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CYPRUS

September 2013

FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND REQUEST FOR MODIFCATION OF PERFORMANCE CRITERIA

The following documents have been released and are included in this package:

- **Staff Report** prepared by a staff team of the IMF, following discussions that ended on July 31, 2013, with the officials of Cyprus on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 30, 2013. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Staff Supplement** of September 10, 2013 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its September 16, 2013 discussion of the staff report that completed the review.
- **Statement by the Executive Director** for Cyprus.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Cyprus*
Memorandum of Economic and Financial Policies by the authorities of Cyprus*
Technical Memorandum of Understanding*

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

CYPRUS

August 30, 2013

FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA

EXECUTIVE SUMMARY

Extended Arrangement. On May 15, 2013 the Executive Board approved a three-year Extended Arrangement under the Extended Fund Facility (EFF) in the equivalent of SDR 891 million (563 percent of quota; €1 billion). A purchase of SDR 74.25 million (about €86 million) was made in May 2013, and another equal purchase (SDR 74.25million, or about €86 million) will be released upon completion of the first review. The European Stability Mechanism has released €3 billion (of €9 billion committed).

Recent Economic Developments. Output contracted in the first half of the year, but by less than projected, and sentiment indicators have rebounded from the trough hit in April. Nevertheless, the economic situation remains very difficult. The March bank crisis, the introduction of payment restrictions, and the drag from fiscal consolidation are all weighing on domestic demand. Internal adjustment has led to rapidly rising unemployment, while inflation has remained subdued. The trade balance has been adjusting mainly through a sharp contraction in imports. With still high uncertainty going forward, the program's macroeconomic framework was maintained broadly unchanged.

Policy Implementation. The program is on track, and ownership by the authorities has improved. Fiscal targets were met with a comfortable margin. All structural benchmarks were also observed, albeit some with a brief delay. The authorities have made important strides to complete the bank resolution process, publish a roadmap to gradually ease payment restrictions, and finalize a restructuring strategy for the cooperative credit sector. However, much remains to be done to fully implement the financial sector restructuring strategy and restore confidence in the system. Key reforms of revenue administration and the social safety net are also underway. Nevertheless, risks to the program remain substantial, given the uncertain impact of the crisis, the still-recovering banking system, and ongoing challenges to policy implementation.

Approved By
Philip Gerson and Mark Flanagan

Discussions were held in Nicosia during July 17–31. The mission met with the Minister of Finance, the Governor of the Central Bank of Cyprus, and other Cabinet Ministers, among others. Staff worked in conjunction with representatives from the European Commission and the European Central Bank. The IMF team comprised Delia Velculescu (head), Nikita Aggarwal, Katja Funke, Vincenzo Guzzo, Alejandro Hajdenberg, Annamaria Kokenyne, Emmanuel Mathias, Uffe Mikkelsen, François Painchaud, Jiri Podpiera, Alejandro Simone, and Oliver Wuensch. Mr. Luis Cortavarría provided support from headquarters. Mr. Kanaris (OED) attended some of the meetings.

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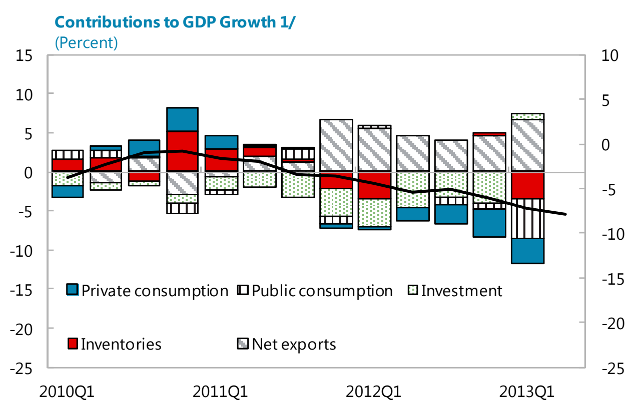
BACKGROUND

1. **The political and social tensions following the March crisis are slowly subsiding.** The unprecedented resolution of the two largest systemic banks with bail in of uninsured depositors was heavily criticized by the opposition and the public, weakening the support of the just-elected government. Leaks, inconsistent messages in the press, and divergences between the government and the Central Bank of Cyprus (CBC), which culminated in the resignation of the CBC's Board of Directors, further dented confidence. Nevertheless, tensions have recently moderated; a new CBC Board is in place; the government has issued public statements in support of the program; and public acceptance of the program as the only way forward toward economic recovery is gradually increasing.

2. **The program has remained on track**. All end-June performance criteria (PCs) have been met with a comfortable margin. The structural benchmark on the strategy to restructure the cooperative credit institutions (CCI) sector was met at end-June, and that on the exchange of €1 billion of domestic debt and rollover of the €1.9 Laiki recapitalization bond was completed on July 1.[1] Two other benchmarks on the assessment of capital needs and viability for Bank of Cyprus (BoC) and the CCIs were partially met by end-June and fully completed by end-July.

RECENT ECONOMIC DEVELOPMENTS

3. **The recession has continued to deepen** (Figure 1). End-June flash estimates suggest that output declined by 5.2 percent y-o-y in the second quarter, reflecting the impact on private sector consumption and investment of the March bank crisis and the introduction of deposit restrictions and capital controls, as well as the drag from the large fiscal adjustment implemented in 2012 and early 2013 (in the first quarter, public consumption contracted by 26 percent). The contribution of net external demand to growth was positive, on account of a sharp contraction of imports of goods by about 20 percent y-o-y through June, while goods exports remained stable.[2] High-frequency indicators (retail sales, manufacturing production, cement sales) suggest that the



Sources: Cystat and IMF staff estimates.
1/ Contributions to 2013Q1 growth reflect data published on June 6. For 2013Q2, only the flash estimate for total GDP growth is available.

1 The closing date for the exchange was set on July 1, as the deadline of June 30 fell on a weekend.

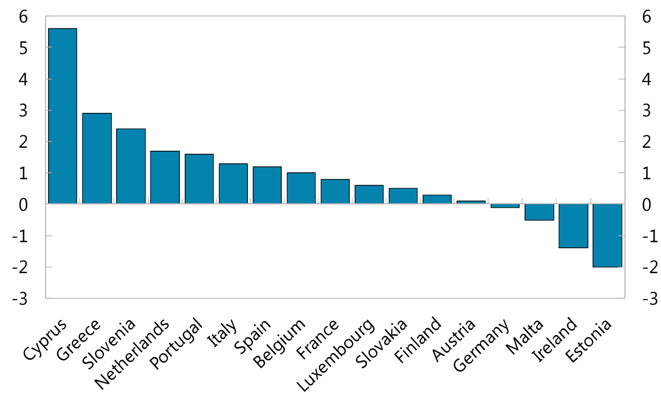
2 Staff's estimate of exports of goods excludes the one-off sale of planes included in the April 2013 data. Including the latter, exports of goods increased 10 percent y-o-y through June.

downturn is widespread, although tourism receipts have held up. While still low, confidence indicators have risen for the last three months from the trough reached in April.

4. Internal adjustment is coming at the cost of higher unemployment (Figure 2). The unemployment rate climbed to 17.3 percent in June compared with 11.7 percent a year before, the highest y-o-y change in the Eurozone, although this reflected, in part, a delayed recession in Cyprus compared to the Eurozone. Firms are only gradually reducing wages, which declined by 0.6 percent in nominal terms through March. More recent sectoral agreements in the tourism and banking sectors suggest that firms are incorporating lower base salaries and benefits (e.g. overtime and pension contributions). Inflation fell to 0.7 percent at end-June from 1.3 percent in March, broadly in line with expectations.

Unemployment rate

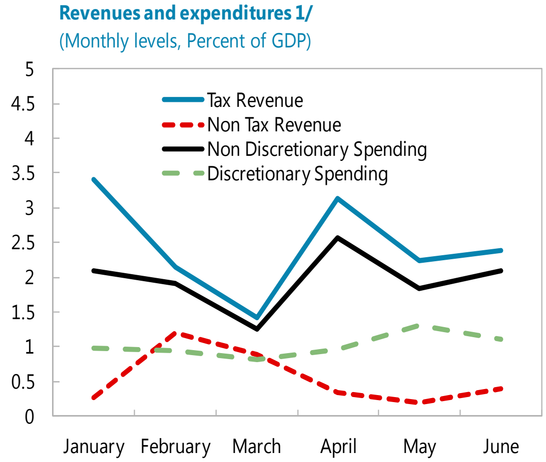
(End-June, y-o-y changes, percentage points)



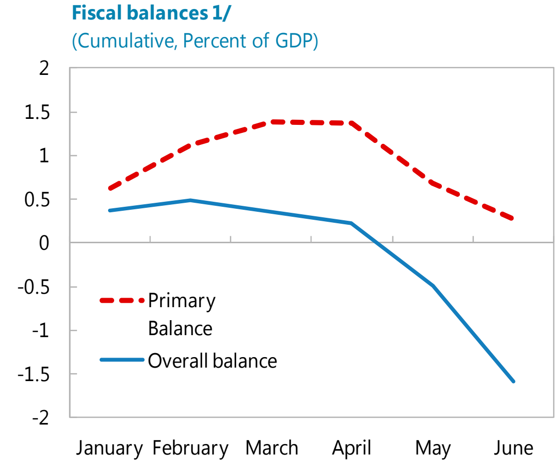
Sources: Eurostat

5. The external balance continues to adjust, as envisaged under the program (Figure 3). The trade deficit declined from about 8 to 6 percent of GDP in the first quarter of 2013 (y-o-y, non-seasonally adjusted), reflecting relatively resilient exports of goods and transportation and tourism services, and a significant contraction in imports in line with weak domestic demand. Nevertheless, the current account deficit increased by about 1.3 percent of GDP y-o-y, as the net income balance deteriorated on account of recognition of income losses by Cypriot bank branches in Greece. On the capital account, financial institutions sold about €10 billion in external portfolio assets to finance loan repayments (€7.2 billion) and deposit outflows (€2.9 billion) in the first quarter. Historical balance of payments statistics were revised, with the 2012 current account deficit lowered from 11.7 to 6.5 percent of GDP, reflecting a lower income balance.

6. Fiscal performance through end-June was better than programmed (Figure 4). The overall fiscal deficit reached 1.3 percent of GDP at end-June. Both the primary surplus and primary spending were better than the targets by 1.8 and 0.5 percent of GDP, respectively (text table). While declining with the recession, revenues over-performed relative to projections, largely on account of higher income taxes—capturing wage adjustments in the broader public sector implemented through increased withholding taxes—and more resilient collections of dividend taxes and VAT. Other revenues underperformed forecasts, in part due to lower demand for government services. On the spending side, prudent execution of discretionary spending, including capital expenditures, more than compensated for an increase in social security and civil service pension payments resulting from rising unemployment and a rush toward early retirement.



Sources: MOF and IMF staff estimates.
1/Based on cash data and the national classification which, unlike ESA, exclude local governments and semi-government entities.



Sources: MOF and IMF staff estimates.
1/ Based on cash data and the national classification which, unlike ESA, exclude local governments and semi-government entities.

General Government, January-June 2013 1/2/

	(Millions of Euros)		(Percent of GDP)	
	Program	Prelim.	Program	Prelim.
Revenue	**3,009**	**3,224**	**18.3**	**19.6**
Taxes on production and imports	1,029	1,156	6.3	7.0
Current taxes on income and wealth, etc	627	782	3.8	4.8
Social contributions	729	744	4.4	4.5
Other revenue	624	542	3.8	3.3
Expenditure	**3,486**	**3,444**	**21.2**	**21.0**
Current expenditure	3,282	3,301	20.0	20.1
Intermediate consumption	376	359	2.3	2.2
Compensation of employees	1,201	1,190	7.3	7.2
Social transfers	1,218	1,206	7.4	7.3
Interest	255	287	1.6	1.7
Subsidies	47	50	0.3	0.3
Other current expenditure	186	208	1.1	1.3
Capital Expenditure	203	143	1.2	0.9
General Government balance	**-477**	**-220**	**-2.9**	**-1.3**
General Government primary balance	**-222**	**67**	**-1.4**	**0.4**
General Government primary spending	**3,230**	**3,156**	**19.7**	**19.2**

Sources: Ministry of Finance; and IMF staff estimates.
1/ ESA95 classification, cash data.
2/ For clarity of presentation and consistency with the original program forecast, sign-in bonuses are included in other revenue. This differs from Eurostat's statistical practice where sign-in bonuses are treated as a sale of intangible assets and thus as a negative capital expenditure.

7. Government financing has been facilitated by a €1 billion debt exchange and the rollover of the Laiki recapitalization bond. The exchange entailed the replacement of domestic bonds maturing between 2013–16 for new bonds with the same coupon (averaging slightly below 5 percent) and extended maturities through 2019–23. The operation triggered a temporary selective default rating by Fitch and S&P, which was reversed once the transaction was concluded. Market reaction was muted, with limited movement in local bond yields, as the exchange was broadly anticipated. The government also exercised a contractual option to roll over the €1.9 billion Laiki recapitalization bond (now held by BoC) until 2014 with the possibility to roll it over annually until 2017. With these two transactions, the authorities completed the requirement of their end-June structural benchmark on government financing on July 1.

8. To protect economic activity, the authorities have gradually eased deposit restrictions and capital controls (text table). These were introduced at end-March to protect financial stability when faced with potentially destabilizing deposit outflows. For example, the ceiling on allowable non-cash business transactions has been substantially raised to facilitate payments and support activity. While large transactions are still subject to scrutiny by the Central Bank's Restrictive Measures Committee, checking documentation for transactions up to €0.5 million has been delegated to the banks themselves. Another key relaxation has been the exemption of transactions of international customers of eligible foreign banks to protect the business services (accounting, consulting, legal) associated with these customers. In addition, 10 percent of uninsured deposits in BoC were unfrozen in early April.

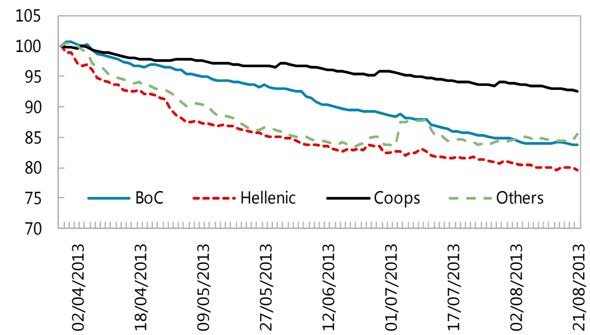
Restrictive Measures on Transactions
(Euros)

	27-Mar	2-Aug
Cash withdrawals (per day per person)		
Natural person	300	300
Legal person	300	500
Cashless payments/transfers w/o justification (per account)		
To other credit institutions in Cyprus		
Natural person (per month)	0	15,000
Legal person (per month)	0	75,000
For the purchase of goods and services w/o documentation	0	300,000 per transaction
To institutions abroad		
Transactions within normal business w/o Committee's approval	5,000 per day	500,000 per transaction
Payments via debit or credit card (per month)	5,000	No limit
Exports of euro notes or foreign currency per person per journey	1,000	3,000
Opening of new accounts is prohibited except: to deposit funds from abroad, and since August, for term deposits created with cash for a minimum of three months, for loans related to new customer credit facilities	No 1/	Yes 2/
It is prohibited to add new beneficiaries in a current account	No 1/	Yes 2/
Transactions of international customers of foreign banks exempted from	No	Yes (16 banks)
Termination of fixed term deposits prior to maturity	Only to repay a loan within same institution	Additional transactions allowed

1/ De facto not possible to open accounts/add new beneficiaries since March 27. The restriction was formalized on April 12.
2/ Or subject to prior approval by the committee.
Source: Central Bank of Cyprus

9. As confidence has not materialized, deposit outflows have continued, straining liquidity in parts of the banking system. The easing of administrative restrictions, while necessary to forestall economic paralysis, allowed steady deposit outflows. Without a return of confidence, fresh inflows have not materialized. Consequently, as of August 21, net outflows reached close to €8 billion or about 12.6 percent of the deposit base since end-March, excluding the conversion of Laiki and BoC deposits into equity in April and May. Of these outflows, 60 percent correspond to non-residents, largely concentrated among uninsured deposits. Outflows from domestic entities represent about 11 percent of their deposit base, with commercial banks more affected than the coops. Foreign banks have lost about 15 percent of their deposits, but have more recently experienced new inflows and a stabilization of deposit trends following their exemption from restrictions. Outflows have been largely financed through own funds, including liquid asset disposals, while about 20 percent of outflows have been used to pay loans within the same bank, with no impact on liquidity. BoC, which absorbed most of Laiki bank and remained under resolution until end-July, remained heavily reliant on Emergency Liquidity Assistance (ELA).

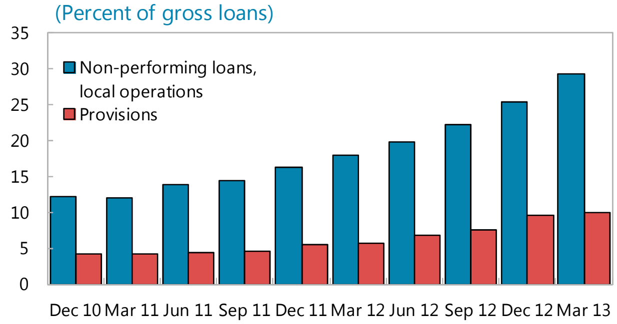
Total customer deposits
(March 28, 2013=100)



Sources: Central Bank of Cyprus

10. Banks' asset quality has deteriorated with the downturn, and credit to the economy continued to contract (Figure 5). Non-performing loans (NPLs) reached almost 30 percent of total loans at end-March. Nevertheless, provisioning for loan losses stands at only 30 percent of total loans, well below the average ratio of 50 percent for European banks. This suggests that bank profitability will be significantly impaired going forward. As was to be expected following the March crisis, credit supply has contracted in the face of rapidly deteriorating asset quality and tight liquidity conditions, but demand has also weakened. As a result, corporate credit contracted by 9 percent y-o-y in June, with mortgage lending and consumer credit falling by about 3 and 7 percent, respectively.

NPLs and Provisions
(Percent of gross loans)



Source: Central Bank of Cyprus

STRATEGY

11. The program strategy remains anchored in the policies agreed in March aiming at restoring financial sector stability and public finance sustainability to support long-run growth. The objective of the authorities' banking sector recapitalization and restructuring strategy is to restore financial intermediation and support economic activity. Key to achieving this objective is ` BoC with large dependence on emergency liquidity support. In the short-run, the strategy was focused on policies to ensure BoC's exit from resolution and its appropriate liquidity support. Over the medium term, the strategy will need to be refined and adapted as needed to ensure that BoC can achieve stable long-run funding, in line with its new restructuring and business plans. In the fiscal area, ambitious yet well-paced consolidation efforts—supported by significant structural fiscal reforms—aim to ensure debt sustainability without putting an excessive burden on the economy in the short run, with an emphasis on protecting vulnerable groups, given rapidly rising unemployment.

POLICY DISCUSSIONS

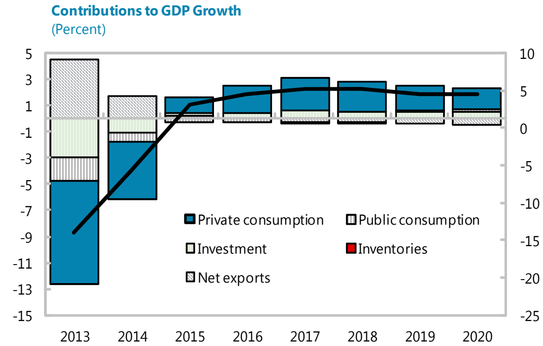
12. **Discussions focused on the need to establish a strong track record of policy implementation to boost confidence.** In particular, discussions focused on: (i) assessing the macroeconomic outlook in light of recent developments and new data; (ii) refining the financial sector reform strategy, including the completion of the resolution of BoC, next steps in the restructuring and recapitalization of remaining financial institutions, strengthening supervision and regulation, developing a roadmap to lift capital controls, and strengthening implementation of the anti-money laundering (AML) framework; (iii) reviewing fiscal developments through end-June and projections for the rest of the year; and (iv) advancing the agenda to modernize fiscal institutions, including revenue administration, public financial management, and social welfare.

A. Macroeconomic Outlook and Risks

13. **The program macroeconomic framework remains broadly unchanged.** There was agreement that recent available data support the baseline projections:

- **In the short run, output** is projected to contract by about 9 and 4 percent in 2013 and 2014, respectively, led by domestic demand and, on the supply side, by a sharp contraction of financial services and the construction sector (Box 1). While the impact of the March banking crisis on private consumption and investment will continue to be felt, the effect of the deposit bail in may be lower than initially expected, given that only about a third of the losses are estimated to have affected residents. The relaxation of payment restrictions has also facilitated transactions, but reported higher reliance on cash could create additional distortions. The authorities agreed with the overall expected contraction, although they saw a relatively milder output decline in 2013 and somewhat deeper fall in 2014. Indeed, the second quarter growth data published on July 15 have been somewhat better than projected. However, given still high uncertainty surrounding developments in the second half of the year, as well as regarding the components of growth in the first two quarters, it was agreed to maintain the current forecast and revisit it once new data becomes available.

