

**ASSESSMENT OF IMPLEMENTATION OF THE BASEL CORE PRINCIPLES
FOR EFFECTIVE BANKING SUPERVISION IN RESPECT OF THE
OFFSHORE SECTOR**

CYPRUS

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PREFACE

The Governor of the Central Bank of Cyprus (CBY) invited the International Monetary Fund to carry out an assessment in March 2001 of the extent to which 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 described in the paper “Offshore Financial Centers – The Role of the IMF” published in July 2000. The overall assessment is being published in a separate report. This document contains a detailed assessment of compliance with the individual Basel Core Principles for Effective Banking Supervision in respect of the offshore banking sector in Cyprus. The principal conclusions of the assessment are also summarized in the main report.

Principle 1: An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

1 (1): An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.

Description

The Law setting up the Central Bank of Cyprus came into effect in 1963. The Central Bank of Cyprus Law provides in Section 6 that the Central Bank of Cyprus (CBC) shall have power:

- To regulate the supply of money and credit;
- To manage and administer the international reserves of the Republic;
- To supervise banks in the Republic; and
- To act as banker and financial agent of the Government of the Republic.

In addition, Section 34 of the Central Bank of Cyprus Law makes “ The Bank responsible, as agent of the Ministry of Finance, for the administration of such foreign exchange control legislation as may be in force from time to time in the Republic. Since there is a foreign exchange Control Law in effect in Cyprus this gives the Central Bank a powerful tool to control offshore enterprises.

The Banking Law provides in Section 26 that the CBC is responsible for the supervision of banks in order to ensure the orderly functioning of the banking system.

All responsibilities for banking supervision rest solely with the CBC. The CBC decides when and how to effect the orderly resolution of a problem bank situation.

However, under the Banking Law (Section 30(3)) the CBC is required before acting to consult with the Minister of Finance with respect to the following enforcement actions (i) completely 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 license of the bank. In addition, the

CBC determines the policy with respect to the granting of licenses to carry on banking business after consultation with the Minister according to Section 4 (5) of the Banking Law. The Banking Law was enacted in 1997. It was amended/updated twice on June 25, 1999 and June 30, 2000, respectively. The CBC's ability to supervise offshore banks emanates from the provisions of the Banking Law.

Assessment: *Compliant.*

1(2) Each agency should possess operational independence and adequate resources

Description

The CBC is an independent organization, separate from the government or governmental agencies. Under the CBC Law, the management of the CBC is in the hands of the Board of Directors consisting of the Governor and five Directors.

The President of the Republic appoints the Governor of the Bank for a term of office of up to five years. The Governor may be removed from office before the end of his tenure and subject to such compensation as may be specified in his service contract. The current law does not specify what reasons must be given for removal of the Governor. The law also does not specify that the reason for the Governor's removal from office must be publicly disclosed.

A new Law is being prepared and its purpose is to ensure the complete independence of the CBC. Under the proposed Law removal of the Governor prior to the expiry of his term of office will not be permitted.

The primary legislation covering the regulation and supervision of the banking industry is the Banking Law. While the Banking Law stipulates the minimum capital base in Section 20, the CBC sets out minimal prudential standards, including the composition of capital elements and ongoing capital requirements, risk limitations and risk management.

The supervision of banks is divided between domestic and international sections. The total number of staff is 35 of whom 12 are responsible for monitoring and examining 31 International Business Units/Administered Banking Units, 116 International Finance Companies and 12 International Trust companies. These individuals regularly share information freely among themselves and with the Head of the Supervision Department. There are currently four staff vacancies.

The CBC is operationally and financially independent of both the industry and the government. The Board of Directors is responsible for the preparation and adoption of the annual budget of the Bank. The CBC principally earns revenues from the issue of national currency and the management of Cyprus's external reserves. The budget of the bank is funded from the above sources and surpluses are transferred to the account of the Government. The budget of the Bank Supervisory function forms part of the Bank's budget.

In addition, the bank has the right to seek reimbursement of the costs incurred for the on-site examination of banks but up to now has not made use of this right. The CBC indicated that this is included as part of the conditions imposed on IBU's license.

The head of supervision has had substantial experience in the position. In general the supervisory regime is characterized 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. Salary levels within the CBC have reportedly in recent years fallen below industry levels.

There is a strong commitment to training and staff development. Training programmes for bank supervision staff cover a variety of areas related to banking. These courses are usually arranged by the FDIC, the Bank of England, the Netherlands Bank and other central Banks and private institutions. The staff also attend meetings of the Offshore Group of Banking Supervisors and visit other regulators when that is deemed appropriate.

Significant emphasis is also placed on developing and maintaining an information technology infrastructure to support the key activities of the bank supervision department.

The CBC can take regular supervisory decisions. However as indicated in principle 1.1 above on certain matters it must consult with the Minister. In addition the Minister's representative on the Board has the ability to delay some decisions for five days if it is thought to be in the public interest. Such a decision can be appealed to the Council of Ministers.

The CBC has general powers under Section 30 of the Banking Law to issue guidelines relating to any function it supervises.

Assessment: *Materially noncompliant.*

The shortcomings in the law, which do not specify that reasons be given for removing the head of the agency, are being remedied. We understand that a new Law is being prepared and one of its provisions is to provide for greater security of tenure for the Governor and to ensure that he cannot be removed prior to the expiry of his term of office.

It is important that public agencies that enjoy independence be accountable. While the CBC publishes an annual report, it does not contain a section on supervisory activities. The CBC should provide such a commentary to help to inform the public about its supervisory activities and how they have been discharged. This is done by supervisory agencies in many countries.

Currently 12 persons are responsible for supervising the activities of IBU's, ABU's IFC's. In our view there is not sufficient staff to carry out supervisory activities. Our assessment is based, to a large extent, on our view that the length of time between on site visits should be shortened.

The target for completing onsite reviews by the CBC is once a year for locally incorporated banks and once every two years for branches. These targets seem reasonable, but it is important that resources be made available to ensure that the targets are being met. Some banks have not had a full review for more than three years.

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.

1(3) A suitable legal framework for banking supervision is necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.

Description

The CBC is the institution designated as the Banking Supervisory authority under the Central Bank of Cyprus Law (Section 6) and the Banking Law (Section 26) for granting and withdrawing banking licenses. The Superintendent of Co-operative Development under the Co-operative Societies Law supervises Co-operative Credit Societies.

The Banking law (Section 30) empowers the CBC to take a large of measures to safeguard the interests of depositors and creditors of banks when in its judgment a bank is not complying with laws and regulations. This includes requiring banks to take such action, as the CBC may consider necessary; to completely prohibit the acceptance of deposits or the granting of credit; assuming control of the bank or revocation of the bank's licence.

The Banking Law (Section 26) also requires banks to make available to the CBC all books and records and to provide the CBC with any information in the form and frequency it deems necessary.

The law enables the CBC to address compliance with laws and the safety and soundness of the banks under its supervision. and permits the CBC to apply qualitative judgement in forming this opinion. The CBC has unfettered access to banks' files in order to review compliance with internal rules and limits as well as laws and regulations.

All formal actions including closures would be acted upon by the governor on the advice of the Head of the Supervision department. All decisions of the CBC are subject to appeal by the affected parties to the high Court of Justice.

Amendments to legislation are frequently suggested by the CBC to the Government. This process not only reflects changing international standards, but also in recent years has come to reflect the desire of Cyprus to harmonize its legislation and practices with the European Union. Cyprus is working towards accession to the EU in the near future.

Although the CBC publishes an annual report the supervisory activities are not covered. The CBC publishes current and historical statistics on the industry and all locally incorporated banks are required to file a copy of their audited financial statements with the CBC.

Assessment: *Compliant.*

1(4) A suitable legal framework is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.

The Banking Law empowers the CBC to set prudential rules autonomously and administratively Section 41 except with regard to the policy of granting banking licenses (sec. 4.5) which is determined by the CBC after consultation with the Minister. The CBC does have unfettered access to banks' files in order to review compliance with internal rules and limits as well as external laws and regulations.

Under Section 30 (1) the Banking Law empowers the CBC to take a range of remedial measures when a bank fails to comply with any of the provisions of the Law, or of any regulations issued by the CBC or with the conditions of its license, or in the opinion of the CBC the liquidity of its assets have been impaired or there is a risk that the ability of the bank to meet its obligations may be impaired, or when considered necessary for the safeguarding of the interests of depositors and creditors. These measures cover prohibiting the acceptance of deposits or the granting of credit facilities by the bank, or both, assuming control of the bank and revocation of a bank's license after consultation with the Minister of Finance.

Section 26 of the Banking Law gives the CBC unfettered access to all of the institutions records and books.

