatory authorities

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

- continuing to provide sufficient and stable financial means, as well as qualified personnel in order to enhance its effective and on-going operation **by Q2-2014;**
- enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers and antitrust, including the power to conduct sector enquiries **by end-March 2014**; and

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

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

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

<u>Housing market and immovable property regulation</u>

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

The Cypriot authorities will:

- define deadlines for the issuance of building certificates and title deeds and ensure their enforcement **by Q1-2014**; ensure that the title deed issuance backlog drops to less than 2,000 cases of immovable property units with title deed issuance pending for more than one year **by Q4-2014** (backlog refers to (i) applications, (ii) units that are eligible for the "ex officio" issuance of title deeds, required certificates and permits). The ex-officio cases will automatically be counted in the backlog from the date the certificate of final approval is being issued by the respective Local or District Authority. Moreover, prepare a joint action plan to streamline the processes within the DLS and between the DLS, the Local and District Authorities and the Ministry of Interior Technical Services **by Q2-2014**;
- every three months, publish quarterly progress reviews, including executive commentaries on developments related to the issuance of building and planning permits, certificates, title deeds, title deed transfers and related mortgage operations;
- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the monetary financial institutions and for all government services **by Q4-2014**; and
- improve the pace of court case handling, in order to eliminate court backlogs **by Q1-2016**.

<u>Tourism</u>

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

- present a progress report on the implementation of the action plan twice per year including an assessment of its implementation based on performance indicators, **by Q1** and **Q3** every year, starting from 2014.

- present a plan enhancing the coordination of the competent authorities having a direct link with tourism **by Q2-2014**. The plan shall include concrete actions and a roadmap leading to an effective mechanism for coordination.

- start implementing an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, taking into account the EU external aviation policy and the EU aviation agreements, while ensuring sufficient air connectivity. This strategy, which will include a concrete action plan, will be adopted **by Q1-2014**. The implementation of the action plan will be reviewed annually by the Cypriot authorities, starting **in Q1-2015**.

Energy

5.5. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package is fully and correctly implemented, particularly during and after the transformation of the sector;

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

  1. updates on the *roll-out plan* for the infrastructure required for the exploitation of natural gas. This plan takes into account the relevant technical and commercial uncertainties and risks and hence should cover: the required investments, associated costs, financing sources and methods, related ownership structure; related major planning risks and bottlenecks; and a projection of the revenue streams over time; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues; next update **by Q2-2014.**

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

  2. *a comprehensive outline of the regulatory regime (CERA) and market organisation* for the restructured energy and gas sector, with a view to introducing open, transparent, competitive energy markets, and taking explicitly into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, the prospects of privatisation of SOEs in the energy sector, and the EU targets for

energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include the following elements: a description of the envisaged institutional framework (the various government and private actors with their respective functions); the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the sequence and envisaged timing of the major actions and changes; the potential for setting-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; and full unbundling of gas suppliers and customers, in particular electricity companies. The Cyprus authorities will provide clarity on the intended use of the available 'isolated market' and 'emergent market' derogations and indicate the intended duration of the latter derogations. An advanced intermediate draft **by Q2-2014,** with a view to a final outline **by Q4-2014**; and

3. a plan to establish the institutional framework for the management of hydrocarbon resources, including a *resource fund*, which should receive and manage various types of public revenues from offshore gas exploitation and sales (direct revenues, fees, dividends etc). The preparatory phase should include the required legal steps and their adoption. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices., The resource fund, whose establishment and objectives are foreseen in the FRBSL (see 3.3), should be based on clear rules governing inflows and outflows, coupled with clear accounting rules regarding dividend and fees from government entities and stakes in the energy sector. To the extent that the FRBSL, does not cover the elements listed above, they should be provided for by the specific law on the resource fund, an advanced draft of which, informed by technical assistance advice will be submitted to programme partners **by Q2-2014,** before its submission to the House of Representatives.

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

6. Technical assistance

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

7. Growth Strategy

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

Annex 1

Budgetary measures adopted by Cyprus in or after December 2012

Fiscal measures with effect in 2012

Expenditure measures

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

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

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

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

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

Revenue measures

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

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

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

Fiscal measures with effect in 2013

Expenditure measures

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

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

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

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

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

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

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

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

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

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

i. freeze public sector pensions;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Revenue measures

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

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

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

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

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

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

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

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

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

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

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

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

Fiscal measures with effect in 2014

Expenditure measures

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

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

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

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

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

I.37 A further targeting of social pensions;

