

## International Monetary Fund

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**Cyprus:** Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

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May 16, 2013

April 29, 2013

The following item is a Letter of Intent of the government of Cyprus, which describes the policies that Cyprus intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Cyprus, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

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## I. Cyprus: Letter Of Intent

Nicosia, April 29, 2013

Ms. Christine Lagarde  
Managing Director  
International Monetary Fund  
Washington D.C.

Ms. Lagarde:

Cyprus is facing an unprecedented crisis originating from our oversized banks, some of which faced solvency problems, compounded by lax fiscal policies. The crisis will have severe implications for economic growth and fiscal sustainability. To face the challenges ahead, we are proposing a strong and ambitious reform program, backed by substantial financing from international organizations, aimed at stabilizing our financial system, achieving fiscal sustainability, and supporting the recovery of economic activity to preserve the welfare of the population and social cohesion.

We have already taken major steps to address these challenges. In the financial sector, these include: divestment of the Greek operations of the domestic banks; the prompt intervention and resolution of Cyprus Popular Bank and transfer of part of it to the Bank of Cyprus; recapitalization of the transferred part with the participation of shareholders, bank debt holders, and partial conversion of uninsured deposits into equity, while fully protecting insured depositors; recapitalization of Bank of Cyprus with the participation of shareholders, bank debt holders, and partial conversion of uninsured deposits into equity, while fully protecting insured depositors; and imposition of temporary restrictions on financial flows to preserve financial stability. On the fiscal side, key recent measures include: the inclusion in the 2013 budget of substantial consolidation measures for the period 2013-15; reform of the public sector COLA wage indexation mechanism; and implementation of reforms of the pension system to improve its long-term sustainability.

But more needs to be done. Under the proposed program, we intend to implement a comprehensive strategy to restore the viability of the financial system and strengthen the banking supervision and regulatory framework. We are also committed to an ambitious fiscal consolidation path that protects the most vulnerable. We will target a primary balance of 4 percent of GDP by 2018, required to ensure that the public debt-to-GDP ratio is placed on a sustained downward trajectory toward a level of 105 percent of GDP by 2020. Finally, we are proposing substantial structural reforms to improve the efficiency of the public sector, including through the timely privatization of viable state-owned enterprises.

We are turning to our international partners for support as we implement these far-reaching objectives. Our estimate is that the external financing need would be up to €10 billion until the first quarter of 2016. We therefore request that the Fund support our policy program through an

arrangement under the Extended Fund Facility which can be drawn over a period of 36 months in the amount of SDR 891 million (about €1 billion and 563 percent of quota). This arrangement, along with support of about €9 billion from the European Stability Mechanism, will help ensure financial stability as we restore market confidence and return to durable growth.

The attached Memorandum of Economic and Financial Policies (MEFP), which has been approved by the Council of Ministers on April 3, outlines the economic and financial policies that the Cypriot government and the Central Bank of Cyprus will implement during the next three years to restructure Cyprus' financial system and ensure fiscal sustainability. The government is fully committed to the policies stipulated in this document and its attachments. We are confident that by the end of the program we will achieve robust growth - eventually supported by the development of prospective gas resources - and lasting stability that will enable us to maintain social cohesion and create entrepreneurial opportunities for our people.

The implementation of our program will be monitored by the Fund through quarterly reviews, quantitative performance criteria and indicative targets, as well as structural benchmarks as described in the attached MEFP and the Technical Memorandum of Understanding (TMU). There will be 11 quarterly reviews under the arrangement. The quarterly reviews will assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives.

While we are confident that the policies set forth in the MEFP are adequate to achieve the objectives under the program, we stand ready to take any corrective actions that may be needed for this purpose. In accordance with the Fund's policies, we will consult with the Fund on the adoption of such actions in advance of revisions to the policies contained in this letter and the MEFP.

Sincerely,

/s/

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Minister of Finance

/s/

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Governor of the Central Bank of Cyprus

## II. Cyprus: Memorandum Of Economic And Financial Policies

### A. Objectives, Strategy, and Outlook

1. **Cyprus is going through an unprecedented banking crisis.** The crisis came to a head following a buildup of large vulnerabilities in recent years. In part, these were related to significant bank exposure to Greece, which resulted in sizeable losses following the Greek debt restructuring (an amount in excess of €4 billion of losses was suffered by the Cypriot banks as a result of the Greek Government Bond restructuring). But the unwinding of a domestic housing boom and the economic downturn in Cyprus also contributed to the deterioration of the banks' loan portfolio. As a result, the two largest banks, comprising about 80 percent of our domestic banking sector and 400 percent of GDP in assets, were confronted with solvency problems. Loss of confidence in the system required prompt resolution of one bank, restructuring of the other bank, and imposition of temporary restrictions to financial flows, which constitute a severe strain on economic activity.

2. **Our weak public finances cannot fully support the large needs of the banking sector without significantly affecting public debt sustainability.** Over the last few years, expenditures have grown faster than revenues, leading to rising fiscal deficits and public debt. Last year, we took significant fiscal consolidation measures to correct these imbalances. However, given massive needs of the financial sector, burden sharing with bank creditors, including uninsured depositors, was also required to ensure that public debt does not become unsustainable. In this way, we have ensured that the Cypriot taxpayer does not need to bear the full burden of bank recapitalization costs. Still, given the difficult economic outlook and significant financing needs, in the absence of policy action, our public finances and sustainability would remain vulnerable.

3. **The country faces two key challenges.** The first challenge is to repair the banking sector, whose business model will need to adapt, so as to restore financial intermediation and support the economic recovery. The second challenge is to attain a sizeable primary fiscal surplus required to place public debt on a firmly downward path. These efforts need to be complemented with structural reforms aimed at raising the efficiency of Cyprus' public sector.

4. **To address these challenges, the government is undertaking a policy adjustment program based on two main pillars:**

- **The first pillar focuses on restructuring the financial sector.** We have already taken steps to deal with insolvency problems in the two largest banks: the Greek branches of the domestic banks have been sold; Bank of Cyprus (BOC) has been recapitalized through partial conversion of uninsured deposits into equity; and Cyprus Popular Bank (CPB) has been resolved and its insured deposits, central bank liabilities (ELA) and certain assets were folded into to BOC. Our efforts will continue to be focused on completing the bank recapitalization process, gradually restoring normal financial flows, and facilitating private sector debt restructuring. Moreover, the credit cooperative institution (CCI) sector will be recapitalized and restructured. To prevent the

build-up of risks in the future, we will reform supervision and regulation and enhance transparency.

- **The second pillar entails a comprehensive fiscal consolidation plan underpinned by structural reforms.** This will build on the fiscal consolidation measures introduced last year, while taking into account short-run cyclical conditions and the need to protect vulnerable groups. In the short run, we will implement additional measures focused on increasing our corporate income tax and tax on interest. Other measures needed to attain our primary fiscal targets will be defined in future budgets. Structural fiscal reforms will focus on revenue administration, public financial management, and privatization. We are also planning to supplement the recent reform of the pension system with additional measures as needed to ensure its long-run sustainability.
5. **Our program will help to build the foundation for sustainable growth over the long run.** Nevertheless, in the short run, the outlook remains challenging and subject to high uncertainty:
- **Real GDP** is projected to contract by 12½ percent cumulatively in 2013-14. Short-run economic activity will be negatively affected by the restructuring of the banking sector and temporary restrictions on transactions, which have been required to safeguard financial stability. This, compounded by the impact of fiscal consolidation already underway, will result in a sharp fall in domestic demand. Little reprieve can be expected from exports amid uncertain external conditions and a shrinking financial service sector. Having had addressed our banking sector problems upfront, we expect growth to rebound in 2015 and attain close to 2 percent over the long run. Upside potential from exploitation of our recently discovered gas resources could further boost growth prospects.
  - **Inflation** is projected to fall in the short-run as a result of the downturn. The recent reform of the COLA wage-indexation mechanism will help to ensure that public wages are aligned with developments in economic activity. Over the medium run, this will lead to an adjustment in overall wages and prices that can improve competitiveness and support the economic recovery.
  - **The current account** deficit is expected to contract to less than 1 percent of GDP in 2013 from 5 percent of GDP in 2012, in tandem with the improvement of the trade balance. A modest adjustment is expected to continue in the medium term, with the current account stabilizing roughly in balance. External debt, in particular related to external liabilities of financial institutions, is expected to decline as part of the broader deleveraging of the financial sector.
1. **The policies contained in our program will put public debt on a sustainable path.** Given that Cyprus has lost access to the international capital markets, financing needs for the coming years will be largely covered by official loans. The banking sector restructuring strategy has been designed to minimize costs to the government. Nevertheless, support to our credit cooperative sector, together with fiscal deficit needs, are expected to lead to an increase in public debt, which is expected to reach around 120 percent of GDP by end-2016. Debt will continue to

decline steadily thereafter, reaching about 105 percent of GDP by 2020, as a result of the rebound in the economy and sustained fiscal efforts to maintain a primary fiscal surplus. Achieving debt sustainability will require full and timely implementation of the program, which is essential to providing a sound foundation for long-run growth.

## B. Financial Sector Policies

7. **We are committed to restoring the health of our financial sector and reducing contingent risks from the banks to the sovereign.** Our oversized banking sector has experienced large losses and liquidity pressures. We are addressing these through a strategy based on five pillars: (i) resolving one insolvent bank and restructuring another at least cost to the Cypriot taxpayer, and restructuring and recapitalizing remaining financial institutions; (ii) normalizing financial flows; (iii) deleveraging core and non-core operations of deposit-taking institutions to reduce the size of the domestic banking sector to the EU average by end-2018; (iv) upgrading the supervisory and regulatory framework; and (v) enhancing preparedness to deal with troubled borrowers. We will also strengthen our AML framework.

### *Resolving, recapitalizing, and restructuring weak institutions*

8. **We have identified capital needs in the banking sector.** In late 2012, in close consultation with program partners, PIMCO was commissioned to undertake an independent due diligence of Cypriot financial institutions accounting for about  $\frac{3}{4}$  of the banking system assets. In February 2013, the final report identified an overall capital shortfall of close to €9 billion for the system, required to reach a core tier I ratio of 6 percent under a stress scenario. It also showed that the two largest banks were confronted with solvency problems, with negative capital of close to €6 billion and overall capital needs of about €8 billion. A sample of 17 cooperatives and the third largest bank were found to be undercapitalized by about €1 billion.

9. **In a first step, we have decisively addressed institutions facing solvency problems without recourse to public resources.** We have taken the following actions:

- **Effective intervention and restructuring of the two largest Cypriot banks.** To address insolvency problems in these banks, on March 25, 2013 the CBC intervened CPB and BoC. The Greek branches of the two banks were sold to Piraeus Bank. CPB was split according to a “good bank—bad bank” strategy. Insured deposits were fully protected by separating them, together with central bank liabilities (ELA) and with sufficient assets to attain a Core Tier I capital ratio of 9 percent under PIMCO’s stress scenario by end-program, and were immediately folded into BoC. Shareholders and other bank creditors, including uninsured depositors and remaining assets were kept in CPB, which is to be liquidated over time. The resolution of CPB was done under the auspices of our new bank resolution law, passed on March 22, which provides for burden sharing, thus minimizing fiscal costs.
- **Completion of BoC’s recapitalization.** On March 29, 2013 the resolution authority initiated the recapitalization of the bank with the participation of equity and bond holdings and subsequent

conversion of 37.5 percent of uninsured deposits into shares with preferred voting and dividend rights. This was required to attain a CT1 capital ratio of 9 percent under PIMCO's stress scenario by end-program. This resulted in an immediate increase in the CT1 ratio to well above 9 percent. Part of the remaining uninsured deposits was temporarily frozen until the completion of an independent valuation (see below). As with CPB, this process minimized fiscal costs.

**10. In a second step, we will continue working toward finalizing the resolution process and ensuring the viability of the intervened banks.** Our work in this area aims to:

- **Complete an independent valuation of BoC and CPB assets by end-June 2013 (structural benchmark) as mandated in the resolution law.** This is needed to ensure that capitalization targets can be met based on a more detailed and updated valuation of assets. To this end, no later than end-April 2013, we will agree with the EC/ECB/IMF staff on the terms of reference of this valuation exercise.
- **Finalize the recapitalization of BoC.** Following the independent valuation described above, if required, an additional conversion of uninsured deposits into shares with preferred voting and dividend rights will be undertaken to ensure that the CTI target of 9 percent under stress by end-program can be met. Should the bank be found to be overcapitalized relative to the target, a share-reversal process will be undertaken to refund depositors by the amount of over-capitalization.
- **Ensure that BoC can operate with maximum safeguards to preserve stability and continued viability during a transition period.** In this regard, we plan to appoint a Board of Directors to manage the bank, in accordance with the resolution law. This team will take over the responsibilities of the special administrator once the resolution process is completed and until a new general assembly is convened. The CBC will require the board to prepare a restructuring plan defining the bank's business objectives by end-September-2013 (**structural benchmark**). To ensure that these issues do not affect its normal business activities, by end-June 2013 we will have ready institutional arrangements to insulate BoC from reputational and governance risks.

**11. In a third step, we will ensure adequate recapitalization of other commercial banks.**

The CBC will increase minimum CT1 capital requirement to 9 percent by end-2013. We have communicated the identified capital needs to remaining banks covered in the PIMCO due diligence. We will instruct them to take the necessary steps to ensure they meet regulatory requirements under PIMCO's stress scenario by end-September. If needed, public funds from the program will be used to recapitalize these institutions.

**12. We are also taking steps to recapitalize and restructure the CCI sector.** The government is committed to preserving a viable credit cooperative sector, as it provides valuable services while maximizing stakeholders' value. To this end:

- Sufficient program resources will be provided at the time of the first review in a dedicated account at the central bank to support the recapitalization and restructuring of the CCI sector.

This will help to boost confidence in the sector. The amounts will be injected in the sector following the identification of capital needs and in accordance with the strategy below.

- We will instruct the CCIs covered by the PIMCO due diligence to meet capital requirements by end-July. If they are unable to raise capital, they will be recapitalized and/or restructured in the context of the overall strategy.
- For individual CCIs not covered by the PIMCO due-diligence exercise, the CBC jointly with the CCI supervisor will complete an assessment of capital needs and viability by end-June 2013 (**structural benchmark**). This will be done in accordance with terms of reference prepared in consultation with EC/ECB/IMF by end-April.
- By end-July 2013, the CBC will develop a strategy to recapitalize and restructure the sector with public money as needed (**structural benchmark**).

