

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, strengthening supervision and addressing expected capital shortfalls;
- 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

The banking sector has been severely affected by the broader European economic and sovereign crisis, in particular through its exposure to Greece. However, many of the sector's problems are home-grown and relate to overexpansion in the property market as a consequence of the poor risk management practices of banks. Furthermore, the financial sector was vulnerable because of its size relative to that of the domestic economy. The handling of problems in the sector has been complicated by the sensitivity of collateral valuations to property prices, and banks have used certain gaps in the supervisory framework to delay the recognition of loan losses, thus leading to significant under-provisioning. The banking sector would benefit from a considerable restructuring in order to restore its solvency and viability, reinforce its resilience and regain public confidence.

Progress since April

Work continued to address the challenges, in particular the downsizing of the banking sector and regulatory reform, as well as the restructuring of the banking sector. First, Bank of Cyprus has been taken out of resolution upon the finalisation of its asset valuation. Second, the authorities have designed a strategy to restructure the cooperative credit institutions. Third, Hellenic bank has launched a capital raising plan. Fourth, administrative restrictions and capital controls have gradually been relaxed.

While the implementation of the restructuring of the banking sector has met with some delays, considerable progress has been achieved on supervision and regulation. The new classification on non-performing loans is in effect since 1 July. A unified data reporting system for both commercial and cooperative banks has been implemented and on 23 July the financial stability indicators in the new framework were available on the website of the Central Bank of Cyprus (CBC). The integration of the supervision of the cooperative credit institutions is being finalised. Monitoring of private sector indebtedness is stepped up with the presentation of the first (internal) quarterly report on 12 July. Concerning dealing with troubled borrowers, a CBC circular was issued end-April to grant a grace period of 60 days and legislation/regulation is in preparation to better manage arrears and to set up a mediation service. The amendments to anti-money laundering legislation have been submitted to Parliament and changes to the trust register to improve the information on the beneficial owner is in the process of legal vetting.

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. As bank liquidity was under pressure after the two largest domestic Cypriot banks have been put under resolution, exceptional measures were necessary with a view to preventing large deposit outflows and preserving the solvency and liquidity of credit institutions. Temporary restrictive measures for cash withdrawals and exports of cash, card payments, credit transfers, the cashing of cheques and account opening were introduced. These measures were designed to minimise disruptions in the payment systems and to ensure the execution of transactions essential for the functioning of the economy. The Government

has introduced and implemented the restrictions in line with the rules on the free movement of capital set out in the Treaty on the Functioning of the European Union. The impact of the restrictions has since been monitored on a daily basis by the Cypriot authorities with full information sharing with the European Commission (EC), the European Central Bank (ECB), the European Stability Mechanism (ESM) and the International Monetary Fund (IMF). A Monitoring Board has been established by the EC and the Cypriot authorities, with the ECB, the IMF, ESM and the EBA participating as observers, in order to ensure monitoring, assessment and timely relaxation of the implemented temporary restrictive measures. A number of restrictions have already been relaxed or lifted, following a gradual approach, after consultation with the Monitoring Board. The remaining restrictive measures will remain in place no longer than is strictly necessary to mitigate serious risks for the stability of the domestic financial system.

1.2. The Cypriot authorities have developed a roadmap which identifies a series of milestones for the gradual relaxation of the remaining measures, also taking into account indicators of investor confidence in the banking system and financial stability indicators, including the liquidity situation of credit institutions. To enhance transparency and predictability of policies, the roadmap was published **on 8 August 2013**. The roadmap foresees two major stages of relaxation: the first pertains to measures within the Republic and the second relates to cross-border movements of capital.

1.3. 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 the issuance of additional government guarantees, if needed.

1.4. The authorities will request domestic banks relying on central bank funding or that are to receive State aid to establish and submit, quarterly, medium-term funding and capital plans, to be communicated at the end of each quarter to the CBC, which 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 plan **by end-September 2013 and mid-October 2013 respectively**. The plans should realistically reflect the anticipated deleveraging in the banking sector and reduce dependency on borrowing from the central bank, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario will be provided by the CBC, in coordination with the ECB.

1.5. The lack of concentration limits in the liquidity framework for euro-denominated assets allowed a concentrated exposure of Cypriot banks to Greek sovereign debt. To avoid similar outcomes in the future, the CBC will update the liquidity regulations **by December 2014**, after consultation with the ECB, the EC and the IMF and informing the ESM.

