

**Cyprus: Assessment of Financial Sector Supervision and Regulation, including Reports
on the Observance of Standards and Codes on the following topics: Banking
Supervision, Insurance Supervision, and Securities Regulation**

This Assessment of Financial Sector Supervision and Regulation for Cyprus was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on June 30, 2006. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Cyprus or the Executive Board of the IMF .

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CYPRUS

ASSESSMENT OF FINANCIAL SECTOR SUPERVISION AND REGULATION

Prepared by the Monetary and Financial Systems Department

Approved by Ulrich Baumgartner

June 30, 2006

This report is based primarily on work undertaken during a visit to Cyprus from March 28 through April 08, 2005, but it includes updated factual information.

The assessment team comprised Mary G. Zephirin (Head), Ahmed Zorome, Bärbel Bernhardt (Assistant) (all MFD), Michael Deasy (Securities regulation expert, Irish Financial Services Regulatory Authority), Henning Goebel (Insurance supervision expert, German Federal Financial Supervisory Authority, BaFin), Marcel Maes (Banking supervision expert, consultant), Timothy Sullivan (Banking supervision expert, consultant). The assessment team received excellent cooperation from the authorities and market participants. The main findings of the assessment were:

- The financial system in Cyprus is in a process of reform generated by the liberalization and regulation brought about by accession to the European Union (EU).
- Competent supervision for the banking sector has been enhanced by legislation and regulation to meet the requirements of EU accession.
- The commitments made for EU accession have placed stress on the skills and resources of the supervisors for the cooperative credit institutions and insurance companies.
- The securities supervision authority is well-staffed with the requisite skills. However, the legal framework for cooperation severely limits the scope of investigative assistance, although legislative amendments are being sought.

The information in this paper refers only to the government-controlled areas of the Republic of Cyprus (the GC areas).

The Annex to this report includes reports on the observance of standards and codes (ROSCs) on banking and insurance supervision, and securities regulation.

The main author of this AFSSR is Mary G. Zephirin, with contributions from the rest of the assessment team.

The AFSSR is a summary report on implementation of the indicated financial sector regulatory standards. It has been developed to help jurisdictions identify and remedy weaknesses in financial sector supervision and regulation. The reviews do not directly assess risks such as those associated with asset quality, markets, or fraud that could affect the soundness of financial systems or individual institutions.

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GLOSSARY

AML/CFT	anti-money laundering and combating the financing of terrorism
BCP	Basel Core Principles for Effective Banking Supervision
EBC	European Banking Committee
ECB	European Central Bank
EU	European Union
CBC	Central Bank of Cyprus
CCI	cooperative credit institution
CEBS	Committee of European Banking Supervisors
CIS	collective investment scheme
CSL	Cooperative Societies' Law
CySEC	Cyprus Securities and Exchange Commission
CSSDA	Cooperative Societies' Supervision and Development Authority
FATF	Financial Action Task Force
FIU	financial intelligence unit
IAIS	International Association of Insurance Supervisors
GWP	gross written premium
IBU	international banking unit
IFRSs	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
ICCS	Insurance Companies' Control Service
ICIS	international collective investment scheme
LIS	Law on Insurance Services and Other Related Issues
MOU	memorandum of understanding
OFC	offshore financial center
ROSC	Report on the Observance of Standards and Codes
SI	Superintendent of Insurance
UCITS	undertakings for the collective investment of transferable securities

EXECUTIVE SUMMARY

The financial system in Cyprus is in a process of reform generated by the liberalization and regulation brought about by accession to the European Union (EU). As a result, the current restrictions on the scope of domestic operations, as well as fiscal differences between domestic and internationally-oriented institutions were eliminated at the end of 2005.

Competent supervision for the banking sector has been enhanced by legislation and regulation to meet the requirements of EU accession. Central bank independence and technical supervisory rules have been improved. The obligations resulting from EU accession have however strained supervisory resources, and it is recommended that skills be enhanced.

The commitments made for EU accession have also placed stress on the skills and resources of the supervisors for the cooperative credit institutions and insurance companies. Significant training will be required by staff in these supervisory agencies.

The securities supervision authority is well-staffed with the requisite skills. However, the legal framework for cooperation severely limits the scope of investigative assistance that can be provided if the Cypriot securities regulator does not have an independent interest in the matter under investigation. Further, the regulator has had difficulty accessing information about the beneficial owner of shares registered in the names of lawyers that act as nominees on behalf of beneficial owners. The regulator is seeking amendments in legislation that would confirm sharing of and access to information. Cooperation in other sectors is good and the authorities have signed a domestic Memorandum of Understanding (MOU) and several abroad.

Table 1 provides a summary of key recommendations and the authorities' response.

Table 1. Key Recommendations and Authorities' Response

Area	Recommendation	Response
Banking		
<p>Senior banking supervision staff of the Central Bank of Cyprus are well-qualified but continuing EU accession work, cross-border bank supervision, and increasing complexity are challenging.</p>	<p>Additional qualified/ specialized supervision staff is required, especially for (a) the supervision of banks' internal risk systems and models; (b) financial stability analysis; (c) meeting commitments towards EU institutions; and (d) expanded cross-border supervision arising from bank expansion.</p>	<p>The CBC aims at taking all necessary steps to strengthen its Banking Supervision and Regulation Division in all aspects in order to meet the increased demands emerging from Cyprus's accession to the EU and the development and innovation process of the banking sector.</p>
Cooperative credit institutions		
<p>The EU credit directives have been transposed into cooperative credit laws, but secondary legislation and guidelines are in process.</p>	<p>Substantially increase resources allocated to supervision, on the basis of the existing plan, inclusive of training.</p>	<p>The Parliament has approved the enhancement of CSSDA (Official Gazette July 2005). The scheme provides for 17 additional staff and the upgrading of the salary levels of the officers. Fourteen officers from the additional staff will reinforce the supervisory staff, tripling the present supervisory resources. Further relevant training will be undertaken.</p>
<p>There is a need for coordination of efforts to expand the CSSDA supervisory process.</p>	<p>Develop an overarching change committee to avoid duplication and prudential gaps.</p>	<p>Changes during the transitional period are managed through strong cooperation between the CSSDA, the Cooperative Central Bank, the Pancyprian Cooperative Confederation, and the Audit Office of Cooperative Societies.</p>

Area	Recommendation	Response
Insurance		
<p>The insurance law is adequate but little secondary legislation or guidance is available.</p>	<p>Draft prudential regulations and guidelines as a starting point to providing companies with guidance on how to comply with the law.</p>	<p>Efforts are underway to outsource legal services for EU harmonization purposes. Within this context, legal services will also be sought for the implementation of the proposed recommended action.</p>
<p>The supervisory authority is inadequately equipped to deal with potential challenges.</p>	<p>Review the existing and required skills in the insurance supervision division with a view to deciding on new staff or areas to be outsourced.</p>	<p>All the necessary procedures will be expedited in order to recruit the appropriate qualified staff the soonest.</p>
Securities		
<p>The regulators cannot adequately cooperate with foreign regulators where the Cypriot regulator does not have an independent interest in the matter being investigated, and does not have legal certainty with regard to obtaining information on beneficial owners of shares registered in the name of lawyers acting as nominees on behalf of beneficial owners.</p>	<p>The authorities should ensure that forthcoming legislation removes these two constraints on the ability to cooperate.</p>	<p>CySEC is finalizing the drafting of a bill amending the CySEC Law under which the obstacle in sharing information and carrying out investigations on behalf of foreign regulators in situations where CySEC has no independent interest in the matter being investigated, is removed. CySEC has also proposed appropriate amendments to the CySEC law in order to give CySEC clear authority to secure information on the identity of beneficial owners of shares which are registered in the names of lawyers acting as nominees of the beneficial owners. The enactment of both amendments is expected</p>

Area	Recommendation	Response
Both CySEC and the Stock Exchange are public administrative bodies. This limits CySEC's legal ability to supervise the Exchange.	Legislation should be urgently introduced to allow effective supervision of the Exchange, and clarifying the respective roles of CySEC and the Exchange.	to take place in 2006. The planned amendment to the Stock Exchange Act was enacted in September 2005. It provides the necessary clarification for CySEC's regulatory role.

I. FINANCIAL SYSTEM OVERVIEW

A. Background

- 1. The Republic of Cyprus joined the EU in May 2004, signaling a major change in its institutional and regulatory structure** which is expected to benefit the financial sector and economy significantly.¹ The government-controlled area of the Republic had a population of 796,000 and per capita income of \$16,602 in 2003.² The single most important industry is tourism, but financial intermediation contributed 5.7 percent to real GDP in 2003, and the group “real estate, rentals and business activities,” which reflects international business services, was 14.1 percent of total output and was an important contributor to real growth in 2003.
- 2. Following a relatively weak performance in 2002–03, the economy recovered with real growth expected to average 3.5 percent in 2004–05.** Recovery has been led by consumption fed by fiscal easing and, possibly, a confidence effect from entry to the EU, though sluggish tourist spending lowered the contribution of expanded arrivals.³ Unemployment remains low by European standards, while inflation has crept up modestly on rising energy prices. The Cypriot pound is pegged to the Euro with a formal fluctuation margin of ± 15 percent, but with a de facto narrow band around the central parity of €1.7086: £C 1; adoption of the Euro is targeted.
- 3. Low corporate tax rates for international companies serving nonresidents were the major attraction of locating in the international or offshore sector in Cyprus up to end-2001.** In addition, geographical location and political stability since the late 1970s attracted to Cyprus companies from areas with political and civil disturbances. Thus, the civil war in Lebanon, formerly an important business center in the Middle East, the dissolution of the former Soviet Union, and East European conflicts attracted business from these areas to Cyprus.
- 4. It is expected that international companies will continue to be attracted to the island despite the increase in taxes and tightened regulations resulting from EU accession.** Continuing stability, prosperity represented by EU membership, an extensive network of over 30 double taxation treaties, and a rate of corporate tax (10 percent) that remains low relative to others in Europe, as well as the skills available on the island are expected to provide the necessary incentives.

¹ The territory remains divided with reunification an issue of international interest. See <http://www.imf.org>, *Cyprus—Staff Report for the 2004 Article IV Consultation*, March 22, 2005, Country Report 05/107.

² The data in this paper refer only to the government-controlled areas.

³ See Country Report 05/107.

5. **The legal provisions and supervisory arrangements for AML/CFT were found to be quite satisfactory by a 2005 MONEYVAL mutual evaluation** of the AML/CFT regime, based on the 2003 FATF Forty Recommendations and the Nine Special Recommendations on Terrorist Financing (both revised in 2004). Nevertheless, the mutual evaluation indicated areas for improvement.

B. Financial Institutions and Markets

6. **Cyprus has three classes of credit institution, an active insurance market, and a developing securities market** (see Table 2). Before the EU-propelled reforms (see Box 1), institutions operating in the offshore or international financial center, including international banking units (IBUs) were distinguished from domestic institutions by their status as foreign-owned entities restricted to doing business with nonresidents in foreign currency and paying the preferential tax rate. Credit cooperatives were, however, lightly regulated relative to the domestic banks. The market is dominated by three groups⁴ which are active in all three sectors—banking, insurance, and securities. However, their banking retail operations are subject to effective competition from the traditional cooperative sector that, not only had looser regulation but has lower operating costs and nonprofit goals.

7. In recent years, the performance of financial institutions and markets has been most affected by the stock market volatility experienced at the end of the nineties. Banks had expanded their investment business and lent for share purchase in the rising market up to 1999. Following the collapse of stock prices, banks had to recognize losses and increase provisions (see Table 3), impacting their profits. In 2004, results were recovering.

⁴ The term “group” is used in this report to accord with the definitions of the CBC’s “Directive for the supplementary supervision of banks in a financial conglomerate” issued in September 2005. The directive defines a “group” as a group of undertakings consisting of a parent, subsidiaries, entities in which the parent or a subsidiary have a shareholding of at least 20 percent, and entities related by unified management, and sets a size threshold on the smallest sector for classification as a financial conglomerate of a group with cross-sectoral holdings.

Box 1. Summary of Changes Resulting from European Union Membership

In May 1, 2004, Cyprus joined the European Union, as the culmination of a series of policy reforms which harmonized its regulations with the *acquis communautaire*. Changes related to capital account liberalization, financial regulation, and taxes have removed official differences between the international and domestic financial sectors, ending their segmentation. Following is a summary of several key changes affecting the financial sector.

Capital account liberalization

December 1999–May 1, 2004: Gradual relaxation of restrictions on inward and outward capital flow together with a simplification of administrative procedures applicable to current transactions. With EU entry on May 1, 2004, the abolition of the Exchange Control Law came into effect through the Capital Movement Law of 2003, removing all restrictions on capital movements and payments, and ending the distinction between residents and nonresidents exercised under the Exchange Control Law.

Financial regulation

January 2001: Legal ceiling of 9 percent on lending rates was removed.

March and October 2002: New guidance notes were issued under the money laundering law, requiring, inter alia, enhanced customer due diligence on beneficiaries and politically exposed persons, and covering money transmission services.

July 2002: The Central Bank of Cyprus Law and Cypriot constitution were amended to make the central bank independent.

December 2002: The CBC issued a directive, effective January 2003, harmonizing capital adequacy with the EU directive.

