

INTERNATIONAL MONETARY FUND

Monetary and Exchange Affairs Department



CYPRUS

ASSESSMENT OF THE OFFSHORE FINANCIAL SECTOR

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PREFACE

In July 2000, the Executive Board approved a program of assessments of the extent to which certain offshore financial centers had implemented international standards of supervisory and regulatory practice on the basis of a paper “Offshore Financial Centers The Role of the IMF” published in July 2000. In this context, the Governor of the Central Bank of Cyprus invited the International Monetary Fund to carry out an assessment in March 2001 of the extent to which the Cypriot supervisory arrangements for the offshore financial sector complied with certain internationally accepted standards. The assessment was carried out on the basis of the “Module 2” approach, as described in the above mentioned paper. The assessment was carried out by a team led by Mr. Peter Hayward and including Mr. Neville Grant, and Ms. Yuri Kawakami of the Monetary and Exchange Affairs Department, Mr. Nadim Kyriakos-Saad of the Legal Department, Mr. Peter Kruschel, expert on Banking Supervision of the Bundesaufsichtsamt für das Kreditwesen, and Mr. Julian Lamb, Assistant Registrar of the Jersey Financial Services Commission. Mr. Dimitri Demekas of the European I Department participated in the discussions and the report was admirably prepared by Ms. Nirmaleen Jayawardane. The team received excellent cooperation and hospitality from the Governor and staff of the Central Bank of Cyprus and from other regulatory bodies as well as from a number of private sector bodies.

I. EXECUTIVE SUMMARY

The development of the offshore financial sector in Cyprus has been facilitated by the island's location, a preferential tax regime, an extensive network of double tax treaties, particularly with Eastern European and former Soviet Union countries, a legal and accounting framework based on U.K. law and practice, the availability of a well qualified labor force, particularly well endowed with accounting and legal skills, a reliable telecommunication system, relatively liberal immigration and visa requirements, and a ready supply of office and residential accommodation of a high standard.

Regulation and supervision of the offshore sector has been facilitated by the Exchange Control Law, which enables the Central Bank of Cyprus (CBC) to attach conditions to permits issued to nonresidents for business and financial activities in Cyprus. By restricting nonresident owned companies to providing financial and other services exclusively to other nonresidents, the authorities have been able to direct tax preferences to a specific category of business activity without affecting the domestic economy.

The Cypriot offshore financial sector is not large in comparison with other offshore centers. Its contribution to employment and to the foreign exchange earnings of the economy is much smaller than that of tourism, and its contribution to government revenue is minor. The services provided are more restricted than in other offshore centers, being confined to a limited number of banks, some insurance services, and some relatively small scale fund management and advisory business. Current policy is that all such activities should be carried on in physical premises in Cyprus, with accounting records and management available for inspection on the island. Banking is the most important offshore activity but, with assets of \$10.8 billion, it is small relative to that carried on in some other jurisdictions and does not create significant risk for the international financial system. There is also a more extensive network of nonfinancial companies registered in Cyprus, only a minority of which have a physical presence.

The mission undertook a Module 2 assessment in accordance with the procedures agreed by the IMF's Executive Board in July 2000. This comprised a Basel Core Principles assessment of the supervision of the offshore banking sector, and an assessment of the provision of company services to the International Business Companies registered in Cyprus. Because the offshore insurance and investment sectors are currently small, a full scale assessment of compliance with the IOSCO and IAIS principles was not attempted. However, an informal review of the supervision of these sectors was carried out. The results indicated that supervision was generally effective and thorough. There was some scarcity of resources available, and this has meant that the amount of onsite supervision has been somewhat less than would be desirable. The approach of European Union (EU) accession has encouraged

the authorities to introduce a large volume of legislative changes to bring Cyprus into line with the EU. However, Cyprus has licensed institutions from some countries often regarded by other supervisory authorities as high-risk, and, in some cases, supervisory action has been taken against them. While customers do not appear to have experienced significant losses, such an environment will require continued vigilance and a high standard of supervision. The anti-money laundering legislative framework, as it applies to the offshore sector, and the measures imposed by the CBC, the Securities and Exchange Commission, and the Superintendent of Insurance appear to be adequate, although as in other jurisdictions there is still some scope for improving the identification of beneficial owners and the reporting of suspicious transactions, across the board and particularly in the case of nonresident controlled companies. It is also noteworthy that both regulators and financial institutions rely to some extent on accounting and law firms. Neither profession is regulated externally and, although the self-regulatory process may be adequate in dealing with client complaints, it is clear that the provision of company services through limited liability companies owned and managed by accounting and law firms is not effectively regulated.

A major challenge is posed by the need to wind down the Exchange Control regime in advance of accession to the EU. A commitment has also been given to the OECD that, in the event of the organization's tax initiative proceeding, Cyprus will abandon, by 2005, the existing framework of tax preferences in favor of offshore businesses. The authorities are aware that these developments would leave a void in supervisory arrangements and are drafting a new Financial Services Bill, extending supervision to cover all provision of investment services in Cyprus, including some domestic businesses currently outside the scope of the current supervisory framework. These steps will eliminate the differentiation between onshore and offshore financial business. Cyprus will then have a financial system free to do business at home and abroad, while allowing foreign businesses, especially from the EU, ready access to Cyprus's markets.

This assessment covered only the provision of financial services offshore and, not the domestic financial sector. Given the fact that the distinction between onshore and offshore activities is likely to diminish, it would be beneficial, therefore, and aid Cyprus's accession to the EU, for a full assessment of the entire financial sector to be undertaken under the IMF's Financial Sector Assessment Program.

II. BACKGROUND

A. Macroeconomic Developments

Cyprus has a robust economy with relatively low unemployment and inflation in recent years (Table 1).¹ Annual real GDP growth averaged nearly 5 percent during

¹ All data in this report refer to the Republic of Cyprus.

1998-2000 as a result of booming tourism that contributed over 20 percent of GDP and 40 percent of current account receipts.² Unemployment averaged 3.5 percent during 1998-2000. Annual increases in consumer prices averaged 2 percent during 1998-99, while inflation accelerated in 2000, owing to higher energy prices, a weaker exchange rate to the U.S. dollar, and the rise in value-added tax rate from 8 percent to 10 percent on July 1, 2000.

Table 1. Cyprus: Selected Indicators, 1997-2000

	1997	1998	1999	2000 Est.
	(Annual percentage changes)			
Real GDP	2.5	5.0	4.5	5.0
Consumer prices (period average)	3.6	2.2	1.8	4.2
	(In percent of GDP)			
Overall fiscal balance	-5.3	-5.5	-4.1	-2.7
External current account balance	-4.0	-6.7	-2.4	-5.1

Sources: Cypriot authorities and Fund staff estimates.

Preparation for EU membership has propelled a series of major financial reforms. First, the Exchange Control Law, which, together with the Banking Law, gives authority to the CBC to supervise the International Business Companies (IBCs) including International Banking Units (IBUs) and Administered Banking Units (ABUs), defined in paragraph 25 below, is expected to be withdrawn over the medium term as Cyprus complies with the EU requirements on freedom of capital flows.³ The gap is expected to be filled by a new Financial Services Law currently under preparation. The CBC embarked on capital account liberalization measures in 1999 (Box 1).⁴ The most recent important liberalization measures include the abolition, in December 2000, of restrictions on domestic banks extending loans in

² GDP per capita in 2000 reached \$13,154. The population in 2000 was estimated at 670,000.

³ IBCs are defined in Cyprus as nonresident-owned entities providing services to nonresidents. This broad definition includes banks and other financial entities. The narrower definition is specifically used for companies whose main activities are in nonfinancial areas, such as commerce and ship management. Cypriot-owned entities (other than banks) engaging in international businesses are not IBCs, and are not subject to the same regulation and supervision as IBCs.

⁴ Liberalization of portfolio outflows and liberalization of inward and outward real estate investment remain incomplete.

Cyprus pounds to nonresidents who are economically active in Cyprus, and the abolition, on January 1, 2001, of restrictions on both domestic banks and IBUs/ABUs extending medium-term (over two years) and long-term loans in foreign currencies to residents.⁵ Second, the statutory interest rate ceiling has been abolished. The Law on the Liberalization of Interest Rates, repealing the legal interest rate ceiling at 9 percent a year, was enacted in December 1999 and came into effect on January 1, 2001.⁶ Third, the statutory independence of the CBC is being strengthened. The Monetary Policy Committee was set up in December 2000 pursuant to an amendment to the CBC Law in July 2000. The committee, which makes recommendations on monetary policy to the Board once a month, will become the decision-making body on monetary policy when the new CBC Law is enacted, which is expected to be around mid-2002. The new CBC Law will also prohibit monetary financing⁷ and the removal of the Governor of the CBC before expiry of his or her term. Fourth, a new insurance companies law is expected to be enacted in 2001 to harmonize regulations with the EU directives. Finally, the government has made an advance commitment to remove any existing restrictions on the ability of Cypriot entities, including offshore companies, to do business in Cyprus and to make preferential tax treatment available to domestic as well as foreign business of the same type (i.e., to abolish the “ring-fencing” of offshore entities) by 2005 in line with OECD recommendations in this regard: IBCs are subject to a profit tax rate of only 4.25 percent, while domestic companies are taxed at a rate of 20 percent, or 25 percent for chargeable income over C£ 40,000. This commitment is conditional on the OECD implementing its proposed measures to eliminate harmful tax practices in member countries by the end of 2003; no decisions have yet been taken by the Cyprus government on the level at which an equalized tax rate will be established or how the process will be phased.

In preparation for EU accession, the Ministry of Finance prepared the Strategic Plan for Fiscal Adjustment 1999–2002, aiming at reducing fiscal deficits to 2 percent of GDP by 2002. Fiscal deficits narrowed to 4.1 percent of GDP in 1999 and 2.7 percent in 2000, well below the target set for 2000 (4 percent of GDP).

⁵ Previously, residents were required to obtain permits from the CBC to borrow in foreign currencies, and the CBC granted permits only to finance big projects such as hotel construction. At end-2000, lending in foreign currencies by domestic banks to residents comprised 9 percent of their total lending. Since January 1, 2001, residents do not need to seek permits from the CBC, but the CBC continues to collect data for statistical purposes.

⁶ Interest rate liberalization had originally been scheduled for January 1, 2000, but was postponed for a year. The liberalization of borrowing in foreign currency by residents was also postponed to January 1, 2001 to coincide with the abolition of the interest rate ceiling.

⁷ Since 1994, monetary financing has been used sparingly. The limit of financing was gradually reduced during 1994–98, and remained unchanged during 1999–2000.