Assessment: *Largely compliant.*

The Banking Law (Section 41) empowers the CBC to set prudential rules autonomously and administratively except with regard to the policy of granting banking licenses (sec4.5) and with respect to remedial measures (Section 30) the CBC is required to consult the Minister of Finance The CBC indicated to us that the issue of specific licenses is not subject to consultation and that in other areas the consultation process involving the Minister has not inhibited the supervisor from taking action. They indicated that consultation does not mean that the approval of the Minister is required. While this may well have been the case in the past there, nevertheless, is the potential for the consultation process to become protracted and delay the decision. There is no question that the Minister should be kept informed of significant matters.

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.

1(5) A suitable legal framework is also necessary, including legal protection for supervisors.

Description

Section 32 of the Banking Law provides that “Neither the Central Bank nor any person who is a Director or an officer of the Central Bank shall be liable in any action suit or other legal proceedings for damages for anything done or omitted in the discharge or purported discharge of the functions and responsibilities of the Central Bank under this Law unless it is shown that the act or omission was not in good faith or was the result of gross negligence.”

This section of the Law provides legal protection to the CBC as well as to its staff against lawsuits for actions taken while discharging their duties in good faith.

Assessment: *Compliant.*

1(6) Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Description

The CBC is responsible for all aspects of banking both domestic and international and is also responsible for the operations of international companies and trusts by virtue of its administration of the Exchange Control Law. Although there are no formal arrangements in place, the Bank has continuing and good contacts with the Superintendent of Insurance, the Registrar of companies and the Head of the Unit for Combating Money Laundering Offences.

Before this unit was set up the CBC undertook money-laundering surveillance relating to banks. In that capacity the CBC officers attended a number of international meetings related to money laundering issues. The CBC continues its close involvement with money laundering issues and often accompanies the Head of the Unit for Combating Money Laundering to various international and other meetings. Training sessions conducted for institutions in Cyprus relating to money laundering also involve cooperation between the CBC and the Unit.

With regard to securities and investment business, a member of the CBC’s staff is on the Board of the Securities and Exchange Commission.

The Banking Law (Section 27) enables 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 consolidated supervision. Information on individual accounts is excluded. However in practice such information can be passed by the subsidiary to its head office or the foreign regulator may obtain permission to come to Cyprus to conduct an onsite review of the operations.

Memoranda of understanding have been signed with a number of countries including Russia, Belarus, Bulgaria and Ukraine. Negotiations on Memoranda of Understanding have been started, largely on the initiative of the CBC, with the banking supervisory authorities of the United Kingdom, Greece, Romania, France, and Austria.

Section 17(4) of the CBC Law provides that every director, officer or employee of the Bank shall be bound to secrecy. In addition, Section 18 of the CBC Law requires that the Bank's Governor, Directors, officers and employees take the oath of fidelity and secrecy before assuming their duties. Moreover, Section 29(1) of the Banking Law provides that persons who have access to the records of banks e.g., bank supervisors, shall not give, divulge reveal or use for their own benefit any information regarding the account of any individual customer, except in the following cases:

- The customer or his personal representatives gives or give his or their written permission to do so; or
- The customer is declared bankrupt or if the customer is a company, the company is being wound up; or
- Civil proceedings are instituted between the bank and the customer or his guarantor relating to the customer's account; or
- The information is given to the police under the provisions of any law or to a public officer who is duly authorized under that law to obtain that information or to a court in the investigation or prosecution of a criminal offence under any such law; or
- The bank has been served with a garnishee order attaching moneys in the account of the customer; or
- The information is required in the course of his duties by a colleague in the employment of the same bank or its holding company or an auditor or legal representative of the bank; or
- The information is required to assess the creditworthiness of a customer in connection with or relating to a bona fide commercial transaction or a prospective commercial transaction so long as the information required is of a general nature and in no way related to the details of a customer's account; or
- The provision of the information is necessary for reasons of public interest or for the protection of the interests of the bank.

Assessment: *Compliant.*

Both legislation and practice provide for a full range of information to be shared with domestic and foreign regulators.

Principle 2: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.

Description

The Banking Law defines the permissible activities of banks. In this respect, licensed banks are authorized to carry on banking business as defined in Section 2 of the Banking Law. In addition, licensed banks are authorized to carry out, directly or through subsidiaries, activities that are integral or closely related to banking business as defined in Section 13 of the Banking Law. According to Section 2 of the Banking Law, banking business is the lending of funds acquired from the assumption of obligations to the public, whether in the form of deposits, securities or other evidence of debt.

The Banking Law Section 13 (3) provides that licensed banks are allowed to engage, directly or through subsidiaries, in securities activities such as trading for own account or for account of customers in securities, participation in securities issues and the provision of services related to such issues as well as portfolio management and advice. Invariably, banks conduct their investment/insurance business through separate subsidiaries.

Section 13 (1) limits a bank from holding directly or indirectly more than ten percent of the share capital of any other company or has control over such company. In the case of a bank incorporated in Cyprus there are two additional restrictions; that the aggregate of shares held for all companies shall not exceed 25 percent of the bank’s capital base and Section 15 a prohibition against acquiring and dealing in its own shares.

Licensed banks are permitted to engage in insurance brokerage services. They are also allowed to hold up to 100 percent of the share capital in an insurance company provided that such company is incorporated in the Republic.

Under the new supervision regime for the securities business, banks will be allowed to carry out securities business in the same way as investment firms.

Under Section 5 of the Banking Law, no person other than a bank shall use in any language the word bank or any variation thereof unless prior written approval is given by the Central Bank. Section 6 prohibits the advertising for deposits by any person other than a bank or a cooperative society or Housing Finance Corporation.

Assessment: *Compliant.*

Use of the titles “bank” and “banking” and all grammatical variations thereof are limited as provided in Section 5 of the Banking Law.

The term “bank” is defined in the Banking Law as a body corporate licensed to carry on banking business under the provisions of the Banking Law. Section 3 of the Banking Law

provides that no person, other than a bank, shall engage in banking business or in the business of accepting deposits. As a result, the taking of deposits is reserved for licensed institutions.

Principle 3: The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Description

The statutory criteria for the licensing of a bank are contained in Sections 3 and 4 of the Banking Law. The CBC is both the licensing and supervisory authority for banks. The CBC supervises all licensed banks. The Banking Law provides for one type of license. However, the CBC may, with an adequately reasoned decision, grant a license without any condition or impose conditions on the license or refuse to grant a license (Section 4 of the Banking Law).

All licensees are required to establish a real presence in Cyprus and actually carry out real business. All licensees must, therefore, operate as fully staffed units as required by the scale of operations in each case. The scale of operations and therefore size of staff varies considerably. There is at least one IBU with almost 100 persons and on the other hand one Unit is considered fully staffed with one person.

An exception to the above rule, is the case of Administered Banking Units which, although carrying on banking business in their own name, have their day-to-day administration conducted on their behalf by another bank (the administering bank) which is already licensed by the CBC to operate in or from within Cyprus. (The designation-banking unit instead of bank has no particular significance. For historical reasons the name was copied from a neighboring jurisdiction, which was licensing offshore business prior to Cyprus' pursuing such business.)

The CBC has, under the provisions of Section 4 of the Banking Law, may grant a license "subject to such conditions, as the Central Bank may consider proper to impose." In addition Section 20 permits the CBC to set higher than the minimum amount of capital.

The CBC has the right to reject applications under the provisions of Section 4 of the Banking Law. The CBC may, with an adequately reasoned decision, refuse to grant a license in circumstances where the Bank considers proper to do so e.g., when the licensing criteria set by the Bank have not been met.

The licensing criteria applied by the CBC encompass compliance of the applicant with the requirements stipulated in the Law as well as a judgmental evaluation of the applicant by the CBC. Thus, the principal licensing criteria are the following:

- At least two directors are required to participate and concur in the effective direction and management of the bank (Section 19 of the Banking Law).
- A bank incorporated in the Republic must have at all times a minimum capital of not less than C£ 3m or such other higher amount that the CBC might determine (Section 20 of the Banking Law).
- Directors, Chief Executives and Managers of the proposed bank must satisfy the CBC that they are fit and proper persons.
- Short history and business objectives of the applicant bank including the reasons for wishing to establish a presence in Cyprus.
- Detailed description of the proposed banking operations, including details of the banking services proposed to be offered and the proposed management structure of the applicant bank.
- Feasibility study of the bank's proposed banking operations incorporating projected financial statements for the first five years of its operation.

In the case of foreign banking organizations the CBC, in addition to the licensing criteria above, approaches directly the applicant bank's home supervisory authority and obtains its consent as well as undertaking that it will exercise consolidated supervision over the global activities of the applicant bank, including the operations proposed to be carried out in Cyprus.

- In the case of foreign banking organizations, the CBC also obtains Letters of Comfort from the principal shareholders.

With regard to IBUs/ABUs, thus, licensees are restricted to deal primarily with non-residents and in currencies other than the Cyprus Pound.