### ***Normalizing financial flows and ensuring adequate liquidity***

13. **To safeguard financial stability, it was necessary to impose temporary administrative measures.** Following the intervention of the two banks and recapitalization of BoC, which required a bank holiday of six days, on March 28, 2013 the banks were opened with temporary capital controls and deposit withdrawal restrictions. Cash withdrawals, electronic payments and transfers abroad have been temporarily restricted to prevent deposit outflows and protect the liquidity position of the banks. The implementation of these measures has been appropriately differentiated across transactions to minimize disruptions in the payments system and ensure the execution of essential transactions.

14. **We aim to gradually lift deposit restrictions and capital controls.** We are committed to removing restrictive measures, including those that are inconsistent with our obligations under Article VIII of the IMF's Articles of Agreement, as soon as conditions allow. To this end, we will monitor liquidity conditions and the impact of restrictions in the banks on a daily basis and will review and relax current restrictions as needed in consultation with the EC/ECB/IMF. In the meantime, we request approval from the Fund of any measures that require such approval under Article VIII.

15. **We will ensure adequate liquidity in the banking system.** The CBC, in close cooperation with the ECB, stands ready to take appropriate measures to maintain sufficient liquidity in the banking system in accordance with Eurosystem rules and procedures. To this effect, the CBC and the ECB will require banks to submit funding plans and closely monitor their progress on returning to a sustainable funding model. Restrictions will be lifted as soon as funding conditions normalize. We commit not to impose any new restrictions or intensify any existing restrictions on the making of payments and transfers for current international transactions, nor to introduce any new multiple currency practices.

***Deleveraging of the banking sector***

16. **We are taking resolute steps to reduce the size of our banking sector.** Our aim is to downsize our domestic banking sector to the EU average by end-2018 from more than 500 percent of GDP at end-2012. This will better serve the needs of our economy and ensure that contingent liabilities from the banks to the sovereign are further reduced. To this end:

- On March 25, 2013 we sponsored the agreement through which Cyprus Popular Bank (CPB), Bank of Cyprus (BoC), and Hellenic Bank (HB) transferred the assets and liabilities of their branches in Greece to the Greek bank Piraeus. This helped to reduce the size of our banks by about 130 percent of GDP, limiting contingent liabilities on the state and transferring responsibility to cover €9 billion of insured Greek deposits from Cyprus to Greece.
- In the context of the resolution of CPB and restructuring of BoC, fair value their asset portfolios as part of the independent valuation exercise mandated by the resolution law. The recognition of fair value losses on the asset portfolio will help to further reduce the size of our domestic banking sector to about 350 percent of GDP.
- We will encourage banks to further deleverage non-core assets and will downsize the CCI sector. This will help to meet the target of reducing the system to the euro-area average by end-2018.

***Enhancing the supervisory and regulatory framework***

17. **We remain committed to strengthening the supervisory and regulatory framework of the banking system.** This is paramount to prevent buildup of new vulnerabilities in the system and limit potential future contingent liabilities onto the state. To this end, we will:

- **Ensure conservative implementation of accounting standards on loan provisioning.** By end-May, the CBC will amend its regulations to classify as nonperforming (NPL) all loans past due by more than 90 days. To enhance transparency, the reclassified historical NPL series will be promptly published. Provisioning for NPLs will be done following international accounting standards and conservative provisioning practices. In this regard, by end-September 2013, we will complete, with the support of an international accounting firm, a technical comparison of the accounting practices followed by the Cypriot banks against those followed by other international financial institutions in other relevant jurisdictions.
- **Assess and strengthen oversight of bank credit-risk management practices.** New prudential regulations covering underwriting standards, proper loan-collection practices, and appropriate collateral valuation practices, will enter into force by end-March 2014. Additionally, legislation will be passed by end-September 2013 to strengthen governance by prohibiting commercial banks from lending to their independent board members including their related parties and removing any board members in arrears on existing debts to their banks.

- **Set up a central credit register.** This register aims to monitor credit risk concentration and enhance the monitoring of large business groups (including those related to bank owners), and become an important tool of off-site and on-site banking supervision. The legal framework for the credit register will be set up by end-September 2013 (**structural benchmark**) and the register will be operational by end-September 2014.
- **Introduce early corrective measures.** To provide stronger safeguards against forbearance and enhance supervisory independence, by end-March 2014 we will pass a law establishing a framework for mandatory supervisory action based on capitalization levels. This framework will require prompt supervisory remedial action at a bank or CCI upon deterioration of its capitalization (such as suspension of dividend payments, etc.).

18. **Supervision and Regulation of CCIs will also be revamped.** To prevent excessive risk taking and protect consumers, we will undertake a reform of supervisory practices for the credit cooperative sector. The reform will include the following elements:

- **Transferring supervisory responsibility to the CBC.** By end-June 2013 we will submit legislation establishing the CBC as the supervisor of CCIs with the view to completing the operational, supervisory, and regulatory transfer of powers by end-July 2013. By end-March 2014, regulatory and supervisory frameworks for CCIs will be harmonized with those of commercial banks to ensure a level playing field and reduce potential mispricing of risks.
- **Enhancing transparency of financial information.** To enhance transparency, by end-September 2013 the largest CCIs (threshold to be determined by the CBC in consultation with the EC, ECB and IMF), will be required to have an annual audit performed by a recognized and independent auditing firm, starting with the 2013 annual accounts.
- **Revising lending practices.** We plan to submit legislation by end-September 2013 to strengthen the governance of CCIs to *inter alia* limiting the CCIs from lending to natural persons that are non-members, independent board members including their related parties, and removing any board members in arrears on existing debts to the cooperative credit institution.

### ***Enhancing preparedness to deal with troubled borrowers***

19. **We will take measures to provide for private sector debt restructuring.** We plan to establish a framework for targeted private sector debt restructuring following the implementation of the resolution and recapitalization of weak banks. This will help to revive financial activity, facilitate new lending, and diminish credit constraints. We are working on three fronts:

- **Temporary moratorium.** Before end-April, 2013 the CBC will issue a directive to recommend banks to provide borrowers a grace period of 60 days without penalties to pay interest only on loans coming due. This measure aims to prevent disruptive effects in related payments throughout the whole economy.

- **Tax incentives to facilitate debt restructuring.** By end-May, 2013 we will amend legislation if needed to eliminate any tax deterrents to credit institutions and customers that may currently be in place with respect to loan restructurings. This will include elimination of any tax deterrents with respect to any losses of income associated with voluntary early loan repayments or discounts given for such repayments to problematic but viable borrowers.
- **A well-targeted approach to debt restructuring of viable debtors.** By end-June 2013 we will identify measures as needed to address legal, administrative, or other impediments affecting the restructuring of viable borrowers while preserving credit discipline. Our approach will be based on market-based voluntary workouts underpinned by measures to strengthen the legal framework to support debt restructuring. In this regard, in addition to the central credit registry, a framework for seizure and sale of loan collateral will be implemented by end-2014, macroeconomic conditions permitting. Moreover amendments to ensure the reduction of built-in costs (fees, requisites) for credit institutions and clients during restructuring will be introduced. Finally, we will establish by end-June 2013 a mediation service to intermedate between banks and their clients to achieve fair debt restructuring.

### ***Strengthening the AML framework***

20. **We remain fully committed to strengthening our anti-money laundering (AML) framework in line with the FATF standards.** While Cyprus' AML regime has received an overall positive evaluation in the 2011 MONEYVAL report, we have agreed to an independent audit of the implementation of the AML framework in credit institutions. We remain committed to strengthening our AML legal and implementation framework. To this end:

- We will further build on recent revisions to our legal framework, as appropriate to: (i) ensure the exchange by the financial intelligence unit of financial intelligence on money laundering, associated predicate offenses and terrorist financing with foreign counterparts without the need to secure a court order; (ii) ensure that all trustees of trusts under Cyprus law are regulated or otherwise registered; (iii) ensure that adequate and accurate information on the beneficial ownership of legal entities registered in Cyprus can be obtained in a timely manner by competent authorities; and (iv) ensure that the use of "nominee directors" (i.e., professionals who provide director services) or nominee shareholders does not create any obstacle to the timely access to adequate, accurate and current information on the beneficial ownership and control of companies. We will finalize these by end-September 2013 (**structural benchmark**).
- To implement the revised legal framework related to the transparency of Cypriot corporations and trusts, we will: (i) conduct a third party assessment of the functioning of the Registrar of Companies and appropriately resource the department of the Registrar; and (ii) strengthen the AML/CFT supervision of lawyers, accountants and trust and company service providers by providing adequate staffing of supervisors, applying a risk-based approach to supervision, and revising the methodology used for supervision and inspection by end-December 2013.

- The supervision department of the CBC will revise its off-site and on-site supervisory procedures to further implement a risk-based approach to AML supervision by end-December 2013.
- Finally, should the independent audit reveal that there is a need, we stand ready to take corrective actions in the implementation of the preventive measures by financial institutions. These will be agreed by end-June 2013.

## C. Fiscal Policy

21. **To place debt on a sustained downward path, the government is committed to achieving a primary fiscal surplus of 4 percent of GDP by 2018.** We will pursue a balanced fiscal consolidation that boosts credibility in our public finances and lowers debt in the long run, while taking into account cyclical considerations. For 2013, we will target a primary balance of -2.4 percent of GDP, after taking into account a significant consolidation already underway, as well as some one-off revenues. Our target may be revised down to incorporate compensation for pension funds in CPB with program funds to ensure equal treatment with such funds in BoC following the conversion of deposits into equity. With the economy continuing to contract and no additional one-off revenues, we will aim for a primary balance of -4.3 percent of GDP in 2014. Thereafter, we will plan to reach a primary deficit of -2.1 percent of GDP in 2015, and surpluses of 1.2, 3, and 4 percent of GDP in 2016, 2017, and 2018 and beyond, respectively.

22. **In a first step toward fiscal consolidation, last December we legislated a comprehensive package of measures for 2013-15.** Under our revised macroeconomic framework, these are estimated to yield about 5 percent of GDP. On the expenditure side, we implemented permanent wage cuts applying to the broad public sector, abolished and/or reduced a number of overlapping benefits, increased the mandatory retirement age in the public pension scheme, and implemented an early retirement penalty, while preserving acquired rights. On the revenue side, we increased excise taxes and VAT rates, extended the existing extraordinary contributions on wages scheduled to expire in 2014, and further increased the contribution rate to the general pension system by both employees and employers.

23. **Achieving our planned fiscal path will require additional consolidation measures amounting to about 7 percent of GDP during 2013-2018.** To this end, we will implement an additional 2.2 percent of GDP in measures in 2013. To secure our long-term primary fiscal target of 4 percent of GDP, we commit to identifying an additional 4.7 percent of GDP of measures to be implemented during 2015-2018. Given our still relatively high budget spending, we will ensure that our consolidation efforts deliver at least 60 percent of total specified yields for 2013-18 in expenditure rationalization.

24. **At the onset of the program, we will implement measures amounting to 2.2 percent of GDP through the adoption of legislation and Council of Minister decisions, as needed (prior action).** On the revenue side, these measures will include: (i) increasing the corporate income tax

rate from 10 to 12.5 percent; (ii) raising the bank levy rate from 0.11 to 0.15 percent; (iii) raising the withholding tax rate on interest received to 30 percent; and (iv) reforming the property tax; and (v) other. These measures are expected to yield 2 percent of GDP. On the expenditure side, we will rationalize housing benefits, which will save 0.2 percent of GDP.

25. **During upcoming reviews, we commit to identifying an additional 4.7 percent of GDP in measures to attain a primary balance target of 4 percent of GDP by 2018.** These will be included in the annual budgets for 2015-18 and the corresponding medium term frameworks. Fiscal structural reforms in the areas of expenditure rationalization and revenue administration will help us to achieve these needed budget savings. In the event of revenue shortfalls or higher social spending needs, the government stands ready to take additional measures to preserve the program's medium-term fiscal balance and debt objectives, including by reducing discretionary spending. Conversely, if there is an over-performance, to the extent that it is deemed permanent, it will reduce the need for additional measures in the outer years. Finally, one-off windfall revenues will not be used to increase spending.

## A. Structural Fiscal Reforms

26. **We are committed to implementing structural reforms to support our fiscal consolidation efforts and ensure the sustainability of our pension system.** Last year, we implemented a comprehensive reform of the COLA wage indexation mechanism to limit the growth of the public sector wage bill. We also implemented parametric pension reforms to improve the system's financial viability and make it more equitable. Building on these efforts, we will: (i) review the system of social insurance and social welfare schemes to contain spending while protecting the vulnerable and preserve long-run viability; (ii) improve public financial management by strengthening our budget framework, and enhancing the management of fiscal risks and future revenues from natural resources; (iii) reform our revenue administration to fight tax evasion and improve revenue collection; and (iv) rationalize the public sector by discontinuing non-core activities and privatizing public assets.

### *Social Insurance and Social Welfare System*

27. **We will continue our reforms of the general insurance pension scheme (GSIS) and the public sector occupational pension scheme (GEPS) to enhance their intra- and inter-generational fairness and to ensure their financial viability.** Taking into account the recent reforms, by end-July 2013 we will conduct an actuarial analysis to determine options to ensure the long-run viability of GSIS until 2060 without the need for government transfers beyond credited contributions. In this context, we will separate in accounting terms the non-contributory pension benefit from the insurance-based (contributory) GSIS pension scheme. Reforms resulting from the actuarial analysis will be adopted by end-December 2013 and enter into force by end-March 2014. The reform will encompass an adequate combination of benefit reduction, statutory retirement age increases, and/or contribution rate increases, taking into account the latter's impact on labor costs. The recent GEPS pension reforms will also be extended to the broader public sector.

28. **We will also reform the social welfare system to minimize overlaps in benefits and improve targeting.** Spending on social programs has increased rapidly in recent years to levels well above the EU average, in part due to overlapping benefits and suboptimal targeting. Building on earlier reforms, by end-June 2013, we will prepare an action plan based on a review that will cover all social programs (i.e., social assistance, housing benefits, family benefits, education allowances, and any other transfer schemes) provided by all public entities. The plan, which will include proposals to consolidate welfare programs, improve targeting, and streamline administration, will aim to attain the budget savings required to reach our program fiscal targets, while ensuring that the poor and vulnerable groups are adequately protected. We will implement this reform by end-2013 (**structural benchmark**).

### ***Public Financial Management***

29. **We are committed to improving our budget processes.** We have legislated a medium-term budget framework (MTBF) in line with EU directives, including a rolling three-year budget framework with a view of enhancing fiscal discipline. In consultation with the EC/ECB/IMF, through regulations in the form of an expanded budget circular, we will ensure that the MTBF will be fully effective starting with the 2014 budget. In the context of a broad review of our PFM system to be completed by end-June 2013 we will develop a new comprehensive *Law on Fiscal Responsibility and Budget Systems* including supplementary secondary legislation to address any remaining inconsistencies between the MTBF law and existing legislation, which will be submitted to parliament by end-December 2013 (**structural benchmark**). The new law will provide an enabling framework for a medium-term PFM reform program.