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

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

Revenue measures

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

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

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

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

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

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

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

Annex 2

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

	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 Q1-2014
	New legislative measures.	1.2.2 CBC and other supervisory authorities to issue guidance to obliged entities in order to explain the new provisions on the introduction of tax crimes (including tax evasion) as predicate offences.	Compliant
	Particular issues relating to PEPs.	1.2.3 CBC to issue additional guidance to obliged entities to adequately identify and establish the source of wealth for PEPs or for customers that become PEPs after the business relationship has been accepted.	Compliant
1.3	**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.	Q1 - 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	**<u>Supervision of financial institutions</u>**		
5.1	**Revise the AML/CFT supervisory structure within the CBC, ensuring it is adequately resourced**	5.1.1 Revise and/or establish organisation structure and management within the CBC's Banking Supervision and Regulation Department (BSRD) to address AML/CFT matters,[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.	Q1 – 2014
5.4	**Establish Formal AML/CFT Training Program**	5.4.1 Establish a formal AML/CFT training program for CBC staff to ensure adequate implementation of the offsite and onsite tools. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools; - customer acceptance policies;	Q2 – 2014

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

		- 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 Q1-2014
		5.5.2 On a quarterly basis, in the context of the programme review, starting Q4 2013 the CBC will on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Ongoing
		Subsequent to the successful development of the tools stipulated under 5.2 and 5.3, the CBC will undertake the following: 5.5.3.1 Implement and adjust the new risk-based offsite analytical tool(s) using the results of the pilot reviews, and develop an onsite supervisory program for 2014. 5.5.3.2 Assign institutional ML/TF risk profiles to financial institutions reviewed under the pilot exercise. 5.5.3.3 Develop customised supervisory strategies for financial institutions reviewed under the pilot exercise. 5.5.3.4 Apply the risk-based off-site analytical tools, assign ML/TF risk profiles, and developed customised supervisory strategies to all financial institutions under its responsibility.	Q2 - 2014
		5.5.4.1 CBC to start implementing the new examination/verification procedures in line with the inspection program for 2014, and to adjust/fine-tune the procedures using the results of the pilot inspections. 5.5.4.2 CBC to update the institutional risk profile and supervisory strategy based on the results of the pilot inspection.	Q2 - 2014
6.	**Supervision and monitoring of lawyers, accountants and TCSPs**		
6.1	**Align resources with**	6.1.1 Ensure adequate human resources and technical capacity to undertake effective AML/CFT monitoring.	Ongoing

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

		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)

Annex 3

The Public Administration Review: Second Batch of Studies

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

Ministries and the Departments/Services falling under each Ministry

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

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

Constitutional Powers /Services

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

Independent Services/Authorities

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

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

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

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

Cyprus—Letter of Intent

Nicosia, March 13, 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).

Policy implementation under the program has remained broadly on track:

- Fiscal performance through end-December continued to exceed expectations, while the decline in output has been somewhat less than anticipated. As a result, we have met all performance criteria (PCs). The PCs on the primary balance of the general government was met with a comfortable margin, due to prudent execution of expenditure and revenue over-performance relative to projections.

- We have made progress toward complying with the requirements of structural conditionality, but some actions have suffered delays, and one structural benchmark (SB) was missed (Table 2).

  - The independent fair value assessment of the cooperative sector and the submission of its restructuring plan to the European Commission (end-January SB) were completed on time. Moreover, following approval of the plan by the Commission, €1.5 billion in capital was injected into the sector.

  - The SB on strengthening the effectiveness and adequacy of resources allocated to AML/CFT has also been met.

  - Parliamentary adoption of the fiscal responsibility and budget systems law (FRBSL) and of measures to fight tax evasion (end-December SBs) were delayed due to longer than anticipated legal vetting procedures. The first was adopted on February 13 and we will submit legislation for the latter as prior actions for the completion of the review.

  - The SB on entrusting the voting rights of legacy Laiki equity stake in BoC to a well-recognized and independent entity was missed. We are planning to complete this action by end-April (modified SB).

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 so as to support long-run growth, while protecting the welfare of the population:

- In the financial sector area, we will ensure implementation of the restructuring plans of Bank of Cyprus (BoC) and the coop sector, while we continue to strengthen supervision and regulation. In addition, we will revamp our debt restructuring framework to facilitate the voluntary workout of non-performing loans. Finally, in the near term, we are taking steps to gradually lift payment restrictions under stage two of our roadmap, while safeguarding financial stability.

- Regarding public finances, reflecting the significant over performance in 2013, we have revised our 2014 fiscal primary deficit target and will continue to execute our budget prudently, given still high macroeconomic uncertainty and potential contingent risks.