There is no time limit on banking licenses issued by the CBC. However, the CBC may under (Section 30 of the Banking Law) revoke a banking license in circumstances where a bank's condition is irretrievably impaired.

As part of the review process, information/references are also obtained from third parties such as the applicant bank's home supervisory authority, correspondent banks, etc.

The information received from the applicant is reviewed and judgmentally assessed by the CBC. If all the above criteria are satisfied and the judgmental evaluation is positive, a banking license is issued by the CBC.

- Directors, Chief Executives and Managers of IBUs have to satisfy the CBC that they are “fit and proper persons” to be involved in the provision of banking services. The “fitness and properness” of the above persons is determined, to the extent possible, by means of detailed questionnaires which are required to be completed by the persons concerned.

Offshore jurisdictions generally limit offshore banks to dealing with non-residents. However, the CBC is liberalizing its treatment of IBUs/ABUs. Since January 1, 2001, IBUs/ABUs have been allowed to make foreign currency loans to residents.

In the last two years five applications for banking licenses were received (one for a domestic bank and four for IBUs).

In one of the cases (application for the establishment of a domestic bank) the CBC rejected the application, as one of the major prospective shareholders was a company whose background and activities rendered it unsuitable. Two of the applications were successful whereas the remaining two have been unable to satisfy the eligibility criteria.

Notwithstanding the above, it should be noted that in the case of IBUs/ABUs the policy of the CBC is to discourage the submission of formal applications under the Banking Law by banks which do not meet the eligibility criteria as set out in the bank’s “Policy Statement and Guidelines for the establishment and operation of IBUs/ABUs.” The CBC also requires prospective applicant banks to obtain the prior approval and support of their home banking regulatory/supervisory authority before submitting a formal application to the CBC for a banking license. In this way, besides the cases referred to in the preceding paragraph, a number of prospective applicant banks have been discouraged, in the last two years, from actually submitting an application.

With respect to the transparency of the ownership structure and the source of capital, the CBC indicated that its policy is to license only branches or subsidiaries of existing international banks.

Section 4.5 of the Banking Law states, that the policy with respect to the granting of licenses to carry on banking business is determined by the Central Bank after consultation with the Minister. The CBC indicated that once the policy is set it is free to operate within the policy framework.

The CBC has in place a process of ongoing supervision and monitoring to determine whether the licensing criteria continue to be met and that the institution is meeting its business goals. The CBC is home supervisor for 17 banks (10 domestic and 7 IBUs/ABUs). Three of the domestic banks maintain branches/subsidiaries in foreign jurisdictions.

Assessment: Largely Complaint.

As standard policy, the CBC, before issuing a license to a foreign bank, approaches directly the applicant bank's home supervisory authority and obtains its consent as well as undertaking that it will exercise consolidated supervision over the global activities of the applicant bank, including the operations proposed to be carried out in Cyprus.

The above are reviewed by the CBC as part of the overall assessment of the application in hand. The assessment of the properness of these executives, directors and managers is based on references supplied by them—for example from correspondent banks and business professionals. The assessment in practice does also focus on the banking experience of the applicant. There is no requirement to submit documents from law enforcement sources in countries where the applicant resided.

More emphasis could be placed on obtaining information, directly from foreign law enforcement agencies and judicial systems in addition to reliance on private investigations, in some cases. This would ensure a more comprehensive investigation into the character and reputation of persons who are associated with the financial services sector in Cyprus.

Principle 4: Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

Description

Section 17 of the Banking Law provides that no person shall be allowed to acquire or have control over a bank without the prior written approval of the CBC.

Control is defined in the Banking Law as beneficial ownership by a person of the bank's share capital, which carries 10 percent or more of its voting rights.

In addition, Section 16 of the Banking Law provides that a bank shall not sell or dispose the whole or part of its business by amalgamation or otherwise, except with the prior written approval of the CBC.

The CBC in deciding whether to grant an approval will ensure that persons of dubious reputation or persons who may pose a threat to the interest of depositors and integrity of the bank are excluded. The CBC will also take into account the need to maintain adequate competition in the banking system.

Regarding IBUs/ABUs' ownership, the CBC considers applications only from banks licensed in jurisdictions, which, in its judgment, exercise proper licensing and banking supervision. In addition, applicant banks must be institutions enjoying a good reputation internationally and having an established record of growth and profitable operation. The CBC never licenses de novo institutions.

- Through a condition of their banking license, locally incorporated IBUs/ABUs may not without the written approval of the CBC: issue any further capital other than its existing beneficial shareholders and other than pro-rata their present shareholdings or register a transfer of any of its shares.

Assessment: *Complaint.*

All acquisitions of material holdings or changes require prior approval of the CBC. It should be noted that the Banks operating in the offshore sector in Cyprus are branches or subsidiaries of banks that are widely owned; many are listed on stock exchanges.

Principle 5: Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Description

Section 13 of the Banking Law regulates investments by banks and sets limits on the acquisition of shares by banks in other companies. Any bank investments exceeding the limits prescribed under Section 13 of the Banking Law require the prior written approval of the CBC.

Specifically, the Law provides that a bank shall not acquire or hold directly or indirectly more than 10 percent of the share capital of any other company and in the case of a bank incorporated in the Republic the value of any share capital held in any other company shall not exceed 10 percent and for all companies in aggregate shall not exceed 25 percent of the bank's capital base. These limits apply to all investments excluding investments in shares of insurance companies and companies which carry out banking business or functions which are integral to or closely related to banking business provided that such companies are incorporated in Cyprus.

In addition, Section 12 of the Banking Law prohibits the acquisition or purchase of immovable property by banks except in certain cases as provided in Section 12 of the Banking Law.

Under Section 13 of the Banking Law banks are not allowed to expand their direct or indirect operations outside Cyprus without the prior written approval of the CBC. The CBC makes its approval conditional upon the on-going availability of information from the overseas operation including the ability to carry out on-site examination and to exercise consolidated supervision.

In granting its approval the CBC reviews the business plan of the proposed operation. The existence and size of ethnic community (Greek or Cypriot) in the proposed country of operation is taken into account.

IBUs/ABUs incorporated in Cyprus, through a condition included in their banking business license must obtain the CBC's prior written approval, to issue any further capital other than to its existing beneficial shareholders and other than pro-rata their present shareholdings and register a transfer of any of its shares. In addition it must also obtain CBC approval before creating any subsidiary companies, participating in the share capital of another bank or credit or financial services enterprise or opening a place of business in the form of a branch or Representative Office.

Assessment: *Complaint.*

Principle 6: Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.

Description

Locally incorporated banks including subsidiaries of foreign banks (domestic and IBUs/ABUs) are required to have a minimum capital, to maintain capital adequacy ratios and to comply with restrictions related to capital base (e.g., maximum exposure to single customer). These requirements do not apply to branches of foreign incorporated banks.

The Banking Law, Section 20, provides for a minimum capital base of not less than £3m for all banks incorporated in the Republic. Moreover, banks incorporated in Cyprus are required to maintain a capital adequacy ratio at such minimum level as may be determined by the CBC from time to time (Section 21 of the Banking Law). At present, the required capital adequacy ratio stands at 10 percent. It was increased from 9 percent to 10 percent with effect from 1.1. 2001.

The capital adequacy ratio is in the form of a mandatory maintenance of a capital base in relation to total assets, including off-balance sheet exposures (Section 21 of the Banking Law). Furthermore, the Law empowers the CBC to determine what constitutes capital base of a bank and the method by which it shall be computed. To this effect the CBC has issued two directives (January 1999) to all banks incorporated in Cyprus, one on the computation of the capital base and one on the computation of the capital adequacy ratio. These directives conform to the Basle recommendations and make use of the BIS risk weights and components of capital.

The capital adequacy ratios of banks are calculated on both a consolidated and solo basis. Applicants for a banking license to conduct offshore business are not required to submit information on the source of funds to be used as capital. Individuals are not allowed to set up banks. Only established banks that meet all eligibility criteria are allowed to set up subsidiaries or branches in Cyprus. In addition, Cyprus has strong preference for branches.

Since all banks conducting “offshore business” are branches or subsidiaries of major banks, invariably, cash endowment is used to finance initial and subsequent capital requirements.

The capital adequacy ratio can vary from bank to bank but must apply uniformly to all banks within the same class. At present and with effect from 1.1. 2001 the ratio is at 10 percent for all banks. The capital adequacy ratio has been raised to take account of banks’ increased activity in the securities market.

Branches of foreign incorporated banks are not required to have capital and therefore they do not maintain a capital adequacy ratio.

The components of the capital base and the risk weights are consistent with the Basle recommendations. The directives from the CBC have been provided.

Off-balance sheet risks, subordinated debt, revaluation gains and unrealized losses are treated in accordance with BIS recommendations for purposes of determining capital adequacy.