30. **We will establish a framework for the management of natural resources in line with best practices.** To ensure transparency and accountability, the framework's legal basis and governance structure will be based on internationally recognized best practices. In this context, we plan to establish a resource fund with clear rules governing inflows and outflows as part of our budgetary framework, taking into account the need to develop the hydrocarbons industry, the need to bring public debt on a steady downward path, and the need to invest for future generations. We will submit both a draft legal framework and a strategy to the EC/ECB/IMF by end-September 2013.

31. **Management of and reporting on fiscal risks from public-private partnerships (PPPs) will be strengthened.** We will put in place a legal and institutional framework for assessing and entering into PPPs or concession agreements, as well as for monitoring their execution by end-2013 through: (i) establishing an effective "gateway process" that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Ministry of Finance in reviewing and approving PPPs at critical points in the gateway process; and (iii) developing financial reporting and accounting rules that ensure timely and transparent communication of PPP related obligations. We will not enter into any new PPPs or concessions (except for any project having reached commercial close by end October 2012) at any government level until the new framework is in place.

### ***Revenue Administration***

32. **We will modernize our revenue administration to increase its efficiency, improve taxpayer compliance, and boost revenue collection.** Enforcing the timely collection of tax revenues and controlling tax evasion remain a challenge, as the current arrangements do not provide for modern and harmonized systems and procedures, good sharing of information between tax agencies, alignment of filing and payment arrangements, and adequate enforcement tools and approaches. The tax administrations need to find ways to benefit from economies of scale and optimized operations. Correcting this means that not only will tax administration be more effective and efficient, but taxpayer compliance costs can be reduced. We will reform the revenue administration in line with the recommendations provided by recent technical assistance on inland revenue and VAT. To this end, we will present by end-June 2013, a comprehensive reform agenda to improve the efficiency and effectiveness of revenue collections, taxpayer services, and compliance, in line with best international practices.

### ***Rationalization of Broader Public Sector and Privatization***

33. **To ensure debt sustainability and improve the efficiency of the public sector, we will streamline extra-budgetary entities and consider divesting state-owned enterprises (SOEs).** While many extra-budgetary entities do not perform essential public services, they are costly to the budget, receiving almost 2 percent of GDP in transfers. To reduce costs, we will take the following steps:

- **Based on their functionality, extra-budgetary entities will be assessed with a view to determine the need to reclassify, restructure, or divest them.** All extra-budgetary entities will be assessed on their relevance for the public sector and their operational performance. On this basis, entities will be classified according to functionality. Entities that perform necessary public functions will be considered to be integrated into the budget, the rest will be either restructured or divested by the end of the program period.
- **We will develop a privatization plan for SOEs and other state assets.** As a first step, by end-June 2013 we will create an inventory including assets with the highest commercial value and at least one third of SOEs, while the full inventory will be completed by end-December 2013. A privatization plan will be developed by end-September 2013 with the aim of achieving proceeds of at least €1.4 billion by end-2018. To support the privatization process, we will implement a legal and institutional framework by end-December 2013.
- **Other SOEs will be closely monitored or closed if needed.** To improve the monitoring of SOEs and semi-government entities, starting with the 2014 budget, we will include a “Statement of SOEs and semi-government entities” as an Appendix I to the annual budget law and annual financial reports. Non-viable SOEs will be either restructured or closed.

## B. Program Financing

34. **Cyprus will face sizable financing needs during the program period.** To reduce these needs and their impact on public debt, we will undertake several measures during the program period:

- Rolling over and extending the maturity of at least €1 billion of domestic debt held by residents. In order to implement this, we will undertake a voluntary sovereign bond exchange covering bonds maturing in 2013-15. The maturing bonds will be exchanged for new longer dated sovereign bonds with maturities between 5 and 10 years. This offer would be par for par and with no change in annual interest cost. The recapitalization bond of €1.9 billion injected in CPB in June 2012 will also be rolled over (both rollovers are an end-June 2013 **structural benchmark**).
- Realizing privatization receipts of at least €500 million for financing purposes.
- Intensifying efforts to obtain financing assurances from the Russian authorities to reschedule the Russian bond falling due in 2016 and extend its maturity to be paid in 5 equal installments starting in 2018 and lower the interest rate to 2 ½ percent.
- Using the allocation of future central bank profits of EUR €0.4, in line with the CBC duties under the Treaties and the Statute (subject to the same safeguards, balance sheet adjustments by the central bank decided by the Board of Directors of the CBC and in accordance with the Treaty will also contribute approximately €1.4 billion in terms of debt reduction).

35. **Remaining balance of payments financing needs of about €10 billion will need to be covered through official financing.** Cyprus faces sizable balance of payments financing needs that are medium term in nature, in particular (a) pressures on the capital account, (b) the need to refinance external debt and (c) a small current account deficit. Beyond our request to the Fund for a three-year EFF (in an amount of SDR891 million, equivalent to about €1 billion, or 563 percent of quota), we have secured additional financial resources from our European partners to fill remaining needs. Euro area partners have committed a total of €9 billion over the period covering May 2013–March 2016. To ensure that this financing helps to maintain debt on a sustainable debt trajectory delivering a debt-to-GDP ratio of about 100 percent by 2020 and declining thereafter, they have committed to new lending at an average maturity of 10-15 years and at favorable interest rate (2.5-3 percent), using the ESM as a financing vehicle. We are confident that resolute implementation of our economic program will help our economy recover and bolster market sentiment. If fiscal consolidation proceeds faster than expected, or if market conditions improve significantly during the program period, we would refrain from drawing on the IMF support on an as needed basis.

## C. Program Monitoring

36. **Progress in the implementation of policies under our program will be monitored through quarterly (and continuous) quantitative performance criteria (PCs) and indicative**

**targets, and structural benchmarks.** These are detailed in Tables 1 and 2. The attached Technical Memorandum of Understanding (TMU) defines the quantitative performance criteria, indicative targets, and structural benchmarks under the program. Quantitative targets up to September 2013 are PCs. The remaining targets for end-2013 and 2014 are indicative. Quarterly targets for the remainder of 2013 will be converted into PCs at the time of the first review. A Memorandum of Understanding (MoU) on specific policy conditionality agreed with the EC, on behalf of the European Stability Mechanism, specifies additional structural policies, and sets a precise timeframe for their implementation.

37. **As is standard in all Fund arrangements, a safeguards assessment of the CBC will be completed by the first review.** In this regard, the CBC will receive a safeguards mission from the Fund and provide the information required to complete the assessment by the first review. As a related matter, and given that financing from the IMF, in the context of addressing Cyprus' balance of payment needs, will be used to provide direct budget support, a framework agreement will be established between the government and the CBC on their respective responsibilities for servicing financial obligations to the IMF. As part of these arrangements, Fund disbursements will be deposited into the government's account at the CBC.

Table 1. Cyprus: Quantitative Conditionality, 2013 1/  
(millions of Euros)

	Performance criteria		Indicative targets	
	Jun-13	Sep-13	Dec-13	Mar-14
Floor on the general government primary balance 2/	-222	-248	-395	-54
Ceiling on the general government primary expenditure 2/	3230	4911	7069	1576
Ceiling on the stock of general government debt	17153	17464	17917	18076
Ceiling on the accumulation of new general government guarantees 2/ 3/	145.3	145.3	145.3	0
Ceiling on the accumulation of external arrears 4/	0	0	0	0
Ceiling on the accumulation of domestic arrears 2/	0	0	0	0
Ceiling on the accumulation of new VAT refund arrears by the general government 5/	10	10	10	10
<p>1/ As defined in the technical memorandum of understanding.                  2/ Cumulative since January of the corresponding year.                  3/ The figures for 2013 reflect guarantees already approved by the government on loans not yet drawn.                  4/ Continuous performance criterion.                  5/ Cumulative since March 2013.</p>				

Table 2. Cyprus: Structural Conditionality

Measures	Timing
<b>Prior action</b>	
Adopt legislation and Council of Minister decisions, as needed, implementing measures consistent with the program targets. Measures include: increasing the CIT rate from 10 to 12.5 percent, raising the bank levy rate from 0.11 to 0.15 percent, raising the tax rate on interest from 15 to 30 percent, and reforming the property tax (for a total consolidation of 2 percent of GDP with immediate effect); and rationalizing the housing benefits (savings of 0.2 percent of GDP).	Before Board meeting
<b>Structural benchmarks</b>	
<b>A. Strengthen financial stability</b>	
There will be no measures to intensify restrictions on the making of payments and transfers for current international transactions or to introduce multiple currency practices	Continuous performance criterion
Complete the due diligence valuation of CPB and BoC assets as described in the resolution law in accordance with the terms of reference agreed with the EC/ECB/IMF	End-June 2013
For individual CCIs not covered by the PIMCO due-diligence exercise, the CBC jointly with the CCI supervisor will complete an assessment of capital needs and viability in accordance with terms of reference prepared in consultation with EC/ECB/IMF	End-June 2013
Develop a strategy to recapitalize and restructure the CCI sector with public money as needed	End-July 2013
Revise the anti-money laundering legal framework (TMU ¶15)	End-September 2013
CBC to require the BoC board to prepare a restructuring plan defining the bank's business objectives	End-September 2013
Adopt the legal framework for a central credit register (TMU ¶16)	End-September 2013
<b>B. Strengthen fiscal institutions, reduce fiscal risks and protect vulnerable groups</b>	
Roll over and extend the maturity of at least €1 billion of domestic debt held by residents through a voluntary debt exchange covering maturities falling due in 2013-15 and roll over the € 1.9 billion recapitalization bond of CPB.	End-June 2013
Submit to Parliament a law on fiscal responsibility and budget systems (TMU ¶17)	End-December 2013
Adopt measures to improve the targeting of social assistance, consolidate welfare programs, and streamline administration costs.	End-December 2013

Table 3. Cyprus: Actions Taken Prior to the Signature of the MEFP

A. Strengthen financial stability	B. Strengthen fiscal institutions and reduce fiscal risks
<p><b>Anti-money laundering.</b> Amended legislation with a view to providing the widest possible range of cooperation to foreign counterparts (December 2012)</p> <p><b>Identification of capital needs.</b> Hired a consultant to assess the capital needs of the financial institutions accounting for about 75 percent of total financial system assets (February 2013)</p> <p><b>Bank Resolution.</b> Adopted legislation putting in place a modern bank resolution framework (March 2013)</p> <p><b>Deleveraging of non-core assets.</b> Sponsored the agreement through which CPC, BoC, and HB transferred the assets and liabilities of their branches in Greece to the Greek bank Piraeus (March 2013)</p> <p><b>Bank intervention and resolution.</b> Intervened CPB, split it according to a "good bank-bad bank" strategy, sold the "good bank" to BoC while safeguarding insured deposits (March 2013)</p> <p><b>Recapitalization.</b> Recapitalized BoC through the full dilution of equity and bond holdings and conversion of 37.5 percent of uninsured deposits into preferred shares (March 2013).</p>	<p><b>COLA reform.</b> Implemented a reform of the COLA wage indexation mechanism in the public sector by extending its freeze to the end of the program and limiting its application to 50 percent of the price index thereafter.</p> <p><b>Pension reform.</b> Introduced reforms to the General Social Insurance Scheme, including freezing pensions under the Social Security Fund until end-2016 and raising employee and employer contributions in 2014. Also introduced reforms to the government pension scheme and froze public sector pensions.</p> <p><b>Medium-term budget framework.</b> Legislated a framework in line with EU directives, including a rolling three-year budget framework.</p> <p><b>2013 budget.</b> Implemented a budget with significant fiscal consolidation measures for 2013-15, including:</p> <ul style="list-style-type: none"> <li>• Reduced outlays for social transfers through the abolition of a number of redundant and overlapping schemes.</li> <li>• Introduced a graduated reduction of the remuneration of the public and broader public sector employees (6.5-12.5%) and legislated a 3% flat reduction for 2014.</li> <li>• Extended the freeze of general wage increases in the public and broader public sector and temporary contribution in the public, broader public and private sectors on gross earnings and pensions until end-2016.</li> <li>• Took steps with a view to reducing the number of public sector employees by at least 4,500 over the period of 2012-16.</li> <li>• Reduced transfers to SOEs and semi-public institutions.</li> <li>• Increased excise duties on tobacco products, alcoholic beverages, and oil products with effect in 2013; and legislated an additional increase for energy products in 2014.</li> <li>• Increased the standard VAT rate from 17 to 18% in 2013 and to 19% in 2014, and the reduced rate from 8 to 9% starting in 2014.</li> <li>• Increased fees for public services by at least 17%.</li> <li>• Abolished all exceptions for paying the annual company levy of EUR 350.</li> </ul>

### III. Cyprus: Technical Memorandum Of Understanding

April 29, 2013

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies (MEFP). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the Fund, European Commission and ECB on a timely basis before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the European Commission, ECB and the Fund with the necessary information for program monitoring.
2. For program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "program exchange rates" as defined below, with the exception of the items affecting government fiscal balances, which will be measured at current exchange rates. The program exchange rates are those that prevailed on April 15. In particular, the exchange rates for the purposes of the program are set €1 = U.S. 1.308099 dollar, €1 = 129.0309 Japanese yen, €1.15222= 1 SDR.
3. For reporting purposes, the Ministry of Finance (MOF) and the Central Bank of Cyprus (CBC) will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the EC, the ECB and the Fund.

#### A. Quantitative Performance Criteria and Indicative Targets

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

4. For the purposes of the program, the general government includes the institutions listed under this category according to ESA 95 for Excessive Deficit Procedure (EDP) reporting purposes. In particular, the general government includes:
  - *The central government.* Includes the Constitutional Powers, the Constitutional Services, the Independent services, the Independent offices, the Ministries and the departments, services, and other bodies they supervise, 21 special purpose funds, and 14 semi government organizations.
  - *The local governments.* Comprise 39 municipalities, 356 village authorities, and all agencies and institutions attached thereto which are classified as local governments according to ESA 95.
  - *The social security funds.* These include the medical treatment scheme, the regular employees' provident fund, the social insurance fund, the holiday fund, the redundancy fund, and the protection of the rights of employees' fund.
  - *Any newly created institution defined as general government under ESA 95.* This includes any new budgetary institution, special fund, social security fund, semi-government organization, municipality, village authority, and any other entity created during the program period to carry

out operations of a fiscal nature. The government will inform the IMF, European Commission and ECB staff of the creation or any pending reclassification of any such new funds, programs, or entities immediately. The general government, as measured for purposes of the program monitoring, for a given year shall not include entities that are re-classified from outside general government into general government during that year.