- We remain committed to our ambitious structural reform agenda. To protect vulnerable groups during the downturn, we aim to implement a welfare system reform in July. Our plans to modernize revenue administration by integrating the two main tax collection agencies are also advancing. To strengthen budget processes, we will work on implementing our new FRBSL law. Finally, to kick-start the privatization process, we have adopted a privatization law establishing the legal and institutional framework for privatizations as a prior action for this review.

Financing of our program remains adequate. We are making progress toward securing additional financing and reducing public debt through the allocation of central bank profits, a debt-to-asset swap, and privatization.

Based on the above, we request the following:

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

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

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

- Establishment of new or modified SBs on the following: (i) appointment of an independent institution to dispose of Laiki's assets and manage its voting rights in BoC, by end-April 2014; (ii) submission to the CBC Board of the first quarterly report regarding BoC's/coops' performance in the implementation of the restructuring plans, by end-May 2014; (iii) submission to Parliament of an enabling law consolidating the two existing tax authorities into a single tax department, by end-April 2014; (iv) completion of the assessment of the operational capacity of coops' loan workout units, including with respect to early arrears, by end-May; (v) submission to parliament of personal insolvency legislation, by end-December 2014; (vi) submission to parliament of corporate insolvency legislation by end-December 2014; and (vii) establishment of an integrated large taxpayers unit, by end-December 2014 (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	Panicos Demetriades
Minister of Finance	Governor of the Central Bank of Cyprus

Cyprus—Memorandum of Economic and Financial Policies

A. Recent Developments and Outlook

1. **While the recession in 2013 has been less severe than anticipated, economic conditions remain difficult.** Output contracted significantly in the first three quarters of last year, with domestic demand particularly hit. Still, the output decline for the full year (preliminarily estimated at 6 percent) is significantly lower than previously expected (7.7 percent), reflecting on one hand, resilient performance of the tourism and professional service sectors, and, on the other hand, a smaller-than-anticipated decline of private consumption. Nevertheless, the situation remains difficult, with unemployment, especially for youth, rising toward very high levels, while disposable incomes are falling. In the banking sector, while signs of stabilization are emerging following the recapitalization of our banks and coops, non-performing loans are increasing, and credit to the private sector continues to decline.

2. **The macroeconomic outlook remains challenging**. We continue to expect a difficult year ahead, with output falling by 4.8 percent as the economy continues to adjust. Efforts to reduce the currently very high levels of private sector debt and ongoing fiscal consolidation will continue to pose a drag on growth. Our economy is projected to return to modest growth of about 0.9 percent next year and to gradually improve toward 2 percent in the medium- to long-run. This projection is based on full and timely implementation of policies detailed in our adjustment program, aimed at restoring the health of our financial sector and putting public finances on a sustainable path through fiscal consolidation and structural reforms. Still, downside risks to the medium-term outlook remain significant.

B. Financial Sector Policies

Restoring the health of our financial sector is a key priority under our program, aiming to strengthen banks' balance sheets so as to pave the way for a sustainable recovery. Following the recent recapitalization of the system, the program now focuses on gradually relaxing payment restrictions, restructuring banks and the coop sector, facilitating the voluntary workout of non-performing loans, strengthening regulation and supervision, and enhancing transparency.

Normalizing financial flows

3. **We remain committed to normalizing payment flows while safeguarding financial stability.** The timely removal of administrative restrictions and capital controls is necessary to support the economic recovery, yet this process also needs to preserve financial stability. Our strategy, detailed in our roadmap published in August 2013, aims to balance these two objectives through a gradual relaxation of restrictions as milestones in our financial sector policy agenda are reached, while taking into account the level of confidence in the banks and other financial stability indicators. In accordance with the roadmap, we have already completed our first stage of relaxations in the second half of 2013, including through facilitating domestic transfers without justifying documents of up to €1 million and allowing the opening of new term accounts with cash. In February 2014, we have also achieved the last milestone related to the second stage of relaxations under the roadmap and—based on our analysis of recent deposit and liquidity trends, also taking into account the independent assessment regarding market confidence—we are now

taking steps to implement these relaxations in a manner consistent with financial stability. Specifically:

- By end-March, we will set up a joint CBC-Ministry of Finance task force to design a well-targeted ***communication strategy*** aiming to regularly communicate to market participants information regarding our roadmap and the progress already made in the implementation of our banking sector strategy.

- On February 21, we ***abolished restrictions*** related to the automatic renewal of maturing fixed-time deposits and ***increased limits*** on domestic transfers.

- To safeguard financial stability, we are continuing to ***monitor*** market conditions. We will enhance coordination between the CBC and Ministry of Finance through the establishment, by end-March, of a high-level committee to inform about market developments and advise on next steps. On this basis, we will take additional steps to raise limits on cash withdrawals and gradually increase domestic transfer limits.