Regulation and supervision of banks and cooperative credit institutions

1.6. Strong efforts should be made to maximise bank recovery rates for non-performing loans, while minimising the incentives for strategic defaults by borrowers. The administrative hurdles and the legislative framework currently constraining the seizure and sale of loan collateral will be amended such that the property pledged as collateral can be seized within a maximum time-span of 1.5 years from the initiation of legal or administrative proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. Based on a report commissioned to an independent expert, the necessary legislative changes will be

submitted to the House of Representatives **by mid-2014** and implemented **by end-2014**, macroeconomic conditions permitting.

1.7. Non-performing loans are threatening bank profitability and need to be properly monitored and managed in order to safeguard the banks' capital buffers. 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 including historical observations reaching as far back as possible.

1.8. 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. The legal framework for the credit register will be set up **by end-September 2013** and the central credit register will be operational **by end-September 2014**.

1.9. 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 will review, **by end-October 2013**, its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Without prejudice to the conclusions of this review and to the existing regulatory and accounting framework in the EU, regulatory amendments will be introduced, drawing on technical assistance, with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will enter into force **by end-March 2014**.

1.10. Legislation will be passed **by end-September 2013** to strengthen banks' governance by prohibiting commercial banks and cooperative credit institutions from lending to independent board members, including their connected parties, and removing any board members whose existing debts to their banks are non-performing in accordance with the new definition adopted by the CBC, while lending to other board members will be prohibited above a certain threshold, which will be calibrated by the CBC. Loans and other credit facilities to each board member will be disclosed to the public. A majority of directors in banks' boards will be independent.

1.11. The CBC will submit draft legislation to Parliament **by end-December 2013** to introduce mandatory supervisory action based on capitalisation levels, drawing upon technical assistance and international best practices, becoming effective **by end-March 2014**.

1.12. The CBC will issue **by end-October 2013** mandatory disclosure requirements to ensure that banks regularly communicate to markets progress in restructuring their operations. Starting **end-December 2013**, banks under restructuring plans will be required to publish quarterly reports describing main developments. To enhance their credibility, the reports will be accompanied by independent assessments made by the banks' external auditors on the basis of agreed procedure with the CBC.

1.13. Stress-testing will be integrated into regular off-site bank supervision and will serve as an input into Pillar 2 assessments. Supervisory stress-tests will be carried out at an annual frequency, with the first exercise completed in accordance with the timeline to be set in the framework of the Single Supervisory Mechanism.

1.14. Cooperative credit institutions have played a significant role in the domestic economy and an important objective of the programme is to strengthen the regulation and supervision of the cooperative sector. To complete the alignment of the regulation and supervision of cooperative credit institutions to that of commercial banks, the Cypriot

authorities will integrate the supervision of cooperative credit institutions into the CBC, for which legislation will be passed as a **prior action**. Subsequently, the CBC will finalise **by end-September 2013** a detailed action plan to effectively exercise the supervision of the cooperative sector. This action plan should include steps to recruit experienced staff, and to apply the CBC supervisory and regulatory model for the effective monitoring of the entire cooperative credit sector, to be fully operational **by end-March 2014**.

1.15. The accounts of cooperative credit institutions, above a size to be decided by the CBC after consultation with the EC, the ECB and the IMF while informing the ESM will be subject to an independent annual audit by an external, recognised and independent auditing firm. The CBC will have the right to overturn the selection of an auditor by any cooperative credit institution. The pro forma consolidated accounts of the cooperative credit institutions will be published beginning from 2013 annual accounts.

1.16. The CBC should have sufficient staff to fulfill its responsibilities and tasks. Legal obstacles to the CBC's ability to employ and retain the necessary and qualified staff should be removed without delay. To further strengthen the regulatory and supervisory framework in line with international best practices, the authorities will also request a stand alone assessment against the “Basel Core Principles for Effective Banking Supervision”, to be completed **by end-2015**.

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.

1.18. Measures will be taken to deal with troubled borrowers following the implementation of the resolution and recapitalisation of banks. 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.