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

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

6. The floor on the GGPCB will be adjusted downwards by:

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

### **Ceiling on the General Government Primary Expenditure (performance criterion)**

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

8. The ceiling on the GGPE will be adjusted upwards by:

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

**Ceiling on the stock of General Government Debt (performance criterion)**

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

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

- Upward (downward) by the amount of any upward (downward) revision to the stock of end-March 2013 general government debt.
- Upward, by debt arising from payments for bank restructuring carried out under the program's banking sector support and restructuring strategy. These payments may include loans to financial institutions and investments in equity of financial institutions (required recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.
- Upward by the payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank

**Ceiling on the Accumulation of new General Government Guarantees (performance criterion)**

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

**Ceiling on the Accumulation of External Arrears (continuous performance criterion)**

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

**Ceiling on the Accumulation of Domestic Arrears (performance criterion)**

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

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

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

## **B. Monitoring of Structural Benchmarks**

### **15. Revision of the anti-money laundering legal framework (end-September 2013).**

**Specification.** The adopted legal framework will provide for the following:

- Ensure that the financial intelligence unit can exchange adequate information with foreign counterparts on money laundering, associated predicate offenses and terrorist financing, in the context of its analytical function, without having to secure a court order;
- Ensure that all trustees of trusts created under and governed by Cyprus law are regulated or otherwise registered. Registers will be kept by the relevant supervisory authorities in order to enable them to carry out their duties and will contain adequate, accurate and current information on the name of a trust and the name and address of its trustee(s);
- Ensure that adequate, accurate and up-to-date information on the beneficial ownership of legal entities registered in Cyprus can be obtained in a timely manner by competent authorities;
- Ensure that the use of “nominee” directors (i.e. professionals who provide director services) or “nominee” shareholders does not create any obstacle to the authorities’ timely access to adequate, accurate and up-to-date information on the beneficial ownership, and control of companies by having a mechanism in place consistent with the FATF standards. To this end, the authorities will require that all nominee directors and nominee shareholders be authorized or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs).

### **16. Adopt the legal framework for a central credit register (end-September 2013)**

**Specification.** The adopted legal framework shall include provisions to:

- Establish a framework that allows credit institutions to keep in a centralized manner critical information on household and corporate borrowers (including their consolidated debt exposure, past due and performing loans, collateral, etc.), while sensitive and/or confidential information shall be safeguarded;

17. **Submit to Parliament a law on fiscal responsibility and budget systems (end-December 2013).**

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

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

### **C. Reporting requirements**

18. Performance under the program will be monitored using data supplied to the IMF by the Ministry of Finance, Cystat, and the Central Bank of Cyprus. The authorities will transmit to the IMF staff any data revisions in a timely manner. Table 1 describes the supporting data needed for monitoring of the quantitative targets, the required frequency of the data, the institution/department responsible for providing the data, and the timing for provision of the data.

Table 1. Cyprus: Reporting Requirements

<b>Information required</b>	<b>Data Frequency</b>	<b>Institution/Department responsible for providing information</b>	<b>Maximum time lag for submission after the end of the reporting period</b>
Detailed execution of revenues, expenditure and financing provided in EDP reporting format	Monthly	MOF. Budget Department/Cystat Government Financial Statistics.	25 days after the end of the month, except end-December data which will be provided 30 days after the end of the month
Debt Issuance, Amortization, and interest cost details by type of debt instrument, maturity, currency, type of debt holder (resident, non-resident).	Monthly	MOF. Public Debt Management Unit.	25 days after the end of the month
Details on any financial balance sheet transactions	Monthly	MOF. Treasury Department	25 days after the end of the month except December data which will be provided 30 days after the end of the year
Central Government Debt stock by type of debt instrument, maturity, currency, type of debt holder. Interest bill for each type of debt instrument on a monthly basis for the current year and the next year, and annual for each year thereafter until 2020	Monthly	MOF. Public Debt Management Unit.	25 days after the end of the month
Budgetary Central Government deposits in the Consolidated Fund and in the Banking System.	Monthly	MOF. Public Debt Management Unit.	5 days after the end of the month
Stock of expenditure arrears of the Budgetary Central Government and their corresponding monthly flows (i.e. inflows, outflows) by type of expenditure	Monthly	MOF. Treasury Department	15 days after the end of the month
Stock of VAT refund arrears and their corresponding quarterly flows	Quarterly	MOF. Customs and Excise Department, VAT service	15 days after the end of the quarter
Stock of government guarantees and their quarterly flows by	Quarterly	MOF. Treasury Department.	25 days after the end of the quarter.

institution.			
Stock of external arrears	Monthly	MOF. Treasury Department.	15 days after the end of the month
Assets and liabilities of the central bank	Weekly	Central Bank of Cyprus	1 working day after the end of the week
Assets and liabilities of the domestic operations of the banking system – aggregate monetary balance sheet of credit institutions by institutional category	Monthly	Central Bank of Cyprus	30 days after the end of the month
Assets and liabilities of the banking system (consolidated group balance sheets, including foreign operations) by institutional category	Quarterly	Central Bank of Cyprus	45 days after the end of the reporting period
Individual operational balance sheet of the domestic operations of the largest banks and coops with detailed information on deposits (by maturity, currency, and type of depositor), central bank funding, interbank funding, debt securities, loans provided to the public and the private sector, details on liquid assets (cash and securities), liquidity position (i.e. the pool of assets eligible for ELA but not already encumbered), other assets and liabilities 1/	Monthly	Central Bank of Cyprus	30 days after the end of the month
Deposits by institution, currency, and residency and end-of-day liquidity buffers	Daily	Central Bank of Cyprus	Next working day
Financial soundness indicators— core set, deposits, NPLs, profitability, asset quality, balance sheet and capital adequacy ratios	Quarterly	Central Bank of Cyprus	90 days after the end of the month 2/

1/ Reporting requirements for cooperative banks will be revisited after the CBC becomes their supervisor.

2/ The scope and frequency of reporting of financial soundness indicators will be revised at the time of the first review.

**IV. Cyprus: Letter of Intent to the European Commission**

**MEMORANDUM OF UNDERSTANDING**

**BETWEEN**

**THE EUROPEAN COMMISSION**

**ACTING ON BEHALF OF THE**

**EUROPEAN STABILITY MECHANISM**

**AND**

**THE REPUBLIC OF CYPRUS**

**WHEREAS**

- (A) The European Stability Mechanism ('ESM') was established by the Treaty Establishing the European Stability Mechanism entered into between the euro area Member States (the "**ESM Treaty**") for the purpose of mobilising funding and providing stability support for the benefit of ESM members which are experiencing, or are threatened by, severe financial problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its member states.
- (B) ESM may grant financial assistance under financial assistance facility agreements by way of loan disbursements under precautionary conditioned credit lines or enhanced conditions credit lines, loans to ESM members under macro-economic adjustment programmes, facilities to finance the recapitalisation of financial institutions in an ESM member state, facilities for the purchases of bonds in the primary or secondary markets, all subject to strict conditionality appropriate to the financial instrument(s) chosen (each such loan or disbursement under such a financial assistance facility agreement being a "**Financial Assistance**").
- (C) The European Commission, in liaison with the ECB, assessed (i) the existence of a risk of financial stability of the euro area as a whole or of its member states, (ii) whether the public debt of the Beneficiary Member State was sustainable and (iii) the actual or potential financing needs of the Beneficiary Member State, and on the basis of such assessment the ESM Board of Governors decided in principle to grant stability support to the Beneficiary Member State in the form of a financial assistance facility.
- (D) This Memorandum of Understanding has been negotiated and finalised between the European Commission (on behalf of the ESM and with the approval of its Board of Governors), the ECB, the IMF and the Beneficiary Member State. The financial assistance to be provided to the Beneficiary Member State by the ESM shall be dependent upon compliance by the Beneficiary Member State with the measures set out in the Memorandum of Understanding.
- (E) The ESM Board of Governors approved this Memorandum of Understanding and the European Commission signing the Memorandum of Understanding on behalf of the ESM.
- (F) The release of Financial Assistance by ESM under financial assistance facility agreement, shall, unless otherwise specified, be conditional upon the ESM Board of Directors deciding, on the basis of reports from the European Commission (in liaison with the ECB) in accordance with Article 13(7) of the ESM Treaty, that the Beneficiary Member State has complied with the conditionality attached to the financial assistance facility agreement, including compliance with the measures set out in this Memorandum of Understanding.

This Memorandum of Understanding may be amended upon mutual agreement of the parties, in liaison with the ECB and the IMF, in the form of an addendum. The addendum will be an integral part of the memorandum and will become effective upon signature.

Done in Brussels on  
English language.

and in Nicosia on

in five (5) originals, in the

**REPUBLIC OF CYPRUS**

/s/

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Represented by Harris Georgiades,  
Minister of Finance

**CENTRAL BANK OF CYPRUS**

/s/

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Represented by Panicos O. Demetriades,  
Governor of Central Bank of Cyprus

**THE EUROPEAN COMMISSION, ON BEHALF OF THE EUROPEAN STABILITY MECHANISM**

/s/

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Represented by Olli Rehn,  
Vice-President of the European Commission

## Cyprus: Memorandum Of Understanding On Specific Economic Policy Conditionality (European Commission)

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

- to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions, strengthening supervision and addressing expected capital shortfalls, in line with the political agreement of the Eurogroup of 25 March 2013;
- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit as soon as possible, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and
- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

### **1. Financial sector reform**

#### **Key Objectives**

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

#### **Progress to date**

The domestic banking sector, including the cooperative credit institutions, represented until recently 550% of GDP. The necessary downsizing and restructuring of the banking sector is already under way. The House of Representatives adopted legislation on 22 March 2013 establishing a

comprehensive framework for the recovery and resolution of credit institutions, drawing, inter alia, on the relevant proposal of the European Commission<sup>1</sup> (EC). Under the terms of that legislation, the Central Bank of Cyprus (CBC) is the single resolution authority for banks and cooperative credit institutions alike. Using this new framework, the Cypriot authorities have proceeded with (i) the carve-out of the Greek operations of the largest Cypriot banks, (ii) the resolution of Cyprus Popular Bank and the absorption of selected assets and liabilities by the Bank of Cyprus and (iii) the recapitalisation of the Bank of Cyprus through a debt to equity conversion, without the use of public money. As a result of these actions, the Cypriot banking sector was downsized immediately and significantly to 350% of GDP and the Bank of Cyprus has been fully recapitalised in order to regain its eligible counterparty status for the purpose of its participation in regular Eurosystem monetary policy operations. Further downsizing will be achieved through the restructuring of the cooperative credit institutions. To preserve the liquidity of the Cypriot banking sector, administrative measures have also been imposed.

## A. Regulation and supervision

### Maintaining liquidity in the banking sector

1.1. As bank liquidity was under pressure, exceptional measures were necessary with a view to preventing large deposit outflows and preserving the solvency and liquidity of the credit institutions. Cash withdrawals, electronic payments and transfers abroad were temporarily restricted. The implementation of these measures was designed to minimise disruptions in the payment systems, and to ensure the execution of transactions essential for the functioning of the economy. The Government committed to managing the introduction and implementation of restrictions in line with the rules on the free movement of capital set out in the Treaty on the Functioning of the European Union. The impact of the restrictions will be monitored on a daily basis with full information sharing with the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF). The restrictions on capital movements will be gradually relaxed, after consultation with the EC, the ECB and the IMF and will remain in place no longer than is strictly necessary to mitigate serious risks for the stability of the domestic financial system. A Monitoring Board comprising the EC, the EBA and the Cypriot authorities is being established to ensure the monitoring and assessment of the implementation of the temporary capital controls.

1.2. Furthermore, the Cypriot authorities will encourage banks to strengthen their collateral and liquidity buffers. The CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector and will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules.

1.3. The authorities will request domestic banks relying on central bank funding or receiving state aid to establish and submit, quarterly, medium-term funding and capital plans, to be communicated at the end of each quarter, **starting from June 2013**, to the CBC, which will be

<sup>1</sup> [http://ec.europa.eu/internal\\_market/bank/crisis\\_management/index\\_en.htm#framework2012](http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#framework2012)

transmitted to the ECB, the EC, the European Stability Mechanism (ESM) and the IMF. The plans should realistically reflect the anticipated deleveraging in the banking sector and reduce dependency on borrowing from the central banks, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario will be provided by the CBC, in coordination with the ECB.

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

#### **Regulation and supervision for banks and cooperative credit institutions**

1.5. Strong efforts should be made to maximise bank recovery rates for non-performing loans, while minimising the incentives for strategic defaults by borrowers. The administrative hurdles and the legislative framework currently constraining the seizure and sale of loan collateral will be amended such that the property pledged as collateral can be seized within a maximum time-span of 1.5 years from the initiation of legal or administrative proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. Based on a report commissioned to an independent expert, the necessary legislative changes will be submitted to the House of **Representatives by mid-2014** and implemented **by end-2014**, macroeconomic conditions permitting.

1.6. Non-performing loans are threatening bank profitability and need to be properly monitored and managed in order to safeguard the banks' capital buffers. The CBC's guidance on the classification of loans as non-performing will be amended to include all loans past due by more than 90 days. This amendment will be introduced **by 30 May 2013**. The time series for non-performing loans will be published including historical observations reaching as far back as possible.

1.7. The CBC will also create a central credit register listing all borrowers and beneficial owners, from both commercial banks and cooperative credit institutions, to enable these institutions to check new loan applications against the register. The credit register will identify the borrowers who are or were in arrears and will help monitor credit risk and large exposures. The legal framework for the credit register will be set up **by 30 September 2013** and the central credit register will be operational **by 30 September 2014**.

1.8. After analysis of the results from the due diligence exercise and taking into account best practices in the implementation of the International Financial Reporting Standards, the CBC will review, **by end-September 2013**, its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Without prejudice to the conclusions of this review and to the existing regulatory and accounting framework in the EU, regulatory amendments will be introduced, drawing on technical assistance, with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will enter into force **by end-March 2014**.

1.9. Legislation will be passed by end-September 2013 to strengthen banks' governance by prohibiting commercial banks and cooperative credit institutions from lending to independent board members, including their connected parties, and removing any board members in arrears on

existing debts to their banks, while lending to other board members will be prohibited above a certain threshold, which will be calibrated by the CBC. Loans and other credit facilities to each board member will be disclosed to the public. A majority of directors in banks' boards will be independent.

1.10. The CBC will introduce mandatory supervisory action based on capitalisation levels, drawing upon technical assistance and international best **practices by end-March 2014**.

1.11. The CBC will implement a unified data reporting system for the banks and the cooperative credit institutions **by end-June 2013**. The publication of the statistical data will be extended to the cooperative credit institutions, for which the CBC will disclose aggregate data covering the same elements as for banks, including balance sheet items, income statements and prudential indicators.