January 2003: Start of the five-year transition period allowed to cooperative credit institutions to prepare for conformity with EU credit institution directives by end 2007; implementation of the Insurance Services Law transposing EU directives.

July 2003: Banking Law amendment harmonizing rules with the EU directive on credit institutions, inter alia, establishing the “single passport” for EU cross-border banking, fitness and propriety for credit institution executives.

July 2003: Deposit Protection Scheme, which initially covered only deposits in Cyprus pounds, was extended to cover deposits in all EU currencies.

July 2003: The anti-money laundering act was amended to transpose the EU directive on money laundering.

January 2003–January 2005: Increasingly stringent criteria for suspension of interest recognition on loans were implemented, with the time period beyond which interest is to be suspended gradually reduced to 90 days.

April 2004: UCITS law harmonizing the legal regime for CIS with EU regulations came into force.

September 2005: Laws harmonizing the listing of securities on the stock exchange, prospectus information, and rules on insider dealing and market manipulation/abuse came into force.

Taxation

July 2002: A single corporate tax rate of 10 percent was introduced from January 1, 2003. All international business enterprises, including International Banking Units (IBUs), operating in Cyprus at December 31, 2001 were given the option of being taxed at the new rate from January 1, 2003 and catering to Cypriot residents, or of being taxed at the original lower rate of 4.25 percent and restricted to doing business with nonresidents until December 31, 2005.

January 1, 2006: All IBUs are subject to tax at the new corporate tax rate, and restrictions on business with Cypriots are removed.

Note: This list represents only a summary of the main changes in legislation and regulation. Further, these will continue to evolve with EU law.

Table 2. Financial System

	2000	2001	2002	2003	2004	2005
Banking sector						
<i>Number</i>						
Credit institutions						
Commercial banks	12	12	14	14	14	14
<i>of which:</i> foreign-owned subsidiaries	2	3	4	4	4	4
branches of foreign banks	2	1	2	2	2	2
specialized financial institutions (private)	1	1	1	1	1	1
specialized financial institutions (state owned)	2	2	2	2	2	2
Cooperative credit institutions	360	363	363	361	358	348
International Banking Units	27	24	28	28	29	28
Total assets (C£ millions)						
Credit institutions						
Commercial banks	12,776	14,936	15,565	16,621	17,818	22,008
<i>of which:</i> foreign-owned subsidiaries	1,202.3	1,575.2	1,650.6	1,714.3	1,972.8	2,283.9
branches of foreign banks	282.3	283.5	256.9	239.3	203.4	222.0
specialized financial institutions (private)	6.5	5.9	5.6	5.5	5.4	4.3
specialized financial institutions (state owned)	513.3	615.8	673.6	725.8	768.3	825.7
Cooperative credit institutions	3,158.5	3,437.0	3,885.5	4,402.1	4,685.9	5,200.9
International Banking Units	6,515.0	6,603.2	4,449.4	4,203.8	5,325.7	8,273.9
Concentration						
Commercial banks 1/	3	3	4	4	4	3
Cooperative credit institutions 2/	46	47	50	51	52	51
International Banking Units 1/	4	6	8	9	6	5
No. of bank branches	504	501	490	476	470	451
No. of bank branches per 100,000 inhabitants 3/	72	71	68	65	63	60
Insurance sector 4/						
<i>Number</i>						
Life insurance companies	13	12	12	12	11	11
General insurance companies	61	53	46	35	28	28
Total assets (C£ millions) 5/						
Life insurance companies	...	...	...	1,226.3	1,197.9	...
General insurance companies	...	...	...	303.5	430	...
Concentration (75 percent of Assets) 1/ 5/						
Life insurance companies	...	...	...	4	4	...
General insurance companies	...	...	...	10	8	...
Securities sector						
<i>Number</i>						
Investment firms (market intermediaries) 6/	...	...	...	13	44	49
International collective investment schemes	4	5	8	12	15	22
International financial companies 7/	90	127	121	59	50	43
<i>of which</i> Financial advisory firms	...	...	...	50	41	36
International trustee services	12	10	10	9	9	7
Total assets (C£ millions)						
Stock market capitalization	8,296	5,578	4,374	4,442	4,506	6,242
International collective investment schemes 8/	...	...	56	50	190	...

Sources: Central Bank of Cyprus, Cyprus Securities and Exchange Commission, Insurance Companies' Control Service

1/ Number of institutions with 75 percent of total assets.

2/ Number of institutions with 75 percent of total deposits.

3/ Data for 2005 is provisional.

4/ Composite insurance companies and EU branches are not included.

5/ Data prior to 2003 are not available because data files were relocated.

6/ Firms licensed by CySEC under the 2002 investment firms laws.

7/ From 2003 international financial companies refer to financial advisory firms plus international trustee services companies.

8/ Data for 2004 is at June.

Table 3. Banking System

	2000	2001	2002	2003	2004	2005
Commercial banks						
	(Cyprus £ million)					
Total assets	12,776	14,936	15,565	16,621	17,818	22,008
Foreign assets	3,064	3,739	3,161	3,749	4,433	7,313
Advances and Loans	6,766	7,652	8,283	8,683	9,332	9,972
<i>Of which:</i> Total claims on private sector	6,516	7,320	7,904	8,302	8,844	9,390
Total deposits	9,995	11,474	11,999	12,193	13,102	16,024
<i>Of which:</i> Non-resident	3,759	4,396	4,209	4,133	4,610	6,649
Foreign liabilities	298	600	505	672	790	1,436
Return on Assets 1/	1.5	0.6	-0.1	-0.1	0.3	0.6
Cooperative credit institutions						
Total deposits	2,822	3,109	3,513	3,986	4,238	4,960
Total loans	2,484	2,519	2,670	2,947	3,276	4,678
Total claims on private sector 2/	...	2,418	2,607	2,876	3,016	...
	(US\$ million)					
International Banking Units						
Total assets	10,545	10,150	8,139	9,036	12,531	17,081
Advances and loans (to customers)	2,889	3,031	2,611	2,557	4,236	5,501
Claims on banks	4,858	4,346	3,215	4,149	4,395	6,199
Total deposits (from customers)	2,181	2,689	3,013	3,384	3,081	4,871
Liabilities to banks	6,109	5,193	2,611	3,860	4,822	6,210
<i>Memorandum item</i>						
Cyprus pounds per US dollar (end period)	0.62	0.65	0.55	0.46	0.43	0.48

Sources: Central Bank of Cyprus and IMF, *International Financial Statistics*

1/ Data is on a cross-border and cross-sector (excluding insurance) consolidated basis. Data for 2005 is for first half only.

2/ Data for 2004 is at September.

8. **The Cypriot banking sector has three distinct components although differences are diminishing with the obligations of EU accession:** (i) commercial banks; (ii) cooperative credit institutions (together forming the domestic banking system); and (iii) the international banking units. The domestic credit institutions consist of 14 commercial banks, including 3 specialized institutions with commercial banking licenses, and 358 cooperative credit institutions. Domestic commercial banking is dominated by three banks which together hold about 70 percent of system assets excluding the cooperative banks, and about half of system assets, including the cooperatives.⁵ These three banks, all locally owned, operate internationally (see Table 4).

9. **In recent years, the strategy of the commercial banks has been influenced both by policy and by the need to compete in a heavily banked market.** In 2003, the government-controlled area of Cyprus had 65 bank branches per 100,000 residents, as compared to the average of 49 in the 15 members of the EU prior to the last accessions. Interest rates were controlled (at 9 percent) until the end of 2000, encouraging non-price competition, including through the branch network. Deregulation of interest rates has enhanced overall competition in banking, particularly between the commercial banks and cooperative credit institutions. As Table 2 illustrates, the number of branches has been declining but a powerful bank employees' union probably constrains the rate of decline.

10. **Deposits at cooperative credit institutions represented about one third of total deposits in local currency in all credit institutions at end-2004.** Virtually every village in the government-controlled area of Cyprus has its own cooperative society, and most Cypriots apparently continue to save with their regional or professional financial cooperatives. Borrowing from cooperatives is cheaper because of their nonprofit orientation, lower regulatory costs to date, and exemption from tax on profits generated by operations with members.⁶ The only cooperative credit institution supervised by the CBC is the Cooperative Central Bank Ltd, which is a licensed commercial bank. It provides banking and other services to the cooperative credit institutions, accepting their surpluses as deposits, lending to them as necessary, and acting as their clearing agent.

⁵ Information from Fitch Sovereign Ratings for Cyprus, August 17, 2004. The banks' published consolidated balance sheets do not provide financial information for the individual banking entities.

⁶ This exemption was granted by the EU after detailed consultations.

Table 4. Three Financial Groups

	Bank subsidiaries/ branches	Insurance Subsidiaries/b ranches	Investment Banking	Asset Management	Other Financial	Other
Bank A						
Domestic	Bank A bank Bank A mortgage institution	1 general 1 life	1 investment firm 1 venture company	1 mutual fund firm	HP & leasing [up to end- 2005] factoring [up to end-2005] stock broker	Property & hotels (2)
Foreign	Greece (branch) UK (branch) Australia (sub) Guernsey (sub) USA (rep office) S. Africa (rep office) Canada (rep office) Russia (rep office) Romania (rep office)	Greece (1 branch general & 1 branch life)	Greece Channel Islands (venture capital— in liquidation)	Greece Ireland	Greece (leasing (2) stock broker)	Greece
Bank B						
Domestic	Bank B bank	3 general 1 life	1 investment company	1 asset management	HP & leasing factoring trustee	Property dev.(2) management serv. auctions
Foreign	Greece (sub) Australia (sub) Guernsey (sub) Serbia (sub) U.K. (branches) S. Africa (rep office) Canada (rep office) USA (rep office) Russia (rep office) Yugoslavia (rep office)	Greece (1 life & 1 insurance agent)		Greece	Greece (factoring, leasing, stock broker)	
Bank C						
Domestic	Bank C bank Bank C Credit institution with restricted banking license	2 general 1 life	1 investment company		HP & leasing, custodian & trustee, factoring	Quality management
Foreign	Greece (branch) S. Africa (rep office) Russia (rep office)	Insurance Agents		Greece (asset management)	Greece (until April 2005)	

Source: CBC

Note: The “group” here is as defined in the September 2005 CBC “Direction on the Supplementary Supervision of Banks which belong in a Financial Conglomerate.”

11. **There are 29 licensed international banking units, although only 26 are in operation.** Two of these belong to companies which also have operations in the domestic banking sector. There is one representative bank office. The international banks have a wide range of ownership origin but the largest are headquartered in Austria (a bank specialized in

public finance), Ireland, France, and the United Kingdom. Lebanon is the home country for eight, Jordan and Russia for four and three, respectively. They vary in size, some having only 4–5 employees, and others up to 60.

12. **The international banks' presence in Cyprus can be attributed to a combination of geographical location, and preferential corporate tax rates.** The Lebanese banks located offices in Cyprus in large part to service Lebanese companies which moved to Cyprus during the civil war in Lebanon. Similarly, East European operations were attracted to Cyprus by its stability and the tax advantages resulting from a longstanding double taxation treaty with the former Soviet Union (signed in 1962) which was originally grandfathered by Russia and the other component states. The domestic profit tax rate on these banks was 4.5 percent until end-2005 when all were made subject to a 10 percent tax rate (see Box 1). It seems probable that the change in tax rate will have little effect on the sector. Cyprus has a network of over 30 double taxation treaties.

13. **The insurance sector also has domestic and international institutions, with the latter originally insulated, like banks, from the domestic market by the exchange controls and tax conditions**—31 licensed companies operate in the domestic market, two of which are foreign undertakings, and 14 international insurers or reinsurers (two of which are captives). Only one of the international insurers has large operations. EU entry has also introduced two other categories—companies in Cyprus under the EU passport which allows for licensed entities in one member to establish in other EU jurisdictions (5 companies), and 119, most from the United Kingdom, were registered (at March 2005) to provide services in Cyprus under the EU passport (it is not clear whether these companies are actually operating as yet). Mainly as a result of the introduction of EU law and regulation, 26 companies exited the non-life market.⁷ At the end of 2004, of the 43 companies writing insurance, 11 were life, 4 composite, and 28 non-life (these numbers include the international companies, but do not include EU branches) (Table 5). The life market is highly concentrated, with the four largest companies controlling three quarters of premium income. The largest three nonlife companies only controlled 36 percent of premium income. The companies' investments are mainly in debt securities, bank deposits, and money market instruments, with less than 20 percent in equity at end-2003, reflecting the stock market crash (see below).⁸

14. **The business of the most significant international insurers is based on strong geographic business relationships and favorable tax rates relative to their home jurisdictions.** Of the 26 nonlife companies exiting the market as a result of EU entry, ten were international, mainly captive, insurers. In 2004, most of the international business was reinsurance (72 percent) and life business (22 percent).

⁷ Satisfactory arrangements were made for customers and beneficiaries.

⁸ See *Insurance in Cyprus, Directory and Statistical Information*, 2003, Insurance Association of Cyprus.