Off-balance sheet items are grouped into four categories depending on the risk that they entail and each category carries out a different risk conversion factor. Then the values of these items as adjusted by the conversion factor are multiplied by the risk weightings attributable to the relevant counterparties.

Subordinated debt is included in tier two capital and cannot exceed 50 percent of tier one capital. Moreover, the total of tier two capital cannot exceed the total of tier one capital. Revaluation gains are credited to revaluation reserve and the balance of this reserve is included in tier two capitals.

Unrealized losses are debited to the revaluation reserve to the extent that these are covered by revaluation gains individually for each item concerned. Any shortfall is debited to the Profit and Loss Account, which is included in tier one capital.

Under Section 30.1 of the Banking Law the CBC has broad powers to take remedial measures. This would no doubt include requiring institutions to take corrective action where their capital ratios fell below a certain limit.

Assessment: *Complaint.*

Principle 7: An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Description

All licensed banks are subject to regular on-site examination. One of the prime objectives of these examinations is to assess the quality of the assets of banks.

Through on-site examination the CBC examiners assess individually the quality of assets, especially major loan accounts, and the adequacy of loan loss reserves and compare the CBC's results with those of the bank.

The CBC examiners also review the procedures, practices and credit administration policies of the bank. These include the appraisal and authorization of individual credit exposures; procedures for identification of substandard lending and provisioning policy. Where weaknesses are identified these are brought to the attention of the bank's management.

Banks are required to review asset quality at least once a year. In addition, under Section 28 of the Banking Law, the CBC can arrange at least once a year trilateral meetings with each bank and its auditors to discuss matters relevant to the CBC's supervisory responsibilities that arise in the course of the audit of banks. Moreover under the same section the auditor may freely report to the CBC any information that is relevant to the latter's supervisory responsibilities.

The asset quality classification criteria that are used by CBC examiners are as follows:

Pass

- This category includes facilities, which do not present any weaknesses and are properly serviced.

Special Mention

Included in this category are credit facilities, which do not presently expose the bank to a sufficient degree of risk but do possess credit deficiencies that deserve management's close attention. Such deficiencies may be:

- Failure to obtain proper documentation;
- Absence of adequate tangible security;
- Excessive credit facilities in relation to turnover;
- Economic or market conditions which may, in the future affect the borrower;
- Conditions imposed on approval of credit facilities not followed.

Substandard

Substandard credit facilities are facilities where the repayment ability of the borrower is in some doubt though fully covered by realizable security. Such facilities display signs pointing to weaknesses in the part of the borrower to repay in the ordinary course of business.

Characteristics of credit facilities deserving classification as substandard are:

- Inability of the borrower to settle facilities in accordance with agreed schedules;
- Loan arrears and inability to bring excesses within limits;
- Rescheduling of existing facilities;
- Persistent hardcore borrowing;
- Frequent requests for excesses;
- Decline in sales;
- Losses incurred;
- Slow collection of debtors;
- Increased bad debts;
- Diversion of funds;
- Increase in leverage; and
- Increase in level of stocks.

Doubtful

Credit facilities classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that they are not covered by realizable security. Amounts classified as doubtful should be provided for up to the outstanding amount.

In the course of on-site bank examination, the CBC reviews extensively the lending practices, credit granting standards and level of provisions and reserves. Any weaknesses identified are drawn to the attention of management and are taken up in the management letter.

Banks, generally, follow the recommendations of the CBC for rectifying any weaknesses identified. However, if need arises e.g. significant shortcoming in the level of provisions, the CBC is empowered to increase the capital requirement (Section 20 of the Banking Law) of a bank. More serious cases could be dealt with through the powers available to the CBC under Section 30 of the Banking Law.

Assessment: *Complaint.*

Principle 8: Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

Description

All licensed banks are, in principle, subject to regular onsite 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 and the adequacy of loan loss reserves. The CBC has developed no general applicable criteria for classifying losses and provisioning policy and considers each bank individually. The level of provisioning is determined by the bank in conjunction with its external auditors in accordance with accounting standards in these areas.

The external auditors when conducting the audit of the financial statements review the provisioning policies of the bank. The level of provisioning for off balance sheet items is also determined by the bank's management in conjunction with the external auditors.

The CBC examiners during their onsite visit review the procedures, practices and credit administration policies of banks and bring any weaknesses to the attention of management. The decision whether a loan should be provided for and thus placed on a non-accrual basis is taken after consideration of all relevant factors including the availability of collateral. The CBC noted that it does not follow any hard and fast rules in determining whether a provision is necessary. This is essentially a judgmental exercise. Non-accrual of interest takes place when a bank classifies a loan as doubtful.

In view of the small number of banks, the examiners of the CBC 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. In the course of on-site examination the CBC examiners review the level and adequacy of provisions. If, in the opinion of the CBC, there is significant shortcoming the matter is discussed with officials of the bank concerned and is taken up in the management letter. Banks have, so far, heeded to the recommendations of the CBC. However, if need arises the CBC may increase the capital requirement (Section 20 of the Banking Law) of a bank.

The asset quality classification criteria used by CBC examiners are described above. In accordance with these criteria all loans classified under the doubtful category should be provided for as they are not covered by collateral and are uncollectible. In addition to the CBC's examiners the external auditors check the adequacy of loan loss provisions and reserves (Section 12 c of the Notice issues by the CBC on the Relation between the CBC and the external auditors).

The internationally recommended standard for classifying loans (the Basle additional criteria) is defined to include at least any loan on which payments are contractually a minimum number of days in arrears e.g., 30, 60 and 90 days.

Assessment: Largely compliant.

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.

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Leaving the judgement to individual banks may not be appropriate under the current circumstances in Cyprus. As indicated earlier, (see Independence and Resources, BCP 1.2) there are 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 are 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 exist for much of the collateral and it is often illiquid.

Experience in other countries indicates that when guarantees are called they are frequently not honoured. 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.

The CBC should develop generally applicable criteria for assessing banks’ loan classification and provisioning 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 the loan to be classified. Refinancing and restructuring the loan would not change its status.

Principle 9: Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Description

Section 11 of the Banking Law sets the following limits with regard to concentration of lending:

- Lending to a single person may not exceed 25 percent of the bank’s capital base;
- Aggregate of all large facilities as defined in Section 11(4)(b) of the Banking Law may not exceed 800 percent of the bank’s capital base;
- Aggregate of all credit facilities granted to the bank’s directors may not exceed 40 percent of its capital base; and
- Total value of any unsecured facilities granted to all the directors of the bank may not exceed 5 percent of the bank’s capital base.

The Law prescribes that lending to connected persons shall be grouped for purposes of establishing compliance with the percentages mentioned above and empowers the CBC to determine that the interests of two or more persons are so interrelated that these persons should be considered as one.

The CBC has issued a directive on the monitoring and control of credit facilities. In this respect, banks are required to submit a return on the concentration of lending so that the CBC monitors compliance with requirements of the Banking Law. Monitoring of the concentration of lending is carried out on a solo as well as consolidated basis.

The information received by the CBC on the concentration of credit is verified in the course of on-site examination by CBC examiners.

In the course of on-site examination the CBC examiners verify that banks have management information systems to identify concentrations within the portfolio on a solo and consolidated basis. In addition, the bank examiners assess the accuracy of management information with regard to concentrations. In cases where weaknesses are identified, these are brought to the

attention of management. However, it should be noted that the small size of Cyprus facilitates the identification of connected interests on an empirical basis as well.

The Banking Law provides that any infringement of the statutory limits on loan concentrations, as described in answer to question 19 above, constitutes a criminal offence for which the bank and its officers are liable (Sections 11 and 43 of the Law).

Assessment: *Complaint.*

Banks are required to adhere to the following definitions:

- 25 percent of a bank's capital is the limit for an individual large exposure to a private sector non-bank borrower or a closely related group of borrowers.

Principle 10: In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Description

Section 11 of the Banking Law as well as the CBC directive on the monitoring and control of credit facilities deal with the transactions between banks and their related parties. The Banking Law (Section 11(1)(c) requires that lending to directors is approved by a resolution of the Board without the director concerned voting on the resolution. Moreover, banks are required to ensure that any transactions with related parties are on an arms-length basis (Section 11(1)(c) of the Law).

In addition, the aggregate of all credit facilities granted to the bank's directors may not exceed 40 percent of its capital base and total value of any unsecured facilities granted to all the directors of the bank may not exceed 5 percent of the bank's capital base (Sections 11(1)(c) and 11(1)(d) of the Banking Law).

In determining compliance with the above limits, facilities to directors are combined with those to connected persons and entities. Again, the CBC may determine that the interests of a director are so interrelated with the interests of another person or persons so that the director and any such person shall be considered as one person for purposes of determining compliance with the limit referred to in the preceding paragraph.