- **Medium-run growth** projections remain unchanged. Growth is expected to turn positive in 2015, as private consumption gradually recovers, although fiscal adjustment will continue to put a damper on domestic demand. A highly educated labor force, high quality of institutions, and low corporate tax regime are expected to support the private business sector and growth over the long run.



Sources: Cystat and IMF staff estimates.

Box 1. A Sectoral Model of Growth

Staff's growth forecast for 2013, discussed in Box 4 IMF Country Report 12/125[1] is complemented here by a simplified model of Cyprus's economy, based on five key economic sectors (tourism, professional services, construction, financial and insurance services, and administrative and education), which together can explain 85 percent of Cyprus's past growth. Available information on leading indicators in each of these key sectors is fed through the model to generate the annual forecast:

- Construction and financial services, after unsustainable growth in the pre-crisis period, will contribute significantly to this year's economic contraction. Specifically, monthly cement sales point to a shrinking construction sector. Moreover, the bail-in of uninsured depositors, the observed deposit outflows, and credit contraction have drastically reduced banks' balance sheets, leading to negative value added growth in the sector.
- To a lesser extent, value added in the administrative and education activities is declining due to downsizing in the public sector and tuition discounts.
- By contrast, tourism and professional services show some resilience. Although there are fewer visitors this year, spending per tourist has remained broadly constant, thus sustaining value added in this sector. Finally, a flat number of company registrations provides some evidence that Cyprus's favorable legal and tax regime remains attractive.

Sectoral Breakdown of Gross Value Added in 2013

Sector	Construction	Professional services	Financial and Insurance	Tourism	Admin. and Education	GDP growth
Leading indicator	Sales of cement	Registered companies	Non-MFI deposits in MFIs / GDP	Revenues	N/A	2013
Correlation with sector's real GVA	0.93	0.77	0.94	1	-	
Jan-June average (percent y-o-y)	-30	1.4	-11.5	0.4	-0.6 1/	
Sector's growth in 2013	-30	0.3	-14	0.0	-3	
Sector's share in GDP (percent)	19	12	19	10	14	
GDP growth contribution (percent)	-5.7	0.0	-2.7	0.0	-0.4	-8.7

Sources: Cystat; CBC; Dept. of Registrar of Companies; and Fund staff estimates.
1/ Q1 data.

The forecast for 2014 can also be explained by this sectoral model. The financial service and construction sectors are still expected to contract next year, but at a gradually reduced pace, stabilizing toward end-2014. Other sectors are projected to grow modestly (professional services and tourism) or face a moderate contraction (administrative services and education).

Sectoral Breakdown of Gross Value Added in 2014

Sector	Construction	Professional services	Financial and Insurance	Tourism	Admin. and Education	GDP growth
Sector's growth in 2013	-12	1	-9	1.3	-2	
Sector's share in GDP (percent)	19	12	19	10	13.5	
GDP growth contribution (percent)	-2.2	0.1	-1.7	0.1	-0.2	-3.9

Sources: Cystat; CBC; Dept. of Registrar of Companies; and Fund staff estimates.

[1] IMF Country Report 13/125, http://www.imf.org/external/pubs/ft/scr/2013/cr13125.pdf

- Given weaker-than-anticipated **employment** dynamics, as firms have shed labor before starting to adjust wages, but also due to an upward revision of historical unemployment statistics by 1 percentage point, the unemployment rate is now projected to be substantially higher, reaching 17 and 19½ percent in 2013 and 2014, respectively. It is expected to gradually decline thereafter.

- The forecast for 2013 headline and core **inflation** remains at 1 percent and 0.4 percent, respectively, in line with the gradual deceleration of inflation shown in the data.

- The **current account** deficit projections remain unchanged, expected to reach 2 and 0.6 percent of GDP in 2013 and 14, respectively, and stabilizing at around 2 percent of GDP in the long run.

14. Risks remain substantial and tilted to the downside. On the domestic front, confidence in the banking sector is yet to be restored. Moreover, the extent of the impact of the banking crisis on households and corporates, as well as on vital service sectors of the economy, could be larger than anticipated. These could result in a deeper and more prolonged recession, as well as in weaker long-run growth, with dramatic consequences for debt sustainability. On the external front, continued economic weakness in the EU could dampen demand for Cypriot exports. On the upside, tourism service exports could benefit from political turmoil in competing destinations and stronger non-EU demand (e.g. China and Russia). Development of the gas sector could also provide an upside to investment and growth over the longer term.

B. Debt Sustainability

15. Public sector debt projections are broadly unchanged. Debt is expected to peak at 126 percent of GDP in 2015 and gradually decline toward 105 percent of GDP by 2020, as economic activity recovers and the primary surplus improves. In 2013, debt has been revised up from 109 to 114 percent of GDP as the €1 billion planned swap of debt held by the CBC for state-owned assets was postponed from the third quarter of 2013 to mid-2014 to allow more time to complete the valuation of assets. As a result, the authorities are requesting a modification of the public debt performance criterion for end-September. The domestic debt exchange completed at end-June resulted in a decline in financing needs, which has been offset by a reduction in projected official financing required later this year, with no impact on debt.

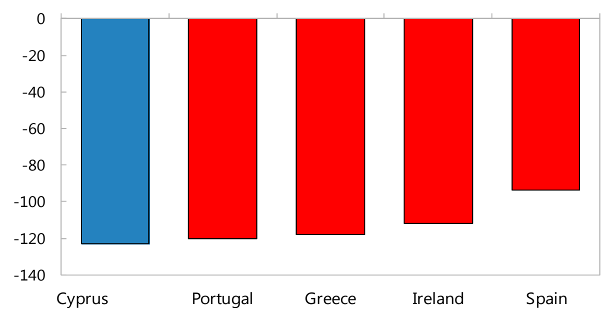
16. Debt sustainability remains highly vulnerable to shocks (Table 9, Figure 6). Lower nominal GDP growth would have profound implications on the debt trajectory. In this case, while available program financing—including a substantial buffer—could accommodate a larger fiscal deficit, the debt-to-GDP ratio would increase, putting at risk long-run sustainability (Annex I). Contingent liabilities from the banking sector also pose risks, as illustrated in the April Debt Sustainability Analysis.[3] Finally, while the recapitalization of BoC without the use of public resources

[3] IMF Country Report 13/125, Appendix I, http://www.imf.org/external/pubs/ft/scr/2013/cr13125.pdf

has avoided a transfer of losses from the private to the public balance sheet, implicit liabilities remain significant: BoC had about 70 percent of GDP in insured deposits at end-March and about 70 percent of GDP in ELA granted by the CBC at end-June. Any additional government guarantees that may be needed to support its liquidity would add to such implicit liabilities. As noted in April, full materialization of risks may require additional financing measures to preserve debt sustainability.

17. External debt will remain elevated over the projection period (Table 10, Figure 7). Since end-2012, Cyprus's gross external debt has declined by about 10 percent of GDP to around 440 percent of GDP at end-March 2013. This is due to lower external liabilities of financial institutions, partially offset by an increase in the CBC's liabilities with the Eurosystem. Cyprus's external debt is expected to decline in the long run, reaching 345 percent of GDP by 2020. Staff's revised projection reflects a correction in the statistical treatment of the divestment of Cypriot banks' Greek branches, which are not recorded in Cyprus' international investment position (IIP). At 123 percent of GDP at end-March 2013, Cyprus's IIP is roughly comparable to that of Ireland, Greece, Portugal, and Spain. External debt sustainability depends crucially on continued external adjustment and the prospective economic rebound, and remains vulnerable to interest rate shocks.

Net international investment position 1/
(Percent of GDP)



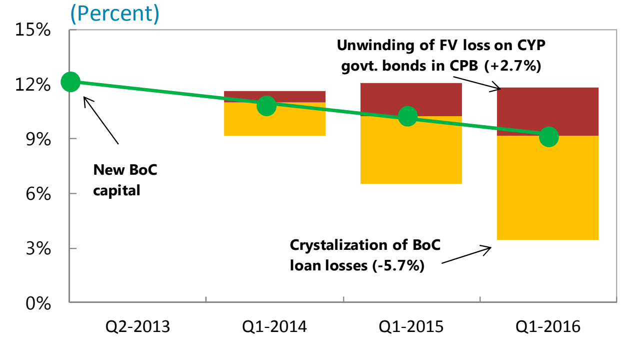
Source: IMF staff estimates.
1/ End-2013Q1 for Cyprus.

C. Financial Sector Policy

18. Discussions focused on immediate measures needed to take BoC out of resolution (MEFP ¶4). This was seen as a critical step toward restoring confidence not only in this bank, but, given its systemic nature, also in the entire financial sector:

- The fair value independent assessment of BoC's end-March balance sheet (including assets and liabilities absorbed from Laiki) was concluded by KPMG on July 26, meeting the respective structural benchmark with a one-month delay. Based on this assessment, it was concluded that total capital needs for the merged BoC amounted to €3.9 billion at end-March, required to reach an initial Core Tier 1 (CT1) ratio of around 12 percent to ensure that the CT1 ratio remains above the regulatory minimum of 9 percent throughout the program period under

BoC CET1 Ratio
(Percent)



Sources: Central Bank of Cyprus and IMF staff estimates.

conservative assumptions (erosion of its capital due to future losses is expected to be mitigated by amortization of accounting losses on the Laiki recapitalization bond, as such losses have been recognized upfront per IFRS).[4] Moreover, conservative assumptions on NPLs and pre-provisioning profits provide an upside (Box 2).

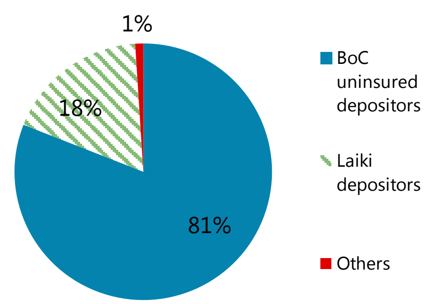
- On the basis of the fair value assessment, on July 30, the resolution authority issued a notice converting a further 10 percent of BoC's uninsured deposits (€0.8 billion) into equity, in addition to the 37.5 percent (€3.1 billion) that had already been bailed in, to cover for additional fair valuation losses (€0.4 billion) as well as further needs arising from the partial exemption of some uninsured deposits (€0.4 billion).[5] Other bailed-in resources (including former equity, junior, and senior debt) had been converted from non-voting into common shares with a €0.01 nominal value to comply with the new EU Capital Requirements Directive (CRD IV) that entered into force at end-June.

Bail-in Amounts
(Billions of euros)

	BoC	Laiki	Total
Uninsured deposits	3.9	4.0	7.8
Senior debt	0.0	0.1	0.2
Subordinated debt	0.6	0.8	1.3
Total	4.5	4.9	9.4

Sources: CBC and IMF staff calculations.

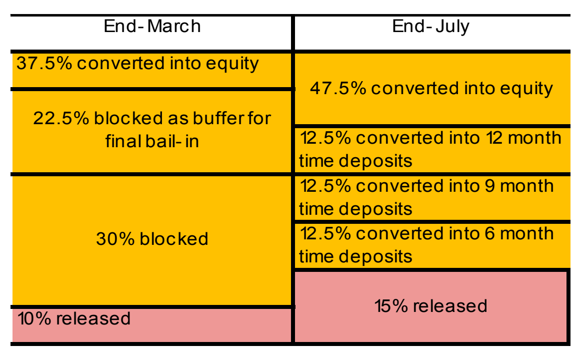
Ownership of BoC
(Percent of total)



Source: Central Bank of Cyprus.

- To ensure that BoC can continue to finance deposit outflows through existing liquidity buffers and expected loan repayments, remaining frozen uninsured deposits (about €3.5 billion or 42.5 percent of its initial uninsured deposits) have been restructured. Specifically, 5 percent has been released, with the remaining 37.5 percent equally split and converted into time deposits with 6, 9, and 12 month maturities, extendable by another 6, 9, 12 months, if needed.

Conversion and Release of Uninsured Deposits



Source: Central Bank of Cyprus.

[4] According to preliminary estimates, BoC Common Equity Tier 1 ratio (CET1) would be similar after the new capital definition is officially adopted in January 2014.

[5] Insurance companies, schools, and charities have been partially exempted from the bail in, with only 27.5 percent of their deposits being subject to the 47.5 percent and 100 percent bail in rate in BoC and Laiki, respectively.

- The completion of the recapitalization of BOC and the orderly unfreezing of its uninsured deposits were key to allowing the bank's exit from resolution on July 30.

Box 2. Assessment of Capital Needs for BoC

Capital needs of BoC and Laiki through 2015 were assessed by an independent third-party due diligence exercise completed by PIMCO in February 2013. In addition, the resolution law mandated a fair value assessment of these banks' balance sheets to allow completion of the purchase and assumption transaction between BoC and Laiki. This study was completed by KPMG in July 2013.

There are important differences between the KPMG and PIMCO assessments. First, while the PIMCO exercise was based on June 2012 data (including Greek operations), the KPMG valuation was based on end-March 2013 balance sheets (after the sale of Greek operations). Second, PIMCO conducted a bottom-up stress test exercise to determine capital needs to reach 9 and 6 percent CT1 through June 2015 under baseline and adverse scenarios, taking into account pre-provision profits after factoring in losses from current and future NPLs over the next 3 years. KPMG, on the other hand, performed a fair value assessment (FVA) of the banks' assets and liabilities, defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." This methodology estimated the net present value of all assets and liabilities using a discount rate reflecting the funding costs of a potential market participant. Third, KPMG used the updated program growth projections, implying a deeper recession than under the adverse PIMCO scenario.

Comparison of KPMG and PIMCO Assessments

(Percent)

	KPMG			PIMCO Adverse		
	2013	2014	2015	2013	2014	2015
Real GDP growth	-8.7	-3.9	1.1	-5.2	-2.3	0
Unemployment rate	15.5	17.2	14.5	13.8	14.6	14.5
3m Euribor	0.2	0.3	0.5	2	2.3	2.5
HICP inflation	0.9	0.9	1.4	1.2	1.3	1.1
House price change	-14	-10	-1.5	-14	-10	-1.5
Peak NPLs 1/	SMEs	Retail		SMEs	Retail	
BoC	45	40		57	50	
Laiki bank	48	35		50	45	

Source: Central Bank of Cyprus.

1/ Peak NPLs for KPMG are staff estimates. These ratios are expressed as past due loans relative to total gross loans at the beginning of the exercise (June 2012 for PIMCO and March 2013 for KPMG).

The results from KPMG revealed different capitalization dynamics and somewhat larger upfront needs. Both exercises estimated probabilities of default and loss given default. While the two exercises are not directly comparable, given differences noted above, preliminary estimates suggest that overall losses on the end-March portfolios were similar, even as KPMG projected somewhat lower peak NPLs.[1] However, the KPMG valuation assigned larger initial losses on Cypriot government debt. Importantly, while PIMCO assumed that banks would continue as an ongoing concern, implying that losses could be booked over time, KPMG accounted the Laiki assets transferred to BoC at fair value, with losses crystallized upfront, and "old" BoC assets as ongoing concern. This implies that under IFRS treatment, the book value of "old" BoC is expected to *decline* over the program period as losses materialize, while for former Laiki assets, it is expected to *increase* over time as significant fair value losses booked on Cypriot government bonds are unwound. Differences in treatment of pre-provisioning profits also led to higher needs under the KPMG exercise.

[1] For comparison purposes only, staff has estimated implicit NPLs for the KPMG exercise on the basis of fair and gross value of loans and after assuming a NPL coverage ratio of 50 percent. NPL ratios are expressed as a percentage of past due loans to total gross loans at beginning of the exercise (June 2012 for PIMCO and March 2013 for KPMG).

19. Ensuring adequate liquidity for BoC was seen as paramount to restoring confidence (MEFP ¶5). After exiting resolution, BoC regained access to ECB's monetary policy operations. The authorities agreed that rapidly replacing ELA with ECB refinancing will help to provide more stable and less costly funding. Indeed, about €1.3 billion of existing ELA has already been substituted with ECB refinancing. In the short run, liquidity could be boosted by pledging as collateral for ECB refinancing the Laiki recapitalization bond and, if needed, new own bonds guaranteed by the government. In this regard, the authorities proposed to augment the ceiling on the accumulation of government guarantees by a maximum of €2.9 billion, to be utilized sparingly to preserve financial stability while also being mindful of risks to the public sector balance sheet. Looking forward, BoC will need to develop a plan to ensure stable long-run funding.

20. The authorities agreed to ensure that BoC swiftly adapts its governance structure and business plan to the new circumstances (MEFP ¶6).

- The Annual General Meeting of BoC shareholders has been called for September 10 to appoint a new Board of Directors. Staff and the authorities agreed that the CBC needs to ensure that newly elected board members are fit and proper. While staff had recommended that the shareholding of legacy Laiki bank in BoC be represented by an independent private party, given the short timeframe until the general meeting, the authorities have chosen to maintain Laiki's representation with its special administrator, appointed by the Resolution Authority. Until the general meeting, the current transitory board will remain in control.
- BoC has been instructed to prepare a strategic restructuring plan with technical support provided by a well-known consultancy firm. The plan, to be submitted together with consistent capital and funding plans, will be assessed by the CBC by end-October (**modified structural benchmark**), to allow for more time to also reflect the business goals of the incoming administration. Restructuring measures already underway include a voluntary retirement scheme expected to reduce staffing by about 25 percent and wage costs by about 35 percent. Upon finalization and the CBC's approval, the new restructuring plan will become BoC's roadmap and an important tool for the CBC to monitor progress made through quarterly reviews of compliance with goals.

21. The mission supported the authorities' efforts to pursue a private sector solution to recapitalize Hellenic Bank (HB) (MEFP ¶7). After the sale of its Greek operations, the bank's capital shortfall identified under PIMCO's adverse scenario amounts to €294 million. Staff supported the authorities' intention to allow the bank more time to raise private capital. To this end, the CBC will instruct the bank to launch an offer for participation in the bank's capital, including through the voluntary conversion of junior debt into shares, by end-September (**structural benchmark**). Currently, HB's junior debt amounts to €308 million, of which only half can be automatically converted into shares under the terms of the debt instruments. The authorities also plan to pass new legislation requiring mandatory burden-sharing among junior bondholders as a precondition for potential injection of public funds, in accordance with revised state aid rules effective since August 1. Reflecting the authorities' revised timeline, it was agreed that the bank will be recapitalized no later than end-December (**structural benchmark**).

22. A restructuring strategy for the credit cooperative sector has been agreed (MEFP ¶7). The authorities have finalized the assessment of capital needs and viability of individual CCIs, meeting the end-June structural benchmark with a slight delay. The assessment, which also included CCIs not covered by the PIMCO exercise, revealed that while the sector remains solvent overall, it is undercapitalized, with capital needs amounting to €1.5 billion. On this basis, the authorities completed the strategy to restructure and recapitalize the sector, fulfilling the end-July structural benchmark. The strategy is based on several key criteria:

- **Recapitalization with state support, fully protecting all CCI depositors**. The authorities' recapitalization strategy makes a clear distinction between solvent and insolvent institutions. Given that the CCI sector was found solvent in the aggregate, but private sources of capital were not available, it was agreed to use public funds to recapitalize the Cooperative Central Bank (CCB) in line with state aid rules, by end-October. The Cooperative Central Bank would, in turn, inject capital into individual CCIs, such that a CT1 ratio of 9 percent is achieved at the sectoral level and 4 percent (in line with European practices for coops) at the individual level.
- **Insulation against political interference in the sector.** As prior action for the review, legislation will be passed, establishing a unit in the Ministry of Finance to manage the state's majority stake in the CCI sector (MEFP ¶7). The authorities argued that this structure (as opposed to an independent resolution fund, for example) ensures technical independence and is easier to manage. On this basis, a relationship framework between the state and the CCIs will be established to ensure that the sector, including the Cooperative Central Bank, operates on a commercial basis, while minimizing political interference in the Cooperative Central Bank's business decisions.
- **Expansion of the role of the Cooperative Central Bank to act as parent bank of all CCIs.** While the Cooperative Central Bank has been the sector's central service provider, it was agreed to expand its role to take responsibility for all strategic and operational aspects of the sector, including risk policy and management, as well as strategic management and monitoring of NPLs workouts and collection processes.
- **Deep restructuring and consolidation of the sector.** It was agreed that to achieve long-term viability and profitability of the sector, the existing 93 CCIs will need to be consolidated into at most 18 institutions (end-March 2014 **structural benchmark**). The final number of CCIs reflects the authorities' assessment of the sector in terms of efficiency, viability, and logistical aspects, while seeking to preserve the role of cooperatives. Staff stressed the need to regularly review the new structure and merge CCIs that become unviable with viable ones.
- **The possibility to exit state control.** Following the capital injection, and provided adequate capital ratios are maintained, the CCIs and the Cooperative Central Bank will be allowed to buy back shares from the state and regain their mutual status. It was recognized that at this stage it is premature to define a specific timetable to return the ownership of the CCIs to their members.