Table 5. Insurance Industry Indicators

	2000	2001	2002	2003	2004
Number of companies by business type					
Life	13	12	12	12	11
Composite	7	6	6	4	4
Non-Life	61	53	46	35	28
Total	81	71	64	51	43
Gross premiums (C£ millions) 1/ 2/					
Life	219.5	144.5	149.5	236.7	200.4
Non-life	106.4	116.8	129.6	182.3	292.2
Net Premiums (C£ millions) 1/ 2/					
Life	210.3	134.7	139.4	216.9	179.4
Non-life	87.8	78.7	86.7	114.6	216.5
Insurance companies investment (C£ millions) 2/ 3/					
Life	...	...	...	129.8	186.5
Non-life	...	...	...	4.3	3.9
Bank-controlled companies 2/					
Number	8	9	9	9	9
Net premiums (C£ millions)	203.7	139.3	145.7	147.8	432.1
Market share (percent) 4/	62.50	53.31	52.20	35.27	39.95
Density of insurance (total premiums per capita) 2/ 5/					
	467.0	370.7	390.2	421.8	668.4
Ratios to GDP (percent)					
Total insurance premiums to GDP 2/	5.97	4.46	4.51	4.67	6.83
Total investment to GDP	19.2	15.1	12.3	12.6	17.8

Source: Insurance Companies Control Service

Notes:

1/ The figures for years 2000-2002 do not include international insurance business units. The data files containing them were relocated and difficult to access.

2/ Composite insurance companies are not included.

3/ Separate data was not kept for years prior to 2003.

4/ Ratio of gross premiums of the bank-controlled companies to total gross premiums.

5/ The figures were extracted from the Directory of the Insurance Association of Cyprus and do not include international business units.

15. Life and motor insurance are the two most important areas of domestic insurance activity. In life insurance, unit-linked⁹ policies have served as an important savings vehicle in the absence of domestic mutual funds and the presence of capital controls, and motor insurance was stimulated by high car ownership and a legal requirement for third party liability coverage. Unit-linked policies were especially popular during the stock market bubble period.

⁹ These are life policies whose investments are linked to the performance of units or the index of a pre-agreed investment.

16. **The securities sector in Cyprus covers the Stock Exchange, market intermediaries, a limited number of collective investment schemes and certain international financial services companies** (Table 6). Unlike many other international and offshore financial centers, it is not a center for the domiciling of mutual funds.

Table 6. Stock Market

	2000	2001	2002	2003	2004	2005
Indices						
CSE General index at end of year	244.5	129.1	94.5	80.6	72.6	110.0
FTSE CySE20 at the end of the year	1,017.3	518.1	363.3	326.5	338.5	576.9
Companies						
Number of listed issuers	120	144	154	152	149	144
Number of listed securities	243	277	262	257	245	235
Shares	124	149	159	156	153	147
Warrants	85	80	60	35	18	14
Corporate bonds	13	9	8	10	12	13
Government bonds	21	39	35	56	62	61
Total market capitalization (in millions of pounds)	8,296	5,578	4,374	4,442	4,505	6,242
Proportion of market capitalization represented by the 3 largest companies	...	...	44	46	52	63.9
Turnover (millions of Euros)	...	3,854	644	265	222	396

Source: Cyprus Stock Exchange

17. **The Stock Exchange is state owned, and has a relatively small number of listed companies** (155 overall). Turnover is very modest—in the region of \$500,000 daily at end-April 2005, while it averaged \$1.8 million in the first 75 trading days of the year. The exchange deals mainly in equities and bonds. The market is dominated by the large banks and utilities, with some 50 percent of market capitalization represented by the three largest banks (67 percent by 10 companies).

18. **The Exchange has five classes of issuers—the bond market, the investment companies market, and three equity issuers.** The equity issuers are, in descending order of size and standing, the main, parallel, and alternative markets. The main market, which includes the major banks, has 18 listings and, in the first quarter of 2005, its average daily turnover was approximately 70 percent of total turnover. Of the three supplementary markets, the parallel market had ¹⁰ 20 listings, the alternative market 89 listings, and the investment funds' market 28 listings. In 1999/2000, two years after it was established, the Exchange witnessed a severe collapse in listed prices—its index fell from about 800 to 80 points over a period of one and a half years. Fiscal measures to stimulate use of the market, in the context

¹⁰ At end-April, 2005.

of an unsophisticated investor public and accompanied by a less comprehensive regulatory regime than currently exists, may have contributed to the stock market bubble that peaked at the end of 1999.

19. The other actors or institutions in the securities market are market intermediaries, and international financial services firms:

- There are 47 authorized market intermediaries, generally offering a broad range of investment services. Thirty-two of these intermediaries offer their services almost exclusively to nonresidents. The remaining 15 intermediaries offer their services locally; many provide stock-broking services.
- There are two categories of international financial service companies (i) international collective investment schemes; and (ii) independent financial advisory firms. Both offer their services almost exclusively to non-residents. Fifteen international collective investment schemes have been authorized with a total net asset value of approximately \$400 million. There are about 40 international financial advisors. They offer investment advice only; they do not execute orders or manage portfolios.

The domestic collective investment schemes industry is in its infancy. Cyprus has just transposed the recently adopted EU UCITS Directives but has not licensed any schemes to date.

20. The formal distinction between international business companies and domestic companies no longer exists following the removal of capital controls and differential taxation as a result of EU accession. However, the markets they serve will probably continue to differ since the international companies locate in Cyprus to take advantage of the location, extensive network of double taxation treaties, and relative political stability. For example, companies offering international financial services can register subsidiaries in Cyprus to reduce the effective tax rate on portfolio capital gains and on income borne by investors.

C. Regulatory Framework, Oversight, and Market Integrity Arrangements

21. Financial institutions in Cyprus are regulated and supervised by four authorities: the Central Bank of Cyprus (CBC), which is responsible for the supervision of domestic banks and international banking units (IBUs); the Cooperative Societies Supervision and Development Authority (CSSDA), supervising the cooperative credit institutions; the Superintendent for Insurance Control (SI); and the Cyprus Securities and Exchange Commission (CySEC).

22. The CBC is the supervisor for domestic banks and IBUs. The two sectors have always been similarly supervised, but have been segmented by exchange control and tax law. In preparation for joining the EU, Cyprus amended its tax laws in July 2002 to introduce a uniform rate of tax (10 percent) on all enterprises, including banks, irrespective of residence of the owner. With the abolition of exchange controls, IBUs who opted to be taxed at

10 percent may operate domestically. All IBUs are treated similarly from end-2005 (see Box 1).

23. **The legislation governing cooperatives was amended in 2003 to transpose the EU directives on credit institutions and hence their regulatory conditions are similar to those of the banks.** The resulting arrangements resemble those of other cooperative credit movements in Europe. The cooperatives will now be expected to conform to the capital requirements and other prudential obligations of EU credit institutions. It is expected that some will prove too small for this to be feasible, and these can opt to be affiliated with the Cooperative Central Bank, meeting consolidated prudential requirements. An independent authority, the Cooperative Societies Supervision and Development Authority (CSSDA) has, since its inception, provided supervision, and development advice, for the cooperative movement in accordance with the Cooperative Societies' Law (CSL). In 2003 the CSL was harmonized with the EU directives—increased requirements for prudential supervision were incorporated and a separate supervisory division created within CSSDA. The governing body of the CSSDA consists of the commissioner and four members appointed by the Council of Ministers for five years. The staff of the Authority consists of the commissioner, two senior officers, 36 officers and secretarial staff. Legally, the commissioner has all the usual financial supervisory powers, including the right to conduct on-site inspections and off-site monitoring.

24. **A Deposit Protection Scheme covering domestic banks was introduced in September 2000** and was brought into conformity with all EU regulations on May 1, 2004, when the IBUs joined, with the exception of those incorporated in other EU member states. An investment compensation scheme for clients of banks which offer investment services commenced operation in May 2004. An investment fund for clients of investment firms was also created in 2004.

25. **A deposit protection scheme for CCIs, established by the Cooperative Societies (Establishment and Operation of the Deposit Guarantee Scheme) Rules for 2000 and 2004, has been in operation since 2000.** The scheme is reportedly very similar to that of banks and conforms to EU Directive 94/19/EC. In addition, the CSL provides that the CSSDA, in cooperation with the Pancyprian Cooperative Confederation Ltd., can issue a legally binding regulation requiring the establishment of a solidarity fund in which CCI participation is mandatory. The solidarity fund would be used to address liquidity or solvency issues before the deposit protection scheme. A preliminary regulation is in draft.

26. **The Superintendent of Insurance (SI) is supported by the Insurance Company Control Service (ICCS) of Cyprus.** The SI was authorized by the Law on Insurance Services and Other Related Issues, 2002, and the staff of the ICCS is governed by the Civil Service Law, while its budget forms part of the Ministry of Finance's budget. The superintendent and the deputy superintendent are appointed by the Council of Ministers and are both public employees. The service is staffed by nine skilled personnel and seven support staff. Domestic and international companies are similarly regulated and supervised.

27. **There are two regulatory bodies in the securities sector the chief of which is the CySEC.** CySEC is responsible for regulating the Exchange, collective investment schemes

and a range of market intermediaries. The Central Bank retains responsibility for the oversight of the international financial advisors and non-retail collective investment schemes referred to above. CySEC has a skilled staff of 40. The CBC has skilled and experienced securities regulation staff.

28. **The Prevention and Suppression of Money Laundering Activities Law of 1996–2004 (PSMLAL), covers, inter alia, credit institutions, investment firms, life insurance companies (domestic and international), and nonlife insurance companies, operating outside of Cyprus, as well as lawyers (in respect of financing business) and accountants/auditor.** The financial regulators in these sectors and the professional bodies of lawyers and accountants/auditors are designated as the responsible supervisory authorities. Each of the supervisors has issued guidance notes under the law for the relevant institutions. PSMLAL criminalizes money laundering with predicate offenses covering all crimes subject to a maximum sentence of 12 months or more, provides for confiscation, freezing and restraint orders for proceeds, and requires customer identification, record keeping, internal control, staff training and suspicious transaction reporting. The financial intelligence unit (FIU) is a multidisciplinary unit with 14 staff; as Chair of the Advisory Authority, it is currently the lead in strategic policy making on AML/CFT.

II. STRENGTHS AND VULNERABILITIES IN THE IMPLEMENTATION OF FINANCIAL STANDARDS

29. **Supervision of the commercial banks is particularly strong; however, supervision of the cooperative credit institutions (CCIs) and insurance requires enhancement, and securities sector cooperation could be improved.** While the legal framework is in place for the supervision of the cooperative credit institutions, implementation is just beginning. EU directives for the insurance sector have been transposed, but supervision requires significant enhancement to be consistent with the EU framework. Regulation of securities activities is also well-developed, though there are shortcomings in international cooperation. The Cypriot supervisors have in large part a satisfactory legal framework and implementation record in cross-border cooperation, information exchange, and consolidated supervision, though clarity is required for the securities framework.

A. Cross-Border Cooperation and Information Exchange

30. The legal and formal arrangements are in place to permit international information exchange by regulators in the banking, cooperative and insurance sectors, with implementation reflecting the general supervision in the sectors.

31. **Given the conglomerate structure of the domestic institutions, the ability to communicate among the different sectoral supervisors is important for international cooperation.** A domestic MOU was signed in 2002 by the three regulatory authorities—the CBC, CySEC, and the SI. In November 2003, it was also signed by the CSSDA. The MOU allows for mutual notification of cross-border provision of activity and exchange of supervisory information, addresses the need for consolidated supervision information, and explicitly allows for cases where cross-sectoral cooperation is needed for cross-border

cooperation, and where the issue is connected to enforcement of the AML law. The agreement nevertheless explicitly excuses the CBC and the CSSDA from sharing information on individual deposit accounts, although there are informal gateways among domestic as well as international banking supervisory and financial regulatory authorities for exchanging supervisory information without any restrictions.

32. **The CBC is authorized to share information with all competent authorities, no matter the sector, by Section 27(1) of the Banking Law, and has a thorough operational program of on-site visits and off-site monitoring** of the foreign branches/subsidiaries for which they are home supervisors. Section 27(4) of the BL requires that the CBC be satisfied that the same confidentiality applies to the information receiving authority as to the CBC itself. Home supervisors of foreign banks located in Cyprus conduct on-site examinations in Cyprus and discuss the results with the CBC.

33. **The CBC has also signed MOUs in the field of banking supervision with several foreign supervisory authorities**—the Central Bank of the Russian Federation, the Bulgarian National Bank, the National Bank of the Republic of Belarus, the National Bank of Ukraine, the National Bank of Yugoslavia, the National Bank of Romania, the Financial and Capital Market Commission of the Republic of Latvia, the National Bank of Slovakia, the Bank of Tanzania, the Central Bank of Jordan, the Bank of Greece, and the Central Bank of Lebanon. In addition, MOUs are being negotiated with a number of overseas banking and regulatory authorities, including authorities in the United Kingdom and Ireland. The CBC has also signed MOUs in the field of international financial services with the following foreign supervisory authorities: the Greek Capital Markets Commission, the Federal Commission for the Securities Market of Russia, the Czech Securities Commission, and the Lithuanian Securities Commission. CySEC is a signatory to the MOU sponsored by the EU Commission of European Securities Regulators (CESR), and is working towards becoming a full signatory to the IOSCO Multilateral MOU, being currently listed in Appendix B of the MOU. It has also signed MOUs with the securities regulators of several states, and is currently negotiating the conclusion of MOUs with non-EU securities regulators.