- Several steps have already been taken and the Cypriot authorities need now to finalise the banks' Code of Conduct for dealing with troubled borrowers and framework for the management of arrears **by end-August 2013**. In this regard, in addition to the central credit registry, a framework for seizure and sale of loan collateral will be implemented
- **By end-September 2013** banks will be asked to submit to the CBC a strategy to implement the framework for the management of arrears. Banks will need to include in the strategy a diagnostic of areas that require strengthening and an action plan to ensure full implementation.
- **By end-October 2013**, banks will submit to the CBC their plan to implement the restructuring framework within their organization. They will also be required to report on restructuring progress along specific performance indicators (e.g. number of loans restructured, cash collections, etc.).

- Building on recent work to identify and address impediments for private debt restructuring, **by end-October 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 mediation service between banks and their clients to achieve fair debt restructuring **by end-November 2013**, while ensuring adequate resources for the service given the expected case load.

Increasing financial transparency

1.19. The anti-money laundering (AML) framework will be further strengthened in line with best practice. While Cyprus' AML regime received an overall positive evaluation in the 2011 MONEYVAL report, the April 2013 audit undertaken by MONEYVAL and an independent auditor identified specific shortcomings. 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:

- 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 Cypriot authorities' commitment to establish trust registers with the supervisory authorities (Action Plan – section 4.3.1)
- 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).
- 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.

Moreover, to address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have committed to revise 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 in response to requests related to money laundering and tax matters:

- To this end, the Cypriot authorities will promptly, **by 11 September 2013** and in any event prior to the release of the second tranche of financial assistance, adopt revisions to the Trust and Company Services Provider law.
- In addition, **by 11 September 2013** and in any event prior to the release of the second tranche of financial assistance, the authorities will amend the Anti-Money Laundering Law in order to enable the provision of the widest possible range of cooperation to foreign counterparts (including with regard to the laundering of the proceeds of tax crimes involving fraudulent activity), and by giving precision to the scope of cooperation by the financial intelligence unit.

- In addition, the authorities will ensure that directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) are revised to lay down clear implementing procedures, in line with relevant legislation and international standards **by Q3 2013**.

B. Recapitalisation, resolution 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**.

Restructuring and resolution of Bank of Cyprus

1.21. A transitory Board of Directors of Bank of Cyprus, appointed on 26 April 2013, has been mandated by the CBC to ensure the bank's stability once it has exited resolution. The transitory Board of Directors has called a General Meeting of the shareholders to be held, no later than **12 September 2013** to appoint a new Board of Directors. The CBC will require the Board to prepare a restructuring plan defining the bank's business objectives and credit policies, including measures to enhance viability and profitability, **by mid-October 2013**. The plan, to be reviewed and approved by the CBC, should specify quarterly goals.

Restructuring and recapitalisation of other commercial banks

1.22. Commercial banks with a capital shortfall, which are deemed viable, can, if other measures do not suffice, ask for recapitalisation aid from the State. Capital should, to the largest extent possible, be raised from private sources including asset disposals and liability management exercises. To this end, **by end-September 2013**, the necessary steps will have been launched. In case, **by end-October 2013**, private sector participation was not successful, State aid can be granted. Any public support granted, must be in line with State aid rules. The banks need to be fully capitalised **by end-December 2013** without burdening depositors.

Restructuring and recapitalisation of cooperative credit institutions

1.23. The CBC assessed the capital needs of individual cooperative credit institutions, indicating a total capital shortfall of EUR 1.5 billion. The CBC has finalised by **July 2013** a strategy for restructuring and recapitalising the sector, including a plan to merge individual cooperative credit institutions into a maximum of 18 entities **by March 2014**. These mergers are designed to achieve viability, efficiency and profitability.

1.24. Within that strategy the CBC will introduce a minimum capital requirement for the core tier 1 ratio of 4% for the individual affiliated cooperative credit institutions. That requirement will enter into force **by end-December 2013**, but the capital will be only injected by the Central Cooperative Bank into individual cooperative credit institutions as mergers are completed. At the consolidated level, the sector is still subject to the general minimum core tier 1 capital requirement of 9%.

1.25. The restructuring plan for the cooperative sector will be submitted to the EC **by September 2013**. Cooperative credit institutions in need of aid from the State will not be recapitalised before the restructuring plan has been formally approved under state-aid rules. 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. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones.