23. To reduce uncertainty and build confidence, the authorities have published a milestone-based roadmap for the lifting of administrative restrictions and capital controls (MEFP ¶10). The mission and the authorities agreed with the need to relax controls as soon as possible, while safeguarding financial stability. While motivated by real economic needs, the relaxation of restrictions to date has not been anchored within an overarching strategy, leading to uncertainty in the markets and a hoarding of cash by the private sector. To provide for a more orderly and predictable process, the authorities have published a roadmap linking key relaxation steps with tangible progress in the bank restructuring strategy, while retaining adequate flexibility (Box 3).[6] Staff has welcomed this important step, while stressing the need to maintain flexibility in the face of changing deposit flows and bank liquidity trends. Staff and the authorities discussed the application of restrictions by banks, which was found to be broadly adequate, and agreed that continued supervisory vigilance is needed to ensure their effectiveness while they remain in place.

Box 3. Roadmap for the Relaxation of Administrative Measures and Capital Controls

To allow for an orderly lifting of controls, but also to increase transparency, on August 9, 2013, the authorities published a roadmap for the relaxation of restrictive measures. The relaxation strategy foresees four liberalization phases, reinstating the free flow of capital first within the country and then across borders. The strategy provides for a milestone-based approach to lift controls, linking relaxation steps to defined milestones on restructuring of the banking sector, while at the same time providing sufficient flexibility to take into account depositor confidence and the banks' liquidity situation. The phases are defined as follows:

- **Phase 1—Reducing cash circulation and the administrative burden:** Initial measures have already been implemented after BoC exited resolution and following the finalization of the restructuring strategy for the CCI sector. In particular, the CBC has authorized the opening of new accounts to create term deposits with a minimum maturity of three months. This is expected to attract cash currently hoarded by the private sector and reduce the volume of cash transactions. In addition, to facilitate new lending, banks have been allowed to open loan accounts related to new customer credit facilities. This phase also envisages steps to lift restrictions on domestic payments above €300,000 and remove approval requirements on certain external payments, contingent on positive developments regarding deposit flows and banks' liquidity.
- **Phase 2—Reinstating accessibility of funds and domestic transfers:** Restrictions on termination of term deposits before maturity and monthly ceilings on domestic transfers not related to the purchase of goods and services will be lifted once BoC's restructuring plan has been approved, Hellenic Bank has been recapitalized, and the restructuring plan for the CCI sector has been finalized. Completing these steps is expected to support confidence and allow free deposit transferability without undermining the liquidity of these banks. According to the program strategy, this phase can be expected to start by end-2013.
- **Phase 3—Lifting of restrictions on cash and checks:** Based on further progress with the completion of the merger of the CCIs and tangible progress with the implementation of BoC's restructuring plan, free movement of capital within Cyprus will be permitted by lifting restrictions on cash withdrawals, cashing of checks, and opening of new bank accounts.
- **Phase 4—Abolishing restrictions on external capital flows:** Remaining restrictions on external flows will be lifted based on progress in establishing a strong track record of policy implementation under the program and restoring confidence in the banking sector, including by broad-based deposit stabilization.

24. The authorities are taking steps to improve financial sector regulation and supervision (MEFP ¶9). These are key to ensure adequate monitoring and management of asset quality and prevent vulnerabilities from building up in the future:

- **Integration of CCI supervision into the CBC.** Weak and separate supervision of CCIs relative to other commercial banks has contributed to a buildup of vulnerabilities in the

[6] http://www.mof.gov.cy/mof/mof.nsf/All/3766C4D62B9EDE71C2257BC2002E22E9/$file/Roadmap%20PresentationLHM07%2008%202012ENG%20[Compatibility%20Mode].pdf

sector. In April, the CBC was empowered to issue orders to the current supervisor of the cooperatives. In addition, as a **prior action** for the review, legislation will be passed establishing the CBC as the sole supervisor of CCIs and the Cooperative Central Bank at both the individual and consolidated levels. The CBC is expected to gradually take over operational responsibility over the next months, in line with the implementation of the CCI restructuring strategy. Staff stressed the need for the CBC to acquire sufficient resources to fulfill its expanded responsibilities.

- **Classification and reporting of NPLs and asset impairment and provisioning.** To increase transparency and guard against forbearance, a new CBC directive will enter into force at end-September, requiring reporting and classification of all loans in arrears for more than 90 days as NPLs, and all loans whose original terms were modified. This is expected to lead to higher officially reported NPLs (program statistics already include these updated categories). Work has also started on a review of asset impairment and provisioning practices, with an independent accounting firm expected to deliver an assessment of current practices and recommendations.

- **Loan origination.** Relying on findings of the PIMCO due diligence, as well as on international best standards, the authorities have identified key weaknesses in banks' loan origination practices. The main finding is that, given over-reliance on asset-based lending, banks have disregarded the borrowers' ability to repay. Consequently, the CBC agreed to put in place a new regulatory framework on loan origination, requiring banks to consider affordability aspects in their lending decisions and curtailing related party lending and lending to bank directors.

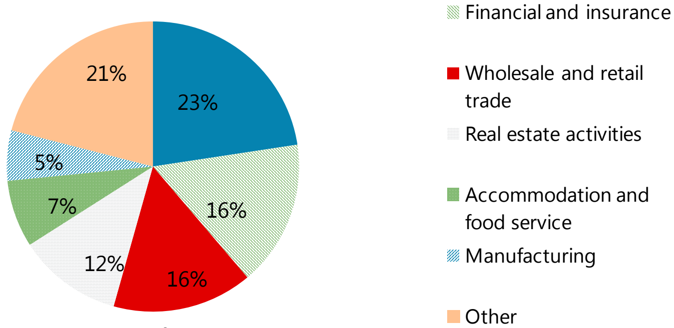
- **Credit register.** To allow banks to make better informed loan decisions based on the creditors' history, while improving monitoring of credit quality, the authorities have decided to merge and expand the databases of the two existing credit registers for commercial banks and CCIs and to require lenders to submit data on performing and non-performing loans to the registers on a regular basis. The CBC, which will oversee the registers and the banks' contributions, will also develop tools to use the information for macro- and micro-prudential purposes.

25. New steps were agreed to facilitate corporate and household debt restructuring to address the high level of private indebtedness (MEFP ¶11). Given the large number of existing and prospective loans in need of restructuring, staff stressed the need for swift improvement in Cyprus's private debt restructuring framework with a view to facilitate a reduction in NPLs and in private sector indebtedness (Box 4).

Box 4. Private Sector Indebtedness

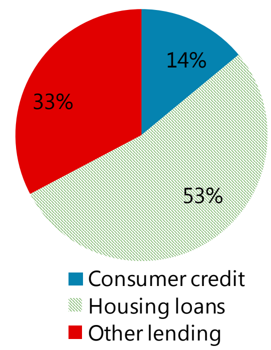
The Cypriot private sector is highly leveraged. The current private sector debt-to-GDP ratio is close to 280 percent, which is the highest in Europe and about double of the EU average. Corporate credit has been concentrated in the real estate and construction sectors. For households, housing loans account for more than half of the total, leading to a high exposure of banks to the decline in house prices that began in 2009 (Figure 1).

Corporate credit by sector, June 2013 1/
(Percent of total)



Source: Central Bank of Cyprus

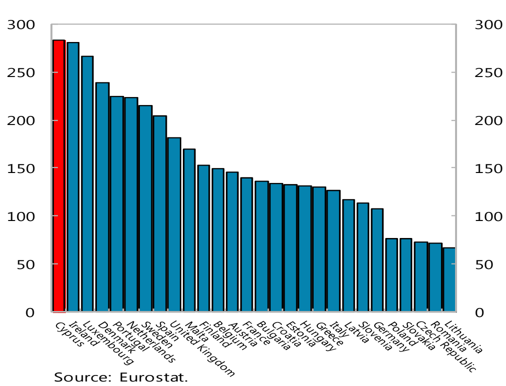
Household credit, June 2013
(Percent of total)



Source: Central Bank of Cyprus

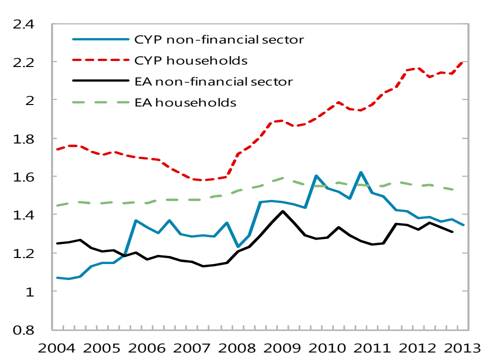
- **The non-financial corporate sector has been adjusting in the past two years**. The rapid expansion of corporate balance sheets in 2004–10 through both loans and debt securities increased leverage substantially above the Euro Area average.[2] Since then, the sector has been adjusting by both reducing exposure through financial instruments and increasing the share of own financing. Although the current leverage is only marginally above the Euro Area, more deleveraging will likely be needed to reach the Euro area long term average of 1.2.[3]
- **Households are yet to start deleveraging**. They are more indebted than the corporate sector, and compared to the Euro Area, the relative increase in leverage has been significant.[2] Household borrowing rose rapidly in the last five years, almost exclusively through mortgages. Returning to more acceptable levels will require making progress in putting in place effective housing loans restructuring procedures.

Private sector indebtedness
(Debt in percent of GDP, 2012 or latest)



Source: Eurostat.

Private sector leverage
(Assets over equity or net financial worth)



Sources: CBC, ECB, and IMF staff estimates

1/ Including self-employed and sole proprietors.
2/Leverage is defined as the ratio of total assets over equity (corporates) or over net worth (households).
3/ See "Macro Financial Implications of Corporate (De)Leveraging in the Euro Area Periphery", IMF Working Paper 13/154.

Discussions focused on two key areas:

- **Arrears management by banks.** The authorities have developed a homogenous industry-wide approach based on international best practice, aiming at enabling fair and expeditious restructuring across the banking sector, including a standardized code of conduct for credit institutions and borrowers and a supervisory framework for arrears management. The new framework requires banks to offer troubled borrowers short- and long-term arrangements and restructuring options customized by asset class and arrears category. On this basis, banks will need to prepare strategies and detailed operational plans to implement the framework, including restructuring options and key performance indicators. As international experience suggests, challenges remain related to banks and borrowers' willingness to compromise and the strength of the legal framework and judicial processes once out-of-court solutions are exhausted.
- **Legal framework.** Staff called for a review of the corporate and household debt restructuring framework and for a report identifying impediments to implementation and measures to address them. On the basis of the review and report, it was agreed to prepare legislation to expand the role of the Financial Ombudsman to facilitate negotiations of a debtor's recovery. Staff stressed that this measure should be carefully designed and subject to adequate legal safeguards to ensure that the interests and incentives of debtors and creditors are appropriately balanced. Additional measures to facilitate debt restructuring will be considered during the next review.

26. The authorities are taking steps to strengthen the anti-money laundering (AML) framework and its implementation by banks (MEFP ¶12). Specifically:

- The recent independent audit and assessment conducted by Deloitte and Moneyval, respectively, revealed weaknesses in the implementation of customer due diligence measures by banks (Box 5).[7] It was agreed to rectify these to ensure a sustainable development of the financial and business service sector going forward. In this regard, the authorities prepared an action plan, including measures to: (i) follow up on possible breach of compliance by banks with AML requirements identified by the audit; (ii) review the AML banking supervision's structure and resources; and (iii) monitor progress on AML supervision on a quarterly basis.
- With regard to their commitment to improve transparency of companies and trusts, the authorities are revising the legal framework which, along with provisions aimed at improving international exchange of financial intelligence, is expected to be amended by end-September (existing **structural benchmark**). In addition, they have agreed to step-up the supervision of professionals involved in company formation and management to strengthen the operations of the company registrar and improve transparency by making available information on companies.

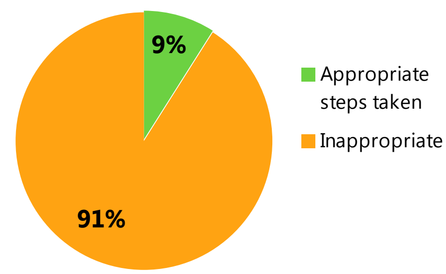
[7] The Moneyval assessment is available at this link, and part of an updated version of the Deloitte report, not including some of the key data from the forensic audit, is available through this link.

Box 5. Recent AML Findings

An independent audit by Deloitte and assessment by Moneyval were performed to assess the implementation of AML measures by banks in Cyprus. Despite an overall positive assessment by Moneyval in 2011, an independent forensic audit was deemed necessary to assess the effective implementation of customer due diligence (CDD) measures by banks. This audit was performed by Deloitte, who sampled 390 customers (the top 180 depositors and 90 borrowers, and a randomly selected additional sample) in six credit institutions with more than €2 billion in deposits. The top borrowers accounted for more than 15 percent of the total loans, and the top depositors for more than 10 percent of the total banking system deposits. In addition, Moneyval conducted an assessment of the implementation of CDD measures by banks using the FATF methodology.

The two reports revealed weaknesses in the implementation of customer due diligence measures, particularly in the context of the frequent use of third party introducers. Accurate customer information is at the root of AML preventive measures, as it forms the basis for effectively knowing the customer, understanding the business relationship, and establishing a proper risk profile. In this respect, Moneyval's new report estimated that 75 percent of international business involves third-party "introducers" (which, in turn, sometimes involve chains of introducers), a practice that removes banks from direct contact with the beneficial owners of legal entity customers and can be problematic when not properly managed. The data provided by Deloitte indicated that many of the deposit holders have complex ownership structures, and 70 percent of such deposit holders have nominee shareholders and an average of three layers between the customer and the beneficial owner(s). More importantly, only in 9 percent of the complex ownership structure cases had proper steps been taken to verify the identity of beneficial owners, which are required by the law and the FATF.

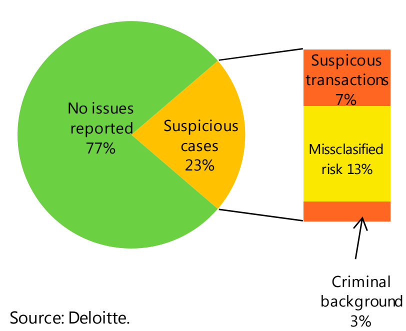
Verification of beneficial owner's identity of deposit holders with complex structures



Source: Deloitte.

The reports also indicated that banks had not reported a significant number of suspicious cases to the authorities, including in compelling cases. Transactions should be reported by banks to the authorities when they have suspicions that funds are the proceeds of a criminal activity or are related to terrorist financing. In turn, banks' ability to report is highly dependent on their knowledge of the customer. Moneyval found that only a few suspicious transaction reports appear to have been made as a result of ongoing monitoring or in relation to tax-related suspicions of money laundering. These weaknesses were confirmed by the auditor's review of the sampled customer files, indicating that only three suspicious transaction reports were sent to the authorities during 2008–12, against 29 potentially suspicious transactions identified by the forensic analysis during the past 12 months alone but not identified by the banks. In 10 other cases, publicly available information pointing to a criminal background of customers and/or beneficial owners could have warranted reporting to the authorities.

Suspicious cases revealed



Source: Deloitte.

D. Fiscal Policy

27. It was agreed that no additional measures are required at this point (MEFP ¶13)**.** With the primary balance and primary spending targets for the first half of the year met with comfortable margins, targets for the remainder of the year remain within reach. In particular, program revenue projections appear prudent when judged against performance through end-June (text table). Nevertheless, given the lingering uncertainties about the macroeconomic outlook in the second half of the year, staff and the authorities agreed on the importance of maintaining a prudent budget execution, including by tightly controlling spending. Discussions also covered revised estimates of consolidation measures already underway, which point to somewhat lower yields on the revenue side (largely on excise and bank interest taxes) compensated by higher yields on the spending side (on social transfers and wage reductions, the latter due to significant cuts in public sector employment which, already at end-June, amounted to double the yearly target of 1,000 layoffs). On this basis, there was agreement that no additional measures would be needed in 2013, with the size and composition of consolidation for 2014 and beyond to be revisited during discussions on the 2014 budget.

Fiscal Performance: Actual and Program

(Annual percentage change)

	Jan-June Actual	2013 Projection
Revenue	0.1	-6.7
Tax Revenue +Social Contributions	-6.9	-11.4
Tax Revenue	-5.8	-10.0
Taxes on production and imports	-5.5	-12.3
Current taxes on income and wealth, etc	-6.3	-6.9
Social contributions	-9.6	-15.2
Other Revenue	59.7	26.2
Expenditure	-8.8	-3.9
Current expenditure	-6.5	-2.3
Intermediate consumption	-10.7	-5.6
Compensation of employees	-8.8	-7.3
Social transfers	-6.0	-4.7
Interest 1/	4.2	15.5
Subsidies	7.0	5.5
Other current expenditure 2/	-5.1	36.5
Capital Expenditure	-41.8	-20.9

Sources: Ministry of Finance and IMF staff estimates.

1/ The 2012 execution was adjusted downwards to exclude the interest from the Laiki recapitalization bond which is recorded by Eurostat on an accrual basis but that was capitalized into the bond and therefore should not be included on a cash basis.

2/ The 2012 execution was adjusted downwards for insurance related payments included upfront on an accrual basis. The 2013 projection includes compensation of losses of pension funds with deposits in Laiki.

28. The authorities request modification of fiscal targets to reflect the one-off compensation of pension funds for losses related to the resolution of Laiki bank (MEFP ¶14). The revision was envisaged at the time of the program request, pending the completion of the independent valuation of BoC. The compensation was considered necessary to ensure equal treatment among pension funds in BoC and Laiki, given that 100 percent of pension fund deposits in Laiki were converted into equity, while only 47.5 percent of such deposits in BoC were transformed into shares. To equalize losses among pension funds, those with deposits in Laiki will be compensated with an amount of about €300 million. The authorities strongly preferred to pay out €154 million before end-September 2013 to the Laiki own pension fund, to facilitate early retirement and a reduction of staff in line with the banks' restructuring plans. The authorities thus requested adjustment of the end-September primary spending and deficit targets to reflect this amount. The remainder is expected to be disbursed before the end of the year and the authorities have incorporated an adjustor to the new December targets to reflect this (MEFP, Table 1, TMU ¶6 and 8).

E. Structural Fiscal Reforms

29. To support ongoing fiscal consolidation efforts, the authorities agreed to an ambitious reform of their revenue administration institutional framework (MEFP ¶17). The administration of domestic revenues—consisting of two separate units: the Inland Revenue Department (IRD) and the VAT Services (VS)—is cumbersome, with segregated taxpayer services, lack of a holistic view on compliance of taxpayers across direct and indirect taxes, and minimal coordination of audit and enforcement activities. To address this, and in line with Fund TA advice, the authorities prepared a high-level action plan to reform the system and replace the IRD and VS with a single, integrated revenue administration, organized along functional responsibilities. The reform, expected to be completed over the next three years, is expected to: (i) increase revenues through better compliance management, (ii) reduce the compliance burden on taxpayers through harmonized and simplified tax procedures, and (iii) improve efficiency and effectiveness of tax administration through economies of scale. Staff welcomed the authorities' plans, while recognizing implementation challenges posed by potential resistance from vested interests.

30. At the same time, the authorities will introduce new short-term measures to fight evasion and improve efficiency of revenue collection (end-December **structural benchmark**, MEFP ¶18). To address the long delays in processing returns and allow for simplified payment processes, the authorities agreed to establish full self-assessment for all income taxpayers. Remaining compliance issues related to evasion will be addressed through targeted joint audits by the IRD and the VS, based on information from different databases and focused on high compliance risk areas, including the self-employed (3/4 of whom declared an income under the taxable threshold in 2011). Finally, it was agreed that the revenue administration's collection enforcement powers should be harmonized and strengthened, including by revising the legal framework to allow seizure of property where warranted.

31. Public financial management is being revamped (MEFP ¶19). The new Fiscal Responsibility and Budget Systems Law (FRBSL) is now planned to be adopted (rather than submitted) by end-December 2013 (modified **structural benchmark**). In the context of this new law, key reforms to budget formulation and execution, as well as to the assessment and management of fiscal risks, will be introduced. The objectives are to:

- ***Reform the budget process to achieve a more efficient use of public resources***. With the FRBSL, the government is introducing a new medium-term approach to develop fiscal policy and budget planning. Ministries will be required to produce medium-term plans outlining their objectives and key performance targets and to make their budgets consistent with these plans. In addition, as capacity improves, ministries will gradually be given more flexibility in executing their budgets, while increasing managers' accountability for the use of public resources.
- ***Strengthen commitment controls***. To reduce the possibility of incurring spending arrears, given uncertain revenue prospects, the authorities agreed to introduce a system of pre-order commitment controls, whereby spending orders need to be recorded and availability

of appropriations to cover the commitment need to be confirmed before placing a legally binding order.

- ***Manage fiscal risks from guarantees***. Currently, guarantees are not monitored and assessed on a centralized basis and in the context of the overall management of public debt. To adequately assess risks and ensure appropriate budgetary provisions for possible payments related to calling of guarantees, it was agreed to assign the Public Debt Management Office the responsibility for monitoring and analyzing the fiscal risks associated with the guarantee portfolio.

- ***Improve monitoring of general government finances.*** Staff emphasized and the authorities agreed with the need to ensure comprehensive and timely monitoring of public finances so as to minimize risks related to slippages by local governments or semi-government entities, which are particularly relevant during a period of deep fiscal consolidation. Currently, such monitoring is done quarterly and mostly based on estimates rather than actual data. To address this, the Treasury department will start in September to collect monthly data on all general government entities and compile monthly reports on their finances.