34. **The insurance law provides for cross-border cooperation in the supervisor's role as home or host supervisor** and the insurance supervisor (ICCS) has joined the EU protocols laying out the process for cooperation in the context of home/host supervision. The supervisor should, however, adopt a more proactive stance with regard to the EU companies operating under freedom of service (FoS), contacting their home supervisors to identify which have begun operations.

35. **Useful provisions for cooperation and information exchange are provided for in the laws governing CySEC, but there are legislative shortcomings in two areas:** the regulators cannot adequately cooperate with foreign regulators where CySEC does not have an independent interest in the matter being investigated; and CySEC has experienced difficulties in obtaining information identifying beneficial owners of shares from lawyers acting as nominees for the beneficial owners. However, a forthcoming bill is expected to correct these shortcomings.

B. Sectoral Findings

Banking

36. **Supervision of international banks and domestic commercial banks, already found to be very competent in the assessment of 2001 (see Annex I) has progressed to reach high standards, although additional resources are recommended.** Independence of the central bank is now assured, both by changes in the central bank law and its enshrinement in the Constitution of the Republic. Prudential oversight has improved with internationally conforming standards provided for nonperforming loan classification, although market risk would be better supervised if the supervisor enhanced its oversight of systems and provided staff with specialized training.

37. **The laws and regulatory structure are in place for the establishment of a satisfactory level of supervision of the credit cooperatives.** However, although implementation has started, it will take some time to complete, and the authorities face a considerable challenge in developing the appropriate affiliation (or merger) arrangements by end-2007, as required, although the impetus and incentives provided by EU accession have proved powerful.

38. **Supervision of banks and cooperatives credit institutions by the CBC and the CSSDA, respectively, puts in place two separate supervisory bodies for deposit-taking institutions.** The objectives and operations of these agencies still differ to some degree, although the CSSDA is moving to generally adopt the supervisory policies and procedures of the CBC. Consequently, these arrangements are likely to prove relatively and unnecessarily costly since supervisory functions will be duplicated, a factor the authorities may wish to consider in their overall longer-term planning.¹¹

Insurance

39. **The legal framework for insurance supervision is largely in place, and provides accountability and budgetary autonomy, however significant operational enhancement is required.** The institutional structure should provide the supervisor with greater independence, and a structure of responsibility that is less dependent on the functions of a single individual, viz. the SI. The supervision division does not have enough resources, in particular in terms of skills, to usher the industry into the EU framework for solvency.

Securities

40. **The skills of the regulators and the rules governing their actions were generally impressive, but important shortcomings were found in information exchange.** The

¹¹ This aspect of the supervisory structure was not discussed at the time of the mission. The CSSDA notes that the authorities discussed this issue in 2003, deciding to maintain two separate supervisory bodies for credit institutions. An MOU has since been signed by the four supervisory bodies.

regulators were unable to collect information and investigate on behalf of foreign authorities where CySEC had no independent regulatory interest in the matter being investigated; and the regulator has had difficulty accessing information identifying the beneficial owner of shares registered in the names of lawyers acting as nominees on behalf of the beneficial owners. The regulator is seeking an amendment in legislation that would confirm access to such information and remove the above restriction on CySEC's ability to cooperate with foreign authorities. Clearer authority for CySEC in its role as supervisor of the stock exchange is also necessary.¹²

Cross-sectoral matters

41. **The arrangements among supervisors to oversee the financial groups which dominate the market would benefit from elaboration and formalization.** However, the insurance companies are a relatively insignificant component of the major banks' balance sheets and incomes; furthermore, banks' risk assessed capital is purposely insulated from insurance risk in the course of supervision (that is, insurance assets do not qualify as capital); the bank supervisors keep a watching brief on insurance sector developments, and can undertake inspections of insurance companies. The sectoral supervisors meet regularly to share information, and these meetings could usefully take under formal consideration the implications of insurance companies' forthcoming compliance with the EU Solvency I directive.

42. **The CBC is developing a comprehensive regulation on corporate governance for banks, and it would be useful if the work in this area could be developed and extended in cooperation with the other regulatory agencies to cover all financial institutions,** including small, family-owned and -run firms. The regulation being developed will supplement the guidance provided in their 2001 regulation on internal control systems, and should be issued by September 2005. The extension of such guidance to all financial firms would improve overall decision making and monitoring in the financial sector.

Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)

43. The following summary reflects the findings of the MONEYVAL mutual evaluation mission which visited Cyprus in the period April 3 to 9, 2005.¹³

44. **The criminalization of money laundering meets the relevant criteria in all respects, but criminalization of terrorist financing should be expanded to include collection of funds.** Powers to trace, freeze, and confiscate proceeds and the necessary associated investigative powers are also well provided for in the law. Cyprus law does not provide for civil forfeiture, but confiscation is actively pursued in criminal cases.

¹² The relevant amendment to the Stock Exchange Act was enacted in September 2005. It is expected to have provided the necessary clarification for CySEC's regulatory role.

¹³ This description was revised on the basis of the draft executive summary of the mutual evaluation report considered by the MONEYVAL plenary in February 2006.

Criminalization of the financing of terrorism as defined in the UN Convention for the Suppression of the Financing of Terrorism is fully achieved and requirements for the suspicious transaction reporting on terrorist financing are in place. However, the financing of terrorism crime should include the collection of funds in the knowledge that they are to be used by terrorist(s).

45. **Supervision by the CBC, CSSDA, and CySEC is quite satisfactory, and these agencies, together with the SI, the Bar Association and the Institute of Certified Public Accountants, are issuing guidance in line with the FATF 40+9.** The CySEC and CSSDA are in the process of issuing revised Guidance Notes.¹⁴ The Bar Association is also drafting a Guidance Note to be issued to its members.¹⁵ Guidance notes should deal explicitly with terrorist financing to provide information to reporting enterprises. The SI should recruit additional staff and conduct on-site inspections. Trust and company service providers are at present regulated only through the supervision of lawyers and accountants/auditors. Legislation is in the process of being drafted for the regulation by the CBC of the provision of trust and company services by persons other than lawyers and accountants/auditors. The Cypriot authorities' resolve to reduce vulnerability to money laundering was noted, and the AML law and enforceable and sanctionable guidance notes were found to meet basic preventive obligations; however, it was recommended that certain provisions currently in supervisory guidance should be in legislation. Formal review of measures covering nonprofit organizations would be beneficial. The FIU is efficient and effective in all aspects of its work.

¹⁴ The CSSDA advises that its guidance note was issued on May 16, 2005.

¹⁵ The authorities have informed that these guidelines have been finalized and issued to the supervised entities/members concerned.

Assessment of the Supervision of International Banking: Status of 2001 Recommendations

Recommendations of 2001 Assessment	Follow-up on Recommendations	Further Measures Noted by Authorities
<p>The CBC should publish an annual report on its supervisory activities.</p>	<p>The annual reports of the CBC for 2002, 2003, and 2004 contain sections on the Bank's supervisory activities in the banking sector.</p>	
<p>Banking General issues Restriction on disclosure of individual deposit account information should be removed from the Banking Law.</p>		<p>In practice information on individual deposit accounts can be passed to the parent by the affected subsidiary or branch, or obtained by the foreign supervisor through onsite review.</p>
<p>Independence and Resources (BCP 1.2) The CBC Law should be amended to provide for greater security of tenure for the Governor. The law should stipulate that reasons for his removal be given and made public.</p>	<p>The new CBC Law enacted in July 2002 stipulates that the Governor cannot be removed prior to the expiration of his term of office, unless he no longer fulfills the conditions required for the performance of his duties or he is guilty of serious misconduct.</p>	<p>It is not stated explicitly in the new CBC Law that the reasons for removal of the Governor should be made public. However, since the removal of the Governor by the President of the Republic would be an extraordinary event, it would be expected to compel the President to make public the reasons for removal. Further, the dismissed governor, entitled to an appeal under the law, would himself also invariably disclose the reasons for dismissal.</p>
<p>There is a general need for additional capacity for the exercise of supervisory functions at the CBC, particularly in order to allow for the planned frequency of on-site inspections. Four existing vacancies should be staffed at an early date.</p>	<p>Supervisory capacity has been strengthened with the employment of two more employees and the frequency of on-site inspections has increased. Some resources were also released when the CBC ceased to be responsible for the supervision of the international financial services companies in September 2002. In addition, a risk-based approach to on-site examinations has been introduced.</p>	<p>Additional qualified/specialized supervision staff are required especially for a) the validation and monitoring of banks' internal risk systems and models; b) financial stability; c) commitment towards EU institutions; and d) the satisfaction of additional demands emanating from the rapid expansion of banks overseas.</p>

Recommendations of 2001 Assessment	Follow-up on Recommendations	Further Measures Noted by Authorities
<p>Supervisory powers (BCP 1.4) The provision in the Banking Law requiring the CBC to consult first with the Ministry for the granting of banking licenses and for remedial powers should be removed. 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.</p>	<p>The Banking Law has been amended to allow licensing policy and remedial measures to be determined without prior consultation with the minister of finance.</p>	
<p>Licensing (BCP 3) The CBC should conduct more comprehensive investigations into the character and reputation of persons who are associated with the financial services sector in Cyprus, for example, by accessing the records of foreign law enforcement agencies and judicial systems.</p>	<p>Applicants are currently required to submit a police clearance from their country of origin.</p>	
<p>Loan classification (BCP 8) The CBC should develop generally applicable criteria for assessing banks' loan classification and provision policies in order to ensure that banks meet best international practices.</p>	<p>As from January 1, 2003, banks have been obliged to follow guidelines on the definition of nonperforming loans and regulations requiring suspension of interest when loan repayment is in arrears for more than nine months. This period was reduced to six months on January 1, 2005.</p>	<p>A CBC directive setting 90 days in arrears as the criteria for the classification of credit as nonperforming, and defining procedures for the suspension of interest and other income came into force on January 1, 2006.</p>
<p>Country Risk (BCP 11) The CBC should consider requiring banks to set formal limits for country and transfer risks or ensure that head offices and parent banks do so and notify them to the CBC.</p>	<p>No formal limits have yet been established. However, on-site examinations and off-site monitoring oversee such exposures and risk</p>	<p>The CBC should consider establishing formal guidance on a framework for country risk and transfer risk management, that could be used by all banks located in Cyprus to formulate their own</p>

<p>Recommendations of 2001 Assessment</p>	<p>Follow-up on Recommendations</p>	<p>Further Measures Noted by Authorities</p>
	<p>management requirements mandate that such limits be established by the banks and/or their parent establishments.</p>	<p>specific limits, as appropriate to the nature of their business and their ability to identify, monitor, and control such risks.</p>
<p>Market risk (BCP 12) The prudential systems of the CBC do not provide a basis for a comprehensive supervision of market risks. The CBC should implement the Basel Core Principles requirement, either by imposing limits or specific capital charges or both.</p>	<p>The CBC has issued the Capital Adequacy Directive (CAD) to banks which sets capital requirements with respect to market risk. The reporting system required by the CAD enables the CBC to monitor the risks being run. Banks submit to the CBC a monthly return on their open position in foreign currency, including that of overseas subsidiaries or branches; as well as a quarterly return on interest risk exposures. The CBC has imposed limits on foreign currency open positions of banks and it regularly reviews and approves asset and liability committee (ALCO) limits for each bank</p>	
<p>Money laundering (BCP 15) Procedures set down in CBC Guidance Notes should ensure that the identity of beneficial owners of accounts in the names of trustees or nominees is appropriately disclosed to banks.</p>	<p>In accordance with the CBC Guidance Note (dated September 17, 2001) and supplement (dated November 26, 2001), banks are required when opening accounts for trusts and nominees of third persons to ascertain, without any exception, the identity of all the settlors and the true beneficiaries of the said accounts.</p>	

Recommendations of 2001 Assessment	Follow-up on Recommendations	Further Measures Noted by Authorities
<p>The recommendation in the CBC's Guidance Note which stipulates that banks are expected to obtain satisfactory evidence of identity of their customers prior to the execution of any banking transaction should be made a statutory requirement rather than an expectation.</p> <p>To strengthen customer identification framework, the list of jurisdictions from which banks are required to submit information to the CBC should include jurisdictions known to have deficient AML frameworks.</p>	<p>The CBC's guidance note to banks sets out what constitutes satisfactory evidence of identity. Observance of the guidance note by banks is legally mandatory and subject to sanctions. It is also enforceable in a court of law.</p> <p>The CBC issued a Guidance Note (dated January 20, 2003) with a list of countries and territories that are considered as "non-cooperative" in the fight against money laundering, in accordance with the FATF criteria. Banks have been requested to exercise additional monitoring procedures in transactions with persons from countries included on the list and to file a suspicious transaction report to the Unit of Combating Money Laundering, in case they are not satisfied as to the legitimacy of the transactions.</p>	
<p>With regard to incoming fund transfers, banks should be required to ensure that satisfactory information on the identity of the ordering customer is obtained on a consistent basis.</p> <p>Encourage banks to comply with ML law by developing employee training programs based on actual transactions.</p> <p>The CBC should carry out more frequent on-site reviews of the recognition and reporting procedures of the banks, especially those considered high risk.</p>	<p>The November 2004 Guidance Note has addressed this issue.</p> <p>The November 2004 Guidance Note requires banks to educate and train employees.</p> <p>Supervisory capacity has been strengthened with the employment of two more employees. The number of on-site inspections has increased. AML</p>	

Recommendations of 2001 Assessment	Follow-up on Recommendations	Further Measures Noted by Authorities
	procedures are tested during on-site examinations.	
<p>Off-site/on-site supervision (BCP 16) Resources need to be increased to allow the planned frequency of on-site examination to take place.</p>	See BCP 1.2	
<p>Understanding banks' operations (BCP 17) The CBC should make it mandatory for a supervised institution to report any material adverse changes in its condition as early as possible on the grounds that, the earlier problems are brought to its attention, the larger the number of options that will be available to resolve the problem.</p>	The Banking Law has been amended to this effect (Section 24 of the 2003 Amendment Law).	
<p>Consolidated reporting (BCP 18) CBC should consider updating itself as regards international experience with the development of early warning systems that use prudential reports and other data.</p>	Committee for managing financial crisis has been formed by the regulatory authorities and the Ministry of Finance. It is focusing on the banks perceived to be higher risk.	In the context of participating in the workings of the Banking Supervision Committee of the European System of Central Banks and one of its two main substructures (the Working Group on Macro-Prudential Analysis), as well as of participation in the "Coordinated Compilation Exercise for Financial Soundness Indicators" of the IMF, the CBC has established the basis for developing a framework for macro-prudential surveillance and analysis.
<p>Corrective action (BCP 22) The Banking Law should be amended to remove any need for consultation with the Ministry of Finance before corrective action is taken.</p>	See BCP 1.4	

Reports on the Observance of Standards and Codes—Summary Assessments

This Annex contains summary assessments of adherence to international standards and codes relevant for the financial sector. The assessments have helped to provide a source of recommendations for improved financial regulation and supervision in various areas.