1.26. The legal framework for a new governance structure to manage the stake of the State in the cooperative credit sector will be established, as a **prior action** for the review. The framework will allocate clear levels of continued accountability and will define the role of the State as the main Central Cooperative Bank shareholder. On this basis, a relationship framework between the State and the Central Cooperative Bank will be established and fully operationalized **by end-October 2013**, 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. Sufficient funds for the recapitalisation of the cooperative credit institutions will be made available from the programme following the fulfilment of the prior action, as mentioned above, and will be deposited in a securities account with the CBC to boost confidence in the system. EUR 1.5 billion of state funds will be injected in the Central Cooperative Bank in exchange for common shares on the basis of capital needs identified in the PIMCO exercise and in line with state aid rules, **by end-October 2013**.

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 2013, listed in Annex 1 and below; (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 as well as initial steps in relation to fiscal-structural reforms. The authorities commit to the full implementation of these measures (see Annex 1) and to monitoring the budgetary effect of the measures taken on a monthly basis. 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,¹ will be saved or used to reduce debt. If instead over-performance materialises, to the extent that it is deemed permanent, this can reduce the need for additional measures in the outer years.

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 2014-20 programming periods, while taking into account available EIB funding. The authorities will ensure that the institutional

¹ 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

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.

Fiscal policy in 2013

2.1. The Cypriot authorities will achieve a general government primary deficit of no more than EUR 395 million (2.4% of GDP) in 2013. The 2013 deficit target may be revised to incorporate compensation for provident and retirement funds in Cyprus Popular Bank (see 2.3). Over 2013, the Cypriot authorities will rigorously implement the 2013 Budget Law (as amended), including the additional permanent measures adopted prior to the granting of the first disbursement of financial assistance (see Annex 1), which should amount to at least EUR 351 million (2.1% of GDP).

The following measures will be adopted after review by and consultation with the programme partners prior to the granting of the second disbursement of financial assistance:

2.2. 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.

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

Fiscal policy in 2014

The Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 678 million (4¼% of GDP) in 2014. To this end, Cyprus should 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 agreed in the context of the 2014 Budget Law consultation.

After review by and consultation with the programme partners **by mid-September 2013**, the 2014 Budget Law will be adopted **by December 2013**. The 2013-2015 expenditure ceilings will be updated for the period 2014-2016 and will accompany the 2014 Budget Law document. The presentation of these ceilings will evolve into a full-fledged Fiscal Strategy Statement in line with the MTBF requirements contained in Directive 2011/85/EU. Any

deviation from the budgetary objectives contained in the 2013-2015 framework will be properly documented and reasons for such deviations will be provided to the programme partners.

Ensure additional expenditure savings, 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.

Fiscal policy in 2015-16

The Cypriot authorities will achieve a deficit in the 2015 general government primary balance of no more than EUR 344 million (2.1% of GDP) and a surplus in the 2016 general government primary balance of at least EUR 204 million (1.2% of GDP).

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

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) implement further reforms of the pension system to address the high projected increase in pension spending; (3) take further steps to control the growth of health expenditure; (4) enhance tax revenues by improving tax compliance and collection; (5) 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; (6) 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 (7) elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatisation programme.

Pension reform

3.1. While taking note that the Cypriot authorities have recently introduced significant reforms (as noted in Annex 1), the implementation of further reforms of the pension system to address the high projected increase in pension spending may be necessary in order to put the pension system on a sustainable path. The overarching objectives of the reforms are: i) to reduce the increase in pension spending, ii) to ensure the long-term financial viability of the pension system through 2060, and iii) to limit the fiscal subsidy to the General Social Insurance Scheme for credited contributions for current and future pensioners and for the non-contributory pension.

In view of this, the Cypriot authorities have implemented/agreed to implement the following measures:

- separate in accounting terms the non-contributory pension benefit from the insurance-based (contributory) pension scheme (in place **since July 2013**). The non-contributory part will be tax financed;
- measures have been adopted to ensure that total annual public pension benefits do not exceed 50% of the annual pensionable salary earned at the time of retirement from the post with the highest pensionable salary of the official's career in the public sector and broader public sector (except for pension benefits for Members of the House of Representatives, for whom the measures will be adopted **by mid-October 2013** and enter into force by **1 January 2014**); and
- 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.

An actuarial study for the GSIS will be submitted **by end-August 2013**, for peer review in the Ageing Working Group of the Economic Policy Committee. The objective of the actuarial study is to provide additional reform options to ensure the long-run viability of the national pension system.