Extensive capital controls have allowed the CBC to pursue some degree of independent monetary policy despite the exchange rate peg to the euro.⁸ As the statutory 9 percent ceiling on interest rates until end-2000 limited the effectiveness of indirect monetary instruments such as repo operations, the CBC occasionally resorted to direct instruments including the banning of lending for stock purchases and the imposition of bank-by-bank credit ceilings, most recently during 1999–2000, when the boom in the Cyprus Stock Exchange was associated with excessive credit growth.

After narrowing in 1999, the current account deficit bounced back to 5.1 percent of GDP in 2000. The improvement in the invisible surplus,⁹ mainly owing to tourism, was more than offset by a deterioration in the trade balance, as imports surged by 23 percent due to surging oil prices and wealth effects from the stock exchange boom in 1999.

B. Domestic Financial Sector

Structure

The domestic banking sector consists of 12 domestic banks¹⁰ and is relatively concentrated; two large banks (the Bank of Cyprus and Popular Bank) together accounted for 65 percent of total deposits at end-2000. Domestic banks offer services largely to domestic businesses and residents, but also have international interests, including foreign branches and subsidiaries. Total assets amounted to US\$12 billion (229 percent of GDP) at end-2000 (Table 2). Cooperative credit societies play a major role in collateralized lending to individuals. Most of the 360 cooperatives are small, but a few are quite large and more sophisticated. Assets held by credit cooperatives are about one third of those held by domestic banks.

⁸ The exchange rate fluctuation bands were widened to 15 percent around the central parity with the euro on January 1, 2001, although the CBC intends to keep the exchange rate within the narrow 2¼ percent bands.

⁹ The balance of payments statistics currently treat the 1,080 IBCs with a physical presence as nonresidents. As a result, foreign exchange that Cypriot residents receive from the IBCs with a physical presence (see Table 7) are recorded as credits in other income in the invisible balance, while IBCs' transactions with nonresidents are not captured.

¹⁰ One of the IBUs has recently obtained a license to operate also as a domestic bank; accounts and branches of the two operations will be separated. Two domestic banks also have licenses to operate IBUs.

Box 1. Cyprus: Capital Account Liberalization from December 1999–January 2001

December 1999

—Abolition of restrictions on use of credit cards by residents for payments abroad.

January 2000

—Liberalization of inward FDI from EU member states: specifically, the CBC abolished restrictions on maximum percentage and minimum amount of inward FDI.

—Relaxation of restrictions on outward FDI: the CBC abolished restrictions on the amount and sector of outward FDI.

—Relaxation of equity participation in CSE-listed Cypriot companies from EU member states, except for banks, where nonresidents' equity participation has been limited to 50 percent since July 1999.

August 2000

—Relaxation of equity participation in CSE-listed Cypriot companies (except for banks) from third countries: ceiling of 49 percent participation maintained.

September 2000

—Relaxation of restrictions on investments in foreign stock exchanges by CSE-listed Cypriot investment companies.

December 2000

—Abolition of restrictions on domestic banks extending loans in Cyprus pounds to nonresidents who are economically active in Cyprus.

January 2001

—Abolition of blocked accounts by nonresidents for local funds that previously could not be immediately transferred abroad.

—Abolition of restrictions on medium-term (over two years) and long-term borrowing in foreign currencies by residents.

Source: Central Bank of Cyprus.

Table 2. Cyprus: Assets and Liabilities of Domestic Banks, 1999-2000
(End of year)

	1999	2000
	(In millions of Cyprus pounds)	
Assets	10,447	12,491
<i>Of which</i> :	5,933	6,768
In Cyprus pounds	5,316	6,143
In foreign currencies 1/	617	625
Liabilities	10,447	12,491
<i>Of which</i> :	8,438	9,992
In Cyprus pounds	5,969	6,488
In foreign currencies 2/	2,469	3,504
	(In percent of GDP)	
Assets and liabilities	209	229

Sources: Central Bank of Cyprus and Fund staff estimates.

1/ Until end-2000, lending in foreign currencies to residents required permits from the CBC.

2/ The bulk of the foreign currency deposits is from nonresidents.

The domestic insurance sector consists of 52 insurance companies. Only 11 of the 19 foreign insurance companies are active. While the domestic insurance market remains relatively small, with gross premiums amounting to 9 percent of GDP in 1999, it expanded rapidly in 1999 as life insurance companies aggressively sold single premium/unit-linked policies during the stock exchange boom (Table 3).

Table 3. Cyprus: Gross Written Premiums of Insurance Companies, 1997-99
(In percent of GDP)

	1997	1998	1999
Domestic insurance companies	4.3	4.4	8.7
Life insurance	2.3	2.4	6.8
Non life insurance	2.0	2.0	2.0
International insurance companies	...	...	1.6
Captive	...	...	0.1
Noncaptive	...	...	1.4

Sources: Insurance Companies Control Service, Ministry of Finance; and Fund staff estimates.

The Cyprus Stock Exchange (CSE) replaced a system of over-the-counter trading in 1996. Tax incentives for newly listed companies were introduced in 1998 and the subsequent significant growth of the stock market spurred a wave of initial public listings in 1999, and 168 IPOs are awaiting regulatory approval as of February 2001. The CSE general index (March 1996=100) shot up to 714 at end-1999, but almost halved by mid-2000, and further plummeted to about 200 by March 2001. Equity market capitalization reached 152 percent of GDP at end-2000; about 27 percent was accounted for by the two largest domestic banks. There are 42 brokering firms, consisting of 125 individual members as of February 2001.

During the 2000 Article IV consultations, the IMF staff found that the domestic securities market was broadly compliant with IOSCO's principles, although some weaknesses were identified.¹¹ Efforts were under way to address these concerns: a) the authorities plan to increase regulatory staff to ease the shortage of experienced staff; b) a mutual fund law was envisaged to provide a legal framework for regulation of domestic collective investment schemes;¹² and c) a centralized share registry/depository was expected to be introduced to remedy the poorly functioning clearing and settlement system. Also, the responsibilities of the Securities and Exchange Commission (SEC) and the CSE were found to overlap,¹³ and there was no regulation of the provision of financial services such as investment advice in the domestic sector.

The domestic financial sector is relatively large compared to the size of the economy. The sector including finance, insurance, and real estate business contributed about 20 percent of GDP, and 9 percent of total employment in 1999.

Regulatory and supervisory framework

The CBC supervises domestic banks pursuant to the CBC Law, the Banking Law, and relevant regulations and guidance notes. Thirty professionals are dedicated to this task. The Commission for Cooperatives supervises credit cooperatives, except for the Central Cooperative Bank which is supervised by the CBC, and reports to the Minister of Trade and Industry.

The Insurance Companies Control Service (ICCS) in the Ministry of Finance supervises domestic and international insurance companies, pursuant to the Insurance Companies Law, and relevant regulations and guidance notes. A new law is expected to be

¹¹ The functioning and regulation of the CSE and its members were reviewed in May 2000. The assessment was based on an interpretation of IOSCO's objectives and principles of securities regulation by IMF staff. See Cyprus-Selected Issues and Statistical Appendix, July 2000, IMF, Washington D.C.

¹² This law has now been enacted.

¹³ The Cyprus Securities & Exchange Commission (Establishment & Power) Law was enacted on April 20, 2001. The main objectives of this law are to enhance the independence of the SEC and its supervisory powers, and to delineate the responsibilities of the SEC and the CSE to rectify the overlap in supervisory responsibilities. The new law also empowers the SEC to license domestic market services firms, including investment advisors. In addition, supervision of market risks will be stepped up in 2001 to bring Cyprus into compliance with the EU Capital Adequacy Directive (CAD).

enacted in 2001 to harmonize regulations with the EU directives, including regulations on the solvency margins and the segregation between life and non-life insurance companies.¹⁴

Both the SEC and the CSE supervise domestic stock brokers pursuant to the Cyprus Securities and Stock Exchange Law, the Insider Trading Law, and relevant regulations and guidance notes. Both SEC and CSE are semi-governmental organizations: board members are appointed by the Council of Ministers and budgets must be approved by the Ministry of Finance.

III. THE OFFSHORE FINANCIAL SECTOR

A. Structure

The term “offshore” is used in this report to define businesses owned by nonresidents providing services primarily to nonresidents. It does not include the “international” business of Cypriot-owned activities, e.g., the banking services provided by domestic banks to foreign customers including that provided through overseas branches and subsidiaries.

The development of the offshore sector in Cyprus has been facilitated by the island’s location, a preferential tax regime, an extensive network of double tax treaties, particularly with Eastern European and former Soviet Union countries, a legal and accounting framework based on U.K. law and practice, the availability of a well qualified labor force, particularly well endowed with accounting and legal skills, a reliable telecommunication system, relatively liberal immigration and visa requirements, and a ready supply of office and residential accommodation of a high standard.

The CBC has issued 47,465 permits since 1976 (Table 4). It is estimated that roughly half of the IBCs that have received permits to date are still operating. There are 1,080 entities maintaining a physical presence in 2000, and 262 of them were established during 1976-90, while 818 were established during 1991-2000. The CBC issued 5,713 permits, and revoked 1,937 permits in 2000: 66 percent of the new entrants were in trading, marketing, and distribution businesses, and 81 percent came from Europe, half of which from EU countries (Table 5).

The IBCs employed 5,864 people, including expatriates and local staff, in 2000, which constituted roughly 2 percent of domestic employment. The majority is employed in IBCs engaged in trade, marketing, and distribution, or in ship management and maritime operations.

¹⁴ Under current legislation, composite companies conducting both life and non-life insurance businesses are permitted.

Table 4. Cyprus: Permits of International Business Companies, 1998-2000
(Number of companies)

	1998	1999	2000
New permits issued	4,846	5,167	5,713
Cumulative number of permits issued	36,585	41,752	47,465
Permits revoked	420	912	1,937
Memorandum items:			
IBCs with a physical presence	1,055	1,082	1,080
<i>Of which</i> : International and administered banking units	...	...	31
International insurance companies	...	...	28
International financial services companies	...	...	116

Source: Central Bank of Cyprus.

Table 5. Cyprus: Permits of International Business Companies by Origin and Activities, 1998-2000
(Number of companies)

	1998	1999	2000
New permits issued	4,846	5,167	5,713
By geographic origin			
<i>Of which</i> : Europe	3,884	4,174	4,644
America	459	489	542
Asia	374	351	423
By activities			
<i>Of which</i>			
Trade, marketing, and distribution	3,394	3,583	3,808
Ship management and maritime operations	75	81	83
Business and professional consultancy	207	241	342
New agencies and other media	14	26	20
Commercial and merchant banking	1	0	1
Life, general, or captive insurance	8	9	6
Third-party financial/trustee services	22	10	13
Investment, holding or royalty	678	734	969

Source: Central Bank of Cyprus.