The CBC's directive on the control of credit facilities elaborates further on the above matters and provides guidance to banks. In this respect, banks are required to submit a return on the concentration of lending so that the CBC can monitor compliance with the requirements of the Law.

Banks are required to ensure that any transactions with related parties are at arms-length – Section 11(1)(c) of the Banking Law. With regard to affiliates any lending which is not at arms length would be regarded as lending of a capital nature and deducted from the bank's capital base.

Transactions between banks and their related parties receive special attention in the course of the on-site examination of banks.

The Banking Law Section 11 (3) and Directive to Banks, Monitoring and Control of Credit Facilities (April 2000) indicate that where the interests of two or more persons are so intertwined that they should be considered one person the credit facilities shall be combined. The CBC list indicates those directors, spouses, a legal entity and its holding company, which have an interest of 20 percent or more in any class of shares in the share capital of that company.

Assessment: *Compliant.*

Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

Description

Although there are no formal limits regarding country risk and transfer risk, the CBC obtains monthly reports that include data on country exposures. In addition, the CBC has from time to time issued letters directing banks to limit their risks to certain countries.

Assessment: *Largely compliant.*

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.

Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and /or a specific capital charge on market risk exposures, if warranted.

Description

The CBC has issued regulations on the calculation of banks' capital against foreign exchange risk. Banks are required to contain their foreign currency exposure for each currency to no more than 10 percent of their capital base, while overall exposure for all currencies together is limited to 15 percent of capital base. The overall open foreign currency position is the sum of all the net short positions or the net long positions whichever is greater.

Furthermore, in the case where the overall net foreign exchange position exceeds 2 percent of a bank's capital base, a capital charge of 10 percent as from 1.1.2001 is required to be set-aside on the amount in excess.

During the course of onsite inspections the CBC verifies that banks have information systems, risk management systems and internal controls that enable them to monitor and control exposures to the above risks.

The current rules are under review. The CBC proposes to lower the limits, with respect to foreign currency exposures, and also introduce different limits for intra day and overnight positions. Banks will also be required to set up appropriate stop loss limits on a daily as well as cumulative basis and demonstrate their ability to monitor these limits.

There are no other regulations or guidelines regarding other market risks.

The CBC views the level of business sophistication in the market activities of international banking units as low—there is no options or derivatives trading. As a result examiners can easily review the operations during onsite reviews.

Assessment: *Materially noncompliant.*

At present the prudential systems of the CBC do not provide a basis for a comprehensive supervision of market risks. The CBC states 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 does 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 (CAD). Whether or not the CBC applies a capital charge, the reporting system that the CAD requires will at least enable the CBC to monitor risks that are being run.

Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

Description

The CBC has issued a directive on prudential liquidity. Banks are expected to place their assets and liabilities in time bands depending on their remaining time to maturity. To ensure that banks have always-adequate liquidity to meet their obligations a maturity mismatch approach is adopted and banks' excess liabilities over assets in specified time bands may not

exceed maximum allowable mismatch ratios set by the CBC. Banks are required to monitor their liquidity position on a daily basis and submit a liquidity return to the CBC on a quarterly basis.

In the course of on-site inspection, the CBC examiners verify compliance with the requirements of the directive. This measure was implemented as from the middle of 2000 for domestic banks. A similar return has been in place for IBUs/ABUs but the allowable mismatch ratios have not yet been determined. It is expected that this will be done in the very near future.

In the course of on-site examination, the CBC examiners review and assess the adequacy of internal controls introduced by banks with a view to minimising operational risks and securing business continuity. Compliance with anti-money laundering legislation is also verified. These processes include appropriate board and senior management oversight and discussions are held during onsite inspections with respect to these matters.

The CBC has the authority (under Section 30 of the Banking Law) to require a bank to hold capital against any risks.

With respect to interest rate risk, banks are allowed to set their own internal limits, which are reviewed by CBC examiners during the on-site inspection. The CBC believes that the limits set by banks are conservative.

With regard to operational risk, banks have back-up facilities to ensure continuity of business. Bank internal auditors regularly review the operational risks. The CBC verifies these matters during onsite examinations.

Assessment: *Compliant.*

Principle 14: Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Description

The CBC in the course of on-site examinations reviews the internal control system of banks. It reviews the following functions:

- Internal audit/controls;
- Credit administration;

- Credit control;
- Credit review;
- Treasury management; and
- Management information system.

In the course of these reviews the Central Bank establishes the extent of coverage of the above functions, tests the efficacy with which they are performed and assesses the adequacy of quality and number of staff employed.

In addition, the banking license of IBUs/ABUs requires that their external auditors shall have the special duty to report directly to the CBC whether in their opinion: the IBU's/ABU's internal control system is adequate for the nature and scale of their business and, also, whether the information which passes from the IBU/ABU to its Head Office/parent bank is accurate and adequate. The external auditors will also include in their report if they believe the staff resources, experience and training of internal audit staff are inadequate.

The internal audit department is part of the internal control system of banks. The CBC in the course of on-site examination reviews the adequacy and efficiency of the internal audit function including access to the entire business lines of the bank, staff adequacy as well as independence and reporting lines within the bank to ensure that senior management acts upon the recommendations of the internal audit function. Any weaknesses identified by the bank examiners in respect of the internal audit function are brought to the attention of management.

The supervisory review process includes meetings with internal auditors and compliance officers. The nature of the discussions between CBC examiners, internal auditors and compliance officers revolves around issues, which arise in the course of their respective work on internal audit/controls and procedures as well as compliance with anti-money laundering legislation. There are no restrictions on the content of the discussions.

The matters of setting of standards for risks for all aspects of a bank's business as well as suitable prudential oversight are addressed in the management letter to the bank's CEO following the completion of on-site examination. Any weaknesses identified are thus brought to the attention of management, which is expected to brief the Board of Directors accordingly. The CBC may address the Board of Directors of a bank directly if it considers this necessary and through regular meetings with the bank's external auditors influence may be brought to bear on the Board of Directors to provide suitable prudential oversight.

With respect to the skills of the board and management to carry out these functions, at the licensing stage bank directors and senior management fill out detailed personal questionnaire,

which are assessed by the CBC. These questionnaires include information on a person's education, employment history, reputation and character. The CBC contacts third parties to obtain independent verification of this information. Moreover, the CBC maintains close contact with various levels of management of the bank and at meetings with senior management and/or directors the CBC assesses their skills and competence for the size and nature of the bank's activities.

All of the international banking units operating in Cyprus are branches or subsidiaries of international banking organizations and rely to some extent on parent internal audit and/or compliance departments to provide inputs to this process. Where visits occur the supervisor may arrange to meet the head office personnel and reports are available to the supervisory staff. In addition some IBU's also have a separate internal audit department that would liaise with the group wide internal auditors.

Assessment: *Compliant.*

The Banking law does not identify the responsibilities of directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management. Nor does the CBC have the legal authority to require changes in the composition and management if it is of the view that an evaluation indicates that the composition of the board of directors and senior management do not have the necessary skills for the size and nature of the activities of the bank and are unable to address the changing risk profile of the bank and external market developments.

While the CBC is not directly empowered by Law to change the board of directors and senior management it believes that it can do so indirectly. Section 30 of the Banking Law permits the CBC to take any measure it deems necessary to protect the interests of depositors or creditors in circumstances where the CBC is of the opinion that the liquidity and character of assets have been impaired or there is a risk that the ability of the bank to promptly meet its obligations may be impaired. This appears to be a rather cumbersome way of achieving the objective of removing one or more directors or management staff.

Principle 15: Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Description

There is specific legislation to combat Money laundering. Cyprus enacted in 1996 the Prevention and Suppression of Money Laundering Activities Law (the "Law") establishing a solid framework that covers the various aspects of money laundering and the role of the financial system in this regard. The salient features of the Law are as follows:

- It defines and criminalizes laundering of proceeds from serious criminal offences.

- It provides for the confiscation of proceeds from serious crime.
- It empowers Courts to issue freezing and restraint orders in respect of such proceeds.
- It requires suspicion of money laundering to be reported to the Unit for Combating Money Laundering (UCML), without this being treated as a breach of confidentiality.
- It empowers the Courts to order the disclosure and production of information held by natural or legal persons, including banks, related to money laundering investigations.
- It requires all persons carrying on relevant financial business to maintain procedures in relation to customer identification, record keeping, internal control and communication and staff training in the recognition and handling of suspicious transactions.
- It enables the registration and enforcement of foreign orders for the freezing and confiscation of proceeds.

In accordance with Section 60(3) of the PSMLA Law, the CBC has issued a Guidance Note on the subject of Money Laundering to all banks (domestic and international) operating in Cyprus.

The CBC has issued a similar Guidance Note to IFCs, ITCs, ICISs and their Managers/Trustees. The purpose of these guidance notes issued by the CBC as the supervisory authority of banks and international financial services companies, is to provide a practical interpretation of the requirements of the Law and indicate good banking/financial practice.