32. A new fundamental reform has been announced to enhance Cyprus's social safety net (MEFP ¶15). To mitigate the impact of the economic crisis on vulnerable groups, including the working poor, who are currently not covered by public assistance programs, the government has developed and announced a comprehensive reform of the social safety net, in line with Fund TA recommendations. The reform will introduce a well-targeted guaranteed minimum income (GMI) scheme that will complement household income to cover basic needs. The cost of the new scheme will be covered by streamlining and reducing other untargeted or overlapping welfare benefits. The new GMI scheme is expected to be in place by mid-2014 (modified **structural benchmark**). Staff supported the authorities' efforts and stressed the need to review the basket of basic needs and put in place adequate means testing to ensure that the scheme is well-targeted, avoids benefit dependence, and stays within budget limits.

33. Staff urged the authorities to press forward with the preparation of a public-private partnership (PPPs) framework and privatization plans (MEFP ¶21 and 22):

- Staff stressed the need to manage potentially significant fiscal risks from public investments, including PPPs, and that this responsibility should be with the Ministry of Finance. The framework now under preparation would need to ensure that decisions to implement a project through publicly-financed procurement or as a PPP are based on value-for-money rather cash-flow considerations. The authorities agreed to reflect in the new FRBSL the principles of international best practice for the management of public investment projects, including project appraisal, project selection, and project design. Secondary legislation and guidelines will have to be issued to address details of public investment management practice.

- The authorities have prepared an inventory of the most important public assets that could be considered for privatization. In a next step, external advisors are being contracted to develop a privatization plan and prepare a draft legal framework for privatization. While the institutional setup for the privatization process has not yet been decided, staff stressed that a light project-based structure supported by experienced external advisors (as opposed to establishing a privatization agency as in other countries) could be most efficient in the Cypriot context, where only a few large companies are expected to be privatized.

PROGRAM MODALITIES, FINANCING AND RISKS

34. Program conditionality for the first review has been largely met, and new conditionality has been proposed (MEFP, Tables 1-3).

- **Prior actions**: Prior to consideration of the review by the Board, the authorities plan to implement two prior actions related to the cooperative credit sector: (i) establish a legal framework for an appropriate ownership and governance structure to manage the state's majority stake in the CCI sector; and (ii) amend the cooperative and banking law provisions to establish the CBC as the single supervisor of the CCI sector (MEFP, Table 2). Staff views these actions as macro critical, as they will help to limit the fiscal risks stemming from the state's prospective involvement in this sector.
- **Quantitative performance criteria (PCs)**: All end-June PCs have been met (MEFP, Table 1). Modifications of end-September PCs are proposed on: (i) the general government primary balance; (ii) the general government primary expenditure; (iii) the stock of general government debt; and (iv) the accumulation of government guarantees. The proposed changes to (i)-(ii) reflect the accommodation of budgetary compensation to ensure comparable treatment between deposits of pension funds in BoC and Laiki. The proposed change to the ceiling on government debt mainly reflects a change in the timing of the implementation of the debt-for-asset swap between the government and the central bank (now expected to take place before end-June 2014). While there is no proposed change to the ceiling on the accumulation of new government guarantees, an adjustor is proposed to allow a maximum of €2.9 billion in additional government guarantees to enhance BoC's pool of Eurosystem eligible collateral (TMU, ¶12). Quantitative PCs are also proposed for end-December 2013.
- **Structural benchmarks**: All program benchmarks have been implemented, albeit with minor delays in some cases (MEFP, Table 2). New benchmarks are proposed (MEFP, Table 3): (i) offer for voluntary recapitalization of Hellenic Bank (end-September 2013); (ii) completion of the recapitalization of Hellenic Bank (end-December 2013); (iii) implementation of measures to boost tax collections (end-December 2013); and (iv) merger of CCIs into a maximum of 18 institutions (end-March 2014). In addition, changes to two benchmarks are proposed: (i) the benchmark on the restructuring plan of BoC has been expanded to include restructuring, business and funding plans, with the plans to be assessed by the CBC by end-

October 2013; and (ii) the FRBSL law is now proposed to be adopted by (instead of submitted to) Parliament by end-December 2013.

35. Financing assurances for the program remain in place. The debt exchange of €1 billion and the rollover of the Laiki recapitalization bond have improved short-run cash flow and allowed for a reduction in projected ESM disbursements in December. The authorities have indicated that the restructuring of the €2.5 billion Russian loan (to extend repayments over 2018–23 and reduce the interest rate from 4.5 to 2.5 percent) has been agreed and is expected to be approved by the Russian parliament later this year. Preparations for the privatization of public assets are ongoing. Finally, the authorities remain committed to complete the allocation of about €0.4 billion of future central bank profits in 2014 and the swap of about €1 billion of debt held by the CBC for state-owned assets by mid-2014. Program financing buffers are sufficient to meet needs beyond the next 12 months.

36. The capacity to repay the Fund is assessed to be adequate. Debt service to the Fund as a ratio of exports of goods and services is expected to peak at less than 2 percent in 2020, while outstanding credit to the Fund is expected to peak at about 563 percent of quota in 2016. While Cyprus's overall external debt remains high, the expected external adjustment coupled with a return of economic growth puts it on a firm downward trend (Table 10, Figure 7). Public debt is also expected to peak during the program period (at about 126 percent of GDP in 2015), before declining as the economy recovers, primary surpluses are registered, and privatization receipts materialize (Table 9, Figure 6).

37. Risks to the program remain significant.

- **The impact of the banking crisis could be larger than expected.** There is still limited evidence to assess the effects of the March shock. A deeper-than-anticipated economic contraction would raise financing needs and have profound implications on debt sustainability.
- **Problems in the banking sector could reemerge**. Confidence in the banking system in general and BoC in particular has been severely affected and may take time to recover. The weak economic environment will negatively affect asset quality and profitability and could result in additional capital needs. Liquidity and solvency problems could then reemerge. BoC's large reliance on emergency funding from the central bank continues to pose risks . Moreover, litigation risks remain, as several bank creditors have challenged resolution actions before the courts, which could add to costs for banks if they are ordered to pay compensation. Finally, failure to execute prudently the plan to lift administrative restrictions and capital controls could endanger financial stability.
- **Policy implementation could be challenging**. Continued internal disagreements could undermine program implementation. Rising unemployment and deteriorating social conditions could test the authorities' resolve to execute policies under the program. Additional fiscal adjustment and implementation of ambitious structural reforms and

privatization are planned for the coming years and will require renewed political will against strong vested interests.

38. There are some factors mitigating these risks. In particular, the program financing buffer remains sizeable and can cover additional fiscal needs even in case of a significant recession (Annex I). The use of the buffer will not increase public debt, as its full utilization is already accounted for in the debt sustainability analysis. The maintenance and gradual relaxation of payment restrictions in an orderly fashion should help to safeguard financial stability. The additional recapitalization of BoC to 12 percent CT1 without recourse to public funds and under conservative assumptions provides some margin against further asset deterioration. Finally, improved program ownership, exemplified by the recent policy actions and public commitments to the program, as well as by strong engagement with Fund technical assistance, helps to mitigate implementation risks.

39. As is standard in all Fund arrangements, staff has completed a safeguards assessment of the CBC. The assessment found a weak governance framework at the CBC and a strained balance sheet given the large amount of ELA extended to commercial banks. The absence of a functioning Board for part of 2013, along with the lack of an Audit Committee and staff resource constraints, had undermined the effectiveness of CBC's audit mechanisms and key operational controls and placed all operations under the control and oversight of the Governor. The CBC published its audited financial statements in a timely manner, but staff advised for more detailed disclosures to improve transparency. Additionally, underlying procedures and controls for ELA will need to be independently reviewed by the Internal Audit Department. More recently, the CBC established a Board Audit Committee and signed a memorandum of understanding with the Ministry of Finance clarifying the roles and responsibilities for servicing Cyprus's financial obligations to the IMF under the extended arrangement.

STAFF APPRAISAL

40. The program is meeting its short-run objectives, but much remains to be done to restore confidence and growth. The authorities have overcome implementation difficulties stemming from political resistance to the program by renewing their commitment and fully implementing near-term stabilization policies, thus meeting the structural benchmarks and performance criteria set in May. However, maintaining a strong pace of policy implementation will become increasingly challenging in the context of still lacking confidence, a deepening recession, and rapidly rising unemployment. Full and timely implementation of the program remains critical to achieving the program's goals to restore financial stability and public finance sustainability to support long-run growth.

41. The authorities have taken important policy steps to complete the banking resolution process. The full recapitalization and merger of the two largest and insolvent banks was finalized, including through additional bail in of uninsured deposits. This, together with measures strengthening their funding base through restructuring of maturities of remaining uninsured deposits, allowed the merged bank to exit resolution and recover counterparty status with the ECB by end-July. While this constitutes an important step toward rebuilding confidence, adequate liquidity support from the Eurosystem is critical in the near term. Looking forward, significant challenges remain to ensure that the bank can adapt its business model to the new conditions and achieve long-run viability, including stable funding.

42. The next steps are to recapitalize and restructure other banks and the cooperative credit sector. The recapitalization strategy for Hellenic Bank will need to preserve private ownership, to the extent possible, including through participation of junior debt holders in the bank's share capital. In the case of the cooperative credit sector, public funds will need to be injected. This will require establishing an adequate governance structure to manage the state's majority stake, as well as the implementation of a comprehensive restructuring and consolidation of sector to ensure the viability of remaining institutions.

43. The authorities' commitment to ease payment restrictions in line with their recently published roadmap is welcome. The imposition of deposit restrictions and capital controls was necessary to safeguard financial stability. Looking forward, their relaxation in an orderly and predictable manner is paramount to building depositor confidence and supporting economic activity. While the tensions between protecting financial stability and growth are expected to remain in the short run, the recently published roadmap linking the easing of restrictions to specific milestones in the banking sector strategy is a key step toward reducing uncertainty. The authorities will need to implement the actions included in the roadmap steadfastly, while maintaining flexibility to account for changes in deposit trends or banks' liquidity conditions. Staff supports the authorities' request for an extension of the approval of existing exchange restrictions in line with Fund policy, on the basis that they have been imposed for balance of payments reasons, are temporary, and are non-discriminatory among Fund members.

44. Bank regulation and supervision and the framework for private debt restructuring need to be strengthened. The financial sector's asset quality is expected to deteriorate with the downturn. To adequately monitor and manage this process, the authorities will need to consolidate supervision of both cooperatives and commercial banks under the central bank, enhance reporting and monitoring of non-performing loans, and strengthen provisioning and loan origination practices. Putting in place an appropriate private debt-restructuring framework will be key to facilitating an orderly private sector deleveraging while maximizing bank asset recoveries. Finally, implementation of the AML framework by banks needs to be improved, including by strengthening supervision in this area.

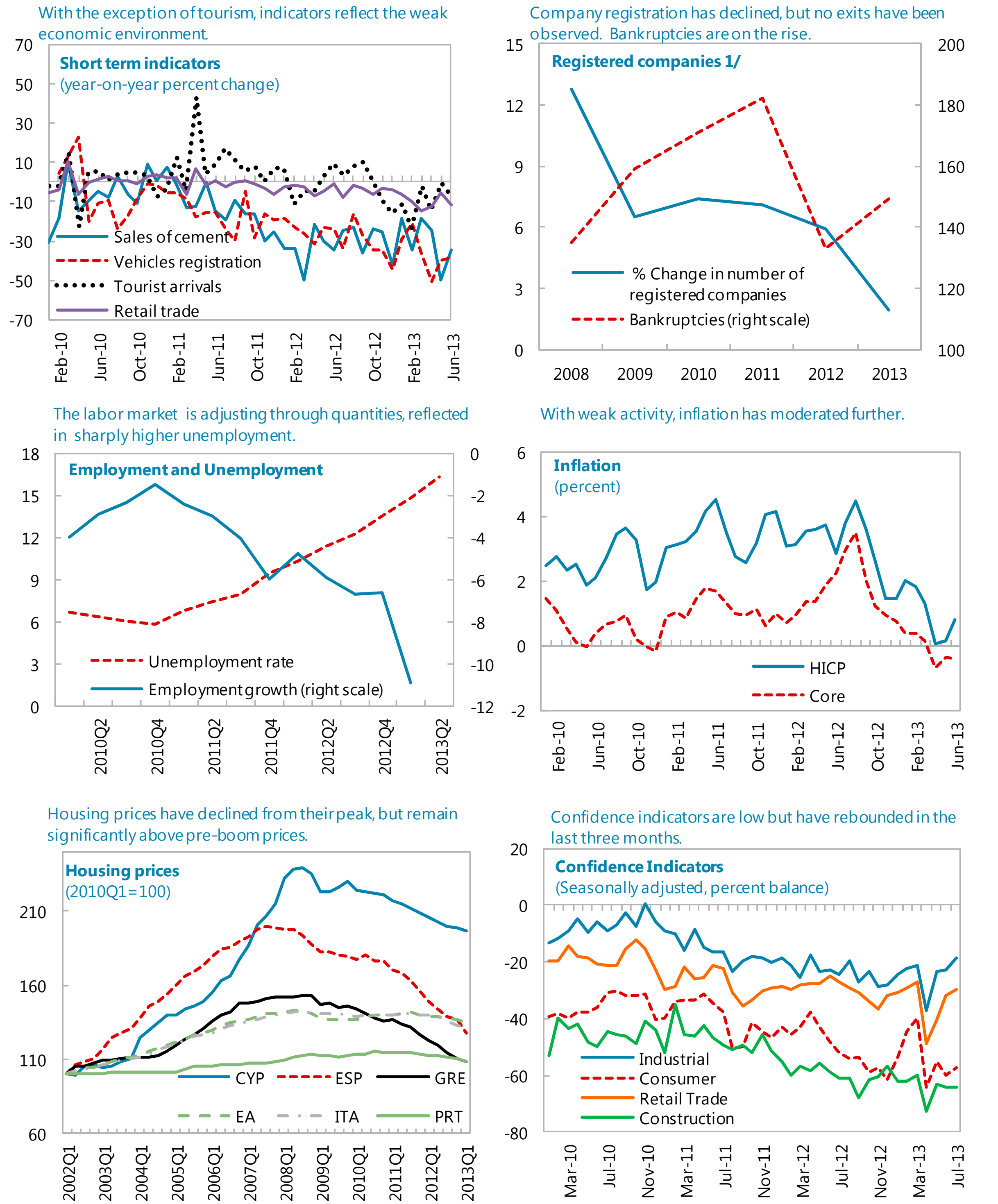
45. Cyprus is on track to meet its 2013 fiscal targets. The ambitious consolidation underway and prudent execution of spending have allowed for meeting half-yearly fiscal targets with a comfortable margin. For the rest of the year, continued prudence is called for given lingering macroeconomic uncertainties. Staff supports the modification of the 2013 targets to reflect one-off bank resolution-related compensation of pension funds. For future years, fiscal policy will need to continue to balance short-run cyclical concerns and long-run sustainability objectives.

46. Fiscal efforts will need to be complemented by ambitious fiscal structural reforms. Staff welcomes the authorities' commitment to integrate revenue administration into a single structure and take measures to protect revenues in the downturn, including by fighting tax evasion by the self-employed. Further, resolute implementation of the new welfare reform introducing a generalized minimum income scheme is needed to mitigate the impact of the recession on vulnerable groups. Finally, steps to finalize the privatization strategy need to be accelerated to prepare key assets for transfer from the state to the private sector. Moving ahead with this ambitious structural agenda will require standing up to strong vested interests.

47. Risks to debt sustainability remain significant. A deeper-than-projected recession and delays in restoring depositor confidence, with associated negative feedback loops with the fiscal and financial sectors, could add to financing needs and put debt sustainability at risk. The program buffer continues to provide a cushion, and the authorities will need to ensure the timely allocation of central bank profits and swap of the central bank debt with assets to facilitate financing needs and lower public debt. While staff welcomes the authorities' renewed commitment to the program, continued strong ownership, including full and timely implementation of the adjustment program, remains essential for the program's success. Should risks to debt sustainability fully materialize, additional financing measures may be necessary.

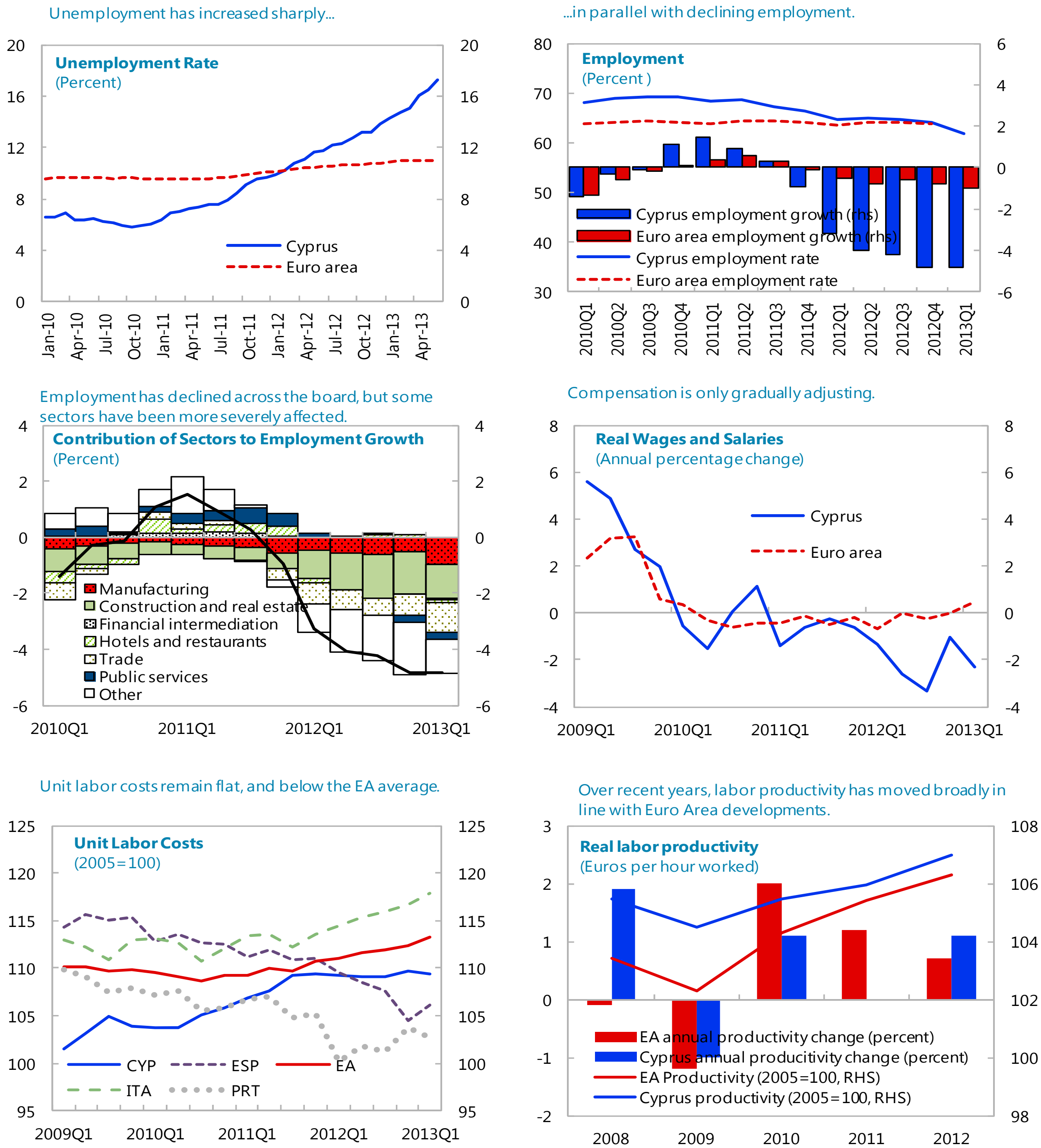
48. On the basis of progress to date and policy commitments going forward, staff supports the completion of the first review and the proposed modifications to performance criteria.