Table 6. Cyprus: Employment by International Business Companies, 1999, 2000

	1999			2000		
	Expats	Locals	Total	Expats	Locals	Total
Total employment by International Business Companies	2,662	2,565	5,227	3,111	2,753	5,864
<i>Of which</i>						
Trade, marketing, and distribution	1,306	675	1,981	1,657	802	2,459
Ship management and maritime operations	501	999	1,500	533	1,064	1,597
Commercial and merchant banking	138	277	415	161	235	396
Business and professional consulting	151	83	234	150	92	242
News agencies and other media	130	33	163	128	33	161
Life, general, or captive insurance	56	90	146	38	70	108
Third-party financial/trustee services	103	41	144	110	45	155
Investment, holding or royalty	23	9	32	21	10	31
Memorandum item:						
IBC employment (in percent of domestic employment)			1.8			...

Sources: Central Bank of Cyprus and Ministry of Finance.

Table 7. Cyprus: Local Expenditures by IBCs and New Registration Fees, 1998-2000
(In millions of Cyprus pounds)

	1998	1999	2000
Total	200	234	258
Local expenditures of IBCs with physical presences	154	184	202
Local expenditures by IBCs	111	143	147
Local expenditures by expatriate staff	43	41	55
New registration fees and others 1/	46	50	56
Memorandum item			
Tourism credit	878	1,022	1194

Sources: Central Bank of Cyprus and Fund staff

1/ Includes fees for providing legal, accounting and other services to IBCs without presences, and corporate and other tax revenues.

Local expenditures by IBCs and their expatriate staff, as well as registration and other fees and taxes, have grown in recent years, but remain much less important than tourism.

Offshore banking

The offshore banking sector comprises 31 Banking Units of which 29 are IBUs¹⁵ and 2 are ABUs. IBUs/ABUs are licensed to operate primarily on an international basis, and are confined to dealings in foreign currencies mainly with nonresidents.¹⁶ IBUs are required to operate as fully-staffed units and can take the form of a branch or a subsidiary of a bank already established in a foreign jurisdiction: there are 24 branches and 5 subsidiaries. The first IBU was licensed in 1982. Seven IBUs originated from Lebanon, three each from France, Jordan, Russia, and Yugoslavia, two each from Switzerland and the U.K., and one each from Bulgaria, the Cayman Islands, Germany, Greece, Romania, and the Ukraine. It is a licensing requirement that the home supervisory authority adhere to the principles of consolidated supervision and other relevant recommendations by the Basel Committee on Banking Supervision. ABUs are required to carry out banking business in their own name, but their day-to-day administration is carried out by another bank (the administering bank), which must already be licensed by the CBC to operate in, or from Cyprus. The two ABUs were both licensed in 1998. Total assets of IBUs and ABUs at end-November 2000 amounted to US\$10 billion (Table 8). Recent capital liberalization has paved the way to increased competition between the domestic banks and the IBUs/ABUs in lending in foreign currencies to residents.

Offshore insurance companies

There are 28 licensed foreign insurance companies that offer insurance services to nonresidents: 11 are captive and 17 are non-captive. Captive insurance companies may only write business for members of the group of companies with which they are affiliated; they

¹⁵ There are 27 IBUs in operation. The CBC revoked the license of Beogradska Banka from Yugoslavia in May 2000 because of its insolvency and inability to meet deposit obligations. The High Court upheld the CBC's decision in December 2000, which is, however, subject to appeal. The CBC licensed Mega Euro Bank A.D. from Yugoslavia in 1998 but has not issued a "letter of commencement of business," which is needed before operations can start. The letter is only issued once banks fulfill the conditions in the license, such as the provision of a letter of comfort or guarantee. The Mega Euro Bank A.D. was affiliated to Beogradska Banka until mid-2000.

¹⁶ Domestic banks are allowed to offer services to nonresidents to a restricted extent. Since January 1, 2001, International Banking Units have been allowed to offer medium- or long-term loans or guarantees in foreign currencies to permanent residents, as part of the financial liberalization.

may not accept business from third parties. The scale of business is very small: total gross premiums in 2000 amounted to 1.6 percent of GDP, of which 0.1 percent was captive.

Offshore investment and securities companies

International Financial Services Companies (IFCs) are Cypriot enterprises owned by nonresidents, and provide financial services to nonresidents. The number of IFCs was 106 at end-2000: 67 IFCs offered financial service to the public at large, while 39 offered financial services only to experienced professional investors. The CBC has started collecting data on the size of funds under management.

The CBC has authorized nine IFCs to act as managers of overseas collective investment schemes—schemes established overseas under foreign legislation—under the Exchange Control Law. Also, the CBC authorized one IFC to act as manager of an International Collective Investment Scheme (ICIS) under the ICIS Law of 1999.

Offshore companies, trusts, and service providers

Excluding finance, commerce is the most important international business activity. Trade, marketing and distribution is the most important activity followed by ship management and maritime operations. Transit trade on the island's seaports is carried out by the IBCs on a large scale. Cyprus has the sixth largest ship register in the world, and the ship management companies maintain extensive facilities and employ sizable staff.

Table 8. Cyprus: Assets and Liabilities of IBUs and ABUs, 1999-2000
(End-November of each year)

	1999	2000
	(In millions of U.S. dollars)	
Assets	8,239	10,838
<i>Of which</i> : lending (net of provisions)	2,515	2,485
Amounts due from affiliated banks	2,907	3,854
Investments	916	1,703
Liabilities	8,239	10,838
<i>Of which</i> : deposits	1,938	2,112
Amounts due to affiliated banks	3,475	4,912
	(In percent of GDP)	
Assets and liabilities	94	131

Sources: Central Bank of Cyprus and Fund staff estimates.

Offshore trusts are formed under the International Trusts Law of 1992. As the law does not require the registration of trusts, the total number of trusts administered in the jurisdiction is not known. Company and trust services include the establishing, undertaking, executing and administration of companies and trusts. These services can be provided by

banks, lawyers, accountants and International Trustee Services Companies (ITCs). The ITCs are Cyprus enterprises owned by nonresidents, providing trustee services to nonresidents, and are authorized by the CBC to act as professional trustees and offer trustee services to the public at large. There were 12 ITCs at end-2000.

B. Regulatory and Supervisory Framework

Regulatory and supervisory authorities

The CBC is the main regulatory and supervisory authority for the offshore financial sector, and supervises IBUs/ABUs, International Financial Companies, International Collective Investment Schemes, International Trustee Services Companies and other International Business Companies. Other regulatory and supervisory authorities include the Superintendent of Insurance and the Registrar of Companies.

Laws governing the offshore financial sector

The offshore financial sector is governed by various laws, regulations, and guidance notes. The most important are the CBC Law, the Banking Law, the Exchange Control Law, the International Trusts Law, the International Collective Investment Schemes Law, the Companies Law, the Income Tax Legislation, and the Prevention and Suppression of Money Laundering Activities Law.

Offshore banking

The Banking Units are registered by the Registrar of Companies but are licensed and supervised by the CBC. All IBUs are exempt from most of the regulations applicable to domestic banks, in so far as they relate to domestic monetary policy, such as minimum reserve requirements, and restrictions on the holding of foreign assets. While there is no capital requirement for IBUs in the form of branches, IBUs in the form of subsidiaries are required to have a paid up capital of at least US\$5 million.

Offshore insurance

Offshore insurance companies are supervised by the Insurance Companies Control Service (ICCS), in the Ministry of Finance, together with domestic insurance companies. The same regulations and supervision apply to both domestic and offshore insurance companies.

Offshore investment and securities companies

The CBC has the authority to conduct both onsite and offsite reviews of IFCs through conditions attached to their Exchange Control permits and to authorization of ICISs under the ICIS Law.

Offshore trust services providers

The ITCs are also supervised by the CBC under the Exchange Control Law, supplemented by guidance notes issued by the CBC.¹⁷ The CBC has issued “A guide to prospective applicants on the establishment of international trustee services companies” and its key features include the eligibility criteria and fit and proper tests.

C. Prior Assessments

Cyprus has received several assessments of its financial sector in recent years. Main findings of prior assessments are as follows.

Council of Europe

The report on the money laundering situation in Cyprus (June 9, 1998) found that “the vulnerability of Cyprus to money laundering activities of an international character flows in part from its geographical location adjacent to certain narcotics production areas.” The report noted that Cyprus has an “attractive onshore and offshore financial sector” and that the “potential for abuse primarily arises at the layering stage.” The report found that the anti-money laundering law provides “a very comprehensive legal framework” and that “there was a sound basis for international cooperation.” The report noted, however, that “there is a need for restraint and confiscation provisions to be used more in appropriate domestic cases.” The report also noted that international cooperation “could be further strengthened by ratification of the European Convention on Mutual Legal Assistance.”

Financial Stability Forum

Subsequent to publication of its report on Offshore Financial Centers (OFC’s) in relation to global financial stability (April 5, 2000), the FSF published (May 26, 2000) a categorization of OFCs “reflecting their perceived quality of supervision and perceived degree of co-operation.” The FSF included Cyprus in Group III, comprising “jurisdictions generally perceived as having legal infrastructures and supervisory practices, and/or a level of resources devoted to supervision and co-operation that are largely of a lower quality.”¹⁸

¹⁷Exchange Control permission to hold assets overseas as trustees is required for lawyers and accountants, but not for banks.

¹⁸ The FSF stated in its press release of May 26, 2000 that “it is important to stress that the categorization of OFCs into these three groupings is based on responses of OFC supervisors and the impressions of a wide range of onshore supervisors at a particular point in time. The categorization does not constitute judgments about any jurisdiction’s adherence to international standards.”

Financial Action Task Force

The FATF report (June 22, 2000) found that “Cyprus has a comprehensive anti-money laundering system” but raised “a specific issue of concern on customer identification in respect of trusts.” It also welcomed “Cyprus’s intention to supervise lawyers and accountants when engaged in financial activities.”

OECD Initiative on ‘Harmful Tax Practices’

Cyprus has made an advance commitment to the OECD to eliminate ‘harmful tax practices’ by 2005. This commitment is conditional on the OECD’s initiative proceeding but, if implemented, would remove one of the main factors distinguishing offshore financial sector activity from onshore activity.