The actuarial study should project the scheme's finances on a cash basis. Given the financial sustainability focus, on the revenues side, the study should not take into account any government subsidy (i.e. contribution that is currently at 4.3% of the payroll and the return on the accumulated notional reserves as at the start of the projection period) with the exception of credited contributions and the contributions made by the government as an employer on behalf of its employees. On the expenditures side, the study should only take into account benefits related to contributions paid and credited contributions, i.e. excluding the costs related to the top-up for the minimum pension (which is considered to be tax financed). The study should analyse the impact of additional reform options such as benefit reductions (while considering adequacy), an increase in the statutory retirement age and increases in contribution rates or combinations thereof taking into account the impact on labour costs.

After review by and consultation with the programme partners, if needed, a comprehensive reform with the aim of establishing the long-run viability of the system, will be carried out; and, this reform will be adopted **by end-December 2013** and enter into force **in Q1-2014**.

Health care expenditure

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

- a) 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 aim at full implementation by **Q2-2015**;
- 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**;
- 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) to complete 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 **Q4-2013**;
- 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 **Q4-2013**;
- 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;
- 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 **Q3-2013**;
- i) continue to code inpatient cases by the system of diagnosis-related groups (DRGs) with the aim of replacing the current hospital payment system by payments based on DRGs by **Q3-2013**; and,
- j) in a first step, establish working time in the Health Service, in conjunction with moving the starting time by half an hour (from 7.30 to 8.00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but

the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00). Following a review, in a second step, revise the regular working hours and stand-by shifts of healthcare staff, including rules to increase the mobility of staff; revise current regulations on overtime pay and fully implement existing laws on recording/monitoring overtime payments (see 3.10) **by Q1-2014**.

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

Budgetary framework and public financial management

3.3. The Cypriot authorities will:

- 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);
- 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**.

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, **by Q4-2013**, will:

- Remove the risk of overspending by making sure all spending commitments are 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.

Public private partnerships (PPPs)

3.4. The Cypriot authorities will:

- create an inventory of PPPs including information on the objectives of current and planned PPPs and more detailed information on signed contracts, including their nature, the private partner, capital value, future service payments, size and nature of contingent liabilities, amount and terms of financing. In addition, an inventory of contingent liabilities including information on the nature, intended purpose, beneficiaries, expected duration, payments made, reimbursements, recoveries,

financial claims established against beneficiaries, waivers of such claims, guarantee fees or other revenues received, indication of amount and form of allowance made in the budget for expected calls, and forecast and explanation of new contingent liabilities entered into in the budget year will be compiled. The inventories will be shared **by Q3-2013** with the programme partners. **As of 2014**, the inventories will be updated annually and included as “Statement of PPPs” and “Statement of Contingent Liabilities” in appendices to the annual budget law and to 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, 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 be drafted **by Q3-2013** and implemented **by Q4-2013**; and
- 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 project having 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:

- establish an inventory of assets, owned by central government and local authorities, including real estate and land. The inventory shall include all SOEs, reflecting up-to-date valuations of those with the highest commercial value **by Q3-2013**. The inventory will indicate which SOEs could be subject to divestment or restructuring or liquidation. The inventory of the largest and most valuable real estate and land assets (those of market value exceeding EUR 1 million) will be ready **by Q3-2013**. The full inventory of all assets (SOEs, real estate and land) will be completed **by Q4-2013**. The inventory will be gradually submitted to the programme partners;
- prepare a plan to strengthen the governance of SOEs in accordance with international best practices and draft a report reviewing the operations and finances of SOEs (see 3.10) **by Q3-2013**. The report will assess these companies' business prospects, the potential exposure of the government to the SOEs and the scope for orderly privatisation. The Cypriot authorities will adopt the necessary legal changes to fulfil this requirement **by Q4-2013**. No additional SOEs will be created throughout the duration of the Programme; and
- 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**.