4. **In this context, we will continue to ensure 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 of 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.

Restructuring financial institutions

5. **We are taking steps to ensure that Bank of Cyprus (BoC) will adequately implement its restructuring plan**. Since the bank has been recapitalized in July 2013, it has started to restructure, including by having reduced operational costs by 42 percent, having limited its risks by reaching agreement on the sale of its Ukrainian operations, and having prepared and submitted to the CBC its arrears management plan. The agreement on the sale of Ukrainian operations, together with the recent parliamentary approval of bank bond guarantees, boosted its potential liquidity buffers. The bank liberalized blocked deposits amounting to €0.9 billion. A supervisory unit has been set up at the CBC to monitor BoC's progress with the implementation of its restructuring plan. By end-February 2015, it will complete a comprehensive technical assessment of BoC' restructuring plan with the aim to identify areas that require further strengthening and review.

6. **We are also preparing for the disposal of legacy Laiki's assets.** To this end, the Resolution Authority has instructed Laiki's Special Administrator to appoint by end-April 2014 (modified **structural benchmark**) well recognized and independent consulting or auditing firms or international institutions to provide services associated with the management of the disposal process of Laiki's assets abroad and be entrusted with the voting rights associated with Laiki's share participation in BoC. As part of the agreed terms of reference, a revised roadmap for the full disposal of the assets will be developed by end-April with a view to maximize value for creditors.

7. **Having completed the fair value assessment, restructuring plan, and recapitalization of the coop sector, we will ensure that the sector is restructured and its governance strengthened**. A new CEO has recently been appointed to lead the restructuring process, which is primarily focused on completing the mergers of individual coops, reducing operating costs, and setting up an effective arrears management process. So far 85 out of 93 coops have already merged into 16 new institutions, and the remaining 8 coops will be merged into 2 institutions. We will complete the mergers by end-March 2014 (**structural benchmark**) and inject capital into individual coops to ensure compliance with the 4 percent individual CT1 ratio for all CCIs by end-April. We remain committed to allow the cooperative central bank (CCB) to operate on a commercial basis without undue political interference. To this end:

- We will strengthen the ***governance*** of the sector by ensuring that all new board members and key managers of the CCIs are appointed by end-May 2014, after obtaining CBC clearance on fitness and probity matters. Immediately after the approval of the recapitalization aid and associated restructuring plan and commitments by the EC under state aid rules, a monitoring trustee will assume his tasks in the coop sector and submit quarterly reports on governance and operations, as well as ad-hoc reports as needed. The monitoring trustee will work under the direction of the EC. In line with 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 sector's operations, have access to Board meeting minutes, and be an observer at the executive committee and other critical committees, including risk management and internal audit functions.

- The CBC and CCB—in consultation with the Ministry of Finance management unit—will agree by end-April 2014 on quantitative indicators to allow for an adequate ***monitoring*** of the implementation of the coops' restructuring plan.

- 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 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.

Strengthening supervision and regulation

8. **We are stepping up reporting requirements and monitoring of BoC and the coops.** This will be key to ensuring an adequate implementation of their restructuring plans. To this end, we have already put in place a work plan for the supervisory units responsible for BoC and the coop sector, respectively, including thematic on-site inspections and off-site reviews on loan restructuring and risk management, operations, and governance. Furthermore, we have allocated additional resources to the two supervisory units, including support from debt restructuring experts. The CBC has instructed BoC and the CCB to submit, starting with end-April, quarterly reports on the implementation of key actions described in its restructuring plan and on progress relative to agreed operational and financial targets. The two CBC units will assess these on a quarterly basis against selected operational and financial targets. The first quarterly report of the

units will be submitted to the CBC Board by end-May **(structural benchmark)**. In addition, to further strengthen market confidence on BoC's and the coops' progress with implementing their restructuring plans, by end-March, the CBC will require them to publicly disclose an agreed subset of operational and financial indicators on a quarterly basis.

9. **We are also taking steps to strengthen bank supervision and regulation in anticipation of broader European initiatives.** As we are preparing for the upcoming integration to the single supervisory mechanism (SSM), we have taken steps to enhance supervision and regulation, including by issuing new regulations on loan origination and asset impairment and provisioning and by adopting a new law on establishing a credit register. At the same time, submission of draft legislation to introduce early corrective actions has been suspended to allow for prior coordination with upcoming SSM policies. Taking into account the imminent increase in the tasks of the CBC, owing in particular to the requirements imposed on the banking supervision department, we are giving high priority to the recruitment of additional resources with adequate qualifications. Looking forward:

- By end-March, we will amend our ***resolution law*** to strengthen the effectiveness of the resolution authority.