The following assessments of financial sector standards were undertaken:

- The Basel Core Principles for Effective Banking Supervision (BCP), by Messrs. Marcel Maes and Timothy Sullivan, Consultants;
- IAIS Insurance Core Principles (ICP), by Mr. Henning Göbel, Bundesanstalt für Finanzleistungsaufsicht (BaFin), using the ICP methodology adopted in October 2003; and
- The IOSCO Objectives and Principles of Securities Regulation, by Mr. Michael Deasy, Irish Financial Services Regulatory Authority (IFSRA), using the methodology adopted in October 2003.

The assessments were carried out during a mission to Cyprus from March 28 to April 8, 2005. Additional information was added during the review process. All the assessments were based on the laws, regulations, policies, and practices in place at the time the assessments were made.

The assessments were based on the following sources:

- Self-assessments by the supervisory authorities;
- Reviews of relevant legislation, decrees, regulations, policy statements and other documentation; and
- Detailed interviews with the supervisory authorities.
- Meetings with industry associations, financial institutions, and auditing firms.

Summary Assessment of Compliance of the Basel Core Principles for Effective Banking Supervision

A. General

46. This Report on the Observance of Standards and Codes (ROSC) for the Basel Core Principles for Effective Bank Supervision was prepared by a team of two independent bank supervision experts.¹⁶ The report provides a summary of the level of observance of the regulation and supervision of banks licensed by the Central Bank of Cyprus (the CBC) with the Basel Core Principles.

B. Institutional and Macprudential Setting, Market Structure—Overview

47. The main event affecting the financial sector and its supervision since the 2001 Module 2 assessment has been the Cyprus accession to the European Union (EU) in May 2004. Major institutional and regulatory reforms, many affecting the financial sector, have been put in place as a result. While these have taxed the public and private sectors, they are expected to benefit growth. Following a relatively weak performance in 2003–04, the economy recovered with real growth expected at 3.4 percent in 2004 and 3.8 percent in 2005. Recovery has been led by consumption fed by fiscal easing and, possibly, a confidence effect from entry to the EU, though sluggish tourist spending lowered the contribution of expanded arrivals.¹⁷ Unemployment remains low by European standards, while inflation has crept up modestly on rising energy prices.

48. The sector (“finance, insurance, real estate”) reflecting international services is, at 22 percent of GDP, the single greatest contributor to real output, and remains an important factor in economic growth, with real growth of 2.7 percent in 2003. Output in the second most important sector, tourism (20 percent of real GDP in 2003), declined by 0.4 percent in real terms in 2003.

49. The **Cypriot banking sector** has two distinct components, although differences are diminishing with the obligations of EU accession: the domestic banking system and the international banking units. The domestic credit institutions consist of 11 commercial banks, three specialized institutions, and 358 cooperative credit institutions (see Table 2). Domestic commercial banking is dominated by three banks which together hold about 70 percent of system assets, excluding the cooperative credit institutions but including the Cooperative

¹⁶ Marcel Maes (Belgium) and Timothy Sullivan (USA)

¹⁷ See IMF Country Report No. 05/107, *Cyprus—Staff Report for the 2004 Article IV Consultation*, January 31, 2005.

Central Bank, and about half of system assets, including the cooperatives.¹⁸ The three largest, Bank of Cyprus, Cyprus Popular Bank (Laiki), and Hellenic Bank, all locally owned, are all international groups with operations in both financial (insurance, asset management) and nonfinancial areas. The three specialized institutions are the Mortgage Bank of Cyprus (a subsidiary of the Bank of Cyprus), which lends longer term for tourism and manufacturing, the Cyprus Development Bank which, in addition to standard development bank services, does consulting, and the Housing Finance Corporation, which provides long-term housing loans to low and middle-income families. The latter two are publicly owned, but total assets of the three are only a small proportion of banking system assets.

50. Currently, there are 26 international banking units operating in Cyprus, 2 of which also carry on domestic banking business (Arab Bank PLC headquartered in Jordan and Société Générale of France).¹⁹ UBS AG has a representative office. They have a wide range of ownership origin but the largest are Kommunalkredit International Bank Ltd. (Austria), DePfa Investment Bank Ltd. (Ireland), Russian Commercial Bank (Cyprus) Ltd., Crédit Suisse First Boston (Cyprus), Ltd (Switzerland), and Barclays Bank PLC (United Kingdom). In preparation for joining the EU, Cyprus amended its tax laws in July 2002 to introduce a uniform rate of tax (10 percent) on all enterprises, including banks, irrespective of residence of the owner. As a result, as of January 1, 2003, the privileged tax treatment of nonresidents was removed but foreign enterprises could elect, for a transitional period terminating at end-2005, to maintain the lower tax rate (4.25 percent), continuing to deal primarily with nonresidents. With the abolition of exchange controls, IBUs who opted to be taxed at 10 percent may provide services to residents. All IBUs will be treated similarly at end-2005.

51. The **cooperative credit institutions** cater—as is usual—to members and operate in the context of a cooperative movement that includes manufacturing and marketing cooperatives which the credit institutions “self finance.” They hold about one quarter of system deposits. A licensed commercial bank, the Cooperative Central Bank Ltd., provides banking and other services to the cooperative credit institutions, accepting their surpluses as deposits, and lending to them as necessary.

C. Main Findings

52. Prudential regulations and powers for the **Cypriot banking sector** are strong and the supervisory process, in general, is effective. This opinion is supported by the fact that all core principles were considered to be compliant or largely compliant.

53. No issues are really predominant. However, the increased demands on the staff of the supervisory department of the Central Bank of Cyprus that supervises the banks, and which

¹⁸ Information from Fitch Sovereign Ratings for Cyprus, August 17, 2004. The banks’ published consolidated balance sheets do not provide financial information for the individual banking entities.

¹⁹ An additional three IBUs are licensed but non-operational.

are related to the accession of Cyprus to the EU and the development and innovation process of the financial sector, requires a number of additional adequately trained and experienced staff. The supervisory authority might also wish to develop and circulate a comprehensive framework of guidelines regarding country and market risk, and finalize the ongoing implementation of the more stringent criteria for the suspension of the recognition of interest on problem loans.²⁰

54. The **cooperative credit institutions** are supervised by the Cooperative Societies' Supervision and Development Authority (CSSDA). They have heretofore been subject to fewer regulations; however, the need to be in line with EU banking directives requires all cooperative credit cooperatives to be compliant by end-2007 with an impressive number of additional requirements pertaining to their organization, internal controls and audit systems, corporate governance and sharp improvement of their prudential ratios. The smaller and weaker ones may have to merge in order to do so and those unable to meet the requirements individually have the option of affiliating themselves with the Cooperative Central Bank and meeting the prudential requirements on a consolidated basis.

D. Principle-by-Principle Findings for the Banks

Objectives, autonomy, powers, and resources (CP 1)

55. Prudential regulations are sound. The CBC is to be commended for the actions taken to enhance Cyprus' regulatory regime and its endeavor to meet international standards.

Licensing and structure (CPs 2–5)

56. An effective licensing authority is in place supplemented by fair and equitable criteria to ensure a consistent approach is applied to permissible activities and ownership.

Prudential regulations and requirements (CPs 6–15)

57. CBC requires licensed banks to maintain an amount of capital commensurate with the nature and scale of its risks. In practice, all Cyprus' banks are operating at capital adequacy levels in excess of the required minimum of 10 percent. As to the more stringent rules on the suspension of interest recognition established in 2004, Cyprus will only gain full compliancy at the end of the transition period on January 1, 2006.²¹ Although market risks are rather limited for the moment, the CBC should require banks to put in place a number of systems

²⁰ In December 2005, the CBC issued the "Directive on the suspension of interest and other income on nonperforming credit facilities," which imposed the 90-day rule for the classification of credit as nonperforming and defined the procedures for interest suspension. The Directive came into force on January 1, 2006.

²¹ See Footnote 20.

and procedures in order to acknowledge the special nature of market risk and enhance its management.

Methods of ongoing supervision (CPs 16–20)

58. Although there are no material differences between the CBC's supervision of domestic banks and its international banks, it has to be noted that for the international banks, the CBC established a risk-focused on-site supervision program in January 2005.²² On-site examinations are to be conducted annually for the domestic banks and the subsidiaries of foreign banks and every two years for the branches of foreign banks. CBC conducts on-site examinations at branches and subsidiaries of its banks located overseas, and promotes cooperative arrangements and exchanges of information with host country supervisors.

59. The off-site supervision function reviews data from various returns. The accuracy of these returns is independently verified during the on-site examinations. CBC supplements its on-site supervision program with a series of tri-lateral meetings held annually with senior management of each bank and the external auditor. The meetings are held to review financial performance, market conditions, supervisory issues, and strategic plans. Additional meetings are held with external auditors.

Information requirements (CP 21)

60. CBC has established requirements for adequate accounting, records, and internal control systems and determines whether each bank has satisfactory accounting processes and internal control systems.

Formal powers of supervisors (CP 22)

61. CBC has extensive legal powers where a bank fails to comply with any of the provisions of the banking law.

Cross-border banking (CPs 23–25)

62. CBC practices consolidated supervision globally by undertaking on-site examination of the branches and subsidiaries of Cyprus' banks located overseas. A dialogue with host country supervisors is arranged during the on-site examinations of overseas subsidiaries/branches. MOUs have been signed with a number of overseas supervisors.

²² In January 2006, a similar program was established for domestic banks.

Table 1. Banks: Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
CP 1.2 Independence	Additional qualified supervision staff is needed to meet the requirements from i) validation and monitoring of banks' risk systems and models; ii) commitments for work with EU institutions; iii) additional demands for cross-border supervision resulting from banks' expansion abroad.
CP 8 Loan Evaluating and Loan Loss Provisioning	Finalize implementation of the more stringent criteria for interest suspension.
CP 11 Country Risk	Establish formal guidance for a framework for country and transfer risk.
CP 12 Market Risks	Improve market risk expertise and supervision.

Authorities' response

The CBC welcomes the assessors' recognition of the overall quality and effectiveness of Cyprus's banking regulatory and supervisory framework in place and the resulting very high degree of compliance with the Basel Core Principles.

Following is the CBC's Action Plan to address the specific recommendations cited in the report:

Reference Principle	Planned Action
CP 1.2 Independence	The CBC aims at taking all necessary steps to strengthen its Banking Supervision and Regulation Division in all aspects, in order to meet the increased demands emerging from Cyprus's accession to the EU and the development and innovation process of the banking sector.
CP 8 Loan Evaluating and Loan Loss Provisioning	In December 2005, the CBC issued a "Directive on the suspension of the recognition of interest and other income on non-performing credit facilities" which took effect on 1 st January, 2006 and by which the "90 days" rule has been applied in full conformity with international practice..
CP 11 Country Risk	The CBC shall proceed with the drafting of guidelines to banks for the management of country and transfer risk in the near future.

Reference Principle	Planned Action
CP 12 Market Risks	Although the level of activities of banks in Cyprus which can generate market risk remains low, the CBC aims at enhancing the scope of its supervision to ensure that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the internal systems/models used to measure market risk as provided in the EU Capital Requirements Directive, which shall come into force on the 1 st January, 2007. Market risk expertise shall be enhanced by additional training provided by the Financial Stability Institute of the Bank for International Settlements as well the supervisory authorities of other EU countries such as the UK, France, Germany and the Netherlands, to specialised staff of the Banking Supervision and Regulation Division of the CBC.