U.S. Department of State

The U.S. Department of State report on Cyprus issued in 2001 noted that “the central bank needs to continue to focus on the increasing supervisory challenges of the offshore sector and on increasing the offshore sector’s transparency.” In this regard, the report mentioned the need to ensure that “the identities of beneficial owners are easily accessible by the central bank.” The report also noted that “the central bank should change its guidance note, which allows banks to open accounts to all forms of trusts without identifying the beneficial owner of the trust.” The report finally noted that Cyprus “should take steps to ensure that all financial and nonfinancial institutions and entities report all suspicious transactions to the financial intelligence unit”, as required under the provisions of the Prevention and Suppression of Money-laundering Activities Law.

IV. ASSESSMENT OF GENERAL ISSUES

This chapter reviews three critical areas, namely, the independence, responsibilities and resources of the supervisory agencies, the extent of, and constraints on, cross-border cooperation and the prudential aspects of efforts to combat money laundering, which cut across all parts of the offshore financial sector and are, therefore, assessed separately.

A. Independence, Responsibilities, and Resources

Legal autonomy and responsibilities

The supervision of the offshore sector in Cyprus is mainly the responsibility of the CBC by virtue of its role as the administrator of the Exchange Control Law and the Banking Law. The Exchange Control Law, based on the U.K. Exchange Control Act of 1947, gives the CBC wide powers to attach conditions to any permit issued to nonresidents for business and financial activities in Cyprus. This enables the CBC to extend its supervisory remit further than most central banks into all financial services, other than insurance, provided by nonresident owned businesses in Cyprus, to other nonresidents, and indeed into nonfinancial

enterprises owned by nonresidents, the so-called IBCs. The Banking Law, which has now been amended to ensure compliance with EU directives, provides comprehensive authority for the supervision of banks, both domestic and offshore. While the CBC supervises banks, other financial institutions in the domestic financial sector, such as the co-operative movement and the securities market, are supervised by other agencies.

The CBC enjoys considerable autonomy, and this is likely to grow as recent and prospective legislation enacted to further harmonization with EU standards takes effect. For example, amendments recently proposed to the CBC Law would make it more difficult for the Government to terminate the Governor's appointment. Also, recent changes in the monetary policy framework give the CBC direct and formal responsibility for the setting of interest rates now that the statutory ceiling on interest rates has been removed. It is also important that public agencies that enjoy such independence be accountable. One step that the CBC could take would be to publish an annual report on its supervisory activities. This is done by many supervisory agencies in other countries and helps to inform the public about their supervisory functions and how they have been discharged. Similar considerations apply to the Superintendent of Insurance and the Registrar of Companies.

The Exchange Control Law also gives the CBC extensive powers to issue and vary the consents it gives under the law. As a result, it has considerable operational autonomy in the regulation of any person or company to whom it has given an Exchange Control permit. However, the Law is likely to expire or lose force in the near future as controls are removed in order to comply with the requirements of the EU for free capital movements. Indeed this process has already begun, and domestic residents are able to carry out a wider range of foreign transactions, and IBUs/ABUs are able to do some business with some residents. For planning purposes, the Exchange Control Law is assumed to cease to be available at the end of 2002. Although the authorities have indicated that they intend to be ready before that date, if accession to the EU is delayed, e.g. for reasons unrelated to Cyprus's preparedness, they would retain the controls until just before accession. The authorities are well aware of the need to fill this prospective gap in the ambit of supervision. To this end, a new Financial Services Bill is at an advanced stage of preparation. This new law would subject the provision of all financial and investment services, excluding banking and insurance, to supervision by the Securities and Exchange Commission.¹⁹ Supervised services would include the management of funds and the provision of advice, activities which are supervised now when provided by offshore institutions but not, or not wholly, when provided by domestic businesses.

The CBC also exercises powers under the Banking Law and the ICIS Law. Both give the CBC extensive operational autonomy, as described in later chapters, although the Banking Law does oblige the CBC to consult the Minister (but does not require his consent)

¹⁹The supervision of ICIS, their management and trustees, under the ICIS law will continue to be carried out by the CBC (see Chapter VI).

on certain matters including termination of the authorization of a bank. Although this may not have delayed, for example, the revocation of the license of Beogradaska Bank, the only case where the CBC has revoked the license of a bank which had not ceased to exist in its home state, it might well do so in the future. Therefore the requirement should be removed, at least with regard to actions on individual institutions.

The other agencies exercising supervisory responsibility for nonresident owned businesses include the Superintendent of Insurance and the Registrar of Companies. In both cases, these officials are endowed by statute with considerable operational autonomy. Some of their decisions are, however, subject to administrative review on appeal to the Minister responsible. In practice, this limitation on their powers has not derogated from the operational autonomy of the office holder whose decisions have normally been upheld.

Resources

There is a general need for additional capacity for the exercise of supervisory functions. While this may be true in many countries, the reputational risks with regard to offshore business in Cyprus are such that it is particularly necessary for the Cypriot authorities to be well resourced. In the CBC's case, the Bank is in charge of its own budget, and there seems to be no external constraint on adding additional resources to the Bank's supervisory functions, or perhaps reorganizing its functions so as to concentrate existing resources on areas, or institutions, of greatest risk. This would involve a more formal basis for assessing risk and establishing priorities on the basis of that assessment. An informal arrangement may be adequate for a simple and small system, but with a more sophisticated system, lack of formality risks failings being overlooked.

The Superintendent of Insurance is more heavily constrained, as is described in Chapter V, and it will be important that the Minister of Finance allows the employment and training of sufficient staff to enable the Superintendent to carry out her responsibilities, which are being considerably enhanced. This should include endowing the Superintendent with financial responsibility for recruitment and retention, including responsibility for pay scales and the hiring of specialist skills on a contract basis, and for investment in new technology as an alternative to more labor intensive methods. While the Registrar of Companies is not a supervisor, there may also be gains in efficiency terms in releasing this department from civil service management and pay arrangements. In all cases, additional financial and operational autonomy should be accompanied by enhanced accountability.

B. Cross-Border Cooperation

The CBC exchanges information with foreign supervisors in the framework of the licensing procedure, as well as during ongoing supervision. When an institution located in a foreign country applies for a license to establish a subsidiary or branch in Cyprus, the CBC contacts the home supervisor asking for its views on the bank and its approval of the establishment. The CBC has held meetings with representatives of some supervisory authorities before granting a license to banks from those countries.

In general terms, the CBC complies with accepted international standards for the exchange of information, and for cooperation with other supervisory agencies.

With respect to branches and subsidiaries of foreign banks operating in Cyprus, the CBC may provide to the supervisory authority of the home country information which, in the opinion of the CBC, enables the home supervisor to exercise its consolidated supervisory functions. Information relating to any individual deposit account is excluded from disclosure under the Banking Law, on the grounds that bank soundness is not so affected by the source of funds as by their use. In practice, home supervisors can obtain such information either through the head office or parent bank, or by examining the bank or subsidiary themselves. Nonetheless, depositor information is often important for the supervision of liquidity and for identifying transactions with related parties, as well as for money-laundering issues. An opportunity should be sought to amend the legislation to remove the exclusion.

Memoranda of Understanding have been signed with the banking supervisory authorities of a number of countries including Russia, Belarus, Bulgaria, and Ukraine. These Memoranda include statements on the scope of information to be forwarded to the other authorities; information about transactions, accounts and deposits of customers are expressly excluded from the exchange of information. In addition, the MoUs stipulate details on the cooperation regarding on-site examinations in the other country and the confidentiality of the information received from the other authority.

Negotiations on Memoranda of Understanding have also been started, mostly on the CBC's initiative, with the banking supervisory authorities of Austria, the Czech Republic, France, Greece, Romania, and the U.K. On the other hand the CBC has rejected applications for a banking license from banks in two countries mainly because conflict in those countries was thought to have undermined the effectiveness of supervision and the soundness of the banks there.

The CBC allows foreign home supervisors to conduct on-site inspections in Cyprus. In the framework of the on-site examinations, the examiners of the foreign country are allowed to see any files including documents on individual deposit accounts. On-site reviews in Cyprus have been carried out by the Central Banks of Lebanon, Jordan, Russia, Bulgaria, and, very recently, Yugoslavia.

The CBC is a member of international groups, like the Offshore Group of Banking Supervisors and IOSCO, and attends meetings of the Council of Europe PC-R-EV committee. Staff of the CBC has participated in evaluations of anti-money laundering measures by the FATF and the Council of Europe. The CBC sends staff to international seminars in which supervisory issues are discussed, and has close contacts with the Bank for International Settlements. Other agencies also participate in international fora. For example, the Superintendent of Insurance is a member of the IAIS, and the Unit for Combating Money Laundering Offences is a member of the Egmont Group.

C. Prudential Aspects of Anti-Money Laundering Efforts²⁰

Cyprus enacted in 1996 the Prevention and Suppression of Money Laundering Activities Law (the “Law”) establishing a comprehensive framework that covers the various aspects of money laundering and the role of the financial system in this regard.

Efforts for including lawyers and accountants in the anti-money laundering framework are under way, including the recent decision by the Council of Ministers designating the Cyprus Bar Association and the Institute of Certified Public Accountants of Cyprus as supervisory authorities. Although the disciplinary boards of both bodies include government officials, it is not clear that they are adequately resourced to carry out this function effectively.²¹ External supervision may well therefore be necessary. There is scope for improving the cooperation of financial and nonfinancial institutions in anti-money laundering efforts, especially in the field of identifying beneficial owners of companies and trusts and in reporting suspicious transactions. Also, the scrutiny of transactions conducted by persons, including companies and financial institutions, from countries which have deficient anti-money laundering frameworks should be enhanced. Clarification that tax evasion is a predicate offence would help in strengthening international cooperation in this regard.

The Law establishes money laundering as a separate offence. The Law was amended in 2000 to provide that any criminal offences punishable by a maximum prison sentence for a period exceeding twelve months as a result of which proceeds were generated shall be defined as a predicate offence.

Penalties are provided for persons who knew or should have known they were engaging in a laundering offence. The Law expressly covers predicate offences committed extraterritorially. There is no provision for loss of authority to do business as a sanction for money laundering, although such action is possible for banks under the Banking Law. The sanctions for money laundering offences include the confiscation of the proceeds from the predicate offence and its instrumentalities. The assessment of benefits related to a laundering

²⁰ This assessment relies on the key supervisory standards adopted by supervisory authorities, in particular Core Principle 15 of the Basel Committee on Banking Supervision, which specifically refers to the need for adequate “know your customer” requirements, suspicious transaction reporting arrangements, and effective procedures for the sharing of information with other supervisors and law enforcement agencies, both domestic and foreign. In keeping with the IMF Executive Board decision to enhance the Fund’s contribution to international efforts to combat money-laundering, this report does not make recommendations with respect to law enforcement aspects.