- 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 estimates of their potential impact on capital by end-April and, by end-March, will instruct them to submit estimates on profitability and coverage ratio to NPLs by end-June. Also by end-April, the CBC will revise the governance directive to specify, among others, the interaction between banks' internal audit units and bank supervisors, in line with best practice.

- By end-May, with external technical support, the CBC will complete an assessment of the plans to use the ***credit register*** for supervisory purposes relative to best practices.

Restructuring private sector debt

10. **We are revamping our debt-restructuring framework to facilitate loan workouts so as to clean up bank, firm, and individual balance sheets**. Voluntary private sector debt restructuring is key to support the reduction of both NPLs and the high level of private sector indebtedness, so as to pave the way for a sustainable economic recovery. We are fully committed to facilitating this process by establishing a sound operational and legal framework with appropriate incentives and safeguards while avoiding interference in negotiations between borrowers and creditors. To this end, our efforts are concentrated in two key areas:

- **Enhancing banks' operational preparedness for arrears management:** We have already developed a code of conduct and arrears management framework. On this basis, we are continuing to work on three fronts:

    - ***Bank reporting*:** Banks have submitted to the CBC their strategies and plans for arrears management. In this regard, by end-March, the CBC will instruct the banks to submit, starting with end-March data, monthly reports on early arrears (including number and amount of past due loans within 1-90 days, type of actions taken, and number and amount of cured or uncured loans), and quarterly key performance indicators for debt restructuring.

- ***Official monitoring***: The CBC has appointed a reputable international consultancy firm which will assist it in completing an assessment of: (i) the operational capacity, including with respect to early arrears, of the commercial banks' loan workout units to implement their plans by end-March (existing **structural benchmark**), and, by end-May for the cooperative sector (**structural benchmark**), and (ii) an assessment of their arrears management policies, procedures, and practices, including the soundness of mechanisms and strategies to manage troubled assets within the institution/sector by end-June. On this basis, the CBC will instruct banks and the coops to implement the recommendations of the assessments no later than end-July. Also by end-July, the CBC will update the Code of Conduct and Arrears Framework directives as needed.

- ***External independent assessment***: 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.

- **Enhancing our debt restructuring legal framework:** At present, voluntary negotiations between debtors and creditors are not leading to effective debt restructurings, contributing to a high level of NPLs and high private sector indebtedness. To address this problem, we are committed to implement a comprehensive package of reforms aiming to strengthen our legal framework, on the basis of international best practice. To this end, we will prepare a reform framework —to be approved by the Council of Ministers by end-May—covering the following areas:

  - ***Foreclosure procedures***: The lack of timely foreclosure processes encourages potentially fraudulent behavior, undermines payment discipline, reduces the incentives for debt restructuring, contributes to the growing NPLs, and impedes the functioning of the insolvency framework. To address these issues, by end-June we will amend legislation to allow for the seizure and sale of loan collateral through private auctions to be conducted by mortgage creditors, while limiting the role of the Land Register in the auction process. Moreover, given the backlog and delays in the issuance of title deeds, which may further hinder foreclosures, by end-September, we will identify the core functions of the Land Register and amend legislation, as necessary. Further, by end-March we will establish a task force comprised of representatives of the Ministry of Finance, Central Bank, the Law Office of the Republic, and the Land Register to prepare a study assessing the magnitude of registered but untitled land sales contracts and underlying mortgages. The task force will develop recommendations by end-June.

  - ***Corporate and personal insolvency:*** A revised corporate insolvency regime is needed to facilitate the return to normal operations of viable but troubled companies. To this end, by end-December we will submit to Parliament legislation for the effective rehabilitation of viable companies, as well as for procedures for the licensing and regulation of insolvency practitioners assisting in the restructuring process (**structural benchmark**). Modern personal insolvency procedures are also needed to permit viable individuals to restructure their debt. Also by end-December, we will submit to Parliament legislation in this regard (**structural benchmark**).

- ***Institutions***: An effective implementation of our debt restructuring strategy also requires strengthening existing institutions. In particular, by end-March, we will clarify the role of the Financial Ombudsman in handling consumer complaints regarding compliance with the Code of Conduct during restructuring negotiations. Moreover, by end-December, we will complete a review of the rules of civil procedure and other court rules to identify potential inefficiencies and develop recommendations.

We will review the private sector debt restructuring legal framework in the second half of 2015 with a view to assess results and define additional measures as needed.