1.12. Stress-testing will be integrated into regular off-site bank supervision and will serve as an input into Pillar 2 assessments. Supervisory stress-tests will be carried out at an annual frequency, with the first exercise completed **before end-June 2014**.

1.13. Cooperative credit institutions play a significant role in the domestic economy and an important objective of the programme is to strengthen the cooperative credit sector. Due to its economic relevance and legal specificities, as well as deficiencies in risk assessment, this segment of the financial sector requires stronger regulation and supervision. The Cypriot authorities will align the regulation and supervision of cooperative credit institutions to that of commercial banks. Since December 2012, the supervision of cooperative credit institutions is being conducted independently of considerations for the development of this sector. The supervision of cooperative credit institutions will be detached from the Ministry of Commerce, Trade and Tourism and integrated into the CBC **by end-July 2013**, for which legislation will be passed **by end-June 2013**. The Cypriot authorities will present, for assessment by the EC, the IMF and the ECB, a time-bound, actionable plan to achieve this **by end-June 2013**. By end-May 2013 legislation will be introduced to authorise the CBC to instruct the current cooperative credit sector supervisor to intervene also at the level of individual cooperative credit institutions.

1.14. The accounts of cooperative credit institutions, above a size to be decided by the CBC after consultation with the EC, the ECB and the IMF, will be subject to an independent annual audit by an external, recognised and independent auditing firm. The CBC will have the right to overturn the selection of an auditor by any cooperative credit institution.

#### **Monitoring of corporate and household indebtedness**

1.15. The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. Data from surveys will be used until the credit register becomes fully operational. The Financial Stability Report, to be published on a yearly basis **as of December 2013**, will include an extended analysis on corporate and household indebtedness. These enhanced monitoring actions will be put in place **by end-June 2013**.

1.16. Measures will be taken to deal with troubled borrowers following the implementation of the resolution and recapitalisation of weak banks. A framework for targeted private-sector-debt restructuring will be established to facilitate new lending, and diminish credit constraints. Ways will

be explored to improve the funding constraints of SMEs. First, **by end-April 2013** a directive will be circulated by the CBC to recommend banks to provide a grace period of 60 days without penalties to pay interest only on loans coming due. This legislation aims to prevent disruptive effects in related payments throughout the whole economy. Second, legislation will be passed, if needed, to eliminate any tax deterrents to credit institutions and customers that may currently be in place with respect to loan restructurings. This will include elimination of any tax deterrents with respect to any losses of income associated with voluntary early loan repayments or discounts given for such repayments to problematic but viable borrowers. Third, **by end-June 2013** the Cypriot authorities will develop a framework and issue legislation as needed to address legal, administrative or other impediments affecting the restructuring of viable borrowers, while preserving credit discipline. The approach will be based on market-based voluntary workouts, underpinned by measures to strengthen the legal framework to support debt restructuring. In this regard, in addition to the central credit registry, a framework for seizure and sale of loan collateral will be implemented. Moreover, amendments will be introduced to ensure the reduction of built-in costs (fees, requisites) for credit institutions and clients during restructuring. Finally, a mediation service between banks and their clients to achieve fair debt restructuring will be established **by end-June 2013**.

### **Increasing financial transparency**

1.17. The anti-money laundering (AML) framework will be further strengthened in line with best practice. While Cyprus' AML regime received an overall positive evaluation in the 2011 MONEYVAL report, the Cypriot authorities are committed to further enhancing their standing by taking a number of measures, in line with recommendations made by IMF staff.

- The legal framework will be further revised<sup>2</sup> to enable the provision of the widest possible range of cooperation to foreign counterparts (including with regard to the laundering of the proceeds of tax crimes involving fraudulent activity), and by giving precision to the scope of cooperation by the financial intelligence unit.
- Following the completion of the April 2013 audit, the findings and recommendations contained in the final reports of MONEYVAL and the auditor will be taken into account in the action plan envisaged in the programme, and the customer due-diligence and suspicious-transaction reporting procedures will be enhanced following the audit report recommendations **by Q2-2013**.
- Furthermore, to address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have committed to an action plan on entity transparency to revise the legal framework and ensure its dutiful implementation, so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts in response to requests related to money laundering and tax matters. To this end, the action plan will envisage that the Cypriot authorities will promptly revise relevant pieces of legislation, including, inter alia, the Trust

<sup>2</sup> The legal framework was substantially revised in December 2012.

and Company Services Provider law and the Anti-Money Laundering law **by Q2-2013**. In addition, directives and circulars issued by supervisory authorities (CBC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) will be revised to lay down clear implementing procedures that are in line with relevant legislation and international standards **by Q2-2013**.

- As part of the action plan, the Cypriot authorities intend to establish trust registers with the supervisory authorities and launch a third-party assessment of the functioning of the Registrar of companies. The trust registers will be for all trusts established under Cyprus law, will be kept by the relevant supervisory authorities in order to enable them to carry out their duties, and will contain the name of the trust and the name and address of the trustee.
- Finally, the supervision department of the CBC will review its off-site and on-site supervisory procedures to further implement a risk-based approach to AML supervision **by Q4-2013**. In particular, the off-site supervisory tool will include monthly reporting by credit institutions on the breakdown by country of origin of the main depositors and the main beneficiaries of loans (and of their beneficial owners).

## **B. Recapitalisation, due diligence, resolution and restructuring**

1.18. A Coordination Committee with representatives from the CBC and the Ministry of Finance will be set up to oversee the implementation of the financial sector reform programme and to monitor developments in the banking sector.

### **Due diligence and restoring adequate capital buffers**

1.19. The CBC will increase the minimum Core Tier 1 capital ratio from the present level of 8% to 9% **by 31 December 2013**.

1.20. An international consultant has conducted an accounting and economic value assessment (due diligence review) of the credit portfolios of Bank of Cyprus, Cyprus Popular Bank, Hellenic Bank and a sample representing about 63% of the cooperative credit institutions' assets, as well as Alpha Bank Cyprus and Eurobank Cyprus. The assessment, which was overseen by a Steering Committee including representatives of the Cypriot authorities, the EC, the ECB, the EBA and the ESM (as members) and the IMF (as observer), started formally on 4 October 2012, with the selection of the external consultant. This due diligence review included both an accounting review and an assessment of the economic value of banks' assets. Its results formed the basis for the bank-by-bank stress tests.

1.21. The bank-by-bank stress tests conducted by the CBC resulted in an overall capital shortfall of EUR 6 billion under a baseline scenario with a Core Tier 1 target ratio of 9% and a shortfall of EUR 8.9 billion under the adverse macroeconomic scenario with a Core Tier 1 target ratio of 6%. These numbers include one foreign bank, but do not include the EUR 1.8 billion of capital already injected by the Cypriot State in Cyprus Popular Bank in June 2012, which will be rolled over, nor do they include the capital needs of those credit cooperative institutions that were not covered by the due

diligence exercise. The specific capital needs were communicated to each participating bank on 18 March 2013.

1.22. In response to the results of the due diligence exercise, Bank of Cyprus and Cyprus Popular Bank have been intervened and restructured using the recently-adopted resolution law. The other commercial banks will be instructed by the CBC to take the necessary steps to ensure that they meet regulatory requirements in a stress scenario by end-September 2013. Cooperative credit institutions will be instructed to meet capital regulatory requirements by July 2013. If necessary, public programme funds will be used to recapitalize these institutions in accordance with EU state-aid rules.

### **Restructuring and resolution of Cyprus Popular Bank and Bank of Cyprus**

1.23. The accounting and economic value assessment already mentioned revealed that the two largest banks of Cyprus were insolvent. To address this situation the government has implemented a far-reaching resolution and restructuring plan. In order to prevent the build-up of future imbalances and to restore the viability of the sector, while preserving competition, a fourfold strategy was adopted, which does not involve the use of taxpayer money. The Cypriot authorities will closely monitor the implementation of this strategy.

1.24. First, all Greek-related assets (including shipping loans) and liabilities were carved-out, estimated in the adverse scenario at EUR 16.4 billion and EUR 15.0 billion, respectively. The Greek assets and liabilities were acquired by Piraeus Bank, the restructuring of which will be dealt with by the Greek authorities. The carve-out was based on an agreement signed on 26 March 2013. With the book value of the assets at EUR 19.2 billion, the carve-out has substantially reduced the cross exposures between Greece and Cyprus.

1.25. With respect to the UK branch of Cyprus Popular Bank, all the deposits were transferred to the UK subsidiary of the Bank of Cyprus. The associated assets were folded into the Bank of Cyprus.

1.26. Second, Bank of Cyprus is taking over -via a purchase and assumption procedure- almost the entire Cypriot assets of Cyprus Popular Bank at fair value, as well as the latter's insured deposits and Emergency Liquidity Assistance exposure at nominal value. The uninsured deposits of Cyprus Popular Bank will remain in the legacy entity. The aim is for the value of the transferred assets to be higher than the transferred liabilities with the difference corresponding to the recapitalisation of Bank of Cyprus by Cyprus Popular Bank amounting to 9% of the risk-weighted assets transferred. Bank of Cyprus is being recapitalised to reach a core tier one ratio of 9% under the adverse scenario of the stress test by the end of the programme, which should help to restore confidence and normalise funding conditions. The conversion of 37.5% of the uninsured deposits in Bank of Cyprus into class A shares with full voting and dividend rights provides the largest part of the capital needs with additional equity contributions from the legacy entity of Cyprus Popular Bank. Part of the remaining uninsured deposits of Bank of Cyprus will be frozen temporarily until the completion of the independent valuation referred to in the paragraph below.

1.27. Third, to ensure that the capitalisation targets are met, a more detailed and updated independent valuation of the assets of Bank of Cyprus and Cyprus Popular Bank will be completed, as required by the bank resolution framework, **by end June 2013**. To this end, **no later than mid-**

**April 2013**, the terms of reference of the independent valuation exercise will be agreed in consultation with the EC, the ECB, and the IMF. Following that valuation, and if required, an additional conversion of uninsured deposits into class A shares will be undertaken to ensure that the core tier one capital target of 9 % under stress by end-programme can be met. Should Bank of Cyprus be found to be overcapitalised relative to the target, a share-reversal process will be undertaken to refund depositors by the amount of over-capitalisation.

1.28. Finally given the systemic importance of Bank of Cyprus, it is important that the operations of Cyprus Popular Bank are quickly integrated, operational efficiency is improved, the recovery of non-performing loans is optimised with the work-out implemented by the going concern entity and the funding conditions are progressively normalised. In order to achieve these goals and to ensure that Bank of Cyprus can operate with maximum safeguards to preserve stability and continued viability during a transition period, the CBC, following consultation with the Ministry of Finance, will appoint a new Board of Directors and an acting Chief Executive Officer until Bank of Cyprus' new shareholders are organised in a general meeting. The CBC will require the Board of Directors to prepare a restructuring plan defining the bank's business objectives and credit policies **by end-September 2013**. To ensure that normal business activities are not affected, institutional arrangements will be designed **by end-June 2013** in accordance with Cypriot law to insulate Bank of Cyprus from reputational and governance risks.

#### **Restructuring and recapitalisation of other commercial banks**

1.29. Commercial banks with a capital shortfall, which are deemed viable, can, if other measures do not suffice, ask for recapitalisation aid from the State. In order to ensure timely recapitalisation, the Cypriot authorities should submit **by 30 November 2013** restructuring plans for these banks to the EC, which are drawn up in compliance with EU state-aid rules, while also informing the ECB and the IMF.

1.30. Capital should, to the largest extent possible, be raised from private sources including internal measures, asset disposals and liability management exercises. Banks in need of aid from the State will not be recapitalised before their restructuring plans have been formally approved under state-aid rules. The terms and remuneration of the state aid will comply with the EU state-aid rules, with due consideration for financial stability. The credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, including on pay levels of executive and supervisory board members, and to a restructuring process in line with EU competition and state-aid requirements, which will be scrutinised by an external monitoring trustee. If the recapitalisation takes the form of state aid, funds for the recapitalisation of these banks will be made available in the context of the programme.

#### **Restructuring and recapitalisation of cooperative credit institutions**

1.31. With a view to minimising state aid, cooperative credit institutions requiring recapitalisation should seek private sector participation **no later than 31 July 2013**.

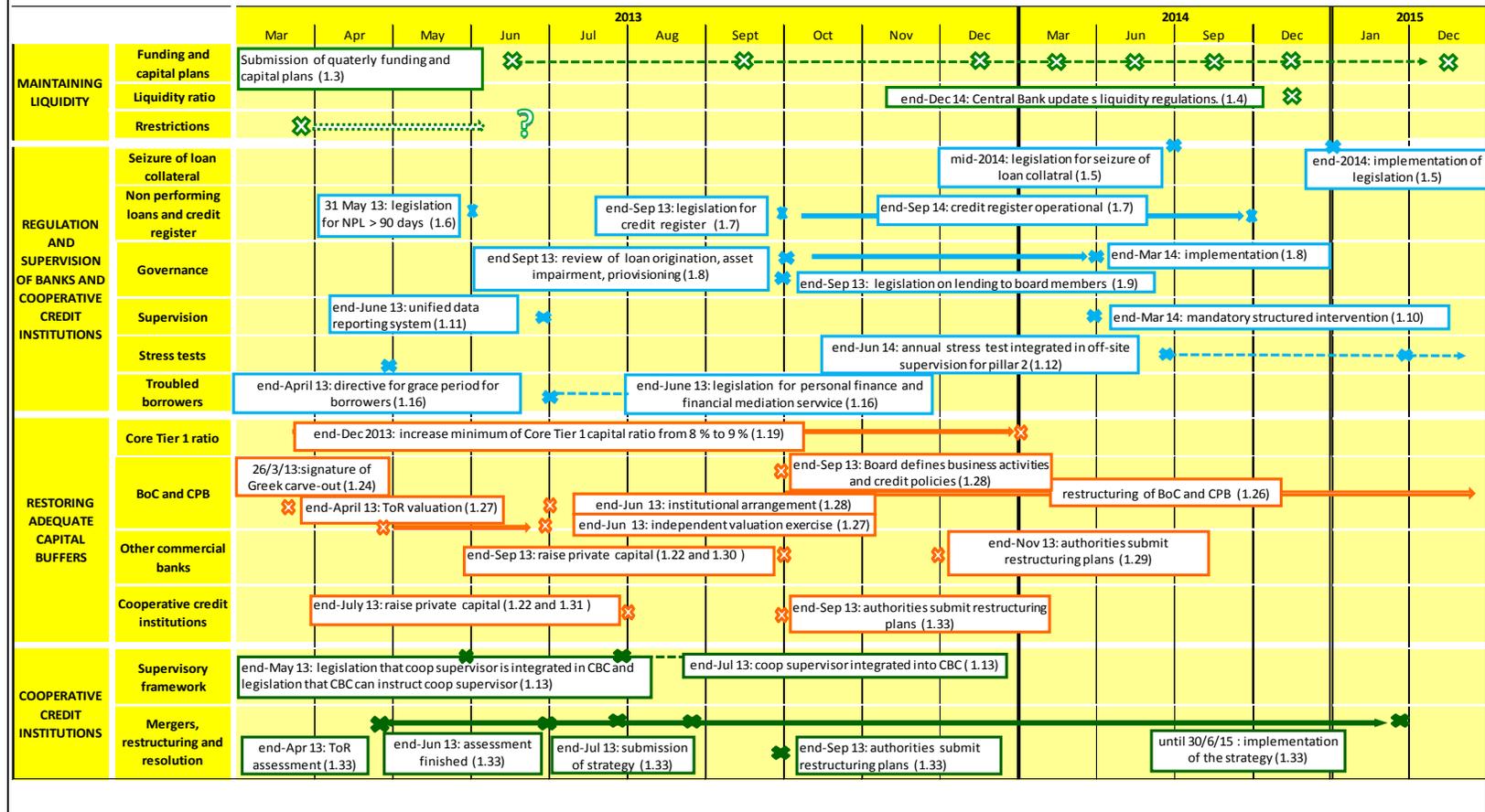
1.32. As regards the cooperative credit institutions, the CBC, assisted by the current supervisor and in consultation with the EC, the ECB and the IMF, will ascertain the viability of individual cooperative credit institutions and design a strategy for restructuring and recapitalising the sector.