E. Principle-by-Principle Findings for the Cooperative Credit Institutions

Objectives, autonomy, powers, and resources (CP 1)

63. Prudential regulations have been adapted to the *acquis communautaire*, and the authorities are to be commended for the actions taken to enhance Cyprus' regulatory regime and its endeavor to meet international standards. However, during a transitional period that will only end on December 31, 2007, the CCIs are allowed to continue their activities without having to comply with the international standards. During this period, the CSSDA will have to develop its supervisory capacity, issue administrative rules, guidelines and best practices papers and encourage the restructuring of the predominantly small CCIs. The support and unwavering efforts of the authorities will be essential to the success of this operation. The dramatically extended responsibilities and objectives assigned to the CSSDA will necessitate additional experienced staff which will have to be facilitated by an appropriate salary system.

Licensing and structure (CPs 2–5)

64. An effective licensing authority is in place supplemented by fair and equitable criteria. However, permissible activities should be defined by regulatory decision.

Prudential regulations and requirements (CPs 6–15)

65. Again, during the transitional period, CCIs will not be subjected to mandatory new capital adequacy requirements. However, the supervisor should enhance his monitoring capabilities in order to allow for timely action if need be. Enhanced prudential reporting should also be installed regarding loans, whereas increased supervisory capacity should facilitate oversight of large exposures and connected lending, expertise regarding new types of risks, and vital organizational issues such as internal control systems of the CCIs. The updating of existing guidance notes on AML/CFT is also to be accelerated.

Methods of ongoing supervision (CPs 16–20)

66. On-site and off-site supervision will of course have to be adapted and developed to the dramatically extended responsibilities and objectives assigned to the CSSDA and will therefore necessitate additional experienced staff.

Information requirements (CP 21)

67. Regulative decisions are in place regarding the establishment of accounts and their auditing according to international standards.

Formal powers of supervisors (CP 22)

68. A range of remedial measures can be used where a CCI fails to comply with any of the provisions of the law.

Cross-border banking (CPs 23–25)

69. No cross-border financial services are performed by the CCIs.

Table 2. Cooperative Credit Institutions: Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
CP 1.1 Objectives	Manage changes during the transitional period through a global change committee.
CP 1.2 Independence	Full government support of supervisory strengthening capacity.
CP 2 Permissible Activities	Finalize regulatory decision defining permissible services and activities.
CP 5 Investment Criteria	Finalize regulatory decision regarding participation in other enterprises.
CP 6 Capital Adequacy	Mandatory semi-annual reporting on each CCI's compliance with capital requirements regime.
CP 7 Credit Policies	Strengthen supervisory capacity. Enhance the supervisors' capacity to evaluate loan policies.
CP 8 Loan Evaluation	Strengthen supervisory capacity. Provide for additional prudential reporting.
CP 9 Large Exposure Limits	Strengthen supervisory capacity.
CP 10 Connected Lending	Strengthen supervisory capacity. Facilities to connected persons should not be granted on favorable terms.
CP 12 Market Risks	Adjust and develop expertise to supervise new risks.
CP 13 Other Risks	Strengthen supervisory capacity. Organize accelerated access to centralized reporting system regarding interest rate risk.
CP 14 Internal Controls	Strengthen supervisory capacity. Undertake efforts to encourage mergers favoring critical mass and organizational capabilities of CCIs.

Reference Principle	Recommended Action
CP 15 Money Laundering	Update guidance note.
CP 16 On-site and Off-site Supervision	Strengthen supervisory capacity.
CP 17 Bank Management Contact	Impose mandatory and timely communication of material changes in activities and adverse developments.
CP 18 Off-site Supervision	Strengthen supervisory capacity. Accelerate direct connection to central data server.
CP 19 Validation of Supervisory Information	Strengthen supervisory capacity.

Authorities' response

Recommended Actions	Planned Action
CP 1.1 Objectives : Manage changes during the transitional period through a global change committee.	Changes during the transitional period are managed through strong cooperation between the CSSDA, the Cooperative Central Bank, the Pancyprian Cooperative Confederation and the Audit Office of Cooperative Societies.
CP 1.2 Independence Full government support of supervisory strengthening capacity	The Parliament has approved the enhancement of CSSDA (Official Gazette July 2005). The scheme provides for 17 additional staff and the upgrading of the salary levels of the officers. Fourteen officers from the additional staff will reinforce the supervisory staff, tripling the present supervisory resources.
CP 2 Permissible Activities Finalize regulatory decision defining permissible services and activities. Make provision that the term "Cooperative Credit Institution" or any derivative of this term cannot be used without the approval of the CSSDA	A Regulatory Decision will be issued as soon as possible.
CP 5 Investment Criteria Finalize regulatory decision regarding participation in other enterprises.	A Regulatory Decision will be issued as soon as possible.
CP 6 Capital Adequacy Mandatory semi-annual reporting on each CCI's compliance with capital requirements regime.	The Committee has approved a new Regulative Directive introducing CAD II. This decision was published in the Official Gazette in April 2005. Based on the above, a Commissioner's Directive is going to be issued regarding the mandatory semi-annual reporting on each CCI's compliance with capital requirements regime.
CP 7 Credit Policies Strengthen supervisory capacity. Enhance the supervisors' capacity to evaluate loan policies.	Recruitment of additional staff (see CP 1.2 above). Further relevant training will be undertaken.

Recommended Actions	Planned Action
<p>CP 8 Loan Evaluation Strengthen supervisory capacity. Provide for additional prudential reporting</p>	<p>The CSSDA is working to design and build new automated analytical monitoring and early-warning systems that will use information provided by those CCIs that are and will be connected through the central server of the Cooperative Computer Society. Additional prudential reporting for loan loss provisions will be required.</p>
<p>CP 9 Large Exposure Limits Strengthen supervisory capacity.</p>	<p>The CSSDA is currently revising and updating its return on large exposures. A Regulatory Decision will be issued as soon as possible.</p>
<p>CP 10 Connected Lending Strengthen supervisory capacity. Facilities to connected persons should not be granted on terms more favorable than those used in the normal course of business.</p>	<p>An amendment of the Law in order to explicitly provide for that, will take place.</p>
<p>CP 12 Market Risks Adjust and develop expertise to supervise new risks.</p>	<p>Relevant training will be undertaken.</p>
<p>CP 13 Other Risks Strengthen supervisory capacity. Organize accelerated access to centralized reporting system regarding interest rate risk.</p>	<p>This information is currently available to the management of the CCIs. The CSSDA supervisors will have direct access when the project of prudential reporting is completed.</p>
<p>CP 14 Internal Controls Strengthen supervisory capacity. Undertake efforts to encourage mergers favoring critical mass and organizational capabilities of CCIs</p>	<p>Due to the ongoing efforts to encourage mergers in the Cooperative Credit Sector we have already reached promising results. In the first half of this year the number of Cooperative Credit Institutions due to the merging procedure has decreased from 358 to 348.</p>
<p>CP 15 Money Laundering Update guidance note.</p>	<p>Guidance notes by CSSDA have been finalized and issued on 16/05/2005.</p>
<p>CP 16 On-site and Off-site Supervision Strengthen supervisory capacity.</p>	<p>Recruitment of additional staff (see CP 1.2 above) and Continuous Training.</p>
<p>CP 17 Bank Management Contact Impose mandatory and timely communication of material changes in activities and adverse developments.</p>	<p>Relevant Regulatory Decision will be issued as soon as possible.</p>
<p>CP 18 Off-site Supervision Strengthen supervisory capacity. Accelerate direct connection to central data server.</p>	<p>The CSSDA has accelerated direct connection to the central data server and use information provided by those CCIs that are and will be connected through the central server of the Cooperative Computer Society.</p>
<p>CP 19 Validation of Supervisory Information Strengthen supervisory capacity.</p>	<p>Recruitment of additional staff (see CP 1.2 above).</p>

Summary Assessment of Observance of the Insurance Core Principles

A. General

70. This section provides summary findings from the assessment of the IAIS Core Principles. The assessment was based on discussions held with the Superintendent of Insurance and her deputy, the staff of the Insurance Company Control Service (ICCS), representatives from domestic insurance companies, the Insurance Association of Cyprus, an auditor, and the Association of Actuaries of Cyprus. The assessment considered several documents:

- Law on Insurance Services and Other Related Issues of 2002 (LIS);
- Amendments I to V to the LIS;
- Guidance for the submission of an application to carry on insurance business;
- Guidance notes on the completion of the annual returns under the LIS;
- Orders concerning the format and contents of annual accounts;
- Report on Insurance in Cyprus for the years 1983–2002; and
- The Audit of Insurers in Cyprus, published by the Institute of Certified Public Accountants of Cyprus.

71. The assessment took account of annual returns and market trends at December 2003.²³

72. In addition to the Insurance Core Principles, the relevant EU directives were also considered.

B. Institutional and Macprudential Setting—Overview

73. The Cypriot market is relatively small and highly fragmented. There are about 44 companies being supervised and approximately 1,600 agents active in the distribution of insurance products. The Cypriot insurance market ranks as follows:

²³ Information was updated for end 2004 following the mission.

Table 1. Market Share Rankings in World and European Markets

Line of Business	World Market Rank	European Market Rank (of 34 countries)
Total Market	56	28
Life Insurance	51	25
General Lines	67	31

74. The following tables show the distribution of financial variables by line of business in 2003 and 2004:

Table 2. Insurance Sector's Domestic Financial Variables by Line of Business, 2003 and 2004

	Gross Written Premium	Net Earned Premium	Assets	Equity	Technical Reserve	Under- writing Result
(in thousands of Cyprus pounds)						
Non-Life						
2003	105,157	59,386	199,226	57,934	109,221	1,996
2004	125,445	74,272	228,566	67,045	126,425	9,048
Life						
2003	151,418	150,340	795,251	58,490	693,160	6,614
2004	151,578	132,381	819,419	63,913	709,771	10,828
Composite						
2003	29,948	24,279	76,288	16,061	50,031	-889
2004	32,979	27,098	82,722	14,610	57,481	-496
Total Market						
2003	286,523	234,005	1,070,765	132,485	852,412	7,721
2004	310,002	233,751	1,130,707	145,568	893,677	19,380

Source: Insurance Companies Control Service

Table 3. Financial Variables by Line of Business for Insurance Companies Transacting Business Outside of Cyprus, 2003 and 2004

	Gross Written Premium	Net Earned Premium	Assets	Equity	Technical Reserve	Under- writing Result
(in thousands of Cyprus pounds)						
Non-Life						
2003	56,884	29,523	104,237	52,213	36,981	4,362
2004	163,888	140,211	197,843	92,320	108,474	32,393
Life						
2003	68,050	67,983	431,066	15,688	398,949	-1,451
2004	48,851	47,070	378,553	27,957	310,850	8,775
Composite						
2003	4,239	6,826	30,443	20,969	9,426	1,981
2004	9,156	9,058	33,668	22,724	10,985	2,484
Total						
2003	129,173	104,332	565,746	88,870	445,356	4,892
2004	221,895	196,339	610,064	143,001	430,309	43,652

Source: Insurance Companies Control Service

75. The leading three life insurance companies have 80 percent of the whole market and these are owned by the leading banks of Cyprus.

76. The general lines market is more fragmented with a total of 30 companies under supervision in 2004 (with only 28 writing business). Only five companies have GWPs of more than £C 10 million. Ten companies have market shares of less than 1 percent each. In both life and general lines, the wide variation in company size implies that the variance in professionalism is significant. Most companies are operating from a family-based platform.

77. The supervision in fact takes a ring-fencing approach against total failure rather than seeking to establish a secure and stable financial infrastructure for the domestic market.

78. Whether all companies in the market will be able to meet future capital requirements, even at a minimum level, needs to be assessed.

C. Main Findings

Background

79. The market is too segregated. The number of companies is not sustainable since current return levels will not lead to or enable significant investment in the market. Further development therefore requires a strong improvement in professionalism which can be obtained and enforced through strict application of EU standards. The operational procedure in the Cypriot insurance market is very labor intensive. The 38 companies who are members of the Insurance Association of Cyprus currently employ 1,640 staff, implying a GWP of £C 250,000 per staff member. The number of agents is expected to drop from approximately 3,600 to 1,600 (the number currently active), but that would still imply an average portfolio of approximately £C 190,000 per agent. As the total market is very small and very fractured, it is unlikely that larger international insurance companies would enter the market.

80. Reserving levels are not satisfactory for a number of companies. Moreover, the reserving techniques recently introduced lead to higher reserving requirements. The existing capital positions of 14 companies are below the minimum requirements of the EU based on Solvency I.

Findings

81. With its current capacity, insurance supervision in Cyprus will not be able to respond adequately to major systematic shocks. The level of skills and resources provided to the SI is suboptimal. Nor is the level of regulation precise enough to set clear expectations for the supervised companies. The authorities should develop a plan of how the insurance supervision can be enabled to perform its duties in a more efficient manner. Adequate resources and skills should be determined, training and legal support should be improved.