Figure 1. Cyprus: Recent Developments



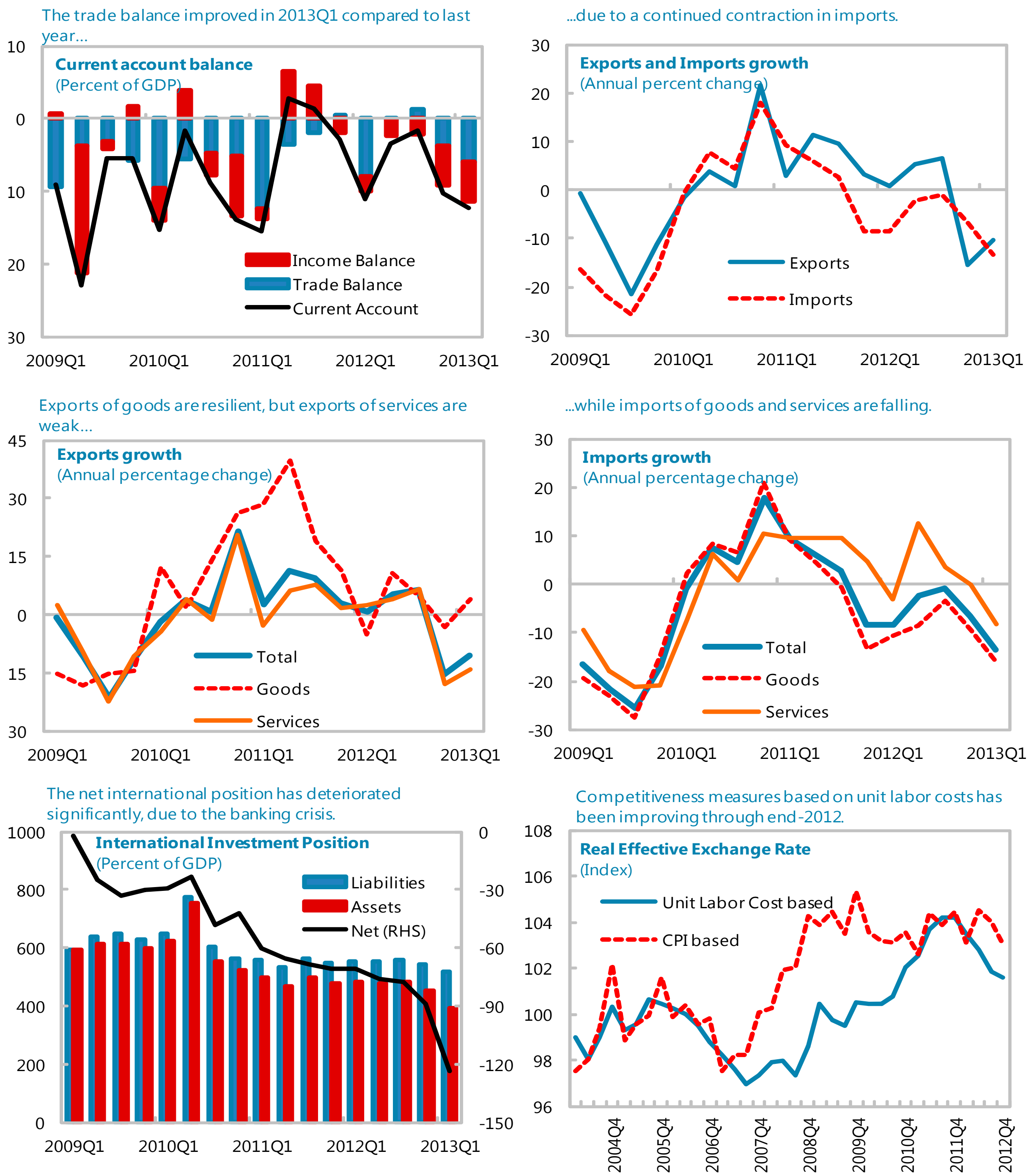
Sources: CYSTAT; Eurostat; and IMF satff calculations.
1/ 2013 figures correspond to annualized data through July.

Figure 2. Cyprus: Labor Market



Sources: Eurostat; ECB; Cystat; and IMF staff estimates

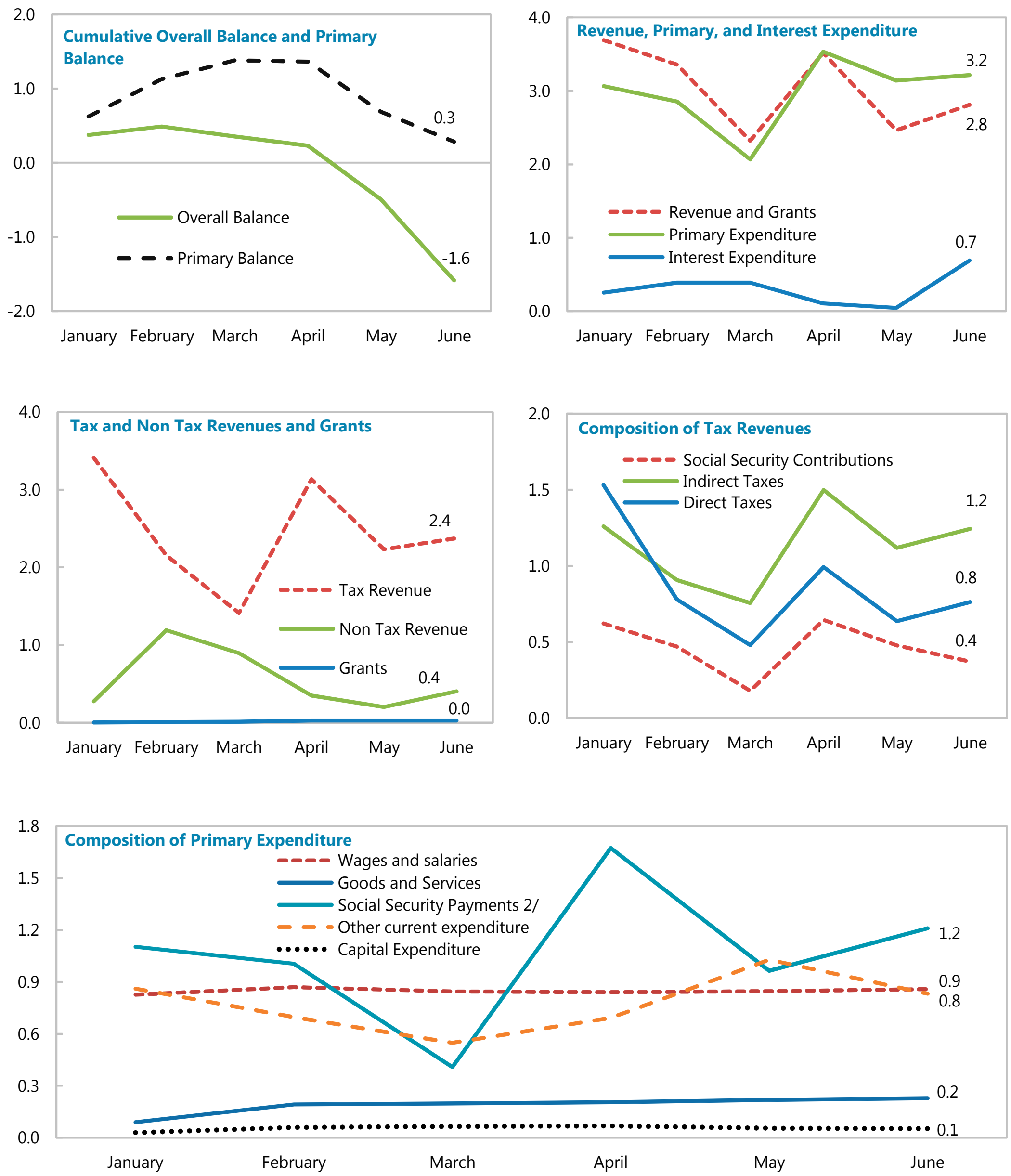
Figure 3. Cyprus: External Indicators



Sources: Eurostat; Central Bank of Cyprus; and IMF staff estimates.

Figure 4 . Cyprus: Recent Fiscal Developments 1/

(Percent of GDP, monthly levels)

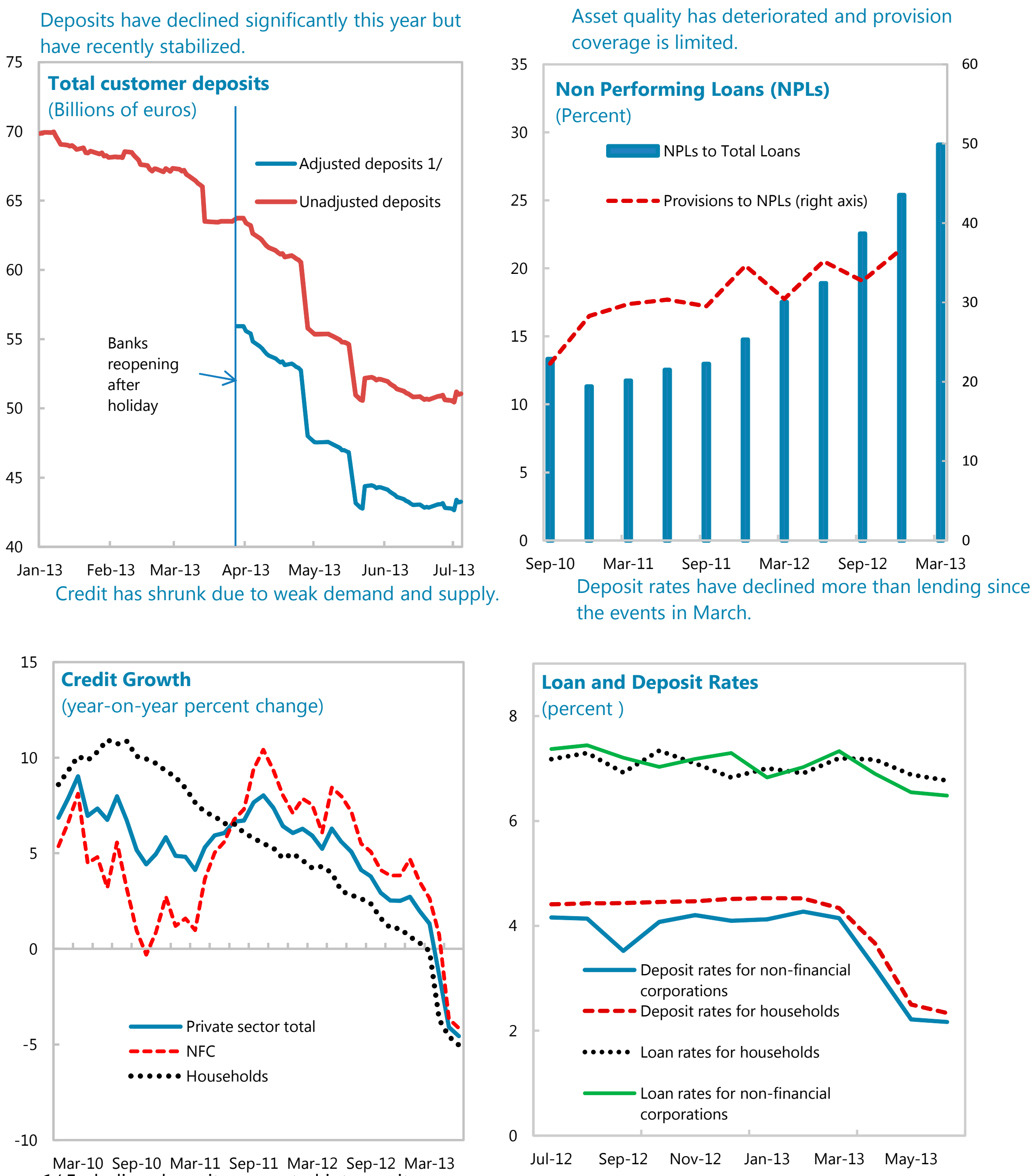


Sources: Ministry of Finance; and IMF staff calculations. National budget classification.

1/ Based on cash data and the national classification which, unlike ESA, exclude local governments and semi-governmental entities.

2/ Includes payments of pensions to the private sector and the civil service, the social pension, redundancy benefits, and unemployment insurance benefits.

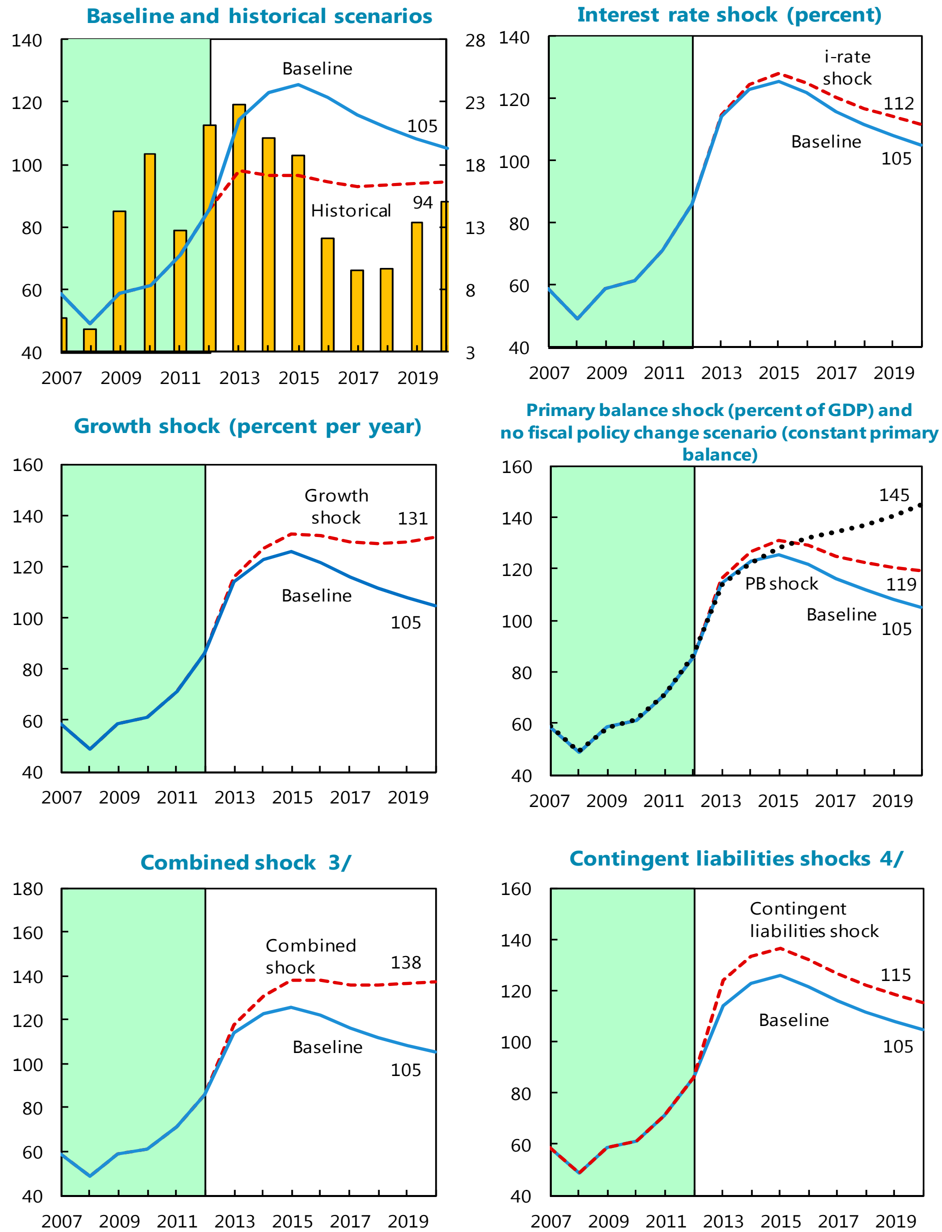
Figure 5. Financial Sector Developments



1/ Excluding deposits converted into equity.
Sources: ECB; IMF staff calculations.

Figure 6. Cyprus: Public Debt Sustainability: Bound Tests 1/ 2/

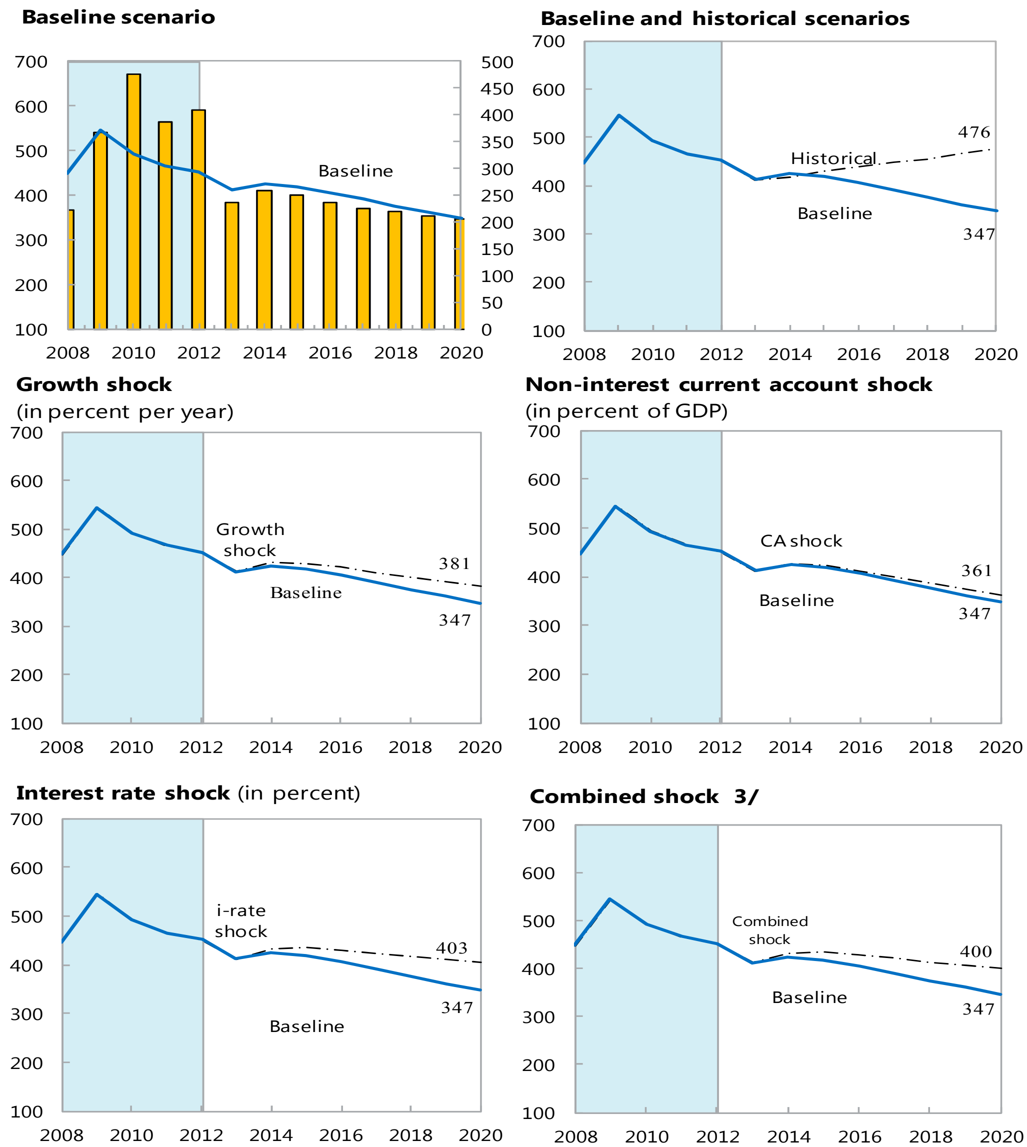
(Public debt as percent of GDP)



Sources: Ministry of Finance and Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are one half of the historical standard deviation. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variables are also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics 9 years ahead.
3/ Combines individual shocks of one half of the historical standard deviation for each variable.
4/ One-time 10 percent of GDP shock to contingent liabilities in 2013.