Under the PSMLA Law, where a supervisory authority is of the opinion that a person falling within its responsibility has failed to comply with the provisions of the Law, it has a legal obligation to refer the matter to the Attorney General.

In this respect, one of the primary objectives of the Central Bank on-site examination of banks and IFCs is to assess the licensees' compliance with its anti-money laundering obligations set out in the Law and relevant CBC Guidance Notes.

In accordance with the provisions of the PSMLA Law, all persons carrying on relevant financial business (including banks and IFCs) should appoint a Money Laundering Compliance Officer.

In this respect, the CBC's Guidance Note on the subject, in its chapter on the duties of Money Laundering Compliance Officers, internal reporting of suspicious transactions and reporting of suspicious transactions to the Unit for Combating Money

Laundering,” contains guidance on the role and responsibilities of the Money Laundering Compliance Officer and the internal organizational procedures designed to assist the Money Laundering Compliance Officer’s functions.

The PSMLA Law requires institutions carrying on relevant financial business to maintain customer identification procedures. The essence of these requirements is that except where the Law states that customer identification need not be made, a financial institution must obtain and verify the identity of a prospective customer.

Financial institutions are expected to obtain satisfactory evidence of identity of their customers at the time of establishing an account relationship and prior to the execution of any transactions.

The PSMLA Law provides that no steps are required to be taken by a financial institution to obtain evidence of a customer’s identity where there are reasonable grounds for believing that the customer is a person who is bound to the provisions of the Law—i.e., the customer is a person carrying on relevant financial business.

Furthermore, in the case of accounts in the names of trustees or nominees, the Central Bank Guidance Note provides that banks may, at their own peril, open an account where the persons beneficially entitled have not been identified. However, the above can only take place in exceptional circumstances where:

- The bank is able to trust without reservation that the trustees/nominees will not introduce accounts connected with criminal funds;
- The trustees/nominees provide an estimate of the likely turnover of the account;
- The trustees/nominees provide an undertaking to the effect that they have taken reasonable steps to establish the identity and background of the beneficial owners and that they will, upon request, make this information available to the bank; and
- Once allowed to operate, these accounts will be monitored closely and, at least twice a year, a note shall be prepared summarizing the results of the review.

The Central Bank’s Guidance Note permits, only in exceptional circumstances, the acceptance by banks of customers, which are companies, whose own shares or the shares of their holding companies have been/may be issued in the form of bearer. The above can only take place provided certain strict conditions are fulfilled. (See paragraph 2.7 of Section 2 of the Central Bank’s Guidance Note).

International regulatory authorities have not settled the conditions under which institutions should accept business from “introducing intermediaries.” The Financial Action Task Force is currently studying the matter. Under the circumstances the stance of the CBC appears reasonable.

The PSMLA Law requires that persons carrying on financial business provide adequate training to their employees in the recognition and handling of transactions suspected to be associated with money laundering. These institutions are required, in particular, to take appropriate measures to make their employees aware of the legislation relating to money laundering as well as the policies and procedures put in place by their organization to prevent money laundering, including those of identification, record keeping and internal reporting. The Law also provides that a member of staff who reports suspicious transactions in good faith to the dedicated senior officer, internal security function, or directly to the relevant authority cannot be held liable.

In order to assist banks and IFCs in the discharge of their legal obligations, the CBC has included examples of suspicious transactions as part of its Guidance Notes on Money Laundering.

The PSMLA Law requires that any knowledge or suspicion of money laundering acquired by a person in the course of a trade, business, profession or employment should be promptly reported to the Unit for Combating Money Laundering or a Police Officer. The Law also provides that such a disclosure cannot be treated as a breach of the duty of confidentiality owed by banks and IFCs to their customers by virtue of the contractual relationship existing between them.

In the period from January 1997 to December 2000, the Unit received a total of 206 domestic reports. Of these, 92 originated from financial institutions, 51 from the Police, 50 from the Customs Department, and 13 from other sources.

There is no formal mechanism through which the Unit is required to communicate such information to the relevant supervisor but this is customarily done through informal channels. The CBC during the course of onsite examinations and on special occasions when the circumstances warrant, checks that banks' money laundering controls and their systems for preventing, identifying and reporting fraud are sufficient. However the shortage of staff has meant that visits to institutions are not as frequent as they should be.

The CBC is not empowered to exchange information directly with other domestic or foreign supervisors. Under the PSMLA Law, the Unit is the competent authority, inter-alia, to co-operate with the corresponding overseas Units for the purposes of investigation of money laundering offences by the exchange of information and by other relevant ways of co-operation.

Assessment: *Largely Compliant.*

There is also scope for improving the efforts of financial institutions especially with respect to the identification of beneficial owners and the reporting of suspicious transactions. Also the scrutiny of transactions conducted by persons and companies and financial institutions from countries, which have deficient anti-money laundering frameworks, should be enhanced.

The Law sets forth the customers' identification procedures that must be implemented by persons engaging in financial activities but does not define what constitutes satisfactory evidence of identity. The CBC Guidance Note states that banks are expected to obtain satisfactory evidence of identity of their customers at the time of establishing an account relationship and prior to the execution of any banking transactions. The CBC should make this 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. This exemption weakens the customer's identification framework provided in the Law. In this regard, 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 several jurisdictions 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 known to have deficient anti-money laundering frameworks and should be extended accordingly.

With regard to accounts in the names of trustees or nominees, including nominee shareholders, the CBC Guidance Note warns that banks may decide, at their own peril, to open an account where the persons beneficially entitled have not been identified. Guidelines are provided with regard to the operation of such accounts including that a bank must require a trustee or nominee to provide an undertaking to the effect that they have taken reasonable steps to establish the identity and background of the beneficial owner and that they will make it available to the bank upon request. These procedures do not ensure that the identity of beneficial owners is appropriately disclosed to banks.

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 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, banks are given the option to request the information from the originator's bank or to ask for a confirmation that the information is available and the transaction is legitimate. This discretion does not ensure that satisfactory information on the identity of the ordering customer is obtained on a consistent basis.

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 for Combating Money Laundering. 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 continue to encourage banks to comply with

the Law. The development of employees training programs based on actual transactions effected in the course of business as reported in the statements of large cash deposits and funds transfers would be helpful in this regard.

The CBC needs to carry out more frequent onsite reviews of the recognition and reporting procedures in banks. This would be particularly applicable for those institutions that are regarded by the CBC as high risk. Arising out of the licensing process (CP3) is a concern that more use could be made of investigations into the fitness and properness of prospective directors and officers of banks through, for example, independent sources. One such method would be the requirement for such persons to provide a police clearance certificate the details of which could be verified through the contacts which law enforcement agencies in Cyprus have with their counterparts in other countries.

The current informal arrangements between the Unit for Combating Money Laundering and the CBC are working well. However, the CBC must ensure that it will always receive reports about suspicious activities. This relates not only to the number of reports being filed, but also to the nature of reports and the names of the supervised entities. Such information will assist the CBC in its continuing surveillance efforts. It may also enable the CBC to focus attention on an industry sector (or sectors) or institutions from which no or relatively few reports have been received by the authorities.

Principle 16: An effective banking supervisory system should consist of some form of both on-site and off-site supervision. (Note: this Principle should be considered in conjunction with Principles 17 through 20.)

Description

The Banking supervisory process in Cyprus entails both offsite monitoring and onsite inspections.

Under the Banking Law, the CBC has extensive powers to obtain information from banks. The CBC, under Section 25 of the Banking Law, has unfettered discretion to add to the information provided by banks. Moreover, bank examiners have access to any books or records of a bank (Section 26 of the Banking Law). There are no differences that apply to IBUs/ABUs.

Off-site monitoring involves the submission of various periodic returns such as monthly balance sheet, profit and loss account, capital adequacy, capital base computation, prudential liquidity, monitoring and control of credit facilities, foreign currency exposure, analysis of assets and liabilities by country, anti-money laundering procedures etc. Findings emerging in periodic returns submitted by banks are analyzed, trended and compared with other banks. This process enables the CBC to monitor the condition of banks as well as their compliance with the Banking Law and other relevant legislation on an on-going basis.

The purpose of on-site examination is to: check for compliance by the bank with the law, including prudential regulations and guidelines: provide independent verification that adequate risk management and internal control systems are in place: determine that information provided by the bank is reliable and to evaluate the condition of a bank and its future prospects at a given time. In this respect, the following main areas are covered:

- The quality of the management of the bank, including internal control aspects and procedures;
- The bank's loan portfolio, with emphasis on credit risk management, the quality of the loan portfolio and the adequacy of the provisions for bad and doubtful debts;
- The bank's treasury operations with emphasis on risk management;
- The profitability of the bank including the analysis of its income generation and costs and the assessment of the returns achieved;
- The compliance with the conditions of the bank's license and with Central Bank directives, regulations and instructions on capital adequacy, large exposures, etc.;
- Adherence to the requirements of the anti-money laundering legislation and guidance notes; and
- The adequacy of internal controls.