82. The assessment against the insurance core principles has to be seen in the light of the existing constraints of the SI and the ICCS. Given the situation as described, improvements in the supervision of the insurance market will require substantial support, financially and politically. Adequate resources, in terms of both finance and skills, is absolutely essential to the performance of a supervisory authority.

83. The superintendent will have to improve regulation and supervisory guidelines. The existing draft of prudential standards is a good starting point. For the internal purposes of the ICCS, supervisory processes should be more clearly defined. The licensing process and rules on fit-and-proper criteria for individuals are in place and appropriate. A joint effort should be made by all regulatory authorities of Cyprus to define applicable rules on corporate governance.

84. More guidance should be given to insurance companies on internal control procedures, business continuity plans and insurance fraud. The SI should also stress the ability to act more preventively.

85. Reserving techniques and the assessment of liabilities should be more closely examined. At the time of the assessment, there were five insurance companies operating in the market with suboptimal reserving levels.²⁴ Assets not qualified as admissible to cover reserves should not be recognized for solvency purposes. Premium receivables should be depreciated and a strict aging structure should be requested to ensure that those assets can be materialized if needed.

Table 3. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Conditions for effective insurance supervision i.e., CP 1	Regulations need to be defined so as to set a framework in which insurance undertakings can operate and to create clear expectations of company from a supervisory standpoint.
Supervisory objectives i.e., CP 2	Clear objectives and measures should be defined for the ICCS. The ICCS should report on its achievements on a regular basis. Moreover, the ICCS should communicate through regulation how it wants the LIS to be applied.
Supervisory authority i.e., CP 3	The SI should be granted a budget in order to perform the duties laid out in the LIS. Also, the SI should be charged with producing a plan laying out the priorities over a year. Those plans would set clear expectations for the council of ministers and the staff of the ICCS. Most importantly, there is an urgent need to assess the composition of skills required to exercise the powers of the LIS. Whether all the skills identified will have to be allocated within the ICCS remains to be seen. At the time this assessment was carried out, the resources provided to the SI were not adequate for insurance supervision responsive to critical situations.
Supervisory process i.e., CP 4	More standardized internal procedures would permit more efficient operations. Also, publications should be made available to the public.
Supervisory cooperation and information sharing i.e., CP 5	Since Cyprus joined the EU in May 2004, there has been no substantial information sharing. In 2005, the SI should contact home supervisors to identify how many of the companies under the FoS have actually started business activities.
Licensing i.e., CP 6	None
Suitability of persons i.e., CP 7	None

²⁴ The authorities point out that the companies had been required to increase their reserves.

Reference Principle	Recommended Action
Changes in control and portfolio transfers i.e., CP 8	None
Corporate governance i.e., CP 9	There should be a joint effort to develop governing rules for undertakings in the financial sector. These rules should be developed by all four supervisory authorities.
Internal control i.e., CP 10	Define standards on internal control as an essential part of sound insurance principles, and enforce those standards through reporting and auditing requirements.
Market analysis i.e., CP 11	The SI should identify the information about the insurance sector required or of interest to other public services. She should also define all information necessary to a market analysis of the insurance sector and determine the process through which this information will be received and updated.
Reporting to supervisors and off-site monitoring i.e., CP 12	Company data should be stored electronically once received. Also, companies should be required to submit the relevant forms in signed hardcopies and on electronic files in prescribed formats. That would allow the ICCS to have updated information on requests without longer delays and manual effort. There should also be a procedure to provide some degree of plausibility testing of received data.
On-site inspection i.e., CP 13	Gain agreement from the MoF to obtain the right to contract third parties to support on-site inspection. Develop a plan to perform regular on-site inspections without the need for evidence that an inspection is deemed to be necessary.
Preventive and corrective measures i.e., CP 14	The ICCS should develop a set of regulatory rules which would prevent noncompliance instead of deciding on corrective measures subsequent to discovery of noncompliance. Although the emphasis will be on corrective measures, the ICCS should consider whether the development of preventive measures could also contribute to a more efficient allocation of resources within the ICCS.
Enforcement or sanctions i.e., CP 15	The MoF should review whether the variety of cases in which an appeal is possible could be reduced.
Winding-up and exit from the market i.e., CP 16	As s157 requires the SI to appoint a liquidator, the ICCS should have a shortlist of potential candidates in order to shorten the appointment process. That list should be part of the process of withdrawing a license.
Group-wide supervision i.e., CP 17	Incorporate relevant information exchange processes and terms of reference for the coordinator into the existing MOU.

Reference Principle	Recommended Action
Risk assessment and management i.e., CP 18	Initial steps toward risk management should be considered when internal control procedures, as laid out in Principle 10, have been put in place, and the other recommendations are implemented through the establishment of sound insurance guidance.
Insurance activity i.e., CP 19	The ICCS should ask the supervised companies to provide risk profiles stating the introduction of new products, availability of rating factors, and changes in their attitude to insurance risks.
Liabilities i.e., CP 20	The determination of appropriate reserves requires the ICCS to have both the ability to contract external resources and recruit further adequately skilled staff. It is therefore referred to the relevant recommendations on Principles 1 and 3.
Investments i.e., CP 21	The investment policy should be part of a risk profile which every insurance company should submit to the ICCS on a regular basis. Also, internal control procedures should cover initial procedures for investment decisions. To address operational risks, contingency plans should be required.
Derivatives and similar commitments i.e., CP 22	None
Capital adequacy and solvency i.e., CP 23	Verification of the timely collection of premiums paid in cash should be made an essential part of a company's internal control procedures. Large amounts of premium receivables could not then accumulate to the existing levels and would not therefore become a substantial issue. The solvency capital should be reported to the ICCS on a quarterly basis in order to avoid the delays that occur at present. There should be an awareness that it is unacceptable for companies to continue operation if they are unable to meet the minimum requirements.
Intermediaries i.e., CP 24	Given the range of tasks that must be undertaken by the supervisor, the planned allocation of resources could be reviewed.
Consumer protection i.e., CP 25	The SI could publish frequency of complaints received on a company level to initiate further incentives for companies to pay more attention to customer protection.
Information, disclosure & transparency towards the market i.e., CP 26	Improve contents and frequency of market report.

Reference Principle	Recommended Action
Fraud i.e., CP 27	See ICP10 recommendations for further details.
Anti-money laundering i.e., CP 28	A common approach should be identified. Also, resources to deal with STRs should be provided on an as-needs-basis. During the assessment of the life market, interviewed managers stated that most of the single premiums paid into unit-linked contracts have not been withdrawn from other forms of saving vehicles, but have been provided either in cash or from other accounts. The source of those premiums and how they have arrived at the life insurance companies, however, have not led to STRs to the SI.

Authorities' response

Reference Principle	Authority's Planned Action
Conditions for effective insurance supervision i.e., CP 1	Efforts are underway to outsource legal services for EU harmonization purposes. Within this context, legal services will also be sought for the implementation of the proposed recommended action.
Supervisory objectives i.e., CP 2	Efforts will be made to upgrade the existing «Report in Insurance in Cyprus», by including a more detailed reference to the ICCS and publishing it annually instead of once every two years.
Supervisory authority i.e., CP 3	This recommended action implies granting the ICCS full financial autonomy from the Government. This requires political decision which is currently under consideration by the Government with a view to rationalize the supervision of insurance and financial services in general. As regards the staffing of the ICCS, all the necessary procedures will be expedited in order to recruit the appropriate qualified staff the soonest.
Supervisory process i.e., CP 4	By the implementation of the previous three proposed recommended actions, a considerable improvement in the efficiency of operations is expected. However, at the same time a balance between efficiency and flexibility should be maintained. Also, the publications will gradually be made available to the public.
Supervisory cooperation and information sharing i.e., CP 5	The ICCS will send by the end of this year a letter to all EU home supervisory authorities in order to implement this recommended action.

Reference Principle	Authority's Planned Action
Corporate governance i.e., CP 9	This recommendation has been discussed at the meeting of the heads of the supervisory authorities of the financial sector that took place on 11/10/2005. It has been decided that each supervisory authority will develop its own rules in close co-operation with each other.
Internal control i.e., CP 10	An initial discussion on this subject will take place within next year with the Institute of Certified Accountants followed by a further discussion with the Cyprus Association of Insurance Companies.
Market analysis i.e., CP 11	This is a subject directly linked to the adequate staffing of the ICCS. Comments under CP3 regarding staffing are relevant.
Reporting to supervisors and off-site monitoring i.e., CP 12	This is a subject directly linked to the computerization of the ICCS. Tender proposals have already been submitted for the development of the appropriate software from the private sector and they are currently under evaluation by a special committee appointed for this purpose. This procedure is expected to be completed by May 2006.
On-site inspection i.e., CP 13	The ICCS will submit specific proposals to the MoF for the appropriate funding for such services. A plan for regular on-site inspections is being prepared in parallel.
Preventive and corrective measures i.e., CP 14	If the upgrading of the ICCS with qualified staff takes place within the next 2–3 years, then the implementation of this recommended action will also take place in parallel.
Enforcement or sanctions i.e., CP 15	Discussions are underway between the MoF and the ICCS for the review of the appeal process.
Winding-up and exit from the market i.e., CP 16	As liquidation of insurance companies does not take place very often, the provisional liquidator who is appointed by the Superintendent of Insurance, will be an officer from the Office of the Registrar of Companies and Official Receiver.
Group-wide supervision i.e., CP 17	It is expected that within the first semester of next year, the implementation of this recommendation will take place.
Risk assessment and management i.e., CP 18	This recommended action will be implemented in the future following the implementation of all the recommended relevant actions mentioned previously.

Reference Principle	Authority's Planned Action
<p>Insurance activity i.e., CP 19</p>	<p>A letter will be addressed in the near future by the ICCS to all insurance companies requesting them to submit this proposed information. It should be noted that assessment of the submitted information will require the possession of appropriate skills and knowledge within the ICCS. Therefore, the timing of the implementation of this proposed action is directly linked to the comments under CP3.</p>
<p>Liabilities i.e., CP 20</p>	<p>This recommended action is directly linked with the implementation of the recommended action under CP3, especially with regard to the adequate staffing of ICCS both in absolute numbers and in appropriate skills.</p>
<p>Investments i.e., CP 21</p>	<p>This recommended action is directly linked with the adequacy of the staffing of the ICCS both in absolute numbers and in appropriate skills. Comments under CP3 are relevant.</p>
<p>Capital adequacy and solvency i.e., CP 23</p>	<p>Early next year a letter will be addressed to all insurance companies in order to implement this recommended action.</p>
<p>Intermediaries i.e., CP 24</p>	<p>This recommended action will be reviewed with a view to reducing the planned allocation of resources for intermediaries.</p>
<p>Consumer protection i.e., CP 25</p>	<p>The ICCS does not have the legal right to examine complaints. In this respect a Bill has been drafted for the establishment of a Financial Ombudsman. In this context this recommended action could be implemented.</p>
<p>Information, disclosure & transparency towards the market i.e., CP 26</p>	<p>Efforts will be made to upgrade the existing «Report in Insurance in Cyprus» and publish it annually instead of once every two years.</p>
<p>Fraud i.e., CP 27</p>	<p>Please see comments under CP10</p>
<p>Anti-money laundering i.e., CP 28</p>	<p>The implementation of this recommended action is directly linked to the carrying out on site inspections. Comments under CP13 are relevant.</p>

A. Summary Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation

A. General

86. The assessment was undertaken as part of the offshore financial center assessment program. It was based on the IOSCO Assessment Methodology of October 2003 for Assessing Implementation of IOSCO's Objectives and Principles of Securities Regulation.

87. The main securities supervisory authority in Cyprus is the Securities and Exchange Commission (CySEC). It was established in 2001 and supervises the Stock Exchange, retail collective investment schemes, market intermediaries and issuers of securities on the Stock Exchange. There are two investment services activities carried out by (i) international collective investment schemes, and (ii) independent financial advisory firms, which are supervised by the CBC. Both services are offered almost exclusively to nonresidents.

88. The main pieces of legislation governing the securities area are the CySEC Law (2001–2004) which established CySEC and the Stock Exchange Law (1993–2005) which established the Stock Exchange. The Exchange Control Law, now revoked, was the basis of the Central Bank's role in the supervision of international financial activities. The Stock Exchange has a limited self-regulatory role in respect of some of its activities. Apart from the Exchange there are no self-regulatory organizations in Cyprus. There is, however, an Association, namely the Cyprus International Financial Services Association (CIFSA), established at the instigation of the CBC, whose purpose is to promote and protect the interests of its members which are international financial services companies. CIFSA acts as a liaison with the financial supervisory authorities in Cyprus. It also examines the complaints filed by investors against its members.

89. In addition to the above named laws, the assessment was based on the self assessments completed by both CySEC and the Central Bank. This information was supplemented by information provided by both authorities and data available on the website. Detailed discussions were held with CySEC, the Central Bank, and the Stock Exchange as well as with relevant private sector companies, representative bodies, the accountancy supervisor, and accountancy firms.

90. Cooperation was freely given by all concerned.

B. Information and Methodology used for Assessment

91. The Stock Exchange is state owned, has a relatively small number of listed companies (18 main and 137 supplementary listings), and turnover is very modest and fluctuating—in the region of \$500,000 daily at the end of April 2005, down from \$1.8 million in the first 75 trading days of the year. In 1999/2000, two years after it was established, the exchange witnessed a severe collapse in market prices—its index fell from about 800 to 80 points in the course of a year and a half.