²¹ The disciplinary board of the Bar Association is chaired by the Attorney General, and the disciplinary committee of the Institute includes the Deputy Accountant General.

offence provides for the reversal of the burden of proof. The Law provides for the making of restraint orders and charging orders by courts and for the realization of confiscated property by a receiver. Disclosures to a police officer or to the Unit for Combating Money Laundering Offences (the “Unit”) do not constitute a breach of any contractual duty of confidentiality. Failure to disclose knowledge or suspicion of money laundering acquired in the course of one’s profession constitutes an offence punishable by imprisonment or a monetary penalty, or both. Advocates are exempted from this obligation with regard to privileged information.

Persons engaged in a broad range of financial activities are prohibited from forming a business relationship or carrying out transactions with or on behalf of another unless procedures related to customer identification, record keeping, internal reporting, control, communication and training are in place. The Law provides sanctions consisting of prison sentences or monetary penalties, or both, for failure to comply with these requirements. These sanctions may apply also to the directors, managers, secretaries, officers or shareholders of the relevant entity having consented to or connived in the commitment of the offence or if it is attributable to their negligence.

The Law provides for supervisory authorities to assess and supervise compliance with the abovementioned measures. The CBC is the supervisory authority for persons licensed to carry on banking business and offshore financial services. The Securities Exchange Commission, the Superintendent of Insurance, and the Superintendent of Cooperative Companies have been designated as supervisory authorities over their respective sectors. In its capacity as supervisory authority, the CBC issues guidance notes from time to time. In November 1999, it consolidated previous guidance notes into a comprehensive guidance note on customer identification and record keeping procedures, recognition and reporting of suspicious transactions, appointment and duties of compliance officers, and education and training of bank employees (the “CBC Guidance Note”). The other supervisory authorities have also issued guidance notes for the sectors within their respective authority. The Council of Ministers has recently designated the Cyprus Bar Association and the Institute of Certified Public Accountants as supervisory authorities for lawyers and accountants. It is not clear at this stage whether the supervisory authorities for lawyers and accountants will be limited to assessing and supervising their compliance with regard to those aspects of their activities that relate to relevant financial activities as defined in the Law or will have a broader scope. Given the variety of lawyers’ and accountants’ financial activities that do not fall within the scope of activities defined in the Law but may, nonetheless, have an impact on the issue of money laundering, the supervisory authorities’ duties for these professions should be extended to all their activities. Moreover, it is not clear that the professional associations are competent to supervise the non-traditional activities of accountants and lawyers, particularly the provision of services to IBCs. The absence of effective supervision of agents for foreign customers can mean that financial institutions that rely on them are failing to comply with recommended “know your customer” procedures. This problem would be resolved if the provision of service to companies and trusts was itself an activity subject to external supervision and is recommended in Chapter VI.

The Law sets forth the customer identification procedures that must be implemented by persons engaging in financial activities but does not define what constitutes satisfactory evidence of identity. This is done in the CBC's Guidance Note which stipulates that banks are expected to obtain satisfactory evidence of identity of their customers and indicates ways of doing so at the time of establishing an account relationship and prior to the execution of any banking transactions. This should be made a statutory requirement rather than an expectation.

Customers' identification requirements do not apply with regard to customers who are reasonably believed to be engaged in financial activities (and thus regulated under Section 58 of the Law) and to have in place procedures relating to customer identification, record keeping, internal reporting, internal control, communication and training. This exemption weakens the customer identification framework provided in the Law because there is no requirement that the customer be actually bound by Section 58, just that he is believed to be bound. With regard to correspondent banks, the CBC issued a guidance note on November 23, 2000 requesting banks to communicate to the CBC information relating to the accounts they maintain for banks incorporated in certain jurisdictions specified by the CBC from time to time and the transactions effected for their account and to refer future applications for opening accounts emanating from such banks to the CBC for guidance. The list of jurisdictions attached to the note does not include certain jurisdictions that are regarded by FATF and some supervisory authorities to have deficient anti-money laundering frameworks and should be revised accordingly.²²

With regard to accounts in the names of trustees or nominees, including nominee shareholders, the CBC Guidance Note warns banks that they run extremely high risks if they open an account where the persons beneficially entitled have not been identified. The Guidance Note specifies the conditions which must be fulfilled before a bank exercises its discretion in opening an account in the name of a trustee or nominee. Such conditions include provision of an estimate of likely turnover, subsequent monitoring and investigation if the turnover is exceeded, and provision of an undertaking by the trustee /nominee that he has taken reasonable steps to establish the identity and background of the beneficial owner and that, upon request, he will make that information available to the bank. Nonetheless, these procedures do not always ensure that the identity of beneficial owners is disclosed to banks except where the bank chooses to exercise its right to demand information about beneficial owners. The guidance notes of the SEC and the Superintendent of Insurance are silent on the risks involved when dealing with trustees or proxies but stipulate that all necessary steps must be taken to ascertain the identity of individuals on whose behalf a trustee or proxy is acting.

Record-keeping procedures must be followed to ensure that evidence of a person's identity or, when not practical, sufficient information to enable the recovery of details of such

²² The list is periodically revised.

identity and details relating to all transactions carried out by that person in the course of the relevant financial business, are maintained for a period of five years. The CBC Guidance Note underlines the importance of including information relating to the ordering and beneficiary customers for credit transfers by electronic means. With regard to incoming fund transfers, as in other countries, banks must request the information from the originator's bank or ask for a confirmation that the information is available and the transaction legitimate. This discretion does not ensure that satisfactory information on the identity of the ordering customer is always obtained.

Internal reporting procedures must include the identification of a compliance officer to whom reports of proven or suspected money laundering offences must be made. Employees of persons whose activities are supervised by a supervisory authority discharge their disclosure duty by reporting to the compliance officer. When a compliance officer determines or suspects that a person is engaged in a money laundering offence, the information must be communicated to the Unit. Given the small number of internal reports submitted by bank employees to compliance officers and of suspicious transactions reports, it is important that the CBC, the SEC, and the Superintendent of Insurance significantly step up their efforts to encourage institutions under their supervision to comply with the Law. The development of employees' training programs based on actual transactions effected in the course of business would be helpful in this regard. Critical reviews of compliance officers' reports stating the reasons for not notifying the Unit of employees' reports are reportedly effected by the CBC, the SEC, and the Superintendent of Insurance during onsite examinations. Given the relative infrequency of onsite examinations, the supervisory authorities should undertake these reviews separately.

The Law provides that the Unit shall, inter alia, be responsible for gathering and analyzing money laundering-related information, conducting investigations, cooperating with foreign units abroad in investigating laundering offences by the exchange of information and by other relevant ways of cooperation (in the absence of powers in the hands of the CBC). It is important that the Unit continues to be adequately staffed and equipped to exercise the full extent of its responsibilities under the Law.

Although not required for the exchange of information, the Unit has signed Memoranda of Understanding with the Financial Intelligence Units of Belgium (CTIF) and France (TRACFIN). The Unit is a member of the Egmont Group. Representatives of the Unit participate in the Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures (PC-R-EV). The Unit fulfils requests for assistance submitted by rogatory letters through Interpol and by other financial intelligence units. Cyprus has ratified the United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime, the Convention on the Transfer of Proceedings in Criminal Matters and the Convention on Mutual Assistance in Criminal Matters.

V. ASSESSMENT OF BANKING STANDARDS

A. Structure

As noted in Chapter III, there are 31 IBUs and ABUs beneficially owned by foreign banks and licensed to carry on banking business in and from within Cyprus. Their licenses stipulate that they should primarily confine their dealings to currencies other than the Cyprus pound and with nonresidents.

However, IBUs/ABUs, as from January 1, 2001, in the context of financial liberalisation, are permitted without restriction to grant medium and long-term loans or guarantees in foreign currencies to permanent residents of Cyprus. The extent of this activity so far is unknown, as the IBUs have not yet filed reports covering a current period. It is expected that in future, IBUs will be permitted to carry on additional activities including the taking of deposits in local currency. The CBC intends to meet the deadline of December 31, 2005 when all distinctions between domestic and offshore banks will be eliminated.

B. Assessment

Cyprus is compliant with 18 of the Basel Core Principles for Effective Banking Supervision (the six parts of the first principle are considered separately) in respect of its offshore financial sector; largely compliant with 8 other principles; materially non-compliant with 2; and 2 were deemed to be not applicable (this assessment is summarized in Table 9). This section deals with the few areas where there is scope for further improvement. The assessors noted that the type of business undertaken in the offshore sector is specialized and not all the criteria normally used for such an assessment are applicable in this case. This section also makes additional suggestions not covered by the Basel Core Principles.

This favorable assessment is in no small measure attributable to good and flexible legislation, which gives the supervisor the ability to adapt to regulatory and supervisory practices in a changing industry. Evidence of this flexibility and adaptation is evident to a large extent in the use of directives, issued from time to time by the supervisor.

In addition to the flexibility of the legislation, the supervisory regime is enhanced by a staff that is well educated and has had substantial experience in the supervision of banks and the other financial institutions for which the CBC has responsibility. The average experience of the staff related to banking supervision is 15 years.

Moreover, significant efforts are made to keep the staff aware of current developments in international banking supervisory techniques. Training programmes for bank supervision staff cover areas such as current developments in bank supervision, loan analysis, treasury operations, interest rate risk management, foreign exchange risk management, liquidity risk and so on. These courses are usually arranged by the FDIC, the Bank of England, the Netherlands Bank, other foreign central banks and private institutions both abroad and in Cyprus.