3.6. The Cypriot authorities will initiate a privatisation plan to help improving economic efficiency through enhanced competition and encouragement of capital inflows, and to help restoring debt sustainability:

- This plan should consider the privatisation prospects of state-owned enterprises (SOEs) and semi-governmental organisations (SGOs), including, inter alia, CyTA (telecom), EAC (electricity), CPA (commercial activities of ports), as well as real estate/land assets. For the privatisation of natural monopolies, an appropriate regulatory framework is a prerequisite. 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 appropriate secondary legislation rules;
- The privatisation plan will be based on the report reviewing and assessing the operations and finances of SOEs (3.5), as well as the inventory of assets. The privatisation plan will be finalised after consultation with programme partners, including asset-specific timelines and intermediate steps **by November-2013**;
- In parallel, the specific legal and institutional framework for the privatisation process will be implemented **by Q4-2013**, after consultation with programme partners; and
- 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**.

Revenue administration, tax compliance, and international tax cooperation

3.7. The Cypriot authorities will reform the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection capacity and the fight against tax fraud and evasion, with a view to increasing fiscal revenue. The reform will comprise of a programme of short-term measures to enhance compliance, efficiency and effectiveness as well as a comprehensive long-term reform covering risk management and the establishment of a new integrated function-based tax administration structure, integrating the existing IRD and VAT services. The short-term programme will be implemented by **Q4-2013** and include the following sets of measures:

Enact legislative changes to enhance tax collection and voluntary compliance by

- 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 taxes is a criminal offense regardless of the type of tax and ensure tax fraud is prosecuted as a criminal offense; and
- 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.

Improve efficiency and effectiveness of the administration by,

- ensuring staff mobility between different tax administration entities in order to ensure appropriate staffing of entities with high revenue collection capacities;
- 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-filing of tax returns and e-payment (e.g. by allowing payment through bank transfers);
- 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;
- deciding on a joint audit programme for large taxpayers, to be conducted **in 2014**;
- developing a joint work programme for conducting targeted audits and enhancing voluntary compliance of known high-risk groups; and
- 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.

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 and on an evaluation of different risk treatment strategies. Work for the risk identification and analysis will begin **in Q4-2013**.
- The full integration of the two tax departments will be completed in several phases and will be accompanied by a set of flanking reform measures, such as the development of a common tax procedure code. As a first step, the authorities will,
 1. establish the project management, including a high-level governmental steering committee chaired by the Minister of Finance and an executive technical committee, which manages the development and implementation of the reform plan and which will be chaired by the Permanent Secretary of the Ministry of Finance **by Q3-2013**;
 2. develop a reform plan that reflects the recommendations of the TA received in February 2013. The reform plan will be agreed with program partners and approved by the government **by Q4-2013**; and
 3. 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 tax gap) **by Q2-2014**.

3.8. The Cypriot authorities will safeguard the timely and effective exchange of information in regard to 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 taxation² 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
- 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.

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

The following measures will be taken to increase revenue and to improve the fairness of the tax burden by levying the recurrent property tax on current market values. An additional objective is to reduce overhead cost in tax base administration.

² The Cypriot authorities have submitted Law N. 205(I)/2012 (enacted on 28 December 2012), transposing the Directive, to the European Commission.

3.9. In view of this, the Cypriot authorities have agreed to:

- implement a property price index that establishes the average market valuation in 2013 by square meter of habitable surface and land plot. This index shall be operational to provide imputed market valuations for each cadastral plot **by Q2-2014**, in time for the immovable property tax collection in 2014. The index shall vary according to location and zoning as well as other tangible building- and plot-related characteristics. Moreover, the authorities will implement a methodology for annual updates of such imputed market valuations;
- implement the recurrent immovable property tax based on such imputed market valuations **by Q3-2014**. The tax rates shall reflect the progressivity and revenue of the preceding property tax. For co-owned land plots, individual owners shall be taxed according to ownership proportions as provided in the cadastre;
- establish the legal basis for a mandatory annual adjustment of the property unit tax base by a competent authority **by Q3-2014**;

In addition, the following studies should be initiated **by Q3-2013**, and their recommendations implemented at the latest **by 1 January 2015**:

- a study on refining the parameters of the imputed property market value index within the bounds of administrative and legal simplicity. In particular, the study shall assess the feasibility of a unit tax base for individual dwellings. Moreover, the study shall report on a mechanism to dampen cyclical variations in the index; and
- 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.

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:

- as a first step, starting on **1 September 2013**, establish working time in the Public Service, in conjunction with moving the starting time by half an hour (from 7:30 to 8:00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00);
- as a second step, further reductions of overtime and related costs to the public sector wage bill are foreseen, 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. Working hours outside regular working time shall be limited by enforcing strict

controls, including requiring pre-approval of any non-emergency work outside regular working time (see 3.2) by **Q1-2014**.