92. There are 47 authorized market intermediaries, generally offering a broad range of investment services. Thirty-two of these intermediaries offer their services almost exclusively to nonresidents. The remaining 15 intermediaries offer their services locally; many of them are members of the Stock Exchange.

93. The retail collective investment scheme sector is in its infancy in Cyprus. Cyprus has just transposed into national law the recently adopted EU UCITS Directives but has not authorized any schemes to date.

94. There are about 15 authorized non-retail collective investment schemes with a net asset value of about \$400 million. There are about 40 international financial advisors. Supervision of these will pass shortly to CySEC in keeping with the transposition of relevant EU legislation so that the only supervisory role remaining with the Central Bank in the area of securities is that of supervising non-retail collective investment schemes.

C. General Preconditions for Effective Securities Regulation

95. The regulatory regime has been very strongly influenced by Cyprus's membership of the European Union. Cyprus has transposed and continues to transpose the many securities regulatory directives of the EU, and its supervisory regime, laws, and regulations are almost exclusively based on the EU directives. Its legal, accounting, company law, and taxation regimes are heavily influenced by their U.K. equivalents. In the accounting area, Cyprus has adopted International Financial Reporting Standards (IFRS) and all statutorily based financial reporting must use the standards. Its accounting and auditing systems appear to be well supervised.

D. Principle-by-Principle Assessment

96. In general, the legislative supervisory framework is comprehensive. It has developed significantly in recent years as Cyprus prepared itself for EU membership. It had adopted all the relevant directives by the date of its accession in May 2004 and continues to do so as more and more EU securities directives are adopted.

97. At present, CySEC appears to have adequate staff resources. These appear to be well trained and competent and showed a detailed knowledge of their work.

98. The medium term challenges facing securities regulation will be the ability of CySEC to retain its current staff and to increase staff numbers as it assumes more responsibilities (e.g., the implementation of a number of significant new EU directives).

99. **Regulator (Principles 1–5).** The regulatory responsibilities of CySEC are generally clearly set down in legislation and CySEC appears to apply them in a clear and consistent manner. One area that requires clarity, however, is the respective roles of CySEC and the Stock Exchange in the supervision of issuers of securities (i.e., listed companies). CySEC's competency in this area has recently been questioned by the courts and an appeal is pending.

CySEC is also seeking an amendment to the Stock Exchange Law to put its regulatory role beyond doubt.²⁵

100. Currently, staff numbers appear adequate, but extra resources will be required in the near future to deal with extra responsibilities which CySEC will be required to assume, e.g., implementation of recently adopted EU directives. The current staff appear to have the requisite skill sets and competencies to carry out the responsibilities of CySEC effectively.

101. **Self-regulatory organizations (Principles 6–7).** Apart from a limited self-regulatory role of the stock exchange, there are no self-regulatory organizations in Cyprus.

102. **Inspections, investigations, and enforcement (Principles 8–10).** CySEC has wide powers of inspection, investigation, and enforcement. However, for constitutional and legal reasons it cannot supervise the Stock Exchange effectively (see below Principles 25–30—Principles for the Secondary Market).

103. **Information sharing and cooperation (Principles 11–13).** There is provision in the law allowing for the sharing of information with both domestic regulators and foreign regulators. However, CySEC cannot collect information and carry out investigations on behalf of foreign regulators unless it has an independent interest in the matter being investigated. CySEC has experienced difficulties in obtaining information identifying the beneficial owners of shares from lawyers acting as nominees on behalf of the beneficial owners. However, a forthcoming bill is expected to correct the above shortcomings.

104. **Issuers (Principles 14–16).** The public offering law, stock exchange law, and company law provide for accurate and timely disclosure of financial results and adequate safeguards for the fair and equitable treatment of shareholders, and there is no reason to believe that these laws are not being implemented effectively. Accounting and auditing standards are in line with best international practice. Cyprus has adopted International Financial Reporting Standards (IFRSs) for accounting purposes.

105. **Collective Investment Schemes (Principles 17–20).** There are two distinct collective investment schemes regimes in Cyprus. One is supervised by CySEC and is based on the EU UCITS Directives. These are targeted at the retail market and can be marketed to Cyprus and non-Cyprus residents alike. The relevant UCITS legislation has just been adopted in Cyprus, and, to date, no Cyprus UCITS has been authorized. The legislation is comprehensive, but CySEC needs to introduce specific rules for the valuing of assets other than shares in publicly quoted companies held by UCITS. CySEC intends to have these rules in place before any UCITS are authorized.

106. The second type—international collective investment schemes—are not marketed to the public and are largely targeted at nonresidents. About 15 such schemes have been

²⁵ The authorities have indicated that the planned amendment to the Stock Exchange Act was enacted in September 2005. It is expected to have provided the necessary clarification for CySEC's regulatory role.

authorized to date with a total net asset value of about \$400 million. There are two types of schemes: (i) those marketed to experienced investors and carrying a minimum investor subscription of \$50,000; and (ii) private schemes which restrict the number of investors to 100. These schemes are supervised and regulated by the CBC, which is the regulatory authority for such schemes under the provisions of the International Collective Investment Schemes Law, 1999.

107. **Market Intermediaries (Principles 21–24).** All market intermediaries with the exception of investment advisors (investment advisors give advice only; they do not, for instance, receive or execute orders, hold client assets or manage investment portfolios) must be authorized by CySEC. Following the transposition of the recently adopted EU Markets in Financial Instruments Directive, which recognizes investment advice as a core investment service for the first time, investment advisors, of which none currently exist in the domestic market, will fall to be supervised as an investment intermediary by CySEC.

108. There are 47 market intermediaries authorized by CySEC, generally offering a broad range of services. Thirty-two of these intermediaries offer their services almost exclusively to nonresidents and were previously categorized as international financial intermediaries supervised by the Central Bank. The remaining 15 intermediaries generally offer their services locally; many provide stock-broking services. The CBC continues to supervise the international financial services companies that offer only investment advice so as to avoid a regulatory gap until the transposition of the EU directive referred to above, when these firms will fall to be supervised by CySEC. There are about 40 of these.

109. The legislative regime for the supervision of market intermediaries and its implementation appear effective.

110. **Principles for the Secondary Market (Principles 25–30).** CySEC is charged with the supervision of the Stock Exchange. However, it faces a particular difficulty in carrying out this function. CySEC, like the Stock Exchange, is a public administrative body and one public administrative body cannot supervise another public administrative body. Consequently, it cannot legally apply a whole range of regulatory tools, such as the imposition of conditions or restrictions, nor has it ever carried out an inspection of the exchange because of these constitutional difficulties. It could, in extreme circumstances, through a circuitous route involving the Council of Ministers, order the temporary suspension of the exchange. In practice, CySEC and the exchange appear to have a satisfactory supervisor/supervisee relationship; for example, CySEC monitors trading on the exchange on a real-time and daily basis.

111. The Stock Exchange is the only securities exchange in Cyprus. It has exclusive rights to undertake stock market transactions in movable securities in Cyprus. This is for political and historical reasons related to the nongovernment controlled areas issues, and not to restrict new entrants into the market. In any event, Cyprus will be required to establish exchange authorization criteria when the recently adopted EU Markets in Financial Instruments Directive is transposed into Cyprus law.

E. Recommended Actions

112. **Principle 26.** Legislation should be introduced as a matter of urgency to allow CySEC to supervise effectively the Stock Exchange. This would entail a revision to the equal constitutional status of both bodies whereby CySEC as a public administrative body cannot supervise the exchange, another public administrative body.

113. **Principle 11.** It is recommended that the authorities remove the obstacle that prevents CySEC from sharing information and carrying out investigations on behalf of foreign regulators in situations where CySEC does not have an independent interest in the matter being investigated. It is noted that this issue will be addressed in forthcoming legislation.

114. **Principle 13.** In the interests of being able to cooperate fully with foreign regulators, it is important that the legal uncertainty surrounding CySEC's ability to obtain information identifying the beneficial owners of shares which are registered in the names of lawyers acting as nominees on behalf of beneficial owners. It is noted that CySEC is seeking an amendment in forthcoming legislation to remove the uncertainty.

115. **Principle 1.** The uncertainty surrounding the respective responsibilities of CySEC and the Stock Exchange in the supervision of issuers of securities should be addressed as a matter of urgency to bring clarity to the situation. It is noted that an appropriate amendment is to be made to the Stock Exchange Law.²⁶

116. **Principle 20.** It is recommended that for UCITS, CySEC introduced specific rules for the valuing of assets other than shares in publicly quoted companies. It is understood that such rules are currently being drafted.

117. **Principle 17.** It is recommended that the Central Bank take a more proactive role, e.g., through the inspection process, in ensuring that no members of the public are investing in the non-retail (that is, ICIS sold to experienced investors and private ICISs) collective investment schemes.²⁷

118. **Principle 2.** It is recommended that the provision in the CySEC Law whereby CySEC must provide the Minister of Finance with any information he may deem necessary for the benefit of the public interest should be revoked to maintain without question the

²⁶ See Footnote 25.

²⁷ In accordance with the ICIS law, private/non-retail ICIS can have a maximum of 100 investors. No such limit exists for public/retail ICIS. The CBC's position is that through (a) its approval of a private/non-retail ICIS's constitutional documents; (b) its offsite review of prudential; and (c) its conduct of ongoing inspections; it can ensure that the number of investors in private/non-retail ICIS does not exceed 100. Hence, the comment made by the assessors that the CBC should ensure that "no members of the public are investing in the non-retail collective investment schemes" is, in the opinion of the CBC, non-applicable.

operational independence of CySEC. It is noted that this issue will be addressed in forthcoming legislation.

119. **Principle 3.** While staff numbers appear to be generally adequate at present, extra resources will be required in the future to cope with the expanding workload of CySEC, e.g., the implementation of new EU Directives.

F. Authorities' Response

Reference Principle	Authorities' Response
Principles Relating to the Regulator (P 1–5)	<p><i>Principle 1</i></p> <ul style="list-style-type: none"> On the 9th of September 2005, three laws came into force in the Republic of Cyprus, which go a long way towards bringing greater clarity to the respective responsibilities of CySEC and the Cyprus Stock Exchange. The first (Law N. 115(I)/2005) is a law providing for significant amendments to the Stock Exchange Law, and clearly designates the responsibilities of the Cyprus Stock Exchange and the CySEC regarding issuers, so as to remove ambiguities and overlaps in the exercise of their respective competencies which existed in the previous legal regime (for example, in the supervision of issuers and the imposition of sanctions). The other two are laws designed for the transposition into domestic law of the EU Prospectus Directive (Law N. 114(I)/2005) and the EU Market Abuse Directives (Law N. 116(I)/2005) and the complete harmonization of the legal regime in Cyprus with the European <i>acquis communautaire</i> in the respective areas. <p><i>Principle 2</i></p> <ul style="list-style-type: none"> CySEC is finalizing the drafting of a bill amending the CySEC Law, under which the provision currently contained in the CySEC Law whereby CySEC must provide the Minister of Finance with information, is revoked. It is expected that this bill will be enacted into law in 2006. <p><i>Principle 3</i></p> <ul style="list-style-type: none"> CySEC plans to significantly increase the numbers of its skilled staff in the following months in order to meet its increased responsibilities. Its budget approved and voted for by the Parliament for the 2006 financial year provides for a 29% increase in the budget allocated for staff costs.
Principles for Cooperation in Regulation (P 11–13)	<p><i>Principle 11</i></p> <ul style="list-style-type: none"> CySEC is finalizing the drafting of a bill amending the CySEC Law, under which the obstacle in sharing information and carrying out investigations on behalf of foreign regulators in situations where CySEC has no independent interest in the matter being investigated, is removed. It is expected that this bill will be enacted into law in 2006. <p><i>Principle 13</i></p> <ul style="list-style-type: none"> CySEC has proposed appropriate amendments to the CySEC law in order to give CySEC clear authority to secure information on the identity of beneficial owners of shares which are registered in the names of lawyers acting as nominees of the beneficial owners. The enactment of this bill is expected to take place in 2006.

Reference Principle	Authorities' Response
Principles for Collective Investment Schemes (P 17–20)	<p><i>Principle 20</i></p> <ul style="list-style-type: none"> No schemes have been authorised by CySEC to-date. CySEC undertakes to have these rules in place before any such authorisation is given.
Principles for the Secondary Market (P 25–30)	<p><i>Principle 26</i></p> <ul style="list-style-type: none"> CySEC shall take the appropriate steps, so that this issue is addressed with the transposition into national law of the EU Directive on Markets in Financial Instruments and to soon be in position to effectively supervise the Cyprus Stock Exchange.

Reference the final sentence of paragraph 18:

CySEC disagrees with this position. The position of CySEC is that bubbles are created even in the best regulated markets worldwide for various reasons, and the absence of non-comprehensive regulation cannot be said to create or contribute to the creation of bubbles. Regulation, however, can limit instances of abuse which can occur during stock market bubbles. The Commission concedes that, should there have existed a more comprehensive regulatory regime in place in the Cyprus capital market during the time of the bubble, it could have limited the extent of abuses which were inevitable to occur during such time.