Table 9: Compliance with Basel Core Principles

Core Principle (CP)	Principle	Degree of Compliance					Comments including improvements underway
		Compliant	Largely Compliant	Materially Non-Compliant	Non-Compliant	Not Applicable	
1.1	Clear supervisory responsibilities	X					
1.2	Independence and resource			X			Reasons for removing the head of the supervisory agency are not in the law. A new law is being prepared that will resolve the matter. Supervisory resources are inadequate.
1.3	Legal framework	X					
1.4	Supervisory powers		X				The legal requirement to consult the Minister could delay enforcement action.
1.5	Legal protection	X					
1.6	Information sharing	X					
2	Permissible activities	X					
3	Licensing		X				More intensive scrutiny of directors and officers through the use of police reports.
4	Transfer of ownership	X					
5	Acquisitions and investments	X					
6	Capital requirements	X					
7	Loan principles	X					
8	Loan classification		X				The CBC does not follow the Basel Core Principles recommendation regarding the classification of loans 90 days past due as non-performing.
9	Large exposures	X					
10	Connected lending	X					
11	Country risk		X				
12	Market risk			X			Market risks are regarded as insignificant and not explicitly taken into account. Capital Adequacy Directive will be implemented later this year.
13	Other material risks	X					
14	Internal controls	X					
15	Money laundering		X				More onsite reviews with greater attention to IBUs that have not reported any suspicious transactions. Use of law enforcement agencies to assist in verifying customer identity.
16	Onsite-offsite supervision		X				Frequency of onsite examinations not maintained at planned levels.
17	Understanding banks' operations		X				The CBC does not require banks to notify it of adverse substantive changes in their activities.
18	Consolidated reporting	X					
19	Independent validation	X					
20	Consolidated supervision					X	
21	Accounting and disclosure	X					
22	Corrective action		X				The law provides for consultation with the Minister which could delay needed actions.
23	Global supervision					X	
24	Cooperation with foreign supervisors	X					
25	Foreign banks' branches	X					

Cyprus maintains good communication with foreign supervisors, CBC staff have visited some countries to obtain a better understanding of those countries' supervisory systems. A number of MoUs are in place and some foreign supervisors have conducted onsite reviews in Cyprus.

Areas where improvements would be beneficial

Independence and Resources (BCPI.2)

The CBC Law provides for the Governor to be appointed by the President. However, the law does not stipulate that reason must be given for his removal and that such reasons be made public.

Recommendation

The CBC Law should be amended to provide for greater security of tenure for the Governor.

The CBC stated that a new law is being prepared to ensure that the Governor cannot be removed prior to the expiration of his or her term of office.

Currently 12 persons are responsible for the supervision of 31 IBUs/ABUs, 116 IFCs, and 12 ITC IBUs and there are four vacancies. In our view the current number is insufficient to conduct the effective monitoring and supervision that is required. The targets for on-site reviews, of IBUs for example, are once a year for locally incorporated banks and once every two years for branches of foreign banks. These appear reasonable, but it is important that resources be made available to ensure they are met. Some banks have not had a full review in more than three years.

Recommendation

Staffing of the vacant positions at an early date would enable the IBU supervisory group to increase the current number of onsite reviews and thereby reduce the interval between such reviews to meet the targets it has set for itself.

Supervisory powers (BCPI.4)

The Banking Law (section 41) empowers the CBC to set prudential rules autonomously and administratively, except with regard to the policy for the granting of banking licences (sec. 4.5) and remedial powers where the CBC is required to consult the Minister of Finance first. The issue of specific licenses is not subject to consultation.

Recommendation

The requirement for consultation should be formally limited to policy issues, so as to ensure that the supervisor has full operational autonomy with regard to the exercise of powers in respect of individual institutions.

Licensing (BCP3)

As part of the licensing process, the CBC conducts a fairly extensive review of the background of directors and senior officers of financial institutions. From our discussions with the CBC and a review of the files it appears that more emphasis could be placed on obtaining information, on a routine basis, directly from law enforcement agencies and court records in addition to reliance on private investigations in some cases.

Recommendation

The CBC should conduct more comprehensive investigations into the character and reputation of persons who are associated with the financial services sector in Cyprus, for example, by accessing the records of foreign law enforcement agencies and judicial systems.

Loan classification (BCP8)

All licensed banks are, in principle, subject to regular on-site examination. One of the prime objectives of these examinations is to assess the quality of the assets of banks. This requires the supervisor to develop criteria to evaluate banks' policies, practices and procedures with respect to asset quality and the adequacy of loan loss provisions, and ensure implementation through on-site examination of the quality of assets, especially major loans accounts, and the adequacy of loan loss reserves. The CBC examiners also review the procedures, practices, and credit administration policies of banks and bring any weaknesses to the attention of their management.

The CBC has developed no generally applicable criteria for classifying losses and provisioning policy and considers each bank individually. Most of the banks are branches, or wholly-owned subsidiaries of major international banks, where loan classification and provisioning is laid down by the head office or parent and subject to supervision by the home supervisor. In view of the small number of banks, CBC examiners are able to review more than 50 percent of the balance sheet value of bank loans and the sample selected is biased towards large or problematic loans.

The internationally recommended standard for classifying loans is defined to include areas.²³er of days in

Leaving the judgment to individual banks may not be appropriate under the current circumstances in Cyprus. As indicated earlier (see Independence and Resources BCP1.2), there is insufficient supervisory resources to conduct an adequate number of scheduled onsite reviews. Some banks indicated that the CBC had not conducted an onsite review of their loan portfolio for more than three years. Moreover, several of the banks come from countries that do not have robust regulation and supervision.

Having regard to the present practice where the CBC is relying on its onsite reviews to ensure that banks are following appropriate classification and provisioning policies, that is a long time without a review.

It is difficult in those circumstances for the CBC to assess the strength of guarantees and appraise the worth of collateral. Moreover, the worth of guarantees and the net realizable value of collateral are at the best of times not easily established. No market values exists for much of the collateral and it is often illiquid.

Experience in other countries indicates that when guarantees are called they are frequently not honored. Other collateral values can easily evaporate because of the delays and costs involved in their realization. As noted above, the majority of IBU/ABUs are branches of foreign banks whose solvency is the primary responsibility of the home supervisor. The seven IBU/ABUs incorporated in Cyprus, are all subsidiaries of foreign banks believed by the CBC to be subject to effective consolidated supervision by the parent bank's home supervisor. In those cases, the CBC also obtains letters of comfort or guarantee from the parent bank with the full knowledge of the parent's supervisory authority.

Recommendation

The CBC should develop generally applicable criteria for assessing banks' loan classification and provision policies in order to ensure that banks meet best international practices.

It would be prudent of the CBC, therefore, to adopt a more conservative stance than currently is the case. This recommendation would put the onus on the bank to demonstrate, in circumstances where deviations from the "90-day-rule" occurred, that it held collateral which had a sufficiently high net realizable value that did not require

²³ "Sound Practices for Loan Accounting and Disclosure," Basel Committee on Banking Supervision, July 1999.

the loan to be classified. Refinancing and restructuring the loan would not change its status.

Country Risk (BCP11)

Cross border exposure is monitored on a monthly basis. No formal limits are set in respect of individual countries but IBU/ABUs with exposures deemed excessive are instructed to reduce them.

Recommendation

The CBC should consider requiring banks to set formal limits or ensure that head offices and parent banks do so and notify them to the CBC.

Market risk (BCP12)

At present the prudential systems of the CBC do not provide a basis for a comprehensive supervision of market risks. The CBC state that very little market risk is assumed by offshore banks at present, but clearly without an adequate monitoring system, the CBC are not in a position to supervise any risks that are being assumed, particularly if banks' own internal systems and controls are deficient. The CBC do have arrangements for supervising foreign exchange exposures but not for interest rate risk or the risk run in securities positions.

The CBC intends to implement policies by the end of the year requiring banks to hold capital in relation to market risks and thereby bring Cyprus in line with the provisions of the EU's Capital Adequacy Directive. Whether or not the CBC apply a capital charge the reporting system that the CAD requires will at least enable the CBC to monitor risks being run.

Recommendation

The CBC should implement the Basel Core Principles requirement, either by imposing limits or specific capital charges or both.

Money laundering (BCP15)

The assessment of this principle and the recommendations for improvement are set out in Chapter III(C).

Off-site/on-site supervision (BCP16)

The procedures and processes are all in place, but resources are not sufficient to allow on-site examinations to take place with the frequency planned.

Recommendation

Resources need to be increased to allow for the planned frequency of on-site examination to take place.

Understanding banks' operations (BCP17)

Banks are expected to report immediately to the CBC any material change in circumstances. Any material change in circumstances as well as periodic updating of relevant information will also be captured in the returns that banks are required to submit.

In addition, section 40 of the Banking Law provides that if any bank has any indication that it may face serious difficulties or become unable to meet its obligations or if it is about to suspend payment it shall forthwith inform the CBC.

While the Law covers situations where the bank believes that it may face serious difficulties or become insolvent there ought to be a requirement to report all significant issues at the earliest possible time. Usually, when the financial situation has deteriorated to the point where mandatory reporting is required, the range of options available to the supervisor may well be constrained. There may well be no option at that stage to liquidation. In addition, there should be mandatory reporting of matters such as the dismissal of a senior officer.

Recommendation

The CBC should make it mandatory for a supervised institutions to report any material adverse changes in its condition as early as possible on the grounds that the earlier problems are brought to its attention the larger the number of options that will be available to resolve the problem.

Corrective action (BCP22)

While all responsibilities for banking supervision rest solely with the CBC, under the Banking Law [section 30(3)], the CBC is required to consult the Minister of Finance before taking the following enforcement actions: (i) prohibiting until further notice the acceptance of deposits or the granting of credit facilities by the bank, or both; (ii) consulting with other banks with a view to determining the action to be taken; (iii) assuming control of, and carrying on in the bank's name, the business of the bank; and (iv) revoking the licence of the bank.

The CBC said that the consultation process had not inhibited the supervisor from taking action. While this may well have been the case in the past, the consultation process could become protracted and that could unduly delay a decision and permit the situation to deteriorate.

In addition, the CBC Law (sections 12(6) and 13 (1)(a)) permits the Minister's representative on the Board to suspend the operation of decisions by the board for five days if

he is of the opinion that the decision is incompatible with the purposes and provisions of the Central Bank Law or is likely to be contrary to public interest. The Board may appeal such a decision to the Council of Ministers. These provisions have never been invoked and supervisory decisions rarely need to be referred to the Board.

Recommendation

The Banking Law should be amended to remove any need for consultation before corrective action is taken.

Early warning system

Many supervisory agencies have recently developed early warning systems, which use the prudential reports that are submitted by financial institutions and other data. These systems can be helpful in alerting supervisors to impending problems in an institution. If problems are discovered early, there are usually more options available to the supervisor in resolving them. In addition, early detection may well avoid having the problem spill over to other institutions.

Recommendation

It is important that the CBC survey international experience in this area with a view to ensuring that its practices are in line with best practice elsewhere.

VI. ASSESSMENT OF PRACTICES RELATING TO COMPANIES, TRUSTS, AND COMPANY AND TRUST SERVICES PROVIDERS

There are, as yet, no internationally accepted standards for the assessment of practices relating to companies, trusts and company and trust service providers. However, the sector of offshore companies and trusts has recently attracted considerable attention, e.g., in the Review of Financial Regulation in the Crown Dependencies (the Edwards Report) and the KPMG Review of Financial Regulation in the Caribbean Overseas Territories and Bermuda. In both reports, some broad general principles were applied, explicitly and implicitly, as guides to what can be considered good practice in these areas.