Strengthening the AML framework

11. **We remain committed to strengthen the implementation of our AML/CFT framework.** Having amended the AML/CFT legal framework, in line with best practices, we continue making progress in its implementation. We have strengthened the effectiveness and adequacy of the AML/CFT supervisory function for financial institutions, including by allocating resources for a total of 7 full-time experienced supervisors by end-2014 (end-February **structural benchmark**) and have published statistics that reflect sustained exchange of financial information with other financial intelligence units. In pursuing our efforts to implement the action plan articulated following the external audit we commissioned, we are concentrating on three areas:

- ***Resuming onsite AML supervision by CBC***: Having secured adequate resources to perform our supervisory functions, we plan to implement an inspection program in the course of 2014, starting in March and covering 4 banks by end-June, and another 7 banks by end-December.

- ***Taking appropriate supervisory measures following-up on the AML audit findings***. The CBC has continued to make progress in following up on the auditor's findings regarding possible breaches of compliance with AML requirements by banks. Having identified breaches of varying degrees of severity in the audited banks, by end-March, the CBC will apply appropriate supervisory measures.

- ***Enhancing the operations of the Registrar of Companies***: A third party assessment of the Registrar of Companies has been finalized. To bolster its capacity, we will finalize and the Council of Ministers will adopt an action plan by end-March aiming 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.

C. Fiscal Policy

Our fiscal policy aims to strengthen our public finances and place debt on a sustained downward path to facilitate our return to the international debt markets.

12. **We have met our fiscal targets in 2013 with considerable margin.** We have achieved a primary deficit (on a cash basis) of 1.7 percent of GDP compared to our adjusted target—taking into account additional compensation for pension funds—of 3.2 percent of GDP for 2013 and compared to the outturn of 3.3 percent of GDP in 2012. This performance reflects both the better-than-expected macroeconomic outturn and a difficult but unavoidable fiscal consolidation primarily aimed at reigning in public spending. Indeed, our prudent execution and control of discretionary spending served us well in managing uncertainties given the difficult economic circumstances. International financial support helped to finance our deficit, avoiding the need for an otherwise even sharper adjustment.

13. **Given the over-performance, we are revising our primary deficit target for 2014 to 2 percent of GDP.** The revision reflects permanent improvements in our wage bill and social contributions (0.7 percent of GDP), as well as additional expected central bank dividends (0.6 percent of GDP). To help meet our targets, we will continue to maintain a prudent execution of the 2014 budget, given still high macroeconomic uncertainty and contingent liability risks. If necessary, we stand ready to consider reallocations within the 2014 budget to facilitate the introduction of our welfare reform in mid-2014. We remain committed to our long-run primary surplus target of 4 percent of GDP by 2018, which requires additional measures in the outer years.

14. **We are committed to maintaining the current short-term debt levels going forward.** Given the better than expected fiscal performance and our interest in lowering interest costs, we have reduced our stock of short-term debt at end-December 2013 by about 1.4 percent of GDP relative to a year ago. Going forward, we are committed to preserve the current level of short-term debt to ensure sufficient financing given still large macroeconomic uncertainty. We will revise our debt targets for 2014 accordingly.

15. **We will continue to support our SMEs through the provision of government guarantees.** We have secured about €600 million in EIB loans to be on lent or provide trade credits to our SMEs in 2014-2016. Of this amount, we expect €100 million to be disbursed as a direct loan to the government in the second quarter of 2014. For the remainder, we plan to provide guarantees of about €150 million in 2014, given the expected schedule of disbursements. In addition, we plan to provide additional guarantees amounting to €75 and €87 million respectively for loan disbursements for ongoing EIB- financed sewerage board projects and for loans to the electricity company EAC. We will modify our debt and guarantee targets accordingly to reflect these developments.

D. Structural Fiscal Reforms

Our fiscal adjustment program is complemented by a set of ambitious structural reforms with the aim of (i) improving the protection of vulnerable groups, (ii) strengthening the administration of public resources through effective public financial management and a

more efficient tax administration, and (iii) privatizing state-owned enterprises to enhance economic efficiency and support public debt reduction.

16. **We remain committed to implement a comprehensive social welfare reform to protect vulnerable groups during the downturn.** The reform, centered on a new Guaranteed Minimum Income scheme (GMI), aims at ensuring adequate and equitable social protection, while preserving work incentives. The GMI will be complemented by other well-targeted benefits, such as child or education benefits. In March, we will initiate consultation with social partners on the elements of the reform, which have already been developed and costed. On this basis, by end-March 2014, the Council of Ministers will approve the final design of the new system, including decisions on the type, level, and eligibility criteria of the GMI, as well as on the level and scope to streamline other benefits (existing **structural benchmark**). We remain committed to implement the reform by end-June 2014 (existing **structural benchmark**), provided that the IT pilot testing phase is completed successfully by end-May.

17. **We are also taking steps to improve the efficiency and effectiveness of our revenue administration**.