Figure 7. Cyprus: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Five-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the five-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Table 1. Cyprus: Selected Economic Indicators and Macroeconomic Framework, 2008–20

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
Real Economy					(Percent change, unless otherwise indicated)								
Real GDP	3.6	-1.9	1.3	0.5	-2.4	-8.7	-3.9	1.1	1.9	2.3	2.2	1.9	1.8
Domestic demand	8.0	-7.0	1.9	-1.6	-6.8	-13.9	-6.0	1.0	2.1	2.8	2.7	2.4	2.4
Consumption	7.4	-4.6	1.4	0.4	-2.7	-11.6	-5.2	0.8	1.9	2.5	2.5	2.2	2.2
Private consumption	7.8	-7.5	1.5	0.5	-3.0	-12.4	-5.7	1.6	2.9	3.4	3.3	2.6	2.4
Public consumption	6.1	6.8	1.0	-0.3	-1.7	-8.9	-3.7	-1.7	-1.3	-0.6	-0.1	0.9	1.5
Fixed investment	6.0	-9.7	-4.9	-13.1	-23.0	-29.5	-12.0	2.3	3.5	5.5	4.3	4.2	4.0
Inventory accumulation 1/	0.9	-1.5	1.8	0.5	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-5.1	6.0	-0.7	2.3	4.7	5.2	1.7	0.2	-0.1	-0.3	-0.3	-0.4	-0.4
Exports of goods and services	-0.5	-10.7	3.8	4.4	2.3	-5.5	-2.5	1.7	2.7	3.3	3.3	3.3	3.3
Imports of goods and services	8.5	-18.6	4.8	-0.7	-7.2	-16.5	-6.8	1.7	3.3	4.5	4.6	4.7	4.7
Potential GDP growth	2.4	1.7	1.6	1.8	-1.5	-8.5	-3.7	0.1	0.8	1.3	1.6	1.7	1.8
Output gap (percent of potential GDP)	2.8	-0.8	-1.2	-2.4	-3.3	-3.5	-3.7	-2.9	-1.8	-0.9	-0.3	-0.1	0.0
HICP (period average)	4.4	0.2	2.6	3.5	3.1	1.0	1.2	1.6	1.7	1.7	1.8	1.9	2.0
HICP (end of period)	1.8	1.6	1.9	4.2	1.5	1.0	1.2	1.6	1.7	1.7	1.8	1.9	2.0
Unemployment rate EU stand. (percent)	3.7	5.4	6.2	7.8	11.9	17.0	19.5	18.7	17.5	15.9	14.4	13.1	11.8
Employment growth (percent)	1.3	-0.4	1.0	-5.6	-4.1	-7.8	-3.7	1.1	1.7	2.2	2.0	1.7	1.7
Public Finance						(Percent of GDP)							
General government balance	0.9	-6.1	-5.3	-6.3	-6.3	-6.7	-7.5	-5.3	-2.3	-0.7	0.3	0.2	-0.2
Revenue	43.1	40.1	40.9	39.7	40.0	40.6	39.3	40.1	41.5	42.0	42.5	42.6	42.7
Expenditure	42.1	46.2	46.2	46.0	46.3	47.3	46.8	45.4	43.9	42.7	42.2	42.4	42.9
General government primary balance	3.8	-3.6	-3.0	-3.9	-3.1	-3.3	-4.3	-2.1	1.2	3.0	4.0	4.0	4.0
General government debt	48.9	58.5	61.3	71.1	85.8	114.1	123.0	125.7	121.7	115.9	111.7	108.1	105.0
Balance of Payments						(Percent of GDP)							
Current account balance	-15.6	-10.7	-9.8	-3.3	-6.5	-2.0	-0.6	-0.9	-1.0	-1.3	-1.5	-1.7	-2.0
Trade Balance (goods and services)	-11.4	-5.5	-6.2	-4.2	-2.5	2.4	4.0	3.8	3.5	3.1	2.8	2.4	2.1
Exports of goods and services	45.0	40.2	41.3	42.7	42.5	44.4	45.1	45.4	45.6	46.0	46.4	47.1	47.8
Imports of goods and services	56.4	45.7	47.5	46.9	45.0	42.0	41.1	41.6	42.1	42.9	43.7	44.7	45.7
Goods balance	-32.4	-25.5	-26.8	-24.2	-21.5	-17.4	-16.0	-16.2	-16.5	-16.9	-17.3	-17.8	-18.2
Services balance	21.0	20.0	20.6	19.9	19.0	19.8	20.0	20.0	20.0	20.0	20.0	20.2	20.4
Income, net	-3.9	-4.1	-3.0	2.0	-3.0	-3.8	-4.2	-4.3	-4.1	-4.0	-3.9	-3.9	-3.9
Transfer, net	-0.4	-1.1	-0.7	-1.1	-1.0	-0.6	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-0.2
Capital account, net	0.0	0.3	0.2	0.3	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account, net	16.1	10.9	9.5	4.3	4.3	-27.7	-17.1	-11.7	-0.9	1.1	1.6	2.1	2.6
Direct investment	-5.2	13.2	0.4	0.7	6.9	0.0	0.5	4.3	4.6	3.1	3.0	4.0	4.0
Portfolio investment	-74.1	-101.1	-11.1	32.0	25.1	80.4	5.0	-3.4	-3.3	-3.2	-3.0	-2.8	-2.7
Other investment	93.8	98.2	19.0	-28.6	-27.9	-108.0	-22.5	-12.6	-2.3	1.2	1.6	1.0	1.3
Reserves (- inflow; + outflow)	1.7	0.5	1.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	…	…	…	…	…	29.5	17.5	12.4	1.8	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.3	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings-Investment Balance													
National saving	7.7	8.9	9.9	14.0	7.0	8.4	9.1	9.1	9.3	9.6	9.5	9.6	9.5
Government	4.9	-0.6	-0.1	-1.8	-2.3	-3.2	-4.3	-2.2	0.8	2.5	3.4	3.3	3.0
Non-government	2.8	9.5	9.9	15.7	9.3	11.6	13.4	11.3	8.5	7.1	6.1	6.2	6.5
Gross capital formation	23.3	19.6	19.7	17.3	13.5	10.4	9.7	10.0	10.4	10.8	11.0	11.3	11.4
Government	4.0	5.5	5.2	4.5	4.0	3.4	3.2	3.1	3.1	3.2	3.2	3.2	3.2
Non-government	19.4	14.1	14.5	12.8	9.5	7.0	6.5	6.9	7.3	7.7	7.9	8.1	8.3
Foreign saving	-15.6	-10.7	-9.8	-3.3	-6.5	-2.0	-0.6	-0.9	-1.0	-1.3	-1.5	-1.7	-2.0
Memorandum Item:													
Nominal GDP (billions of euros)	17.2	16.9	17.4	18.0	17.9	16.4	16.0	16.4	17.0	17.7	18.4	19.1	19.8

Sources: Eurostat; Central Bank of Cyprus; and IMF staff estimates.
1/ Contribution to growth.

Table 2. Cyprus: Fiscal Developments and Projections, 2008–20 1/

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
Revenue	43.1	40.1	40.9	39.7	40.0	40.6	39.3	40.1	41.5	42.0	42.5	42.6	42.7
Current revenue	43.0	40.0	40.8	39.6	39.9	40.6	39.2	40.0	41.5	42.0	42.4	42.5	42.7
Tax revenue	30.6	26.4	26.5	26.2	25.8	25.3	24.9	25.4	26.2	26.4	26.5	26.6	26.7
Indirect taxes	17.7	15.2	15.4	14.5	14.8	14.1	14.2	14.8	15.4	15.5	15.6	15.6	15.7
Direct taxes	12.9	11.2	11.1	11.7	11.1	11.2	10.7	10.5	10.8	10.9	10.9	10.9	11.0
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	7.8	8.7	8.9	8.7	9.1	8.4	8.7	8.8	9.0	9.1	9.2	9.2	9.3
Other current revenue	4.6	4.9	5.4	4.7	4.9	6.8	5.6	5.8	6.3	6.5	6.7	6.8	6.7
Sales	2.9	2.4	2.6	2.4	2.8	2.8	3.1	3.3	3.6	3.7	3.8	3.8	3.8
Other	1.8	2.5	2.8	2.3	2.2	4.0	2.4	2.5	2.8	2.8	2.9	2.9	2.9
Capital revenue	0.0	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Expenditure	42.1	46.2	46.2	46.0	46.3	47.3	46.8	45.4	43.9	42.7	42.2	42.4	42.9
Current expenditure	38.2	40.7	40.9	41.5	42.3	43.8	43.6	42.3	40.8	39.5	39.1	39.2	39.8
Wages and salaries	14.6	16.2	15.8	16.0	15.8	15.9	15.9	15.7	15.2	14.8	14.7	14.6	14.6
Goods and services	5.0	5.4	5.6	5.3	5.1	5.2	5.2	4.9	4.5	4.3	4.1	4.1	4.1
Social Transfers	12.2	13.5	14.4	14.6	15.1	15.7	16.7	16.3	15.7	15.3	15.0	15.1	15.2
Subsidies	0.4	0.2	0.4	0.5	0.5	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5
Interest payments	2.8	2.6	2.2	2.4	3.2	3.3	3.2	3.2	3.5	3.7	3.7	3.8	4.2
Other current expenditure	3.1	2.9	2.5	2.8	2.7	3.1	1.9	1.6	1.2	1.0	1.0	1.1	1.2
Capital expenditure	4.0	5.5	5.2	4.5	4.0	3.4	3.2	3.1	3.1	3.2	3.2	3.2	3.2
Overall balance	0.9	-6.1	-5.3	-6.3	-6.3	-6.7	-7.5	-5.3	-2.3	-0.7	0.3	0.2	-0.2
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.9	-6.1	-5.3	-6.3	-6.3	-6.7	-7.5	-5.3	-2.3	-0.7	0.3	0.2	-0.2
Net financial transactions	0.9	-6.1	-5.3	-6.3	-6.3	-6.7	-7.5	-5.3	-2.3	-0.7	0.3	0.2	-0.2
Net acquisition of financial assets	-4.4	2.7	-0.6	5.3	8.6	13.4	-2.6	-0.2	-2.5	-2.3	0.0	0.0	0.0
Currency and deposits	-4.5	1.9	-1.3	4.7	-3.5	3.9	1.9	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.2	0.6	0.7	1.0	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	-0.3	0.0	0.0	0.0	10.4	9.5	4.3	-0.2	-2.5	-2.3	0.0	0.0	0.0
Other assets	0.2	0.3	0.0	-0.4	0.1	0.0	-8.8	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-5.3	8.8	4.7	11.6	14.9	20.1	4.8	5.1	-0.2	-1.6	-0.3	-0.2	0.2
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-8.3	9.2	4.8	7.6	1.7	-8.5	-5.6	-6.6	1.7	1.5	4.2	4.5	4.9
Loans	3.0	-0.3	0.0	4.0	12.6	28.6	10.4	11.7	-1.9	-3.1	-4.5	-4.6	-4.7
Other liabilities	0.1	0.0	0.0	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:													
Cyclically adjusted overall balance	-0.1	-5.8	-4.8	-5.4	-3.9	-3.3	-4.2	-2.7	-1.4	-0.6	0.3	0.2	-0.2
Cyclical balance	1.1	-0.3	-0.5	-0.9	-2.4	-3.3	-3.3	-2.7	-0.9	0.0	0.0	0.0	0.0
Cyclically adjusted primary balance	2.7	-3.2	-2.6	-3.0	-0.8	0.0	-1.0	0.6	2.1	3.0	4.0	4.0	4.0
Structural Primary Balance 2/	0.7	-3.5	-3.1	-2.4	0.6	0.9	1.2	3.0	4.7	5.7	6.6	6.6	6.6
Primary balance	3.8	-3.6	-3.0	-3.9	-3.1	-3.3	-4.3	-2.1	1.2	3.0	4.0	4.0	4.0
Public debt	48.9	58.5	61.3	71.1	85.8	114.1	123.0	125.7	121.7	115.9	111.7	108.1	105.0

Sources: Eurostat; and IMF staff estimates.

1/ Historical fiscal statistics are based on Eurostat and are thus reported on an accrual basis. For projections, and to be consistent with the cash basis of the program, the fiscal statistics are reported on a cash basis.

2/ Cyclically adjusted primary balance net of one offs. Given the high uncertainty related to the size of the output gap and temporary versus permanent effects on potential output in the short run, it likely underestimates the amount of consolidation underway.

Table 3. Cyprus: Calculation of Gross Financing Requirements and Sources of Financing, 2013–17
(millions of euros)

	2013 May-December	2014	2015	2016	2017
Gross financing requirement including a buffer	**5,859.2**	**4,180.2**	**3,522.4**	**2,120.1**	**1,682.4**
Government	3,768.6	3,233.8	3,065.7	2,045.3	1,682.4
Fiscal deficit ("+" = financing need)	1,151.1	1,226.4	876.1	392.6	115.8
Debt maturities	2,617.5	2,007.4	2,189.6	1,652.8	1,566.6
Medium- and long-term	1,631.7	1,021.6	1,203.9	667.1	580.9
Domestic	172.2	390.9	294.4	442.9	364.3
Foreign	1,459.6	630.7	909.5	224.2	216.6
Short-term	985.7	985.7	985.7	985.7	985.7
Domestic	985.7	985.7	985.7	985.7	985.7
Foreign	0.0	0.0	0.0	0.0	0.0
Banks recapitalization/support	1,500.0	0.0	0.0	0.0	0.0
Market financing	**1,015.7**	**985.7**	**985.7**	**1,317.1**	**1,282.4**
Government	1,015.7	985.7	985.7	1,317.1	1,282.4
Fiscal deficit	0.0	0.0	0.0	0.0	0.0
Debt maturities	1,015.7	985.7	985.7	1,317.1	1,282.4
Medium- and long-term	30.0	0.0	0.0	331.4	296.7
Short-term	985.7	985.7	985.7	985.7	985.7
Net financing requirement	**4,843.4**	**3,194.5**	**2,536.6**	**802.9**	**400.0**
Government	2,752.9	2,248.1	2,080.0	728.2	400.0
Fiscal deficit	1,151.1	1,226.4	876.1	392.6	115.8
Debt maturities	1,601.7	1,021.6	1,203.9	335.7	284.2
Medium- and long-term	1,601.7	1,021.6	1,203.9	335.7	284.2
Short-term	0.0	0.0	0.0	0.0	0.0
Official Financing Sources and Financial Buffers	**4,843.4**	**3,194.5**	**2,536.6**	**802.9**	**400.0**
Domestic Financing Sources	**0.0**	**400.0**	**500.0**	**500.0**	**400.0**
Official financing sources	**4,843.4**	**2,794.5**	**2,036.6**	**302.9**	**0.0**
IMF	258.4	344.5	344.5	86.1	0.0
ESM	4,585.0	2,450.0	1,692.2	216.8	0.0

Source: IMF staff estimates.

Table 4. Cyprus: Balance of Payments, 2008–20 1/

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
						(Millions of Euros)							
Current account balance	-2,679	-1,808	-1,712	-602	-1,161	-335	-99	-150	-175	-221	-271	-327	-390
Trade balance (Goods and Services)	-1,953	-930	-1,082	-763	-449	396	635	621	587	546	508	463	423
Goods balance	-5,555	-4,292	-4,664	-4,349	-3,853	-2,854	-2,560	-2,652	-2,800	-2,984	-3,181	-3,395	-3,619
Exports	1,190	1,001	1,137	1,411	1,439	1,458	1,483	1,523	1,579	1,660	1,746	1,838	1,937
Imports	-6,745	-5,293	-5,801	-5,760	-5,291	-4,313	-4,044	-4,175	-4,379	-4,643	-4,927	-5,233	-5,556
Services Balance	3,601	3,363	3,583	3,585	3,404	3,250	3,195	3,273	3,387	3,530	3,689	3,857	4,042
Exports	6,538	5,779	6,049	6,262	6,168	5,834	5,715	5,897	6,149	6,462	6,801	7,164	7,552
Imports	-2,937	-2,416	-2,467	-2,676	-2,765	-2,583	-2,521	-2,624	-2,762	-2,932	-3,112	-3,306	-3,510
Current income, net	-662	-686	-514	357	-528	-632	-667	-705	-692	-698	-719	-737	-766
Current transfers, net	-64	-193	-116	-196	-184	-99	-67	-67	-70	-69	-60	-53	-47
Private	22	-106	-56	-101	-126	-57	-30	-25	-22	-21	-19	-14	-10
Public	-86	-86	-60	-94	-57	-42	-37	-41	-48	-48	-41	-38	-37
Capital account, net	6	51	35	46	23	36	31	30	33	31	31	32	31
Financial account, net	2,765	1,834	1,647	781	776	-4,545	-2,726	-1,917	-161	197	297	410	524
Direct investment	-890	2,224	65	132	1,230	0	80	705	786	542	552	764	794
Portfolio investment	-12,722	-17,039	-1,934	5,753	4,482	13,200	790	-555	-556	-557	-551	-545	-538
Other investment	16,085	16,557	3,315	-5,146	-4,994	-17,745	-3,596	-2,066	-390	212	295	191	268
Reserves (- inflow; + outflow)	291	92	200	43	58	0	0	0	0	0	0	0	0
Program financing	…	…	…	…	0	4,843	2,794	2,037	303	-7	-57	-115	-165
Errors and omissions	-92	-77	30	-225	361	0	0	0	0	0	0	0	0
						(Percent of GDP)							
Current account balance	-15.6	-10.7	-9.8	-3.3	-6.5	-2.0	-0.6	-0.9	-1.0	-1.3	-1.5	-1.7	-2.0
Trade balance (goods and services)	-11.4	-5.5	-6.2	-4.2	-2.5	2.4	4.0	3.8	3.5	3.1	2.8	2.4	2.1
Goods balance	-32.4	-25.5	-26.8	-24.2	-21.5	-17.4	-16.0	-16.2	-16.5	-16.9	-17.3	-17.8	-18.2
Exports	6.9	5.9	6.5	7.8	8.0	8.9	9.3	9.3	9.3	9.4	9.5	9.6	9.8
Imports	-39.3	-31.4	-33.3	-32.0	-29.6	-26.3	-25.3	-25.5	-25.8	-26.3	-26.8	-27.4	-28.0
Services balance	21.0	20.0	20.6	19.9	19.0	19.8	20.0	20.0	20.0	20.0	20.0	20.2	20.4
Exports	38.1	34.3	34.8	34.8	34.5	35.5	35.8	36.0	36.3	36.6	36.9	37.5	38.1
Imports	-17.1	-14.3	-14.2	-14.9	-15.5	-15.7	-15.8	-16.0	-16.3	-16.6	-16.9	-17.3	-17.7
Current income, net	-3.9	-4.1	-3.0	2.0	-3.0	-3.8	-4.2	-4.3	-4.1	-4.0	-3.9	-3.9	-3.9
Current transfers, net	-0.4	-1.1	-0.7	-1.1	-1.0	-0.6	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-0.2
Private	0.1	-0.6	-0.3	-0.6	-0.7	-0.3	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	0.0
Public	-0.5	-0.5	-0.3	-0.5	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2
Capital account, net	0.0	0.3	0.2	0.3	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account, net	16.1	10.9	9.5	4.3	4.3	-27.7	-17.1	-11.7	-0.9	1.1	1.6	2.1	2.6
Direct investment	-5.2	13.2	0.4	0.7	6.9	0.0	0.5	4.3	4.6	3.1	3.0	4.0	4.0
Portfolio investment 2/	-74.1	-101.1	-11.1	32.0	25.1	80.4	5.0	-3.4	-3.3	-3.2	-3.0	-2.8	-2.7
Other investment 2/	93.8	98.2	19.0	-28.6	-27.9	-108.0	-22.5	-12.6	-2.3	1.2	1.6	1.0	1.3
Reserves (- inflow; + outflow)	1.7	0.5	1.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	…	…	…	… …		29.5	17.5	12.4	1.8	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.3	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Eurostat; Central Bank of Cyprus; and IMF staff estimates.

1/ Balance of Payments historical data and projections exclude data related to the operations by entities without a physical presence in Cyprus as data coverage on these entities is still incomplete and subject to substantial revisions. This is also consistent with the treatment of these entities in the National Accounts.

2/ 2008-09 data reflect the transactions between Greek banks and their subsidiaries in Cyprus.

Table 5. Cyprus: External Financing Requirements and Sources, 2012–20
(Millions of Euros)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
GROSS FINANCING REQUIREMENTS	**70,089**	**56,411**	**42,100**	**40,575**	**39,510**	**39,343**	**39,876**	**40,007**	**40,722**
Current account deficit ("-" = CA surplus)	1,161	335	99	150	175	221	271	327	390
Medium- and long-term debt amortization	15,854	10,418	2,859	2,478	1,891	1,942	2,530	2,636	3,519
Public sector	593	1,460	631	910	224	217	745	808	1,646
Banks	14,442	7,664	947	301	373	390	408	407	406
Other private	819	1,295	1,281	1,268	1,294	1,335	1,377	1,421	1,467
Short-term debt amortization	53,074	45,658	39,142	37,947	37,444	37,172	37,018	36,929	36,649
Public sector	8,297	7,468	5,112	4,726	4,109	3,470	2,826	2,118	1,153
Central Bank	7,992	7,468	5,112	4,726	4,109	3,470	2,826	2,118	1,153
Of which: ECB access									
General government and SOEs	306	0	0	0	0	0	0	0	0
Banks	43,724	36,914	32,816	32,067	32,067	32,220	32,456	32,779	33,114
Other private	1,053	1,277	1,214	1,154	1,268	1,482	1,735	2,032	2,381
EU and IMF	0	0	0	0	0	7	57	115	165
SOURCES OF FINANCING	**70,089**	**51,568**	**39,305**	**38,539**	**39,207**	**39,343**	**39,876**	**40,007**	**40,722**
Capital account (net)	23	36	31	30	33	31	31	32	31
Foreign direct investment (net)	1,230	0	80	705	786	542	552	764	794
New borrowing and debt rollover	65,633	41,398	39,415	39,109	39,321	39,244	39,772	39,606	41,280
Medium and long-term borrowing	16,474	2,256	1,468	1,665	2,149	2,227	2,843	2,957	3,849
General Government	2,120	30	0	0	224	217	745	808	1,646
Banks	11,146	996	251	271	435	473	512	513	514
Other private	3,208	1,230	1,217	1,395	1,490	1,537	1,586	1,637	1,689
Short-term borrowing	49,158	39,142	37,947	37,444	37,172	37,018	36,929	36,649	37,431
Public sector	7,468	5,112	4,726	4,109	3,470	2,826	2,118	1,153	161
Central Bank	7,468	5,112	4,726	4,109	3,470	2,826	2,118	1,153	161
General government	0	0	0	0	0	0	0	0	0
Banks	40,414	32,816	32,067	32,067	32,220	32,456	32,779	33,114	34,770
Other private	1,277	1,214	1,154	1,268	1,482	1,735	2,032	2,381	2,500
Other	3,202	10,134	-220	-1,305	-933	-475	-479	-395	-1,383
Of which: Net errors and omissions	361	0	0	0	0	0	0	0	0
FINANCING GAP	**0**	**4,843**	**2,794**	**2,037**	**303**	**0**	**0**	**0**	**0**
ESM	0	4,585	2,450	1,692	217	0	0	0	0
IMF	0	258	344	344	86	0	0	0	0
ROLLOVER RATES									
General government	236%	2%	0%	0%	100%	100%	100%	100%	100%
Central bank	93%	68%	92%	87%	84%	81%	74.9%	54.4%	13.9%
Private	93%	77%	96%	101%	102%	102%	103%	103%	106%
Banks	89%	76%	96%	100%	101%	101%	101%	101%	105%
Non-financial corporates	240%	95%	95%	110%	116%	116%	116%	116%	109%

Sources: Eurostat; Central Bank of Cyprus; and IMF Staff estimates.