Some jurisdictions used extensively by those seeking to establish nonresident companies and trusts have established special regulatory and supervisory regimes for the registration of offshore companies and trusts, and, more importantly, for those who provide services to them. Among the reasons for these regulatory and supervisory frameworks is the fact that the principal feature that distinguishes an IBC from a domestic company is that the beneficial owner and de facto controller is a nonresident, and therefore often must employ an agent, who is normally resident in the jurisdiction of incorporation, to perform many functions which may include acting as director, manager, and secretary, operating bank

accounts, acting as custodian of financial assets, and preparing its accounts, and sometimes hiring directors, managers and secretaries.

The assessment in this chapter has taken into account the nature of offshore companies, trusts and company and trust service providers, the nature of the activities of entities registered in Cyprus, the client base served by these entities, and the present supervisory policies in force in Cyprus. An overall assessment was undertaken by comparing the supervisors' compliance with good practices for effective company, trust, and service provider supervision in other jurisdictions that are host to significant numbers of such entities. In assessing this sector, it is recognized that administration of offshore companies, trusts and their associated service providers differs from one jurisdiction to the next and that activities within the offshore sector are changing rapidly around the world and theories, policies, and best practices of supervision are swiftly evolving.

A. Companies

Cyprus is estimated to have in the region of 20,000 active IBCs which are set up under the Companies Law, licensed under the Exchange Control Law, and enjoy preferential arrangements under the income tax legislation. IBCs are defined as companies whose beneficial ownership and business activities lie outside Cyprus. The number of IBCs with a physical presence in Cyprus at end-2000 was 1,080. Employment of expatriates by these IBCs amounted to 3,111, while that of locals was 2,753 (see Table 6).

The main types of activities conducted by such companies can be segregated into financial services and nonfinancial services business.²⁴ "Financial services" include dealing in investments, managing investments, offering investment advice, and establishing and operating collective investment schemes. IFCs are generally run by small teams, often of no more than one or two people with support from parent institutions. The main business activities of IBCs are trade, marketing and distribution (42 per cent of total IBCs) and ship management and maritime operations (27 percent of total IBCs). The total foreign exchange revenue from the IBCs and ship owning companies for 2000 was C\$258 million (see Table 7).

The major financial advantages of an IBC are as follows:

- IBCs are taxed at 4.25 per cent of their net profits.
- Branches of IBCs are totally exempt from corporate or income tax.
- The shareholders of IBCs are not liable for additional tax on dividends or profits over and above the amount paid or payable by the respective IBC.

²⁴ This chapter does not deal with IBCs licensed as banks, which are discussed in Chapter IV.

- Expatriate employees of IBCs living and working in Cyprus are taxed at half the rate of local employees. If the employees work outside Cyprus, they are exempt from local income tax so long as they are paid through a bank in Cyprus.
- There is no capital gains tax on the sale or transfer of shares of an IBC.
- There is no inheritance tax on the transfer of shares of an IBC.
- In some cases, IBCs and their employees may acquire duty-free items such as office equipment, household equipment, and motor cars.
- IBCs investing through the Cyprus Stock Exchange are not liable to income tax for any profits realized.

IBCs (including IFCs) are formed by the filing of applications with the CBC and the Registrar of Companies. The qualifications required to obtain the permission of the CBC is that the applicant should be a “fit and proper person.” This qualification is determined by the CBC upon consideration of a detailed questionnaire, which must be completed by the applicant and verified by personal interviews. This process also involves the verification by the CBC of the shareholders’ trustworthiness and business integrity by the mandatory submission of references from banks of high standing. The applicant must appoint experienced and qualified executives; in the case of financial companies, a letter of comfort in terms satisfactory to the CBC is required. Although nominee shareholders are allowed in Cyprus, the ultimate beneficial owners of IBCs must be disclosed to the CBC as part of the application process. The identities of ultimate beneficial owners are not a matter of public record, but are maintained on file with the CBC and would be communicated to the relevant authorities pursuant to a court order to that effect.

B. Trusts

Until 1992, Cyprus trust law was modeled on English law as it was before 1960. The International Trusts Law 1992 has introduced a new set of rules for “International Trusts,” while other Cypriot trusts are governed by common law, and the obligations of trustees by the existing Trustees Law of 1955.

The basic requirements of an International Trust are:

- The settler should not be a permanent Cyprus resident;
- at all times at least one trustee should be a permanent Cyprus resident;
- no beneficiary, other than a charity, should be a permanent Cyprus resident; and
- the settled property should not include immovable property situated in Cyprus.

There is no registrar of trusts, therefore the number of international trusts is unknown. The number of ITCs currently supervised by the CBC is 12. The volume of business dealt with by these companies is relatively low.

C. Company and Trust Services Providers

The submission of documentation for the establishment of an IBC must be effected by a practicing Cypriot accountant or lawyer to the CBC. Only a practicing lawyer can file an application with the Registrar of Companies.

The process of vetting all IBCs, including IFCs and ITCs, gives some comfort that wrongdoing by unregulated service providers will be prevented but it appears that considerable reliance is, in practice, placed on the intermediaries by banks and nonresident owners of IBCs. In addition, from discussion with different parties from within the CBC and others, it appears that it is possible for local companies (usually associated with accounting and law firms) to administer foreign-incorporated companies from Cyprus, so long as the assets are held in another jurisdiction and the beneficial owners are not Cypriots. It is not known to what extent this business is being carried on in Cyprus. Given the importance of the audit performed by accounting firms of all IBCs in providing additional safeguards against breaches of their Exchange Control permits, the lack of any external supervision in this area is a cause of concern. Finally, the inter-relationships between accountants, lawyers and their service provider functions exposes the system to a number of potential conflicts of interest. Local accountants and lawyers are monitored by their respective associations to ensure they are fit and proper for the purpose of practicing accountancy and law. Although the professional associations monitor compliance with their own internal codes of conduct, there appears to be no independent process for the review of these procedures, particularly where lawyers and accounting firms are performing service provider functions. The disciplinary procedures of accountants' and lawyers' associations are primarily set up to deal with complaints from clients against their members, and may not be adequate to supervise the activities of limited liability companies established by accountancy and law firms to provide ancillary services.

The Cypriot authorities should, therefore, consider adopting a system of external regulation and supervision of company and trust services providers possibly through the new Financial Services Law. Under such a system, all firms who provide services to companies and trusts would be licensed and supervised. Such a requirement would include law and accounting firms, their associated companies, and independent service providers. The supervisory body, would have the power to: (i) issue rules under statutory authority; (ii) authorize service providers; (iii) monitor licensees; (iv) require provision of information; (v) enforce compliance with regulatory requirements; (vi) remove the license of unfit licensees; (vii) wind up the business if necessary; (viii) exchange information with other regulators; and (ix) undertake the supervisory responsibilities under the money-laundering law presently delegated to the professional bodies.

D. Regulatory Authorities

The Current role of the CBC

There are clear reporting lines for the CBC's licensing and ongoing supervision of IFCs and IBCs through the International Banking and Financial Services Supervision Department (IBFSSD) and the International Business Department (IBD). A recent review has improved workflow with particular tasks being transferred from the IBD to the IBFSSD that now undertakes all tasks in relation to IFCs.

The responsibility for the administration of the Companies Law is that of the Registrar of Companies. However, to avoid duplication, some documents concerning the filing of Collective Investment Schemes are retained with the IBFSSD. This appears to be working well. Procedures relating to licensing and supervision of IBCs were clearly documented and, judging by the sample surveyed, these procedures were seen to be adhered to.

The IBFSSD and the IBD at present have appropriate powers for the conduct of their activities through the application of legislation, particularly the Companies Law and the Exchange Control Law. The accession of Cyprus to the EU will require the repeal of the Exchange Control Law. A new Financial Services Law presently being drafted is intended to ensure that regulation of financial services will continue.

The CBC staff is required to perform all elements of the regulatory process, including authorization, monitoring, compliance, and enforcement. From our discussions with CBC staff, representatives of authorized institutions and a subsequent review of files, it appears that the IBFSSD is finding it difficult to perform all these functions equally well. The department has begun an informal review process assessing the risk of regulated entities. The goal of this process is to identify which entities will require more frequent visits.

Supervisors in other jurisdictions are now moving to a more risk-based approach to supervising financial entities. Assessment methods need to be designed to help alleviate some of the problems the scarcities may produce. It would benefit the CBC if a more formal approach to the assessment of relative risk were put in place. This might result in a greater concentration of resources on particular aspects of the supervisory process or on specific institutions regarded as high risk, or a combination of both approaches.

The staff of the relevant departments are all well qualified. The key members of the staff have been with the CBC for a considerable length of time ensuring the CBC has substantial experience. Nonetheless, the CBC should consider the issues of human resource management required to fulfill its obligation with regard to the supervision of the financial sector. Even with a more formal risk based supervision approach, the requirement to conduct more extensive external visits, monitor on an ongoing basis, and authorize businesses will stretch the present complement of staff. A further increase in staff and more staff training may well be needed to ensure that the risks are adequately contained.

All IFCs are required to conduct an annual audit and file the auditors' report with the CBC. As part of this audit, auditors must confirm that the company has complied with its Exchange Control permit. A number of companies use their external auditors as an additional compliance function. Visits by the staff of the CBC are conducted periodically, but their frequency and extent could be improved. Given the type of business, this area is well monitored.

IBCs other than IFCs are required to file audited financial statements each year. An annual return to the CBC allows for ongoing monitoring, in addition to the audited financial statements. The control of these low risk companies is superior to most other jurisdictions permitting the equivalent type of company.

The legal framework permits the exchange of information provided a court order is obtained.

VII. REVIEW OF INSURANCE STANDARDS

A. Structure

The organization of the domestic insurance sector in Cyprus is largely based on U.K. practice. Including 19 branches and agencies of foreign companies, there are 52 companies, a relatively large number given the size of the economy. The industry is, as in most countries, divided into life and general (that is non-life, including property and casualty) insurance provided both by separate companies and by composite companies. The life sector is dominated by some five large companies accounting for about 90 percent of premiums, three of which are owned by the two largest banks. The general insurance sector is less concentrated; the top five companies account for about 50 percent of the market. They offer mainly conventional products sold through a network of some 7,000 agents and sub-agents. During the stock exchange boom, there was a rapid expansion of sales of single premium policies as the life companies sought to tap the popular interest in the stock market. The popularity of this product evaporated with the collapse of the stock market in 2000, although some unit-linked products continue to be sold.