- ***Integrating VAT and Inland Revenue services*:** We remain committed to reforming our revenue administration. In this regard, in early January, the Council of Ministers approved the plan to create a new function-based tax administration integrating the existing Inland Revenue Department (IRD) and VAT Services (VS), aimed at improving the efficiency of tax administration. As a first step, by end-April, we will submit to parliament the enabling law consolidating the two existing tax authorities into a single Department of Taxation by transferring powers and existing operations of the IRD and VS to the new department (**structural benchmark)**. By end-December 2014, we will establish an integrated unit for large taxpayers—which account for the largest share of revenues—in the new department (**structural benchmark**).

- ***Short-term measures to boost tax collections*:** We are intensifying efforts to protect revenues during the downturn. To this end, we are focusing on several areas:

  - ***Monitoring***: To mitigate the risk of revenue loss during the integration of the tax departments, we will closely monitor monthly performance indicators including registration, filing and payment, auditing and debt collection. This will allows us to detect slippages and consider timely corrective actions.

  - ***Auditing***: We have developed a work program for conducting targeted joint audits for large taxpayers and high-risk sectors during 2014, including by setting numerical audit targets. On this basis, we plan to finalize two pilot comprehensive field tax audits by end-June.

  - ***Tax debt recovery:*** In order to gauge the size and nature of tax debt, including assessing the amounts that are directly and immediately collectible, by end-March 2014, we will prepare a report on tax debt covering IRD and VS tax accounts. On this basis, we will prepare a plan by end-June, specifying the modalities to recover debt, which include case-by-case installment schemes, set-offs, and other options.

- ***Enforcement powers***: To facilitate the debt recovery process and provide incentives to remain current on tax obligations, as a **prior action** for conclusion of the third review, we will submit to Parliament legislation to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to garnish assets, or prohibit the alienation or use of assets, including property and bank accounts.

18. **We continue to improve public financial management**. In this regard, we are taking a number of steps. First, the Fiscal Responsibility and Budget Systems Law has been adopted as a **prior action**, aiming to strengthen budget formulation and execution, public investment management, and the management of fiscal risks. Second, we have amended the Public Debt Management Law to facilitate the monitoring of government guarantees. Third, also to improve monitoring of fiscal risks associated with state owned enterprises (SOEs) and semi-government entities, we have supplemented the 2014 budget with an SOE annex. Finally, to avoid budget overruns, we have introduced pre-invoicing controls, making government orders subject to pre-commitment validation. Going forward, by end-April, we will prepare a roadmap detailing the steps required to fully implement the FRBSL, including additional legislation and guidelines, and their prioritization. In this context, also by end-June, we will adopt secondary legislation and/or guidelines for public investment management, including for project appraisals.

19. **We remain fully committed to our privatization objectives**. Through privatization of state assets, we aim to improve economic efficiency, reduce our public debt, and encourage foreign direct investment in our economy. In this regard, we have adopted a privatization law as a **prior action**. The approval of the law will allow for the establishment of a unit to manage the privatization process, which will become fully operational by mid-May. Once the unit is in place, we will initiate preparations for the privatization of the state-owned enterprises with the highest commercial value. We will start with the telecommunications company (CyTA) and the commercial activities of the ports administration (CPA), which we aim to privatize before the end of our program. Privatization of the electricity company (EAC) will require substantial preparations, including unbundling the activities of the company, and is expected to be finalized by mid-2018. In this regard, we will appoint financial advisors for these three transactions by end-September.

E. Program Financing and Monitoring

20. **We remain committed to limit financing needs and lower public debt.** The CBC will allocate central bank profits to the government (in line with CBC duties under the Treaties and the Statute) expected to result in the transfer of €0.2 billion to the budget by end-April, after finalization of the CBC's financial accounts, and of an additional €0.2 billion during the program period. Separately, we are conducting an independent valuation of state assets, to be finalized by end-March, followed by a second valuation on behalf of the CBC, to be completed by end-May. On this basis, we aim to conduct a debt-to-asset swap to be decided by the CBC in accordance with its rules and the Treaties, aiming to reduce public debt by approximately €1 billion by end-June.