In addition, the Cypriot authorities are commissioning an independent external review of possible further reforms of the public administration. The review will include a horizontal and a sectoral element.

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

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

and will comprise two batches:

- the first batch will be undertaken by the World Bank and the UK public administration and will cover the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies and Official Receiver. 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 after consultation with programme partners, submit it to the House of Representatives for approval and implement it by **Q2-2014**.
- 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**. 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 **Q1-2016**.

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:

- first, define the minimum consumption basket in terms of composition and weights (**Q3-2013**);
- thereafter, refine the costing and the coverage of the new guaranteed minimum income scheme (GMI) which will replace the existing public assistance scheme (**end-October 2013**);
- 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**);
- 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), (see 3.10).

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:

- 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;
- 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
- 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 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.

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 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:

- 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;
- 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;
- 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;
- 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
- reviewing and enhancing the cooperation between the public employment service 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 **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.

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: Sector-specific legislation

5.1. The Cypriot authorities will adopt any remaining necessary amendments to the sector-specific legislation (e.g. construction, tourism, car rental services, employment agencies), in order to fully implement the Services Directive, easing the requirements related to provision of services and establishment. Amendments will be adopted **by Q3-2013**. 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.

Reform of regulated professions

5.2. The Cypriot authorities will:

- eliminate any existing total bans on the use of a form of commercial communication (advertising) in specific regulated professions, such as veterinarians, as required by the Services Directive **by Q3-2013**; and
- 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. This review will be completed **by Q3-2013** for a list of priority professions, to be agreed with programme partners before mid-August 2013, and **by Q4-2013** for the rest of regulated professions. Following completion of the review, the requirements that are not justified or proportional will be eliminated **by Q1-2014**.

Competition and sectoral regulatory authorities

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**;
- 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**;
- promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition **by Q4-2013**;

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 legislative amendments that may be necessary to reach these objectives will be adopted **by Q4-2013**.

Housing market and immovable property regulation

5.4. 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:

- enact legislation for mandatory registration of sales contracts for immovable property **by Q3-2013** and implement guaranteed timeframes for the issuance of building certificates and title deeds **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); take action to accelerate the swift clearing of encumbrances on title deeds to be transferred to purchasers of immovable property **by Q4-2014**;

- 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, starting end-July 2013;
- 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**. Any requirements on the proof of legal interest for access to these data by these bodies shall be abolished **by October 2013**;
- amend the procedure on the forced sale of mortgaged property (see 1.6) 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
- 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.

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:

- provide a concrete action plan leading to the implementation of the quantified targets identified, inter alia in the recently revised Tourism Strategy 2011-2015 **by Q3-2013**;
- present a progress report on the implementation of the action plan twice per year, starting **in Q4-2013**, including an assessment of its implementation based on performance indicators.
- amend the current hotel and other relevant legislation (eg. the immovable property law and town planning policies), in order to facilitate mixed-use developments, **by Q4-2013**;
- provide a report on the analysis and assessment of concrete needs based on the existing and the future air services agreements **by Q4-2013**. This report will provide the basis for an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, while ensuring sufficient air connectivity. This strategy accompanied with a concrete action plan will be launched **by Q1-2014**. The implementation of the action plan will be reviewed annually by the Cypriot authorities, starting **in Q1-2015**.

Energy

5.6. 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; and provide clarity on the intended use of the available 'isolated market' and 'emergent market' derogations and indicate their intended duration of the latter derogations;

- 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:
 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; first version **by Q3-2013**;
 2. a *comprehensive outline of the regulatory regime (CERA) and market organisation* for the restructured energy sector and gas exports, 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. 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; full unbundling of gas suppliers and customers, in particular electricity companies; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues; by **Q4 2013**, with a view to a final outline **by Q2 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. As a first step, clear rules governing inflows and outflows should be established as part of Cyprus' budgetary framework, coupled with clear accounting rules regarding dividend and fees from government entities and stakes in the energy sector. These will be anchored in the FRBSL (see 3.3) which will be adopted **by Q4-2013**.

Since these three key elements are strongly interdependent, they need to be developed in parallel over time. In addition, the strategy should take into account the current uncertainty over 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 plan 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 a request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-September 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.