The criteria used by the CBC to determine the frequency and scope of on-site reviews is as follows:

- The relative size of the banking operation;
- The annual growth rate of the operation;
- The relative contribution of the operation to the group as a whole;
- The results of the offsite review;
- Special issues; and
- The availability of resources.

Based on the above criteria, the frequency of on-site reviews is as follows:

Once a year

Locally incorporated banks:

During on-site examinations of banks, Central Bank examiners review customer identification procedures to ensure compliance of banks with the procedures prescribed in the Guidance Note issued by CBC under the PSMLA Law (Section 2).

The CBC has access to copies of reports submitted to the Board by the internal and external auditors. The CBC also has access to the minutes of Board meetings. In fact Section 26 of the Banking Law gives the CBC access to all types of records and information within an institution.

The Banking Law Section 26(3) provides that any information obtained from banks by the CBC in its supervisory capacity, other than information which is published, shall be kept secret and used only for the purposes of the Banking Law and the Central Bank of Cyprus Law. Notwithstanding the provisions of Section 26, Section 27(1) of the same Law enables the CBC to provide to the appropriate overseas banking supervisory authority any information in its possession that will enable the overseas authority to exercise its corresponding supervisory functions. However the CBC is not allowed to divulge information relative to individual deposit accounts (Section 27 (2) of the Banking Law.

In the case of IBUs/ABUs, a standard condition of their banking business license states that IBUs/ABUs are required, as a matter of course, to make available to the CBC, copies of any management letters and/or other similar correspondence received from their external auditors.' At the same time, IBUs/ABUs are required to make available to their external auditor's copies of any letters received from the CBC raising any points of concern. The on-site examination findings are communicated to the bank's management and discussed with the bank's CEO and senior management in a meeting especially convened for this purpose. Following this meeting, a management letter is addressed to the bank's CEO summarizing the CBC's findings and recommendations. The bank's CEO and senior management are asked comment in writing on the CBC's on-site examination findings and to indicate how they intend to rectify any weaknesses identified.

Bank examination report findings and conclusions as well as the analysis of periodic returns are reported to the Governor of the CBC.

In addition, the CBC may also conduct ad hoc on-site examinations if and when the need arises in relation to special issues.

The CBC obtains independent validation of supervisory information through regular on-site examination carried out by Central Bank examiners.

The CBC carries out meetings with external auditors in which the CBC and external auditors discuss issues, which arose in the course of their respective work on corporate governance, risk management and internal control systems (Section 28 of the Banking Law is relevant). In the case of overseas branches and subsidiaries, the CBC maintains close contact with the supervisory authorities of the country concerned.

In the case of IBUs/ABUs, through a condition of their banking license, the CBC may require an IBU/ABU to ask its external auditors to audit any returns and/or information required by the CBC.

The CBC continually reviews its onsite and offsite procedures and systems in order to determine whether there are weaknesses or areas that require adjustment.

Assessment: Largely *Compliant*.

While the systems and procedures are largely in place, the frequency of onsite inspections needs to be stepped up. This takes into consideration the fact that a number of banks are from jurisdictions that are not regarded as having robust supervisory regimes.

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

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.

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 practices elsewhere.

Principle 17: Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.

Description

The scope of off-site monitoring and on-site examination is described in the previous principle. Off-site monitoring as well as on-site examinations enables the CBC to have frequent contact with and a thorough understanding of the bank's management and operations.

Moreover, once an institution is licensed the supervisor has continuing regard to the performance of its management. With regard to the assessment of the quality of management, the CBC maintains close contact with various levels of the management of the bank through ad-hoc meetings and in the course of on-site examination where their skills and competence are assessed.

The CBC also holds meetings with the CEO and senior management of the bank following the completion of on-site examination to discuss the findings and recommendations of the CBC emanating from the on-site inspection. These meetings provide the CBC with an opportunity to assess the skills and competence of senior management of the bank.

The CBC arranges at least once a year trilateral meetings with each bank and its external auditors to discuss matters relevant to the CBC's supervisory responsibilities (Section 28 of the Banking Law). At these meetings, the CBC is presented with an opportunity to assess the quality of the bank's management.

In all cases the CBC is looking to management to have a good understanding of the institution's environment and a good indication of its future development and sound judgment regarding its business.

The actual level of complexity in the market activities of banks has up to now been very low. Market risk is minimal. Therefore, the market activities of banks are easily monitored through off-site monitoring and on-site examination. No in-house resources are specifically devoted to the monitoring of such activities. Despite the above, the CBC intends to implement the CAD in the course of 2001.

Assessment: *Largely compliant.*

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 a 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.

The real in-depth meetings during onsite inspections are becoming less frequent because of shortage of staff and some institutions have not had an onsite review for more than three years. The opportunities to understand the banks' business and assess the quality of management have therefore been reduced.

The CBC should make it mandatory for a supervised institution to report any material adverse change 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.

Principle 18: Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

Description

At present, International Banking Units are not permitted to have subsidiaries or branches abroad, therefore, there is no scope for consolidated supervision.

Section 26 of the Banking Law gives the CBC the authority to obtain from banks any information and with whatever frequency that it deems necessary. As a result, the bank obtains data on their financial condition and performance, at regular intervals.

Banks in the same category i.e. domestic, IBUs/ABUs are required to submit the same information with the same frequency.

Supervision is exercised through off-site monitoring and on-site examination. Off-site monitoring entails the submission of various periodic returns such as monthly balance sheet, liquidity return, analysis of assets and liabilities by country, foreign currency exposure return, analytical six-monthly profit and loss account, analysis of liabilities and assets by class of customer, capital adequacy return, large credit exposures, etc.

The information submitted is analyzed and assessed in order to predict potential financial difficulties in banks e.g. balance sheet monthly comments, level and adequacy of provisioning etc. In the course of on-site examination, the examiners of the CBC verify that the information contained in the returns submitted is accurate, properly classified and disclosed according to the CBC's instructions.

The CBC has standardized returns with comprehensive instructions that all banks must complete.

Both off-site monitoring and on-site examination are used as early warning systems to predict potential financial difficulties in banks.

The salient features of both off-site and on-site supervision were described under Principle 17.

Apart from these considerations there is no early-warning system in place.

The Banking Law, Section 42, provides that any institution that fails to provide the requested information within specified time limits; knowingly or negligently provided inaccurate data or misleading information; knowingly or negligently made available in an incomplete form, records, books, accounts or other information is subject to an administrative fine ranging from one thousand to ten thousand pounds, depending on the severity of the contravention.

A consistent pattern of reporting errors would result in the CBC requiring the banks to rectify the matter. In such a situation the external auditors may be asked to look at the bank's systems.

Assessment: *Compliant.*

Many supervisory agencies have recently developed early warning systems that use the prudential reports that are submitted by financial institutions and other data. These systems can be useful in alerting supervisors to impending problems in an institution. If problems are discovered early, there are usually more options available to the institution and the supervisor in resolving them. In addition, early detection may well avoid having the problem spill over to other institutions. It is important that the CBC updates itself with international experience in this area.

Principle 19: Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

Description

Under Section 26 of the Banking Law, there are no restrictions on the CBC's access to information about any aspect of a bank's business.

As part of their licensing requirements IBU's are always required to keep books and records in the jurisdiction.

Findings emerging in the course of on-site reviews are part of the subject matter of discussion between the CBC and external auditors. The external auditors' own report may give rise to supervisory measures by the CBC. This was the case with the removal of Beogradska Banka's banking business license.

Special investigations are carried out when the need arises by bank examiners of the CBC. The Banking Law provides that CBC examiners may be assisted in the course of their work by a duly qualified person nominated for this purpose by the CBC provided that this person shall be bound by the same requirements regarding confidentiality as those applicable to the CBC officials (Section 26 of the Banking Law).

In the case of IBUs/ABUs, it is a standard condition of their banking business license that, in carrying out its supervisory and inspection duties, the CBC may appoint a professional firm of accountants/auditors, other than the IBU's/ABU's external auditors to carry out an investigation into their affairs and report directly to the CBC.

The CBC has not invoked the above provisions in the last two years.

The external auditors of banks, prior to their appointment, are required to be expressly authorized by the CBC (Sections 2 and 24 of the Banking Law). In practice, banks are audited by the big five international firms of accountants/auditors.

Section 28 of the Banking Law provides that the CBC shall arrange, at least once a year, trilateral meetings with each bank and its auditors to discuss matters relevant to the CBC's supervisory responsibilities, which arise in the course of the audit of banks. The CBC's notice to banks on the relation between the CBC and the external auditors of banks is also relevant.