1.33. This strategy, including the possibility of the application of mergers and restructuring, will be submitted to the EC, also informing the ECB and the IMF **by end-July 2013** based on an assessment of capital needs and viability to be finalised **by June 2013**. The terms of reference for this assessment will be finalised in consultation with the EC, the ECB and the IMF **by April 2013**. The restructuring plans for the cooperatives will be submitted to the EC **by September 2013**. Cooperative credit institutions in need of aid from the State will not be recapitalised before their restructuring plans have been formally approved under state-aid rules. The terms and remuneration of the state aid will comply with the EU state-aid rules, with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process in line with EU competition and state-aid requirements, which will be scrutinised by an external monitoring trustee. Implementation of the strategy should be completed **by 30 June 2015**. Until the overall strategy has been agreed, there will be no change in the structure of the sector, without prior consultation with the EC, the ECB and the IMF.

1.34. Sufficient funds for the recapitalisation of the cooperative credit institutions will be made available from the programme following the first programme review and will be deposited in a dedicated account with the Central Bank to boost confidence in the system. The amounts will be injected following the identification of the capital needs and in accordance with the agreed strategy, after approval of the restructuring plans. A new governance structure will be established, which allocates clear levels of continued accountability and provides for proper incentives to avoid moral hazard, having regard to a two-tier supervisory system applied in other EU Member States.

1.35. Information pertaining to articles 1.4, 1.13, 1.14, 1.32 and 1.33, will also be shared with the ESM.

## Time Span for Conditionality in the Financial Sector



## 2. Fiscal policy

### **Key objectives**

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

In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation in order to achieve a 3% of GDP primary surplus in 2017, 4% of GDP in 2018 and maintain at least such a level thereafter; (2) to correct the excessive general government deficit as soon as possible; (3) to this end, to fully implement the fiscal consolidation measures listed in Annex 1 and the fiscal consolidation measures for 2013 listed in paragraphs 2.2 – 2.11 below; (4) to achieve the annual budgetary targets as set out in this Memorandum of Understanding (MoU) through high-quality permanent measures, and additional measures in the outer years, in particular to reduce the growth in expenditure on the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on vulnerable groups; and (5) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see Section 3), including the implementation of a Medium-Term Budgetary Framework designed in accordance with EU specifications.

The Cypriot authorities adopted a number of fiscal measures for 2012-2014 as well as initial steps in relation to fiscal-structural reforms.<sup>3</sup> The authorities commit to the full implementation of these measures (see Annex I) and to monitoring the budgetary effect of the measures taken on a monthly basis. Any deviation from the projected budgetary effect of the measures will be evaluated and addressed accordingly in the quarterly programme reviews, taking into account macroeconomic developments. The fiscal measures taking effect in 2012 were included in the amended 2012 Budget Law, which was submitted to the House of Representatives after consultation with the programme partners (i.e. EC/ECB/IMF). Likewise, the budgetary measures with effect in 2013 were embedded in the 2013 Budget Law after consultation with the programme partners. The impact of the additional permanent measures for 2014 has been embedded in the multi-annual expenditure targets accompanying the 2013 Budget Law.

In the event of underperformance of revenues or higher social spending needs, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the

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<sup>3</sup> The adopted bills amounted to consolidation measures of about 5.0% of GDP for 2012-2016, in particular 0.3% of GDP in 2012, 2.3% of GDP in 2013, and 1.9% of GDP in 2014, and ½% of GDP in 2015-2016 based on the macro-economic projections of 23 November 2012.

programme period, cash revenues above programme projections, including any windfall gains,<sup>4</sup> will be saved or used to reduce debt. If instead over-performance materialises, to the extent that it is deemed permanent, this can reduce the need for additional measures in the outer years.

### **Fiscal policy in 2013**

2.1. The Cypriot authorities will achieve a general government primary deficit of no more than EUR 395 million (2.4% of GDP) in 2013. The 2013 deficit target may be revised to incorporate compensation for provident and retirement funds in Cyprus Popular Bank to ensure equal treatment with such funds in Bank of Cyprus following the conversion of deposits into equity. Given the social welfare nature of provident and retirement funds, the Cypriot authorities will use the necessary amount out of programme financing for such compensation.

Over 2013, the Cypriot authorities will rigorously implement the 2013 Budget Law with additional permanent measures of at least EUR 351 million (2.1% of GDP).

After consultation with the programme partners, the 2013 Budget Law was adopted in December 2012. The budgetary target for 2013 was also adopted, accompanied by elements for a medium-term budgetary framework, in particular expenditure ceilings for the budget years 2013-2015 for each government entity.

Additional permanent measures for 2013 will be adopted after review by and consultation with the programme partners and prior to the granting of the first disbursement of financial assistance (applicable to the measures outlined in 2.2, 2.3, 2.4, 2.5, 2.7, 2.8, 2.9, 2.10 and 2.11).

To this end, the Cypriot authorities will amend the 2013 Budget Law, which will contain the additional consolidation measures, and, accordingly, the revised general government primary deficit. In addition, the authorities will update the expenditure ceilings for the budget years of 2013-2015.

The additional consolidation measures will include the following and will, where legally possible, be applicable retroactively from 1 January 2013:

### **Revenue measures**

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

2.3. Increase the statutory corporate income tax rate to 12.5%.

2.4. Increase the tax rate on interest income to 30%.

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

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<sup>4</sup> Windfall gains associated with hydrocarbons shall mean only the blocks' licencing fees or related signature bonuses for exploration thereof. It is noted that any streams of revenues associated with hydrocarbon exploitation are dealt with under section 5.6, second bullet-point, indent 3.

2.6. Undertake by June 2013 a reform of the tax system for motor vehicles, based on environmentally-friendly principles, with a view to raising additional revenues, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.

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

### **Expenditure measures**

2.8. Introduce measures to control healthcare expenditure (see 3.2, measures a), b), c), d) and e).

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

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

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

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

### **Fiscal policy in 2014**

The Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 678 million (4¼% of GDP) in 2014.

The budgetary target and the permanent measures for 2014 already adopted by the Cypriot authorities (see Annex I) were considered in the adopted Medium-Term Budgetary Framework, accompanying the 2013 Budget Law. After review by and consultation with the programme partners **by mid-September 2013**, the 2014 Budget Law will be adopted **by mid-December 2013**. The 2013-2015 expenditure ceilings will be updated for the period 2014-2016 and will accompany the 2014 Budget Law document. The presentation of these ceilings will evolve into a full-fledged Fiscal Strategy Statement in line with the MTBF requirements contained in Directive 2011/85/EU. Any deviation from the budgetary objectives contained in the 2013-2015 framework will be properly documented and reasons for such deviations will be provided.

### **Fiscal policy in 2015-16**

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

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

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

## ***3. Fiscal-structural measures***

### **Key objectives**

Cyprus enjoyed above euro-area average growth rates for more than a decade and in parallel expanded its public sector employment, support and services considerably. Looking ahead, if the public sector is to provide appropriate support for the sustainable and balanced growth of the Cypriot economy, fiscal-structural reform steps are needed to ensure the long-term sustainability of public finances, to provide the fiscal space necessary to support the diversification of the economy, and to alleviate the adverse impact on jobs and growth arising from Cyprus' exposure to external shocks. In this context, the objectives are: (1) to improve the efficiency of public spending and the budgetary process by means of an effective Medium-Term Budgetary Framework (MTBF) that is fully compliant with the Directive on requirements for budgetary frameworks and the Treaty on Stability, Coordination and Governance (TSCG); (2) implement further reforms of the pension system to address the high projected increase in pension spending; (3) take further steps to control the growth of health expenditure; (4) enhance tax revenues by improving tax compliance and collection; (5) undertake reforms of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services; (6) undertake reforms of the overall benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; and (7) elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatisation programme.

### **Pension reform**

3.1. While taking note that the Cypriot authorities have recently introduced significant reforms (as noted below), the implementation of further reforms of the pension system to address the high projected increase in pension spending may be necessary in order to put the pension system on a sustainable path. The overarching objectives of the reforms are: i) to reduce the increase in pension

spending, ii) to ensure the long-term financial viability of the pension system through 2060, and iii) to limit the fiscal subsidy to the General Social Insurance Scheme for credited contributions for current and future pensioners and for the non-contributory pension.

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

- separate in accounting terms the non-contributory pension benefit from the insurance-based (contributory) pension scheme **by 30 June 2013**. The non-contributory part will be tax financed;
- for the General Social Insurance System (GSIS): (i) increase the minimum age for entitlement to an unreduced pension by 6 months per year to be brought in line with the statutory retirement age; (ii) introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iii) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; and (iv) gradually (1 year per year) extend the minimum contributory period in the system from the current 10 years to at least 15 years over the period 2013-17 (in place since December 2012);
- for the Government Employee Pension Scheme (GEPS): (i) increase the statutory retirement age by 2 years for the various categories of employees; (ii) increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; (iii) while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iv) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; (v) introduce a change of indexation of all benefits from wages to prices; and (vi) pension benefits will be calculated on a pro-rata basis taking into account life-time service as of January 2013 (in place since January 2013);
- ensure that total annual public pension benefits for public sector employees and state officials do not exceed 50% of the annual pensionable salary earned at the time of retirement from the post with the highest pensionable salary of the official's career in the public sector and broader public sector (in place since January 2013);
- ensure that pension entitlements that will accrue after 1 January 2013 are considered as personal income, thus becoming fully taxable also in the case in which they are received as a lump-sum payment. At the same time, employees will be granted the option of converting all or part of the lump-sum into an actuarially neutral annuity (in place since January 2013); and
- ensure that all of the above measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees.

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

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

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

### **Health care expenditure**

3.2. To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following measures will be adopted prior to the granting of the first disbursement of financial assistance:

- a) abolish the category of beneficiaries class "B" and all exemptions for access to free public health care based on all non-income related categories except for persons suffering from certain chronic diseases depending on illness severity. Introduce as a first step towards a system of universal coverage a compulsory health care contribution for public servants and public servant pensioners of 1.5% of gross salaries and pensions. The measure will be reviewed **by Q2-2014** with the programme partners. For families with three or more dependent children, the participation in this health care scheme will be voluntary;
- b) increase fees for medical services for non-beneficiaries by 30% to reflect the associated costs of medical services and create a co-payment formula with zero or low admission fees for visiting general practitioners, and increase fees for using higher levels of care for all patients irrespective of age;
- c) introduce effective financial disincentives for using emergency care services in non-urgent situations;
- d) introduce financial disincentives (co-payment) to minimise the provision of medically unnecessary laboratory test and pharmaceuticals; and
- e) adopt a new decision by the Council of Ministers concerning a restructuring plan for public hospitals, improving quality and optimising costs and redesigning the organisational

structure of the hospital management, by putting into practice recommendations from the 2009 "Public Hospital Roadmap".

In addition, the programme partners will review and be consulted on the following measures before their implementation:

- f) assess and publish, before parliamentary discussion, the potential risks and benefits of the planned introduction of the National Health System (NHS) in an updated actuarial study, taking into account possible proposals for implementing NHS in stages **by Q2-2013**;
- g) make the award of the tender for the IT-infrastructure conditional upon the results of the study and the decision for implementing the NHS;
- h) review income thresholds for free public health care in comparison to the eligibility criteria for social assistance while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures **by Q4-2013**;
- i) create protocols for laboratory tests and the prescription of pharmaceuticals based on thorough scientific evidence;
- j) introduce a coherent regulatory framework for pricing and reimbursement of goods and services based on the actual level of costs incurred in accordance with Article 7 of Directive 2011/24/EU of the European Parliament and of the Council of 9 March 2011. An interim report will be ready **by Q3-2013**;
- k) conduct an assessment of the basket of the top 4 publicly reimbursable healthcare products in terms of annual spending and prepare a report to establish an integrated system for health-technology assessment to increase the cost-effectiveness of the basket of publicly reimbursed products; and prepare the implementation of 10 new clinical guidelines focusing on high annual volume and high cost diseases **by Q2-2013**;
- l) start coding inpatient cases by the system of diagnosis-related groups (DRGs) with the aim of replacing the current hospital payment system by payments based on DRGs **by Q3-2013**;
- m) in a first step, establish working time in the Health Service, in conjunction with moving the starting time by half an hour (from 7.30 to 8.00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00). Following a review, in a second step, revise the regular working hours and stand-by shifts of healthcare staff, including rules to increase the mobility of staff; revise current regulations on overtime pay and fully implement existing laws on recording/monitoring overtime payments (see 3.11) **by Q1-2014**; and
- n) define a basket of publicly-reimbursable medical services based on objective, verifiable, criteria, including cost-effectiveness criteria **by Q2-2013**.

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

### **Budgetary framework**

3.3. The Cypriot authorities will:

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in law **by Q2-2013**;
- complete the adoption of the law transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and provisions pertaining to the fiscal compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts ensuring that adopted measures are fully effective **by Q2-2013**. In particular, integrate the presentation of the existing multi-annual budgetary objectives (MoU fiscal targets and the rolling three-year expenditure ceilings) into a comprehensive Fiscal Strategy Statement in compliance with MTBF requirements in the sense of Directive 2011/85/EU to guide the preparation of the 2014 budget **by Q2-2013**; and
- submit to the House of Representatives a draft high-level Fiscal Responsibility and Budget System Law applicable to the entire general government sector. The draft law will encompass, inter alia, macro-fiscal policy-making, and budget formulation and approval. It will address remaining gaps and inconsistencies and codify existing good budget practices **by Q4-2013**.