In addition, there is an offshore insurance industry that consists of a small group of 11 'captive' companies, and a larger group of 17 companies carrying out third party business. The 'captives' are essentially brass plate companies attracted by the favorable tax regime. They have no particular connection with Cyprus and could move easily to another center; apart from two Russian companies, they all come from North America and Europe. The authorities consider that they are unlikely to survive the removal of the tax preferences to be completed by 2005 if, and when, the government's understanding with the OECD is fulfilled.

The Cypriot authorities have never promoted Cyprus as a center for captive insurance companies; the existing captives are likely, therefore, to move to those centers where this business is well established. The remaining offshore companies consist of two large

businesses owned by European insurance companies and a number of smaller companies, from Europe, the Middle East, and Russia. These do have a basis for being in Cyprus and find the presence of a well-developed infrastructure and a market for skilled labor attractive. They may well, therefore, remain after the tax preferences are phased out, provided that the tax burden is still reasonably competitive.²⁵

The industry is supervised by a Superintendent of Insurance who heads a small ICCS within the Ministry of Finance. Although the Superintendent claims to have considerable operational autonomy in practice, but subject to appeal in certain cases to the Minister, for budget and staffing purposes the service is considered a part of the Ministry. Fees paid under the insurance law are passed direct to the Government. The Superintendent has no financial resources under her control.

The Superintendent's operational powers will be increased under the new legislation, but her judgments on new license applications and revocations of licenses will still be subject to appeal to the Minister who can, therefore, overrule the Superintendent's decisions. The Superintendent informed the mission that Ministers have upheld such decisions in the past.

The current insurance law is about to be replaced by a much more comprehensive statute, designed to bring Cyprus into full compliance with the EU directives on insurance. As is currently the case, the same law will govern both domestic and offshore businesses. The only difference at present is that advantage is taken of a provision in the existing law, which allows the Minister to exempt certain companies from provisions that are regarded as 'onerous.' Certain supervisory requirements, e.g., minimum solvency requirements, requirements for reinsurance etc. are waived under this provision in respect of 'captive' companies on the grounds that such companies do not expose the general public to risk. The Superintendent stated that 'captives' are monitored to ensure that they remain captives, and indeed some companies have been removed from the list for providing insurance for third parties. Other offshore companies are supervised on the same basis as domestic companies. All 'offshore' companies must also obtain a permit from the Central Bank under the Exchange Control Law, which provides that they must be owned by nonresidents and only provide insurance to nonresidents. Furnished with such a permit they become eligible for the same favorable tax treatment enjoyed by other offshore financial institutions.

²⁵ As noted above, the authorities have yet to give any indication as to the future level or structure of corporate taxes if and when the preference is removed. Many offshore institutions regard a tax on corporate profits of around 10 percent as acceptable. Much above that, many offshore companies would begin to question the viability of their continuing presence in Cyprus.

B. Review

Given the small size of the offshore sector, the fact that the future of the captive companies is limited, and given the radical restructuring of the supervisory and regulatory regime about to take place, the mission has not attempted a full assessment of the offshore insurance industry. However, the mission carried out an informal review on the basis of discussions with the Superintendent of Insurance.

The mission concluded that current supervisory regime, as it is applied to the offshore companies was not one that imposed unacceptable risks. The business of the captive companies appears to be effectively limited to affiliated businesses that are genuinely captive. Some evidence for this lies in the fact that three companies have been removed from the list for attempting to indulge in non-captive business. As regards the non-captive international business, the predominant share is carried on by subsidiaries of well-established and regulated international companies. There has been no rapid growth in the sector and the authorities have not attempted to promote Cyprus as an offshore 'center' for insurance.

It is clear however that the ICCS is severely understaffed. There is little capacity for onsite examination, for example. The Service has no legal staff, no in-house actuarial staff, and there is a shortage of qualified accounting personnel. Moreover, under current arrangements, the Superintendent has little control over staffing, terms of employment, and budgeting. Income generated by the supervisory process and fines for non-compliance accrue to the Government and not to the Service. Insurance supervision is a skilled business and needs dedicated and trained professional staff. Reliance on the pool of government accountants, few of whom have relevant experience, is unlikely to be a satisfactory long term solution. The Superintendent has prepared plans for a significant expansion of the Service, but these have yet to be approved, although some limited expansion has been agreed for this year. Currently, the Service consists of only eight professional staff, only three of whom are certified accountants, and four clerical staff. For actuarial staff, the Service has to rely on the Department of the U.K. Government Actuary, largely through correspondence.

The mission concluded that the Superintendent's operational autonomy should be extended to give her control over resources needed to fulfill her statutory obligations. Consideration should also be given to allowing the Superintendent freedom to determine pay scales and conditions of service. Consideration should be given to making the Superintendent's decisions directly reviewable by the Courts or through some other judicial arrangements, rather than to a Minister first, and then to the courts. This should be counterbalanced by a greater degree of accountability. The Superintendent should be required to report annually on the use of her powers and the extent of the resources employed.

C. Issues and Efforts Under Way

As noted above, a new insurance law has been drafted. This is a comprehensive attempt to meet the requirements of the EU insurance directives. The mission had not had an opportunity to examine the new law, which is now awaiting final approval from the Ministry

of Finance and the Attorney General before being presented to the legislature, probably in the summer. But the mission was informed that it would include major changes in the calculation of solvency requirements, a full separation of life and non-life business, and more clearly defines the roles of agents and brokers. Given the all party commitment to meeting the requirements for EU accession, major revision is believed to be unlikely. However, there is no evidence yet that the resource implications of the new legislation have been dealt with. Approaches have been made to the office of the U.K. Government Actuary to increase the use currently made of his services. This may be sufficient for the purposes of the Service in the short term, but it would clearly be preferable if the Superintendent were given financial resources to hire actuarial services on a contract basis.

VIII. REVIEW OF INVESTMENT AND SECURITIES STANDARDS

A. Structure

The main securities market activity in Cyprus takes place on the CSE. The CSE is regulated by the SEC appointed by the Government. The CSE is a domestic market, and at present it is insulated from international business by the Exchange Control Law. There are some foreign-owned intermediary companies, e.g., brokers. But there are no nonresident issuers, although it is possible for foreign investors to participate in the market. However, their presence so far has been limited. This report, therefore, does not cover the activities of the CSE and the SEC. There is no offshore market in securities, and indeed the only investment business is in fund management and advisory services. This chapter is, therefore, devoted to these aspects to the extent that they relate to offshore business, that is the activities of entities resident in Cyprus but owned by nonresidents, and whose business is largely confined to that of other nonresidents. This distinction is expected to erode as the Exchange Control Law ceases to have effect and when the tax preferences currently in force cease to distinguish between offshore and other business. Indeed the new Financial Services Bill is expected to subject domestic and international business to the same regulations and supervision.

Collective investment schemes

While the bulk of investment activity in the offshore sector consists of individual fund management and advisory business, on which see below, the Cyprus House of Representatives passed a law in 1999 allowing the formation of collective investment schemes in the offshore sector. The ICIS Law has not yet been greatly utilized, but as intermediaries become more familiar with its provisions and the regulatory practices, it is possible that it will become more used.

So far, in the first six months that the law has been effective, only five schemes have been authorized, and all of these have been private schemes, (defined as schemes with less than one hundred investors), for which no prospectus is required and no advertising permitted. In practice, the number of investors has averaged about twenty. There are also

about six further schemes in the pipeline and these will involve public offerings. The law requires that the investors and immovable assets be outside Cyprus. On that basis, the funds can benefit from the nonresident tax status. However, both manager and trustee must have a place from which to carry on business in Cyprus. This may not preclude them from being treated as nonresident under the Exchange Control Law. Whereas it had been expected that the law would be of benefit to investors in East Europe and in the Former Soviet Union, where the investor could take advantage of the network of double tax treaties that Cyprus has with many of these countries, in fact most of the schemes planned to date invest in Western European countries

B. Review

International collective investment schemes

Given the absence of much substantive securities and investment business, the mission did not undertake a full assessment of the Objectives and Principles of Securities Regulation. The business carried on by the offshore sector is limited to fund management and investment advisory activities. The mission noted the self-assessment undertaken by the Cypriot authorities and the assessment of the domestic securities industry undertaken by a Fund mission in 2000. The mission confined itself to an informal review of the arrangements for international collective investment schemes in terms of Principles 17-20 on the basis of discussions with the CBC, which is responsible for these schemes' supervision. The mission noted that in the self-assessment referred to above, the Cypriot authorities stated that there was at present no machinery for domestic collective investment schemes but that legislation was in preparation, in line with the EU directives, that would allow such an activity to develop. Such arrangements would be supervised by the SEC, whose role is also to be developed in accordance with a new SEC Law and the proposed Financial Services Law. There will then be a need for a full assessment of the entire industry which could be done in the context of a future possible Financial Sector Assessment Program.

The regulatory framework appears to be broadly satisfactory. There is a regulatory structure of the type called for in Principle 17. The system provides rules governing the legal form of CIS and segregates and protects clients' assets, as required in Principle 18. Principle 19 provides for disclosure to investors and potential investors both of the assets in the scheme and the value of the investor's interest. Section 64 of the Law provides for this, although little such information has been generated so far given the recent introduction of these schemes. Finally, Principle 20 calls for a proper and disclosed basis for asset valuation and the pricing of the units in a scheme, including on redemption. This is also covered under the ICIS Law (see Section 66).

The principles that deal with the role of the regulator are also important here. In this case the regulator is the CBC. Whereas in its other responsibilities towards the offshore sector, the CBC acts using powers delegated to it under the Exchange Control Law, in the case of ICIS, the ICIS Law specifically provides that the CBC shall be the regulatory authority. The Mission has not been able to assess the extent to which the CBC has used its

powers under the Act appropriately and in compliance with the IOSCO Principles. In part, this is due to the fact that only six months have passed since the Law became effective and it seemed premature to undertake a full assessment at this stage.

Investment management and advice

The main, and more long-standing activity of the IFCs is the investment of clients' funds and the provision of investment advice. (See chapter VI for the arrangements for the formation of IBCs generally.) Authorization relies heavily on the collection of references supplied by the applicant. This policy is rigorously applied but its credibility could benefit from the collection of information from foreign law enforcement agencies and judicial systems. All IFCs are audited, and the auditor is required, in addition, to report to the CBC on the company's compliance with the terms of its permit under the Exchange Control Act. This permit specifies the type of business the IFC is permitted to undertake. Effectively, external auditors thus provide a compliance function. Together with the off-site monitoring by the CBC, the supervisory process appears adequate. It could, however, benefit from greater use of onsite visits, particularly where these could be targeted on vulnerable companies.