Table 6. Cyprus Monetary Survey, 2008–13
(In millions of Euros, unless otherwise indicated, end of period)

	2008	2009	2010	2011	2012	Jun-13
Aggregated balance sheet of the Monetary Financial Institutions (MFIs)						
Assets	118.1	139.4	135.0	131.6	128.1	100.9
Claims on Central Bank of Cyprus	1.3	3.1	2.3	3.2	3.9	2.9
Claims on Cypriot resident Other MFIs	3.3	5.4	5.6	5.0	4.6	3.8
Claims on Cypriot resident non MFIs	47.2	50.3	54.0	58.2	60.6	57.9
General government	3.7	4.6	4.5	5.3	6.5	5.7
Private sector excluding brass plates 1/	39.4	42.7	46.5	48.6	49.3	47.6
Households	19.1	20.6	22.5	23.5	23.9	22.6
Non-Financial Corporations	19.7	21.5	23.3	24.1	24.4	24.0
Non-Bank Financial Intermediaries	0.6	0.6	0.7	1.0	1.0	1.1
Brass Plates 2/	4.1	3.0	3.0	4.4	4.8	4.6
Claims on non-residents	63.4	76.9	69.3	61.3	55.9	31.8
Other assets	2.9	3.8	3.8	3.9	3.2	4.5
Liabilities	118.1	139.4	135.0	131.6	128.1	100.9
Liabilities to the Central Bank of Cyprus	4.7	7.6	5.5	5.5	9.8	11.4
Liabilities to Cypriot resident Other MFI	3.3	5.3	5.5	4.9	4.5	3.7
Deposits of Cypriot resident non MFIs	39.5	41.0	45.4	43.7	43.3	35.0
General government	0.3	0.4	0.5	0.5	0.5	0.4
Private sector excluding brass plates	33.4	34.5	36.8	37.4	37.5	31.9
Households	23.4	24.6	25.4	26.0	26.4	23.7
Non-Financial Corporations	6.3	6.1	6.7	6.7	5.7	3.9
Non-Bank Financial Intermediaries	3.6	3.9	4.7	4.6	5.4	4.3
Brass Plates	5.7	6.1	8.1	5.8	5.3	2.7
Deposits of non-residents	51.7	66.6	60.6	56.5	51.3	31.6
Debt securities	5.6	4.8	2.4	2.6	1.7	0.5
Capital and reserves	10.0	10.8	12.8	11.3	15.1	15.1
Other liabilities	3.4	3.3	2.8	7.1	2.4	3.6
Money and Credit						
Net foreign assets	3.0	1.9	4.0	-1.4	-1.0	-5.6
Monetary Financial Institutions	5.9	5.4	6.3	2.2	3.0	-0.2
Central Bank of Cyprus	-2.9	-3.5	-2.3	-3.7	-4.0	-5.4
Net domestic assets	45.5	49.9	53.9	56.7	59.9	56.4
General government sector credit, net	4.5	5.3	5.2	5.3	7.2	5.2
Private sector credit excluding brass plates	41.0	44.6	48.7	51.5	52.7	51.2
Brass Plates credit	4.1	3.0	3.0	4.4	4.8	4.6
Other items,net	-10.5	-10.8	-12.3	-11.8	-15.6	-15.4
Cypriot Resident Broad money (M2)	40.6	42.2	46.6	45.0	44.6	36.5
Cypriot Resident Narrow money (M1)	9.1	10.4	10.6	11.1	11.5	9.2
		(Percent of GDP)				
General Government sector credit, net	26.4	31.6	30.1	29.2	40.0	31.6
Private sector credit excluding brass plates	238.7	264.8	279.7	286.4	294.8	311.6
Brass plates credit	23.9	17.5	17.4	24.2	26.7	27.8
Cypriot Resident Broad money (M2)	236.7	250.2	267.4	250.2	249.6	222.0
Cypriot Resident Narrow money (M1)	53.0	61.8	61.2	61.9	64.2	55.8
		(Annual percentage change)				
General Government sector credit, net		17.4	-1.6	0.4	36.2	-27.8
Private sector credit excluding brass plates		8.9	9.1	5.7	2.4	-0.8
Gross Household and non-financial corporations credit excluding brass plates		8.6	8.5	4.2	1.2	-3.0
Brass plates credit		-28.1	2.3	44.0	9.9	12.4
Cypriot Resident Broad money (M2)		3.9	10.4	-3.4	-0.8	-18.8
Cypriot Resident Narrow money (M1)		14.5	2.3	4.4	3.2	-17.8
Memorandum items:						
Credit to deposits Ratio, Euro area residents (in percent)	87.8	80.7	85.7	99.2	111.2	123.2
Deposits from Cypriot Private Sector excluding brass plates (y-o-y percent change)		3.4	6.5	1.7	0.3	-15.0
Brass Plates Deposits (y-o-y percent change)		6.2	33.8	-28.3	-9.4	-51.2

Sources: European Central Bank, Central Bank of Cyprus, and Fund staff estimates.
1/ Includes public entities classified as outside the general government as no information is available to separate them. The data excludes brass plates, companies that are established in Cyprus for tax purposes. While they have a physical presence in Cyprus and are therefore treated as residents, given their limited interaction with the domestic economy, it is analytically useful to separate them out.
2/ Data on Brass Plates only became available from July 2008 onwards.

Table 7. Cyprus: Indicators of Fund Credit, 2012–20 [1/]

(In millions of SDRs)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Existing and prospective Fund credit									
Disbursement	0.0	222.8	297.0	297.0	74.3	0.0	0.0	0.0	0.0
Stock	0.0	222.8	519.8	816.8	891.0	884.8	835.3	736.3	594.0
Obligations	0.0	1.6	4.7	10.4	17.2	24.2	70.5	117.9	156.7
Repurchase	0.0	0.0	0.0	0.0	0.0	6.2	49.5	99.0	142.3
Charges	0.0	1.6	4.7	10.4	17.2	18.0	21.0	18.9	14.4
Stock of existing and prospective Fund credit									
In percent of quota	0.0	140.8	328.5	516.3	563.2	559.3	528.0	465.4	375.5
In percent of GDP	0.0	1.5	3.7	5.7	6.0	5.7	5.2	4.4	3.4
In percent of exports of goods and services	0.0	3.5	8.2	12.6	13.2	12.4	11.2	9.3	7.1
Obligations to the Fund from existing and prospective Fund credit									
In percent of quota	0.0	1.0	3.0	6.6	10.9	15.3	44.5	74.5	99.0
In percent of GDP	0.0	0.0	0.0	0.1	0.1	0.2	0.4	0.7	0.9
In percent of exports of goods and services	0.0	0.0	0.1	0.2	0.3	0.3	0.9	1.5	1.9

Source: IMF staff projections.

1/ Calculated based on full disbursements of the available amounts of the proposed arrangement.

Table 8. Cyprus: Schedule of Review and Purchases

Availability Date	Amount of Purchase: Millions of SDR	Amount of Purchase: Percent of Quota	Conditions
May 15, 2013	74.25	46.93%	Approval of arrangement
September 15, 2013	74.25	46.93%	First review based on end-June 2013 performance criteria
December 15, 2013	74.25	46.93%	Second review based on end-September 2013 performance criteria
March 15, 2014	74.25	46.93%	Third review based on end-December 2013 performance criteria
June 15, 2014	74.25	46.93%	Fourth review based on end-March 2014 performance criteria
September 15, 2014	74.25	46.93%	Fifth review based on end-June 2014 performance criteria
December 15, 2014	74.25	46.93%	Sixth review based on end-September 2014 performance criteria
March 15, 2015	74.25	46.93%	Seventh review based on end-December 2014 performance criteria
June 15, 2015	74.25	46.93%	Eighth review based on end-March 2015 performance criteria
September 15, 2015	74.25	46.93%	Ninth review based on end-June 2015 performance criteria
December 15, 2015	74.25	46.93%	Tenth review based on end-September 2015 performance criteria
March 15, 2016	74.25	46.93%	Eleventh review based on end-December 2015 performance criteria
Total	891.00	563.21%	

Source: IMF staff estimates.

Table 9. Public Sector Debt Sustainability Framework, 2008-2020

(In percent of GDP, unless otherwise indicated)

	Actual															
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018	2019	2020	
								I. Baseline Projections								Debt-stabilizing primary balance 8/
Public sector debt 1/	48.9	58.5	61.3	71.1	85.8			**114.1**	**123.0**	**125.7**	**121.7**	**115.9**	**111.7**	**108.1**	**105.0**	**0.2**
o/w foreign-currency denominated	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Change in public sector debt	-9.9	9.6	2.8	9.7	14.7			28.3	8.9	2.7	-4.0	-5.8	-4.2	-3.6	-3.1	
Identified debt-creating flows (4+7+12)	-5.5	7.0	3.4	4.3	6.7			14.3	10.9	2.3	-2.1	-4.2	-4.9	-4.3	-3.8	
Primary deficit	-3.8	3.6	3.0	3.9	3.1			3.3	4.3	2.1	-1.2	-3.0	-4.0	-4.0	-4.0	
Revenue and grants	43.1	40.1	40.9	39.7	40.0			40.6	39.3	40.1	41.5	42.0	42.5	42.6	42.7	
Primary (noninterest) expenditure	39.3	43.7	43.9	43.6	43.1			44.0	43.6	42.2	40.3	39.0	38.5	38.6	38.7	
Automatic debt dynamics 2/	-1.7	3.4	0.4	0.4	3.5			11.0	6.6	0.2	-0.9	-1.2	-0.9	-0.3	0.2	
Contribution from interest rate/growth differential 3/	-1.7	3.4	0.4	0.4	3.5			11.0	6.6	0.2	-0.9	-1.2	-0.9	-0.3	0.2	
Of which contribution from real interest rate	0.2	2.5	1.1	0.7	1.8			2.8	2.0	1.4	1.3	1.5	1.5	1.7	2.1	
Of which contribution from real GDP growth	-1.9	0.9	-0.7	-0.3	1.7			8.1	4.6	-1.3	-2.2	-2.7	-2.4	-2.0	-1.9	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 5/	-4.4	2.6	-0.6	5.4	8.1			14.0	-2.0	0.4	-1.8	-1.6	0.7	0.7	0.7	
Public sector debt-to-revenue ratio 1/	113.5	145.8	150.0	179.0	214.7			280.9	312.9	313.4	292.9	275.7	262.9	253.9	245.5	
Gross financing need 6/	4.9	14.2	18.9	12.7	21.1			22.7	20.1	18.7	12.1	9.5	9.7	13.3	15.1	
in billions of U.S. dollars	0.6	1.7	2.5	1.6	2.9	10-Year Historical Average	10-Year Standard Deviation	2.8	2.4	2.3	1.6	1.3	1.4	2.0	2.3	Projected Average
Key Macroeconomic and Fiscal Assumptions																
Nominal GDP (local currency)	17.2	16.9	17.4	18.0	17.9	14.8	2.6	16.4	16.0	16.4	17.0	17.7	18.4	19.1	19.8	17.6
Real GDP growth (in percent)	3.6	-1.9	1.3	0.5	-2.4	2.5	2.1	-8.7	-3.9	1.1	1.9	2.3	2.2	1.9	1.8	-0.4
Average nominal interest rate on public debt (in percent) 7/	5.2	5.1	4.0	4.0	4.4	5.0	0.6	3.5	2.7	2.7	2.9	3.1	3.4	3.6	4.0	3.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.6	5.1	2.0	1.2	2.5	2.1	1.5	3.0	1.7	1.2	1.1	1.3	1.4	1.6	2.1	1.8
Nominal appreciation (increase in US dollar value of local currency, in percent)	6.8	5.7	5.0	-4.6	8.2	-3.0	9.5	-3.0	0.6	0.7	0.8	0.7	0.7	0.0	0.0	1.0
Inflation rate (GDP deflator, in percent)	4.6	0.1	1.9	2.7	2.0	2.9	1.5	0.6	1.1	1.5	1.8	1.8	1.9	1.9	2.0	1.6
Growth of real primary spending (deflated by GDP deflator, in percent)	5.9	9.1	1.9	-0.1	-3.6	4.8	4.2	-6.9	-4.8	-2.1	-2.6	-1.0	0.8	2.1	2.3	-1.8
Primary deficit	-3.8	3.6	3.0	3.9	3.1	0.2	3.5	3.3	4.3	2.1	-1.2	-3.0	-4.0	-4.0	-4.0	-0.4
								II. Stress Tests for Public Debt Ratio								Debt-stabilizing primary balance 9/
A. Alternative Scenarios																
A1. Key variables are at their historical averages in 2012-2020 8/								**98.1**	**96.3**	**96.4**	**94.7**	**93.1**	**93.5**	**93.8**	**94.2**	**-0.4**
A2. No policy change (constant primary balance) in 2012-2020								**113.9**	**121.7**	**128.5**	**131.8**	**134.3**	**137.0**	**140.6**	**144.7**	**0.2**
B. Bound Tests																
B1. Real interest rate is at baseline plus one-half standard deviations								**114.8**	**124.6**	**128.2**	**125.1**	**120.2**	**116.8**	**114.0**	**111.7**	**1.0**
B2. Real GDP growth is at baseline minus one-half standard deviations								**115.9**	**127.2**	**132.7**	**131.8**	**129.3**	**128.9**	**129.7**	**131.5**	**1.6**
B3. Primary balance is at baseline minus one-half standard deviations								**115.9**	**126.6**	**131.0**	**128.8**	**124.7**	**122.1**	**120.3**	**118.9**	**0.2**
B4. Combination of B1-B3 using 1/2 standard deviation shocks								**117.9**	**131.0**	**137.8**	**137.8**	**135.9**	**135.8**	**136.3**	**137.5**	**2.7**
B5. 10 percent of GDP increase in other debt-creating flows in 2013								**124.1**	**133.6**	**136.3**	**132.2**	**126.3**	**122.0**	**118.4**	**115.3**	**0.2**

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ In 2012, the residual reflects mostly the recapitalization of Laiki. Going forward, it includes financial sector recapitalization, the program buffer and other below-the-line transactions (privatization, asset swap, capitalization of Laiki recapitalization bond interest, contributions to ESM capital).
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year for each scenario.

Table 10. Cyprus: External Debt Sustainability Framework, 2008-2020
(percent of GDP, unless otherwise indicated)

	Actual							Projections								Debt-stabilizing non-interest current account 6/
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018	2019	2020	
Baseline: External debt	447.4	544.1	491.9	465.6	451.8			**410.9**	**424.3**	**418.2**	**405.1**	**389.5**	**374.8**	**360.6**	**346.9**	**-7.3**
Change in external debt	119.4	96.7	-52.3	-26.3	-13.8			-41.0	13.5	-6.2	-13.1	-15.6	-14.7	-14.2	-13.7	
Identified external debt-creating flows (4+8+9)	31.0	-4.6	49.4	-18.0	-3.5			28.6	15.8	-7.1	-10.5	-10.1	-9.2	-8.4	-7.8	
Current account deficit, excluding interest payments	5.9	2.5	0.8	-3.3	-4.4			-6.9	-9.2	-9.2	-9.2	-8.8	-8.4	-8.0	-7.4	
Deficit in balance of goods and services	11.4	5.5	6.2	4.2	2.5			-2.4	-4.0	-3.8	-3.5	-3.1	-2.8	-2.4	-2.1	
Exports	45.0	40.2	41.3	42.7	42.5			44.4	45.1	45.4	45.6	46.0	46.4	47.1	47.8	
Imports	56.4	45.7	47.5	46.9	45.0			42.0	41.1	41.6	42.1	42.9	43.7	44.7	45.7	
Net non-debt creating capital inflows (negative)	20.0	7.0	1.8	-7.1	-11.9			-16.1	-1.5	-3.6	-4.0	-2.4	-2.4	-3.4	-3.5	
Automatic debt dynamics 1/	5.1	-14.2	46.8	-7.6	12.7			51.5	26.6	5.7	2.7	1.1	1.6	3.0	3.1	
Contribution from nominal interest rate	9.8	8.2	9.1	6.6	10.9			8.9	9.9	10.1	10.2	10.1	9.9	9.7	9.4	
Contribution from real GDP growth	-11.6	7.9	-7.6	-2.5	11.3			42.6	16.7	-4.4	-7.6	-8.9	-8.3	-6.7	-6.3	
Contribution from price and exchange rate changes 2/	6.9	-30.3	45.4	-11.7	-9.5			...	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	88.4	101.4	-101.7	-8.2	-10.2			-69.5	-2.4	1.0	-2.6	-5.5	-5.5	-5.7	-5.9	
External debt-to-exports ratio (in percent)	993.1	1352.6	1191.3	1091.0	1062.4			925.5	940.3	922.0	889.0	847.4	807.2	765.6	725.6	
Gross external financing need (in billions of US dollars) 4/	51.8	90.1	109.4	91.7	96.3			51.5	54.3	53.5	51.7	51.1	51.4	51.3	52.2	
in percent of GDP	221.8	366.3	475.5	386.8	408.0	5-Year	5-Year	236.9	258.9	250.6	235.6	225.1	218.9	210.1	205.9	
Scenario with key variables at their historical averages 5/								**410.9**	**418.1**	**430.2**	**440.2**	**447.7**	**455.3**	**465.4**	**475.5**	**8.7**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation									
Real GDP growth (in percent)	3.6	-1.9	1.3	0.5	-2.4	0.2	2.4	-8.7	-3.9	1.1	1.9	2.3	2.2	1.9	1.8	
GDP deflator in US dollars (change in percent)	-2.1	7.3	-7.7	2.4	2.1	0.4	5.6	0.9	0.4	0.7	1.0	1.1	1.2	1.9	2.0	
Nominal external interest rate (in percent)	3.0	1.9	1.6	1.4	2.3	2.0	0.7	1.8	2.3	2.4	2.5	2.6	2.6	2.7	2.7	
Growth of exports (US dollar terms, in percent)	-3.4	-6.0	-4.0	6.4	-0.7	-1.5	4.8	-3.8	-2.0	2.3	3.4	4.3	4.5	5.3	5.4	
Growth of imports (US dollar terms, in percent)	6.3	-14.7	-2.9	1.7	-4.4	-2.8	7.8	-14.1	-5.5	2.8	4.2	5.3	5.4	6.2	6.2	
Current account balance, excluding interest payments	-5.9	-2.5	-0.8	3.3	4.4	-0.3	4.2	6.9	9.2	9.2	9.2	8.8	8.4	8.0	7.4	
Net non-debt creating capital inflows	-20.0	-7.0	-1.8	7.1	11.9	-2.0	12.5	16.1	1.5	3.6	4.0	2.4	2.4	3.4	3.5	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex 1. Sensitivity of Program Financing and Debt to Growth Shocks

This appendix analyzes a tailored **adverse growth shock** and its implications for additional fiscal financing needs and debt sustainability. The growth shock analyzed comprises an additional decline in growth of about 9.2 percent in 2013–14 (with 2/3 in 2013 and the rest in 2014) on top of the baseline decline, for a total recession of 22 percentage points. On the basis of regression analysis, a 1 percent fall in growth relative to the baseline was estimated to lead to a 0.26 percent decline in inflation and the deflator. The corresponding effect on the deflator was assumed for 2013–14, gradually diminishing as the economy recovers in 2015, with full convergence with the baseline inflation path achieved by 2017.

The fiscal effects of the growth shock are as follows:

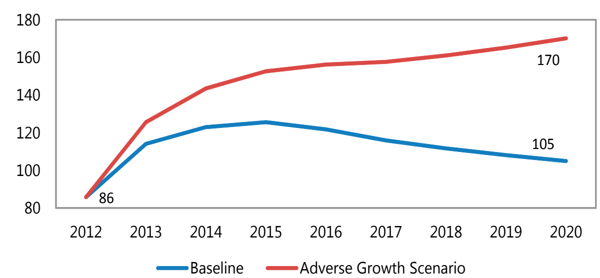
Summary of Scenarios

	Baseline	Adverse
Growth in 2013-2014 (in percent)	-12.6	-21.8
Implied Q2 GDP growth (y-o-y, in percent)	-9.1	-17.1
Primary deficit 2020 (in percent of GDP)	-4.0	3.8

Source: IMF Staff Estimates

- Revenues: a 0.4 percent of GDP decline in revenues was assumed per each percentage point fall in growth in 2013–14. Revenues were assumed to recover in 2015–17, reducing the peak loss in 2014 by 50 percent from 2017 onwards.
- Safety net spending: a 0.1 percent of GDP increase in safety net spending per each percentage point fall in growth was assumed for 2013–14. In 2015–17, as the economy recovers, the permanent spending increase, as a result either of permanently higher unemployment and/or more people being dependent on the safety net, is assumed to be 1/3 of the peak effect at end 2014.