### **Public private partnerships (PPPs)**

3.4. The Cypriot authorities will:

- create an inventory of PPPs including information on the objectives of current and planned PPPs and more detailed information on signed contracts, including their nature, the private partner, capital value, future service payments, size and nature of contingent liabilities, amount and terms of financing. In addition, an inventory of contingent liabilities including information on the nature, intended purpose, beneficiaries, expected duration, payments made, reimbursements, recoveries, financial claims established against beneficiaries, waivers of such claims, guarantee fees or other revenues received, indication of amount and form of allowance made in the budget for expected calls, and forecast and explanation of new contingent liabilities entered into in the budget year will be compiled. The inventories will be shared **by Q3-2013** with the programme partners. As of 2014, the inventories will be updated annually and included as “Statement of PPPs” and “Statement of Contingent Liabilities” in appendices to the annual budget law and to the annual financial report;
- put in place an adequate legal and institutional framework for PPPs designed according to best practices, including ex-ante assessment and monitoring of the fiscal risks of engaging in PPPs and concessions as compared to other public investments. A proposal for such a

strengthened legal and institutional framework for PPPs should be drafted **by Q3-2013** and implemented **by Q4-2013**; and

- commit not to enter into any new tendering process and not to sign any new PPP contract before the implementation of the legal and institutional PPP framework, excluding any project having reached commercial close by end-October 2012.

### **State-owned enterprises and privatisation**

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

- establish an inventory of assets, owned by central government, municipalities and regional administrations, including real estate and land. As a first step, priority will be given to assets with the highest commercial value, including at least one third of SOEs **by Q2-2013** and the remaining SOEs **by Q3-2013**. This inventory will indicate which SOEs could be subject to divestment or restructuring or liquidation. The inventory of the largest and most valuable real estate and land assets will be ready **by Q3-2013**. The full inventory of all assets (SOEs, real estate and land) will be completed **by Q4-2013**. The inventory will be gradually submitted to the programme partners;
- prepare a plan to strengthen the governance of SOEs in accordance with international best practices and draft a report reviewing the operations and finances of SOEs (see 3.11) **by Q3-2013**. The report will assess these companies' business prospects, the potential exposure of the government to the SOEs and the scope for orderly privatisation. The Cypriot authorities will adopt the necessary legal changes to fulfil this requirement **by Q4-2013**. No additional SOEs will be created throughout the duration of the Programme; and
- submit to the House of Representatives a draft law to regulate the creation and the functioning of SOEs at the central and local levels and enhance the monitoring powers of the central administration, including reporting on SOEs in the context of the annual budgetary procedure **by Q4-2013**.

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

- This plan should consider the privatisation prospects of state-owned enterprises (SOEs) and semi-governmental organisations (SGOs), including, inter alia, CyTA (telecom), EAC (electricity), CPA (ports), as well as real estate/land assets. For the privatisation of natural monopolies, an appropriate regulatory framework is a prerequisite. The provision of basic public goods and services by privatised industries will be fully safeguarded, in line with the national policy goals and in compliance with the EU Treaty and appropriate secondary legislation rules;
- The privatisation plan will be based on the report reviewing the operations and finances of SOEs, as well as the inventory of assets. The privatisation plan will be created after

consultation with the programme partners, including asset-specific timelines and intermediate steps **by Q3-2013**;

- In parallel, the specific legal and institutional framework for the privatisation process will be drafted **by Q3-2013** and implemented **by Q4-2013**, after consultation with the programme partners; and
- The privatisation plan identified by the Government after consultation with the programme partners will raise at least EUR 1 billion by the end of the programme period and an additional EUR 400 million by 2018 at the latest.

### **Revenue administration, tax compliance, and international tax cooperation**

3.7. The Cypriot authorities will propose a comprehensive reform plan to improve the effectiveness and efficiency of tax collection and administration **by Q4-2013**, for implementation as of the budget year 2014. The reform shall encompass the following elements:

- attribute personal responsibility for payment of company taxes to those, who -in the case of non-listed companies- truly and effectively control a company;
- attribute personal responsibility to the responsible manager for fraudulent filing of company taxes;
- strengthen powers by the tax authorities to ensure payment of outstanding tax obligations, e.g. by having authority to seize corporate assets, prohibiting alienation or use of assets, including property and bank accounts, by the taxpayer;
- harmonise the legislation among tax types so that not paying taxes is a criminal offense regardless of the type of tax and that there is an administrative appeals process for all of these taxes before going to the courts;
- increase staff mobility between different tax administration entities in order to ensure appropriate staffing of entities with high revenue collection capacities;
- where not in place, establish clear performance objectives, including on revenue collection results, for each revenue administration entity, and improved transparency regarding the performance of revenue administration entities, e.g. via publication of the tax gap for main revenue categories (the difference between the tax owed and the amount actually collected);
- optimise use of IT systems in the tax administration based on: (i) facilitating information exchange between tax administration entities; (ii) enhancing the use of e-filing of tax returns and e-payment (e.g. by allowing payment through bank transfers); (iii) improving the exchange of information, including data on natural and legal persons, between relevant authorities for tax collection purposes, taking into account legal provisions for data protection; (iv) enhancing reporting capabilities in relation to obligations under Council Directive 2003/48;
- enhance the efforts to reduce administrative burden on businesses, with a view to reducing informal activities and achieving voluntary compliance to the widest possible extent. In this

respect, systematically measure the time and cost for taxpayers to complete revenue administration procedures such as registration or filing;

- step up administrative tax fraud investigations and enhance cooperation between the tax and judicial systems, while addressing potential bottlenecks in the tax appeal system;
- improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer; and
- remove from the income tax law the Director's prerogative to act as deemed necessary in relation to the application of the Law's provisions, including the decision on the withdrawal of lawsuit for unpaid taxes.

3.8. The Cypriot authorities will implement reforms, which build on the main recommendations derived from the diagnostic technical assistance mission conducted in February 2013. To this end, the authorities will elaborate a comprehensive reform agenda and consult with the programme partners on this agenda **by Q2-2013**.

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

- fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation<sup>5</sup> and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;
- ensure timely access to information on beneficial ownership of trusts and to an audit trail of financial transactions of trustees. To this end, the programme partners take note of the Cypriot authorities' intention to establish registers of trusts held by the respective competent supervisory authority and of the recently-introduced obligation to have, at any given time, for trusts under Cyprus law at least one trustee who is a resident in Cyprus. Professional trustees should be authorised or otherwise regulated (i.e. as lawyers, accountants or Trust and Company Service Providers) and all trustees, whether regulated or not, should be registered (see paragraph 1.17). Trustees should report information to their respective supervisors on their relation to a trust. In addition, the Cypriot authorities will require trustees of trusts under Cyprus law to declare their status to credit institutions<sup>6</sup> when using the financial system in Cyprus, and require credit institutions established in Cyprus to

<sup>5</sup> The Cypriot authorities have submitted Law N. 205(I)/2012 (enacted on 28 December 2012), transposing the Directive, to the European Commission.

<sup>6</sup> As defined in Art. 2.1(1) of the Third Anti-Money Laundering Directive, 2005/60/EC

obtain a corresponding declaration of status from trustees of trusts created under and governed by foreign law as a mandatory condition for using the financial system in Cyprus **by Q3-2013**;

- ensure that they have timely access to information on who truly and effectively controls a company established in Cyprus. To this end, they will either a) require nominee directors<sup>7</sup> and nominee shareholders to disclose the identity of their nominator to the company and to the company register; or b) require that all nominee directors and nominee shareholders be authorised or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs). In the case of the trustee service being provided by a TCSP, the information that the TCSP is a professional service provider will be accessible through the registers under the TCSP Law **by Q3-2013**;
- ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States; and
- implement the recommendations put forward in the in-depth review of Cyprus' legal and regulatory framework under the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and commit to address any shortcomings to be identified in the forthcoming evaluation of implementation issues.

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

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<sup>7</sup> Under Cyprus law, there is no legal concept of 'nominee director', but it is used with reference to professionals who provide director services.

### **Immovable Property Tax Reform**

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

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

3.10. In view of this, the Cypriot authorities have agreed to implement the following measures:

- implement a property price index that establishes the average property market valuation in 2013 by square meter of habitable surface and land plot. This index shall be operational to provide imputed market valuations for each non-agricultural cadastral plot **by Q2-2014**, in time for its application in the calculation of the immovable property tax in 2014. The index shall vary according to location and zoning as well as other building- and plot-related characteristics. Moreover, propose and implement a methodology for annual updates of such imputed market valuations;
- implement the recurrent immovable property tax based on imputed market valuations of land plots according to a unit tax base established by this property index **by Q3-2014**. The tax rates shall reflect the progressivity and revenue of the preceding property tax. For co-owned land plots, individual owners shall be taxed according to ownership proportions as provided in the cadastre;
- establish the legal basis for a mandatory annual adjustment of the property unit tax base by a competent executive authority **by Q3-2014**; and
- in order to retain a stimulus to property demand and reduce distortions in property prices, provide for an extension of the reduction in property transaction fees until 2016 by Q2-2013.

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

- a study on refining the parameters of the imputed property market value index within the bounds of administrative and legal simplicity. In particular, the study shall assess the feasibility of a unit tax base for individual dwellings. Moreover, the study shall report on a mechanism to dampen cyclical variations in the index; and
- a further study on the scope of consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope of shifting revenue from transaction fees and taxes to recurrent taxation **by early 2015**.

### **Public administration reform**

3.11. The public sector represents a large share of public expenditures in Cyprus. To ensure an efficient use of government resources, while delivering a quality service to the population; the Cypriot authorities will undertake the following reform measures:

- reduce impediments to staff mobility within the public and broader public sector, inter alia, by removing restrictions arising from the Public/Broader Public Service Laws as to the duration and placement of secondments, as well as the need for employee consent **by Q2-2013**; and
- in a first step, as of 1.9.2013, establish working time in the Public Service, in conjunction with moving the starting time by half an hour (from 7:30 to 8:00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00). Following part 1 of the below review, in a second step, further reduce overtime and related costs to the public sector wage bill by making working time more flexible so as to cover - as a minimum - service hours from 7:00 until 17:00 in the entire public sector and service hours from 7:00 to 19:00 for public sector services with extended operating hours (including, but not limited to, healthcare and security), under regular working time. Working hours outside regular working time shall be limited by enforcing strict controls, including requiring pre-approval of any non-emergency work outside regular working time (see 3.2) **by Q1-2014**.

In addition, the Cypriot authorities will commission an independent external review of possible further reforms of the public administration based on the terms of reference already agreed with the programme partners.

The review will comprise two parts, covering the following areas:

Part 1:

- examination of the role, the competences, the organisational structure and the size/ staffing of relevant ministries, services and independent authorities;
- examination of the possibility of abolishing or merging/consolidating Non-profit Organisations/Companies and publicly owned enterprises; and
- re-organisation/re-structuring of local government.

Part 2:

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

The first part of the review will be published **by Q1-2014**. The second part of the review will be published **by Q3-2014**. Based on the findings of the review, the Cypriot authorities will agree upon a reform after consultation with the programme partners, submit it to the House of Representatives

for approval and implement a reform of the public administration (part 1 **by Q2-2014** and part 2 **by Q4-2014**).

### **Welfare system**

3.12. The welfare system in Cyprus encompasses a broad range of individual benefits provided by different Ministries and Departments. To ensure efficient use of public funds within the welfare system, while at the same time ensuring an appropriate balance between welfare benefits and incentives to take up work (as further specified in section 4.3 below), the Cypriot authorities will carry out a reform of the welfare system to be implemented and applied as of 1 January 2014 after review by and consultation with the programme partners (draft reform plan to be submitted **by Q2-2013**). The reform will cover the following elements:

- streamlining the number of benefits available through merging and phasing out;
- better targeting of various social transfers, so as to reduce the total number of beneficiaries while protecting the most vulnerable by:
  - the introduction of a common definition of income sources, financial assets and movable and immovable property to be taken into account for means-testing, so as to ensure consistency across different benefit schemes;
  - the introduction or tightening of means-testing criteria, on the basis of the above definition, for benefit provision and continued access to benefits by lowering income thresholds, accounting for wealth such as financial assets, movable and immovable property, and broadening the sources of income to be taken into consideration. With respect to the latter, as a general principle benefits provided should be fully accounted for in the computation of personal income;
- a review of the appropriate levels of individual benefits and the index for adjustment of benefit levels; and
- transferring of all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour and Social Security, which should be appropriately equipped in terms of financial and human resources, reassigned from other departments of the public administration by Q1-2014 (see 3.11).

The reforms must be consistent with the fiscal targets defined in this MoU.

## **4. Labour market**

### **Key objectives**

While the Cypriot labour market was characterised by high employment rates and low unemployment in the years leading up to the crisis, the unwinding of unsustainable imbalances and worsening of macroeconomic conditions and prospects have resulted in rapidly rising unemployment and important labour market challenges over the medium-term. Labour market reforms can mitigate the impact of the crisis on employment, limit the occurrence of long-term and

youth unemployment, facilitate occupational mobility and contribute to improving the future resilience of the Cypriot economy in the face of adverse economic shocks. In this context, the objectives are: (1) to implement a reform of the system of wage indexation commensurate with ensuring a sustainable improvement in the competitiveness of the economy and allowing wage formation to better reflect productivity developments; (2) to prepare and implement a comprehensive reform of public assistance in order to achieve an appropriate balance between public assistance and incentives to take up work, target income support to the most vulnerable, strengthen activation policies and contain the public finance impact of rising unemployment; and (3) to help attenuate adverse competitiveness and employment effects by linking any change in the minimum wage to economic conditions.

### **Cost of living adjustment (COLA) of wages and salaries**

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

- a lower frequency of adjustment, with the base period for calculating the indexation (COLA) being lengthened from the current period of six months to twelve months. Indexation would take place on 1st January each year;
- a mechanism for automatic suspension of application and derogation procedures during adverse economic conditions, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation would be effected for the following year; and
- a move from full to partial indexation, with the rate of wage indexation being set at 50% of the rate of increase of the underlying price index over the previous year.

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

A tripartite agreement will be pursued with social partners for the application of the reformed system in the private sector **by end-2013**. Furthermore, based on the current economic outlook, wage and salary indexation is foreseen not to be applied in the private sector until 2014.