Under the same section, the auditor may freely report to the CBC any information, which is relevant to the latter's supervisory responsibilities. The Law protects the auditor from the consequences of any breach in his duty of confidentiality.

In the case of IBUs/ABUs, pursuant to a condition attaching to their banking license, the external auditors, in preparing their report on the annual accounts, also have the special duty to report directly to the CBC:

- Any instances where the operations of the IBU/ABU have not been in compliance with the conditions of its license;
- Whether the IBU's/ABU's internal control system is adequate; and
- Whether the information, which passes from the IBU/ABU to its Head Office/Parent Bank, is adequate and accurate.

All such special reports received in the last two years were satisfactory.

Section 28 of the Banking Law provides that "no duty of confidentiality to which an auditor of a bank may be subject shall be regarded as contravened by reason of his communicating in good faith to the CBC, whether or not in response to a request made by it, any information or opinion which is relevant to the CBC's functions and responsibilities under the Banking

Assessment: *Compliant.*

Principle 20: An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Description

With regard to IBUs/ABUs, the CBC's policy is not to allow locally incorporated IBUs/ABUs to establish branches or subsidiaries in foreign jurisdictions.

Assessment: *Not applicable.*

Principle 21: Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Description

The Banking Law Section 24 (1) requires that, within four months from the end of each financial year, each bank must submit to the Central Bank a copy of the balance sheet and profit and loss account for that year in the form prescribed by the Central Bank. The return must be certified by an approved auditor together with a signed copy of his report.

The Law also allows the CBC to prescribe the manner and form in which accounts have to be prepared. The CBC has set accounting standards for banks provided that the Bank is guided in this respect by international practice and EU directives (Section 41 of the Banking Law). The CBC has issued directives specifying the content of financial statements and the manner in which they must be presented. Essentially, the CBC in its directive has adopted international accounting standards with slight modifications designed to harmonize with the EU directive on bank accounts.

In addition, for IBUs/ABUs this requirement is attached as a condition to their banking license.

Financial statements are required to be prepared on a consolidated basis. For IBUs/ABUs this requirement is not applicable as licensed offshore banks are subsidiaries or branches of foreign incorporated banks and do not have subsidiaries of their own.

More specifically, in the case of IBUs/ABUs there are conditions attached to their licenses requiring them to prepare their financial statements in accordance with international accounting standards.

The Banking Law requires that banks incorporated in the Republic publish, within six months from the end of each financial year, in such manner and form as the CBC may determine, the balance sheet and profit and loss account for that year together with the auditor's report (Section 24 of the Banking Law). This ensures that information from bank records are verified by external auditors.

In addition, for IBUs/ABUs which are subsidiaries of foreign incorporated banks a condition is attached to their banking license to the effect that they will make available to any interested user a copy of its latest audited accounts and auditors' reports.

Branches of foreign incorporated banks are not required to publish their financial statements.

The CBC's web site on the Internet provides information concerning licensees, the scope of authorized activities, the identity of senior management and those authorized to act in the name of the licensee. CBC supervisory staff updates the web site regularly.

In addition, in the case of locally incorporated banks, the Companies Law requires filing of information regarding shareholders and directors with the Registrar of Companies.

As a condition of the license of IBU's the CBC requires that it must approve the auditors. Through that mechanism, the ability to approve auditors the CBC is able to exert sufficient moral authority to have auditors report matters of material significance, for example, failure to maintain the licensing criteria, or breaches of banking or other laws. The Banking Law Section 28 (3) protects auditors from breach of confidentiality when information is communicated in good faith to the CBC whether or not in response to a request made by it, any information or opinion which is relevant to the Central Bank's functions and responsibilities.

The Cyprus Institute of Certified Public Accountants requires that all company auditors conduct their audits in accordance with International Auditing Standards. The auditors' report is required to state this fact. In this connection, Section 24 of the Banking Law gives the CBC the power to prescribe the form of the auditors' report. The CBC has issued guidelines in this regard.

Section 28 (1) requires the CBC to arrange trilateral meetings, no less frequently than once a year, with each bank and its auditors to discuss matters relevant to the CBC's supervisory responsibilities.

The CBC has circulated to banks and their auditors a note regarding the Relation between the Central Bank of Cyprus and the External Auditors of Banks. It discusses the tripartite meetings and indicates that certain matters should be brought to the attention of the CBC, including breaches of the law, inability to maintain statutory ratios and inadequate systems.

The CBC through the publication of key banking statistics obtained from banking returns provides the industry and the public with information about banking activity.

Assessment: *Compliant.*

Principle 22: Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

Description

Section 30 of the Banking Law provides the CBC's with extensive remedial powers, including the power to prohibit the acceptance of deposits or the granting of credit facilities by the bank, or both; assume control of the business of a bank and revocation of the bank's license.

Under the Law, the CBC needs to consult with the Minister of Finance before taking most remedial measures, for example, the prohibition of acceptance of deposits, assumption of control of the business of the bank and revocation of license.

Section 42 of the Banking Law empowers the CBC to impose administrative fines if a bank fails to provide information to the Bank within specified time limits. Other offences and penalties are covered in detail in Sections 42 and 44. Administrative penalties have been threatened but not imposed so far.

In addition, the CBC Law (Sections 12 (6) and 13 (1)(a)) permit 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. The CBC stated that these provisions have never been invoked and that supervisory decisions rarely need to be referred to the Board.

The CBC does not have the authority to apply penalties and sanctions to members of a bank's management or board. However, the CBC believes that the Exchange Control Law provides it with sufficient authority to bring about whatever changes are necessary in management or the board.

In the case of IBUs/ABUs the CBC has in recent years revoked a number of banking licenses. For example, on November 18, 1998 and June 1, 1999, the banking licenses of the Cyprus branches of Inkombank and Menatep of Russia were revoked following similar action by the Central Bank of the Russian Federation.

On May 3, 2000, the banking license of the Cyprus branch of Beogradaska Banka of Yugoslavia was revoked, dictated by the need to safeguard the interests of depositors and third parties arising out of going concern problems. The CBC, also, in a number of cases imposed restrictions with regard to the level of business that could be assumed by an IBU in response to similar action taken by the home supervisor.

Assessment: *Largely compliant.*

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 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 license of the bank.

The CBC states 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.

The requirement for consultation with the Minister before supervisory action is taken should be deleted from the legislation so as to ensure that the supervisor has full independence in these matters.

Principle 23: Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

Description

With respect to offshore banks, the CBC policy is that they are not allowed to operate branches or subsidiaries abroad.

Assessment: Not applicable.

Principle 24: A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

Description

With regard to IBUs/ABUs, the CBC's policy is not to allow locally incorporated IBUs/ABUs to establish branches or subsidiaries in foreign jurisdictions.

Nevertheless the CBC exchanges information with foreign supervisors in the framework of the licensing procedure as well as during ongoing supervision. When an institution 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 some supervisory authorities before granting a license to banks from those countries.

In addition, with respect to branches and subsidiaries of foreign banks operating in Cyprus, The CBC may provide to the supervisory authorities in the home country information, which the CBC believes will enable the home supervisor to exercise its consolidated supervisory functions. Information related to any individual deposit account is excluded

From disclosure under the Banking Law, on the ground that their soundness is not so affected by the source of funds as their use. However, in practice home supervisors can obtain such information either through the head office or parent bank or by examining the bank or subsidiary themselves.

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. In addition the MOU's stipulate details on the cooperation regarding onsite examinations in the other country and the confidentiality of that information received from the other authority.

Negotiations on Memoranda of Understanding have also been started, mostly on the initiative of the CBC with the banking supervisory authorities of the United Kingdom, Greece, Romania, France and Austria. Concluding MOU's with these countries is intended to enhance the reputation of the CBC.

The CBC allows foreign home supervisors to conduct onsite inspections in Cyprus. Examiners of the foreign country are allowed to see any files including information on individual depositors. The Central Banks of Lebanon, Jordan, Russia, Bulgaria, and Yugoslavia carried out Onsite reviews in Cyprus.

Assessment: *Compliant.*

Principle 25: Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Description

Local branches of foreign banks are exempted from own capital and capital adequacy requirements. However, inspection, and regulatory reporting requirements for foreign banks are similar to those for domestic banks.

For purposes of the licensing process as well as ongoing supervision, the CBC has visited a number of jurisdictions and has signed MOU's with several countries. Details are set out in response to Principle 24.

Home country supervisors are given onsite access to local offices and subsidiaries for safety and soundness purposes. The CBC does obtain information from supervisory authorities in the home country regarding the financial soundness and prudent management of the applicant and will not grant a licence unless the applicant obtains permission from its home authority.

Where a material matter occurs, the CBC would inform the home country supervisor of any action it has sought from the institution.

Assessment: Compliant.