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.

Revenue measures

I.36 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.37 Increase the standard VAT rate from 18% in 2013 to 19% in 2014.

I.38 Increase the reduced VAT rate from 8% to 9%.

I.39 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.40 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.

Annex 2

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

	<i>Heading/Deficiency</i>	<i>Action</i>	<i>Timeline</i>
1	<u>Customer Due Diligence</u>		
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.	Q4 - 2013
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.	Q4 - 2013 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.	Q4 - 2013
	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.	Q4 – 2013
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.	Q4-2013 Q2-2014

2	<u>Reliance/introduced business</u>		
	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.	Q4 – 2013
	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.	Q3 – 2013
3	<u>Suspicious Transaction Reporting</u>		
	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	<u>Transparency of beneficial ownership</u>		
4.1	<u>Access to information</u>		
	Ensure that transparency and availability of beneficial ownership information is in line with international standards and best practice.	4.1.1 Revision of Trust and Company Services Providers Law as appropriate and AML Law to ensure that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to the domestic competent authorities and their foreign counterparts; and revise the directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, ICPAC). 4.1.2. In the case of nominees, either a) require nominee directors ³ and nominee shareholders to disclose the	Q3 – 2013 Q3-2013

³ Under Cyprus law, there is no legal concept of “nominee director”, but it is used with reference to professionals who provide director services.

		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).	
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, and ensure the department of the registrar is appropriately resourced.	End 2013
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.	Q3 - 2013
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, ⁴ in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Q4 – 2013
		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. ⁵ 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. ⁶	Q4 - 2013

⁴ in accordance with BCP 2 and FATF 26-27

⁵ FATF Immediate Outcome (IO) 3

⁶ See BCP 2.6c

5.2	Develop risk-based supervisory tool(s) for offsite surveillance/monitoring activities prior to implementation	<p>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:</p> <ul style="list-style-type: none"> - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas,⁷ 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). 	Q4 - 2013
5.3	Develop risk-based supervisory tool(s) for onsite inspections prior to implementation	<p>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:</p> <ul style="list-style-type: none"> -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	<p>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:</p> <ul style="list-style-type: none"> - newly developed offsite and onsite risk-based tools; - customer acceptance policies; - customer due diligence (CDD); - monitoring of transactions; - identification and reporting of STR; - funds transfers; - correspondent banking; - recordkeeping; - compliance function; - internal controls; - audit functions; - corporate governance; 	Q2 – 2014

⁷ 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).

		- 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 CBC to establish corrective actions and follow-up on the cases revealed by Deloitte. Apply appropriate enforcement actions with regard to any breaches of compliance, and apply sanctions if applicable.	Q3 - 2013
		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.	Q4- 2013, 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.	<u>Supervision and monitoring of lawyers, accountants and TCSPs</u>		
6.1	Align resources with risks Establish an effective monitoring structure for AML/CFT matters	6.1.1 Ensure adequate human resources and technical capacity to undertake effective AML/CFT monitoring. The level of resources should be commensurate with the size, complexity, and risk profiles of each business and professional. To meet this objective, if deemed necessary by the supervisory authorities, hire AML/CFT experts with the necessary professional skills and experience (e.g. professionals having performed monitoring or supervision of these professions abroad) – subject to necessary confidentiality restrictions.	Q4 - 2013
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: <ul style="list-style-type: none"> - 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 etc.	Q2– 2014 (CBA and ICPAC) Q4-2014 (CySEC)
6.5	Implement adequate supervision	6.5.1. On a quarterly basis, in the context of the programme review, starting Q4-2013, the CySEC, CBA and ICPAC will, on a confidential basis, share anonymised information with the programme partners by granting access, to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Q4 – 2013, 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 3.11 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 ⁸
- ii. Authority for the Supervision of Cooperative Societies ⁹
- iii. Competition Protection Commission¹⁰

⁸ It functions according to *acquis communautaire* prescriptions and it employs only a limited number of people (4 persons).

⁹ The relevant organisation is dealt within the context of the financial sector part of the MoU.

¹⁰ CPC is currently under review by PAPD and should be finalised by Q4 2013, as part of MoU paragraph 5.3. Once the review is finalised, programme partners will assess whether an independent review for the CPC will be needed.