### **Minimum wage**

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

### **Public assistance and activation of the unemployed**

4.3. The increase in unemployment underlines the need for an overall assessment of activation policies and available instruments for income support after the expiration of unemployment insurance benefits. The planned reform of public assistance should ensure that social assistance serves as a safety net to ensure a minimum income for those unable to support a basic standard of living, while safeguarding incentives to take up work, ensuring consistency with the reform of the welfare system as described in section 3.12. Therefore, the Cypriot authorities will:

- ensure that the planned reform of public assistance includes measures aimed at activating benefit recipients by facilitating their reinsertion in the labour market, reducing disincentives to work and imposing job-search requirements for continued benefit receipt. To this end, the draft reform plan on public assistance will be submitted to the programme partners by Q2-2013 for review and consultation;
- provide an assessment of current activation policies by Q2-2013; and
- review and enhance the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed.

## **5. Goods and services markets**

### **Key objectives**

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

### **Services Directive: Sector-specific legislation**

5.1. The Cypriot authorities will adopt the remaining necessary amendments to the sector-specific legislation in order to fully implement the Services Directive, easing the requirements related to entry and establishment. In addition, requirements concerning minimum tariffs should be eliminated unless they are justified according to article 15(3) of the Services Directive. Amendments

will be presented to the House of Representatives by Q2-2013 and minimum tariff requirements without justification will be abolished by Q2-2013.

### **Reform of regulated professions**

5.2. The Cypriot authorities will:

- eliminate any existing total bans on the use of a form of commercial communication (advertising) in regulated professions, as required by the Services Directive by Q2-2013; and
- further improve the functioning of the regulated professions sector (such as lawyers, engineers, architects) by carrying out a comprehensive review of requirements affecting the exercise of activity by Q3-2013 and eliminating those that are not justified or proportional by Q1-2014; and
- requirements affecting the access to the activity shall be assessed in order to repeal those which are not justified or proportionate after the adoption of the Directive amending Directive 2005/36/EC on the recognition of professional qualifications and Regulation on administrative cooperation through the Internal Market Information System, and in accordance with the evaluation, methodology and timeframe to be defined in the said amending Directive.

### **Competition and sectoral regulatory authorities**

5.3. The Cypriot authorities will:

- ensure the independence and enhance the effective functioning of the Commission for the Protection of Competition and its ability to enforce effectively the competition rules **by Q4-2013**; and
- ensure the necessary independence and power of the national regulatory authorities (NRA) and enhance their ability to exercise their responsibilities and to carry out effectively their tasks, including monitoring the competitive situation in their respective sector **by Q4-2013**.

### **Housing market and immovable property regulation**

5.4. The Cypriot authorities will take the following measures to ensure market clearing of the property market, allow for efficient seizure of property collateral, and for market-based assessment of property prices, as well as alleviating the factors deterring both domestic and foreign demand. A particular risk arises from legal disputes, which may be due to incomplete documentation of ownership and property rights and the slow pace of judicial procedures.

The Cypriot authorities will:

- provide for mandatory registration of sales contracts for immovable property **by Q2-2013**. **By Q4-2014**, eliminate the title deed issuance backlog to less than 2,000 cases of immovable property sales contracts with title deed issuance pending for more than one year. The Cypriot authorities will enhance cooperation with the financial sector to ensure the

swift clearing of encumbrances on title deeds to be transferred to purchasers of immovable property, and implement guaranteed timeframes for the issuance of building certificates and title deeds;

- publish quarterly progress reviews of the issuance of building and planning permits, certificates, and title deeds, as well as title deed transfers and related mortgage operations throughout the duration of the programme;
- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the financial sector and government services **by Q4-2014**. Personal data privacy legislation shall be reviewed and amended to alleviate legal impediments to such electronic access, in particular concerning the procedures for proof of legal interest **by Q2-2013**;
- introduce legislation on amending the procedure on the forced sale of mortgaged property to allow for private auctions as under the rules for immovable property recovery under bankruptcy regulations. The Cypriot authorities shall enact regulations to provide for the conclusion of such private auctions within shortest feasible timespans (see 1.5) **by end-2013**; and
- better target the rules of court to improve the pace of court case handling. The Cypriot authorities shall assess the need for additional measures – including if necessary legislative reforms - to eliminate court backlogs by end of the programme. Moreover the authorities shall provide for specialized judges akin to the rules for criminal case handling in order to expedite the handling of cases under commercial and immovable property laws **by Q4-2013**.

### **Tourism**

5.5. Tourism is an important export sector and is of great importance to domestic value added and employment. Since 2011, tourism has experienced a significant increase in tourism arrivals and incomes, while the prospects for the continuation of that upward trend in 2013 are excellent. In particular, in 2011, there was an increase of 10.1% in tourism arrivals and 12.9% in revenue growth compared to 2010, while in 2012 (latest data August) there was a further increase of 5% and 8.5% respectively compared to 2011. To strengthen the competitiveness of the tourism sector, the Cypriot authorities will:

- carry out a study on how to improve the tourism sector business model, in particular, with a view to lengthening the tourist season, increasing occupancy rates of hotels and promoting resident tourism during winter time, developing a multi-dimensional and high quality tourism, *inter alia*, by defining thematic niches such as sport, cultural and medical tourism, developing individual tourism, promoting professionalism of tourist service providers and ensuring the dissemination of best-practices on upgrading the quality of the services provided, improving the role of tourism-related infrastructure investment. The Tourism Strategy for 2011-2015 will be reviewed and, if necessary, revised based on the study's findings **by Q2-2013**;
- facilitate condo hotel projects with the aim of enhancing access to financing investment in hotel development, including the removal of any legal impediments **by Q2-2013**; and

- in order to enhance attractiveness of the country as a destination, engage in a thorough analysis of the best means of achieving sufficient air connectivity for Cyprus, including by negotiating new or amending existing air services agreements.

## **Energy**

5.6. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package has been completely transposed and fully implemented and notify the European Commission that the necessary legislation has been transposed; indicate the date of delivery of the first commercial supply of natural gas under a long-term supply contract, thereby ending Cyprus' derogation of an isolated energy network and initiating the application of the emergent market derogation; and indicate the intended duration of the latter derogation;
- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy, to be developed under the full authority of the Cypriot Government, should include at least the following three key elements, which should be presented to the programme partners for consultation according to the timeline specified below:
  1. a *roll-out plan* for the infrastructure required for the exploitation of natural gas, taking into account possible commercial uncertainties and risks. The plan should cover: the required investments, associated costs, financing sources and methods, related major planning risks and bottlenecks; and a projection of the revenue streams over time; first version **by Q3-2013**;
  2. an *outline of the regulatory regime (CERA) and market organisation* for the energy sector and gas exports, which would be conducive to the introduction and proper functioning of open, transparent, competitive energy markets, taking into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, and the EU targets for energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include the following elements: the potential for setting-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; full unbundling of gas suppliers and customers, in particular electricity companies; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues **by Q2 2013**; and
  3. a plan to establish the institutional framework for the management of hydrocarbon resources, including a *resource fund*, which should receive and manage the public revenues from offshore gas exploitation. The preparatory phase should include the required legal steps and their adoption. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices. In particular, clear rules governing inflows and outflows should be established as part of Cyprus' budgetary framework, giving due respect to the need to develop the hydrocarbon

industry, including the necessary infrastructure, the importance of bringing Cyprus' public debt on a steady downward path and the need to invest and generate value for all strata of society, including future generations **by Q3-2013**.

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

## *Appendix I—Budgetary measures adopted by Cyprus in or after December 2012*

### **Fiscal measures with effect in 2012**

#### **Expenditure measures**

- I.1 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-1000: 0%; EUR 1001-1500: 6.5%; EUR 1501-2000: 8.5%; EUR 2001-3000: 9.5%; EUR 3001-4000: 11.5%; above EUR 4001: 12.5%.
- I.2 Extend the suspension of the practice of COLA for the public and broader public sector until the end of the programme (Q1-2016) (see section 4.1).
- I.3 Extend the freeze of increments and general wage increases in the public and broader public sector and temporary contribution in the public, broader public and private sectors on gross earnings and pensions by three additional years until 31 December 2016.
- I.4 Reduce the number of public sector employees by at least four thousand five hundred over the period of 2012-16 by: i) freezing the hiring of new personnel on first entry posts in the broader public sector for three additional years until 31 December 2016; ii) implementing a policy of recruiting one person for every four retirees (horizontal); iii) introducing measures to increase the mobility of civil servants within and across line ministries (see 3.11); and iv) implementing a four-year plan aimed at the abolition of at least 1880 permanent posts (see I.16).
- I.5 Freeze the hiring of new hourly paid employees and enforce immediate application of mobility within and across ministries and other government entities. In the case of health and security posts, recruitment of one person for every five retirees will be possible to meet urgent needs.

#### **Revenue measures**

- I.6 Appropriate a one-off additional dividend income collected from semi-governmental organisations.
- I.7 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.095% to 0.11% with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.
- I.8 Introduce a mechanism for a regular review of excise taxes to secure the real value of excise tax revenue. Such a mechanism should be non-recurring and should, by no means lead to an automatic indexation mechanism of excise taxes to price developments.

### **Fiscal measures with effect in 2013**

#### **Expenditure measures**

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

allowances under public assistance, the abolition of the special grant and the streamlining of the Easter allowance for pensioners.

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

- i. taxing pensionable allowances provided to senior government officials and employees (secretarial services, representation, and hospitality allowances) in the public and broader public sector;
- ii. reducing the allowances provided to broader public sector employees and reducing all other allowances of broader public sector employees, government officials and hourly paid employees by 15%; and
- iii. reducing the daily overseas subsistence allowance for business trips by 15%. Ensure a further reduction the subsistence allowance of the current allowance when lunch/dinner is offered by 50% (20% - 45% of overseas subsistence allowance instead of 40% - 90% currently paid).

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

- i. suspending the right to travel first/business class by state officials, senior government officials and employees with the exception of transatlantic travel. The right to business class travel shall be maintained for the President of the Republic of Cyprus and the President of the House of Representatives;
- ii) abolishing the right to duty free vehicles for employed and retired senior public sector officials; and
- iii) extending the wage freeze and temporary contribution on gross earnings to cover all state officials and permanent secretaries (129 individuals) for 2013-2016, including members of the House of Representatives. Include pensionable and tax-free allowances of these individuals in the calculation of their taxable income. Introduce a contribution of 6.8% on the pensionable earnings of these individuals.

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

- i. freeze public sector pensions;
- ii. increase the statutory retirement age by 2 years for the various categories of employees; increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral;
- iii. reduce preferential treatment of specific groups of employees, like members of the army and police force, in the occupational pension plans, in particular concerning the contribution to the lump-sum benefits;

- iv. introduce a permanent contribution of 3% on pensionable earnings to Widows and Orphans Fund by state officials who are entitled to a pension and gratuity. Introduce a contribution of 6.8% on pensionable earnings by officials, who are entitled to a pension and gratuity but are not covered by the government's pension scheme or any other similar plan;
  - v. amend Article 37 of the Pensions Law to abolish the provision according to which, in the case of death of an employee, if the deceased had a wife/husband at the time of his/her retirement and thereafter he/she remarried, his/her last wife/husband is considered a widow/widower. With the abolition of this provision, the second wife/husband will not be considered a widow/widower and thus she/he will not be entitled to pension;
  - vi. increase the contribution rate on the pensionable earnings of the members of the Tax Tribunal Council and the Tender Review Authority from 3.4% to 6.8%; and
  - vii. the contributions to the Widows and Orphans Fund will no longer be reimbursable.
- I.13 Implement further reform steps under the General Social Insurance Scheme by:
- i. actuarially reducing pension entitlements from the General Social Insurance Scheme by 0.5% per month for retirements earlier than the statutory retirement age at the latest from January 2013, in line with the planned increase in the minimum age for entitlement to an unreduced pension to reach 65 (by 6 months per year), between 2013 and 2016;
  - ii. freezing pensions under the Social Security Fund for the period 2013-2016;
  - iii. abolishing the increase of pensions for a working dependent spouse under the General Social Insurance Scheme at the latest from January 2013 onwards.
- I.14 Reduce transfers by EUR 25 million from central government to state-owned enterprises and semi-public institutions.
- I.15 Ensure a targeted reduction of budgetary appropriations for a series of semi-governmental organisations in the 2013 Budget Law, supported by well-defined activity-reducing measures.
- I.16 Implement a four-year plan as prepared by the Public Administration and Personnel Department aimed at the abolition of at least 1880 permanent posts over the period 2013-2016.

### **Revenue measures**

- I.17 Increase excise duties on tobacco products, in particular on fine-cut smoking tobacco, from EUR 60/kg to EUR 150/kg. Increase excise duties on cigarettes by EUR 0.20/per packet of 20 cigarettes.
- I.18 Increase excise duties on beer by 25% from EUR 4.78 per hl to EUR 6.00 per hl per degree of pure alcohol of final product. Increase excise duties on ethyl alcohol from EUR 598.01 to EUR 956.82 per hl of pure alcohol.
- I.19 Increase excise duties on energy, i.e., on oil products, by increasing tax rate on motor fuels (petrol and gasoil) by EUR 0.07.
- I.20 Increase the standard VAT rate from 17% to 18%.

I.21 Introduce a tax of 20% on gains distributed to winners of betting by the Greek Organisation of Football Prognostics S.A. (OPAP) and the National Lottery for winnings of EUR 5,000 or more.

I.22 Abolish all exceptions currently in place for paying the annual company levy of EUR 350.

### **Fiscal measures with effect in 2014**

#### **Expenditure measures**

I.23 Ensure a reduction in total outlays for social transfers by a at least EUR 28.5 million to be achieved through streamlining and better targeting of child benefits and educational grants, and abolition of social cohesion benefits provided by the welfare services.

I.24 Implement a further reduction in emoluments of public and broader public sector employees and pensioners by a flat rate reduction of 3% on all wages.

I.25 Introduce a fee on monthly transportation cards for the use of public transportation services by students and pensioners.

#### **Revenue measures**

I.26 Extend the application of the temporary contribution on gross earnings and pensions of public and private sector employees up to 31 December 2016 as follows: EUR 0 – 1,500: 0%; EUR 1,501 – 2,500: 2.5%; EUR 2,501 – 3,500: 3.0%; and > EUR 3,501 - : 3.5%.

I.27 Increase the standard VAT rate from 18% in 2013 to 19% in 2014.

I.28 Increase the reduced VAT rate from 8% to 9%.

I.29 Increase excise duties on energy, i.e., on oil products, by increasing the tax rate on motor fuels (petrol and gasoil) by EUR 0.05.

I.30 Increase the contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point on pensionable earnings, i.e. 0.5 of a percentage point from employees and 0.5 of a percentage point from employers and 1 percentage point in the case of self-employed persons.