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

22. **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	
	Dec-13			Mar-14	Jun-14	Sep-14	Dec-14
	Target	Adjusted target	Actual				
Floor on the general government primary balance 2/	-435	-518 4/	-272	-22	-65	72	-307
Ceiling on the general government primary expenditure 2/	7,205	7,288 4/	7,121	1,504	3,143	4,734	6835
Ceiling on the stock of general government debt	18,668	18,620 5/	18,407	18,399	18,183	18,233	19129
Ceiling on the accumulation of new general government guarantees 2/	25	129 6/	51	0	127	207	312
Ceiling on the accumulation of external arrears 2/ 3/	0		0	0	0	0	0
Ceiling on the accumulation of domestic arrears 2/	0		-0.3	0	0	0	0
Ceiling on the accumulation of tax refund arrears by the general government 2/	10		-31	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 target was adjusted to reflect the compensation of pension funds for the losses related to the resolution of Laiki bank.
5/ The target was adjusted to reflect a correction of the end-March 2013 debt level on account of sewerage boards debt incorrectly classified within the general government.
6/ The target was adjusted to reflect the provision of guarantees for the EAC Vassilikos Power Plant Phase IV loan.

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 Actions	
Submission to parliament of measures to fight tax evasion (TMU ¶17)	Before Board meeting
Adoption by Parliament of the legal framework for privatizations (TMU ¶18)	Before Board meeting
Adoption by Parliament of the fiscal responsibility and budget systems law	Before Board meeting
Proposed New or Modified Structural Benchmarks	
Appoint a well-recognized and independent consulting or auditing firm(s) or international institution(s) to be entrusted with the voting rights of legacy Laiki equity stake in BoC and manage the disposal of Laiki's assets abroad	End-April 2014 (Modified structural benchmark)
Submission to Parliament of the new Cyprus Tax Department's enabling law	End-April 2014
Completion of the assessment of the operational capacity of cooperative credit institutions' loan workout units, including with respect to early arrears	End-May 2014
CBC units responsible for the supervision of BoC and the coops to submit to the CBC Board the first quarterly report regarding BoC's/coops performance against selected operational and financial targets	End-May 2014
Submission to parliament of legislation to modernize personal insolvency procedures	End-December 2014
Submission to parliament of legislation to modernize corporate insolvency procedures and to regulate insolvency practitioners assisting in the restructuring process	End-December 2014
Establishment of an integrated large taxpayers unit	End-December 2014
Existing Structural Benchmarks	
Completion by the CBC of an in-situ assessment of the degree of operational capacity of the banks' loan workout units to implement their arrears management plans	End-March 2014
Approval by the Council of Ministers of the final design of the reformed social welfare system, including decisions on the type, level and eligibility criteria for GMI and any remaining benefits, consistent with the 2014 and medium term budget ceilings	End-March 2014
Merger of the credit cooperative sector into a maximum of 18 institutions which will be recapitalized to fulfill the capital requirements under the law	End-March 2014
Implementation of a new social welfare system to improve the targeting of social assistance, consolidate welfare programs, and streamline administration costs	End-June 2014

Cyprus - Technical Memorandum of Understanding

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

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

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

A. Quantitative Performance Criteria and Indicative Targets

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

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

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

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

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

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

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

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

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

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

- The 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)

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

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

8. The 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)

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

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

- Upwards (downward) by the amount of any upward (downward) revision to the stock of end-March 2013 general government debt.
- Upwards (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)

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

For reporting purposes, the stock of guarantees within the year will be derived on the basis of material fluctuations.

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

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

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

Ceiling on the Accumulation of Domestic Arrears (performance criterion)

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

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

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

B. Monitoring of Prior Actions and Structural Benchmarks

16. **Adopt a law on fiscal responsibility and budget systems (prior action).**

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

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

17. **Submit to parliament 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 to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to garnish assets, or prohibit the alienation or use of assets, including property and bank accounts.

18. **Adopt a privatization law establishing the legal and institutional framework for privatizations (prior action)**

Specification. The privatization law will include the following elements: (i) the definition of the scope of the privatization program; (ii) the institutional set-up to govern the process; (iii) the procedures and modalities to carry out privatizations; (iv) specification that proceeds will be channeled through the budget; and (v) the requirement to regulate potential monopolies prior to privatization.

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

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

- The authorities will develop, in consultation with Fund staff, a supervisory program for 2014, taking into account the risks faced by Cyprus that will include a combination of full AML/CFT inspections and thematic reviews focused on risks related to third party introducers, Politically-Exposed-Persons, and the laundering of the proceeds of tax evasion.
- In order to enable the AML/CFT supervision unit to implement its 2014 annual inspection program, adequate resources and staffing will be dedicated to perform all its supervisory tasks, including for off- and on-site activities. In this regard, by end-February, full-time resources will be allocated to complement the existing two full-time AML dedicated staff with a minimum of five additional experienced supervisors over the course of 2014.
- By end-February, tenders will be submitted to complement resources with external auditors with recognized supervisory experience, including for AML/CFT, to ensure that each onsite inspection visit can be supported by external support.

AML supervision's implementation:

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

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

Exchange of financial intelligence:

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

C. Reporting Requirements

20. 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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