Public Debt
(Percent of GDP)



Source: IMF Staff Estimates

- Nominal primary expenditure: nominal spending is assumed unchanged (and hence not affect financing needs), but the share to GDP rises due to the lower nominal GDP.
- Combined impact of fiscal effects on financing: the revenue and safety net nominal spending effects imply that financing needs increase by about €210 million during the program period per each additional percentage point decline in growth.

Results: The tailored shock results in a full exhaustion of the program financing buffer, in the absence of additional fiscal measures. However, the debt-to-GDP ratio rises to 153 percent by 2015 and increases thereafter, leading to unsustainable debt dynamics. This suggests that while the program buffer can accommodate fiscal automatic stabilizers for relatively larger growth shocks, debt sustainability cannot be safeguarded without additional measures. Moreover, if growth shocks also generate additional bank capital needs, the program buffer would be able to accommodate commensurately smaller shocks.

Appendix 1. Cyprus: Letter of Intent

Nicosia, August 29, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington DC

Ms. Lagarde:

In the attached update of the Memorandum of Economic and Financial Policies (MEFP) of April 29, 2013 we describe progress and policy steps towards meeting the objectives of the economic program of the Cypriot government, which is being supported by an arrangement under the Extended Fund Facility (EFF).

Our policy implementation under the program has remained on track:

- Fiscal performance through end-June has exceeded expectations, as demonstrated by our meeting of all fiscal quantitative performance criteria (PCs). This reflects prudent budgetary execution, especially with regard to primary spending, in the context of macroeconomic developments that have remained in line with our conservative baseline. We have also facilitated government financing by meeting our structural benchmark on the exchange of €1 billion of domestic debt maturing during the program period and the rollover of the €1.9 billion Laiki recapitalization bond.

- On financial sector policies, despite some initial delays associated to the complexity of the challenges in front of us, we have made substantial progress toward stabilizing the financial system:

    - We have fully recapitalized Bank of Cyprus (BoC) and taken it out of resolution following completion, albeit with some time lag, of the structural benchmark requirement on an independent fair valuation of BoC and Laiki balance sheets.

    - The administrative restrictions imposed at end-March to preserve financial stability have been gradually relaxed, and we have thus fully met the continuous performance criterion on non-intensification of restrictions of payments and transfers for current international transactions or to introduce multiple currency practices.

    - We have also fully met our structural benchmark to develop a strategy to recapitalize and restructure the cooperative sector on the basis of completion with a minor delay of the structural benchmark requirement to assess capital needs and viability of all individual cooperative credit institutions (CCIs). As prior actions for this review, we will amend legislation to strengthen its supervision and establish a legal framework to facilitate the recapitalization and restructuring of the sector.

Looking forward, our main priority continues to be the restoration of confidence in and soundness of our banking system. In this regard, in line with Eurosystem rules, we will aim to strengthen BoC's liquidity position as needed, as it adapts its governance and business structure to the new environment. We will also proceed with ensuring adequate capitalization and restructuring of other banks and the CCI sector, while strengthening their supervision and regulation. These will be key milestones in our newly developed strategy to relax administrative restrictions in an orderly and predictable way. Finally, we will revamp our private debt-restructuring framework and take action to strengthen AML implementation.

We will also embark on a significant modernization of our fiscal structural institutions to support our ongoing fiscal consolidation efforts so as to achieve sustainable public finances. We are committed to a substantial overhaul of our revenue administration, anchored by the integration of the internal revenue department and the value added tax services. At the same time, to protect revenue collection during the downturn, we will intensify our efforts to fight tax evasion. In addition, to ensure adequate and effective social protection for those most in need during the difficult adjustment period ahead of us, we will undertake a fundamental reform of our social welfare system, based on the introduction of a guaranteed minimum income program and consolidating overlapping benefits.

Financing of our program remains adequate. The recent debt exchange and rollover of the Laiki recapitalization bond have facilitated our cash flow management. We also expect to complete the restructuring of the Russian loan maturing in 2016 in line with program assumptions, and remain committed to finalizing the assessment of state assets and the privatization plan in line with our program's objectives.

On this basis, we request the following:

- Completion of the first review under the extended arrangement and the second purchase under this arrangement in the equivalent of SDR74.25 million;

- Modification of the end-September PCs on: (i) the general government primary balance, general government primary expenditure, and the stock of general government debt to accommodate budgetary compensation ensuring comparable treatment between pension funds with deposits in BoC and Laiki; and (ii) the accumulation of government guarantees, to ensure adequate liquidity buffers for BoC (Table 1);

- Establishment of new quantitative performance criteria for end-December 2013 (Table 1);

- In addition, we propose new or modified structural benchmarks on the following (Table 3): (i) offer for voluntary recapitalization of Hellenic Bank; (ii) completion of the recapitalization of Hellenic Bank; (iii) restructuring, business and funding plans to be prepared by BoC and assessed by CBC; (iv) merger of CCIs; (iv) adoption by Parliament of our fiscal responsibility and budget systems law; and (v) implementation of measures to fight tax evasion.

We are fully committed to the policies set forth in the letter of intent of April 29, 2013 and in the attached update to the MEFP, which we believe are adequate to achieve the objectives under the program. We stand ready to take any measures that may become appropriate for this purpose as circumstances change. We will consult with the Fund on the adoption of any such actions in advance of revisions to the policies contained in this letter and the MEFP, in accordance with the Fund's policies on such consultations.

Sincerely,

/s/

Harris Georgiades
Minister of Finance

/s/

Panicos Demetriades
Governor of the Central Bank of Cyprus

Attachment 1. Cyprus: Memorandum of Economic and Financial Policies

A. Strategy, Recent Developments, and Outlook

1. **Macroeconomic conditions have deteriorated, but remained broadly in line with the program assumptions.** Since March, economic conditions have become more difficult, with activity severely affected by the high uncertainty related to the state of the banking system and the effects of the administrative restrictions. This is reflected in the very high unemployment rate. However, confidence indicators have rebounded somewhat from their lows reached in April. Falling domestic demand resulted in a substantial adjustment of the external sector, primarily through a contraction of imports. But it also led to a drop in inflation in the second quarter, which can help to improve Cyprus's competitiveness. Given the significant uncertainty surrounding the outlook, our program will continue to remain guided by the macroeconomic baseline developed in April. The economy is expected to contract this year and next, but with firm program implementation, expected to lead to a recovery of confidence, we anticipate growth to resume in 2015. Our strong service sector, in particular professional services and tourism, is expected to drive long-run growth.

2. **In this context, full and timely implementation of our adjustment program is critical to restoring financial stability, ensuring fiscal sustainability, and returning to sustainable growth.** Our program's main objectives are to restore the health of the financial sector and put public finances on a sustainable path through fiscal consolidation and structural reforms. Given the urgent need to restore confidence following the deep banking crisis in March, the first review of the program focuses on stabilizing our financial sector: we aim to ensure that the new Bank of Cyprus (BoC) will be able to adapt to the new circumstances, set a clear roadmap to restructure and recapitalize the rest of the financial sector, and put in place a strategy to gradually lift capital and administrative controls. In the fiscal area, the review aims to set in motion significant institutional reforms of our revenue administration and welfare system, while also defining short-term structural measures to protect vulnerable groups and fight tax evasion.

B. Financial Sector Policies

3. **Our key priority is to stabilize our financial sector and ensure its return to health.** We have already taken important steps to build confidence and restore the viability of our credit institutions. First, we have completed the independent valuation of BoC and Laiki balance sheets on July 26, on which basis we have fully recapitalized the new BoC and taken it out of resolution. Second, we have finalized a strategy to recapitalize other banks in an adequate and timely fashion and without any depositor involvement. Third, we have assessed the capital needs and viability of our cooperative credit institutions (CCIs), which has allowed us to develop a comprehensive strategy for their recapitalization and restructuring. Looking forward, we will build on these steps to ensure that our financial sector is well capitalized and can support our economy.

Recapitalizing and restructuring financial institutions

4. **We have taken the necessary steps for BoC to exit resolution as an adequately capitalized institution:**

- The capital needs of BoC have been confirmed through an independent fair value assessment. On July 26, KPMG completed its assessment of both BoC and Laiki assets and liabilities, on the basis of internationally accepted valuation methodologies and our program's macroeconomic baseline. This assessment was done in accordance with our resolution law, so as to enable adequate and fair compensation for the respective shareholders of new BoC. On the basis of this assessment, the Resolution Authority identified an additional capital shortfall in the new BoC necessary to achieve an adequate capitalization now and in the future, so as to preserve the bank's viability and the financial system's stability.

- The new BoC has been fully recapitalized on this basis. Given the systemic nature of the bank, and in the context of low depositor confidence, the bank's CT1 capital was brought to about 12 percent of risk-weighted assets with the contribution of its uninsured depositors. This has helped to restore BoC's solvency and viability such that it can maintain a CT1 ratio of 9 percent throughout the entire program period.

5. **We will work to strengthen BoC's liquidity position, in line with Eurosystem rules.** We stand ready to consider the issuance of additional government guarantees up to €2.9 billion in line with state aid rules and in compliance with the provisions of our Public Debt Management Law, to be used to enhance BoC's pool of Eurosystem eligible collateral, if needed to safeguard financial stability. To further safeguard the bank's liquidity position, we have rescheduled the maturity of the remaining uninsured deposits over a 12 month period, which can be extended up to a 24 month period if needed, while allowing depositors to use such funds to repay loans from BoC. The Central Bank of Cyprus (CBC), in consultation with the ECB, will continue to monitor the liquidity situation of all banks and will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules.

6. **We will also make the necessary arrangements to ensure that BoC swiftly adapts its governance structure and business plan to the new circumstances.** To this end:

- The CBC appointed a transitory Board of Directors, with a view to rapidly establishing a permanent governance structure. The transitory board, appointed on April 26, has been mandated by the CBC to ensure BoC's stability once it has exited resolution. The transitory board has called an Annual General Meeting of the shareholders to be held no later than September 12, 2013, to appoint a new Board of Directors.

- The CBC has instructed the bank to prepare restructuring, business, capital and funding plans, and will prepare an assessment of these by end-October 2013 (modified **structural benchmark**). The plans will need to define the bank's business objectives and credit policies, include measures to enhance its profitability and liquidity, and specify quarterly goals.

7. **We are also taking steps to facilitate the recapitalization of the remaining domestic financial institutions. In particular:**

- Hellenic Bank (HB) will be recapitalized by end-December 2013 (**structural benchmark**). We have instructed HB to take steps to raise capital (in line with the capital needs identified by the PIMCO exercise) using private sources, including new equity issuance or voluntary liability management. While this represents a slight delay with respect to the original recapitalization strategy for the bank, it can allow it to remain under private ownership. HB will be instructed to launch the offer for private participation in the bank's capital by end-September (**structural benchmark**). If private negotiations do not result in a successful and adequate capitalization of HB by end-October, to the extent that public support is needed, it will be in line with state aid rules, so as to fully recapitalize the bank by end-December 2013.

- We have developed a comprehensive strategy to restructure the CCI sector and ensure its long-run viability. The strategy encompasses the following steps:

    - We have assessed the capital needs of all individual CCIs, on which basis we have revised our estimate of capital needs to €1.5 billion, based on PIMCO's assessment and methodology. As the CCIs have reported that private funds are not available, they will be recapitalized with public funds.
    - As prior action for the review, we will establish the legal framework for an appropriate ownership and governance structure to manage the state's majority stake in the CCI sector. On this basis, by end-October 2013, we will establish and fully operationalize a relationship framework between the state and the Cooperative Central Bank (CCB) to ensure that the latter adopts sound policies and restructuring measures to enhance the viability of the CCI sector, but without undue political interference in its business decisions. Also by end-October the Central Bank will issue a circular to define a 4 and 9 percent CT1 capital requirement at the individual and consolidated level, respectively.
    - Immediately following adoption of the legislative amendments, we will deposit €1.5 billion in public funds in a securities account with the CBC as evidence of our full commitment to fully recapitalize the sector without burdening depositors.
    - By end-October 2013, we will inject the state funds in the CCB in exchange for common shares, in line with state aid rules.
    - We will merge the CCIs into maximum 18 institutions by end-March 2014 (**structural benchmark**), with the aim to ensure the profitability, efficiency, and considering the asset quality, of the individual institutions, which will be recapitalized to fulfill the capital requirements under the law. Going forward, we will review the new structure and require CCIs that become unviable to be merged with viable ones.

8. **We will transfer the supervision and regulation of the CCIs to the CBC.** To ensure that the CCIs will maintain prudent levels of risk going forward, we will include in the amendment to the cooperative and banking laws provisions to establish the CBC as the single supervisor of the CCI sector, also as prior action. Subsequently, the CBC will finalize by end-September 2013 a detailed action plan to exercise the supervision of the cooperative credit sector. This plan will include steps to recruit

experienced staff and apply the CBC's supervisory and regulatory model for the effective monitoring of the entire cooperative credit sector, to be fully operational by end-March 2014.

9. **We will continue to improve our regulatory and supervisory framework to stabilize the financial system and prevent the buildup of new vulnerabilities.** To this end:

- We will submit by end-December 2013 draft legislation to Parliament to introduce early corrective measures to enhance supervisory powers to address capitalization issues, to enter into force by end-March 2014. This will allow for prompt supervisory remedial action at any financial institution upon deterioration of its capitalization (such as suspension of dividend payments, etc.).

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

- To ensure conservative implementation of accounting standards on loan provisioning, by end-October 2013, the CBC will complete a review of banks' practices regarding loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning.

- We will strengthen the CBC's supervisory capacity by ensuring it has sufficient staff. To further enhance our regulatory and supervisory framework in line with international best practices, we will also request a standalone assessment against the "Basel Core Principles for Effective Banking Supervision," to be completed by end-2015.

10. **We have developed a milestone-based roadmap to ease administrative restrictions and capital controls as soon as possible while preserving financial stability**. Removal of these measures is important to support the economic recovery, but acting prematurely could endanger financial stability. Accordingly, the lifting of restrictions will be based on reaching specific milestones pertaining to our bank recapitalization and restructuring strategy, while retaining some flexibility to adapt to significant new developments. To enhance transparency and predictability of policies, the roadmap was published on August 9, 2013. The roadmap will be guided by a number of key principles: (i) domestic restrictions will be removed before lifting controls on cross border transfers; (ii) the relaxation of restrictions will be based on key milestones, including: completing BoC's recapitalization and resolution, approval of the restructuring strategy of BoC, recapitalization of HB, and the restructuring strategy and disbursement of the funds for the recapitalization of CCIs; (iii) relaxations will also take into account the prevailing level of confidence in the banking system and financial stability-related indicators, including the liquidity situation of credit institutions. On this basis, we request extension of the approval from the Fund on measures falling under Article VIII.

11. **We are taking steps to revamp our corporate and household debt-restructuring framework**. By end-August, we will publish a Code of Conduct to guide negotiations between troubled

borrowers and banks and establish debt restructuring options and an appeals process. Also by then, we will publish a Framework for Arrears Management to ensure that banks adopt minimum standards and procedures to restructure problematic loans on the basis of best international practices. Next steps include:

- By end-September 2013, banks will be asked to submit to the CBC a strategy to implement the framework for arrears management. The strategy will need to include a diagnostic of areas that require strengthening and an implementation roadmap.

- By end-October 2013, the CBC will require banks to submit a detailed implementation plan for arrears management and to report on restructuring progress along specific performance indicators (e.g. number of loans restructured, cash collections, etc.).

- Building on our recent work to identify and address impediments for private debt restructuring, by end-October 2013 we will perform a legal review of the relevant legislation with technical assistance as needed and prepare a report on impediments in the framework and measures to address them.

- Subject to the findings of the review and report, by end-November 2013 we will pass legislation to expand the role of the financial Ombudsman to assist in restructuring disputes in a way that respects the rights of lenders and borrowers alike, while ensuring that it has adequate resources.

12. **We are committed to implement corrective actions to address shortcomings identified with the help of the recent independent AML audits.** Two independent audits of implementation of the AML framework by the banks were completed at end-April. On this basis, we have developed an action plan and will take steps to strengthen AML implementation, as follows:

- In implementing the AML legal framework and as supervisor, the CBC will follow up on possible breach of compliance with AML requirements by banks identified by the auditor (e.g. misclassification of customer risk, unreported suspicious transactions). It will apply appropriate supervisory enforcement actions with regard to any breaches of compliance, including sanctions, if applicable, by end-September 2013;

- The CBC will review its own AML/CFT supervisory structure on the basis of relevant Basel Core Principle and FATF standards with help from technical assistance, if required, and, on this basis, establish an effective and adequately resourced structure by end-December 2013;

- The Ministry of Finance (MOF) will commission a third party assessment of the functioning of the Registrar of Companies, which will be completed by end-December 2013. Also by then, the companies' department of the Registrar will be appropriately resourced. Further, to increase transparency, the Registrar will revise its pricing policy on access to basic information on all companies incorporated in Cyprus by end-June 2014, in order to make available basic information free of charge while ensuring budget neutrality.

- The CBC (with help from technical assistance) and relevant AML supervisors will develop and implement the necessary risk-based tools for off- and onsite AML supervision of financial institutions (by end-June 2014), lawyers and accountants (by end-September 2014), and trust and company service providers (by end-December 2014).

C. Fiscal Policy

13. **We remain committed to achieving the necessary budgetary savings required to restore the sustainability of our public finances.** We have comfortably met our end-June fiscal targets, given the ambitious fiscal consolidation undertaken at end-2012 and in April 2013. The primary balance for the first half of the year was €289 million (1.8 percent of GDP) better than programmed, and our primary spending was below target by €74 million (0.5 percent of GDP), respectively. We will continue to maintain a prudent budget execution to ensure the program fiscal targets for 2013 are met, including by tightly controlling discretionary spending given high revenue uncertainty.

14. **We will ensure adequate compensation of pension funds with deposits in Laiki bank for resolution-related losses.** These funds' deposits in Laiki have been fully converted into equity following the bank's resolution, while the deposits of pension funds in BoC have been partially converted into equity. To ensure comparable treatment between pension funds in the two banks, the funds with deposits in Laiki will be compensated following the conversion of deposits into equity (based on the total balance of deposits held in Laiki as of March 26 and the remaining balance of deposits in BoC after conversion into equity). Under these terms, compensation will not exceed €300 million. Out of this amount, we will release up to €154 million by the time of the second review of the program.

D. Structural Fiscal Reforms

Social Welfare System and Social Insurance

15. **We will reform our social welfare system to better protect vulnerable groups.** Our existing system does not in all cases provide benefits to those who are most in need, including the working poor, and its administration has shortcomings. To address these shortcomings and ensure adequate social protection during this economic downturn and beyond, we have developed a comprehensive reform plan to introduce a guaranteed minimum income (GMI) scheme while eliminating duplicate benefits. The GMI will provide assistance to those who do not have sufficient income to cover basic needs, thus effectively expanding the coverage of public assistance, while remaining within the budgetary envelope. Basic needs will be defined by a minimum consumption basket, which will be reviewed by end-September 2013. On this basis, we will estimate the cost of the GMI scheme in line with the program's macroeconomic framework by end-October 2013 and refine the means testing mechanism by end-December 2013. In addition to the GMI, other benefits may continue to be granted while overlapping benefits will be consolidated. The legal framework for the new social welfare system will be adopted by end-May 2014. The new system will be implemented by end-June 2014 (modified **structural benchmark**).

16. **We will continue to reform our pension system.** Building on earlier reforms, by end-August, we will complete an actuarial study of our general insurance pension scheme (GSIS) to determine options to ensure the system's long-run viability. Reforms resulting from this analysis will be adopted by end-December 2013 and enter into force by end-March 2014.

Revenue Administration

17. **We will also reform our revenue administration to increase its efficiency and bring it in line with best practice.** Tax administration is complicated by differing systems and procedures that have become outdated and burdensome for the taxpayer, affecting tax revenues. Our aims are to (i) increase revenues through better compliance management, (ii) improve efficiency and effectiveness of tax administration and reduce costs through economies of scale, and (iii) improve taxpayer services by reducing the administrative burden. To this end, we will put in place a new function-based tax administration integrating the existing Internal Revenue Department and VAT Service. As a first step in our reform agenda, we will establish by end-September 2013 a steering committee and a project team tasked to develop a reform plan. The reform plan will be agreed with program partners and approved by the government by end-December 2013. The Ministry of Finance would seek technical assistance, as appropriate.

18. **To support revenue collection in the short run, we will take a number of measures to fight tax evasion (end-December 2013 structural benchmark).** We will use information from databases across government agencies to identify non-compliant taxpayers in high-risk professions and industries for audit. Building on these efforts, we will develop a work program for conducting targeted joint audits through end-December 2014. We will also amend relevant legislation to establish self-assessment for all income taxpayers to expedite the tax filing process and allow focus on post-assessment audits selected on the basis of risk. Finally, we will pass legislation to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to seize assets, or prohibit the alienation or use of assets, including property and bank accounts, and turning the act of and assistance to tax evasion into a criminal offense.

Public Financial Management

19. **We are continuing to take steps to strengthen our public financial management.** In particular:

- We have accelerated the preparation of our new Fiscal Responsibility and Budget Systems Law (FRBSL) so that a Fiscal Council can be established as of January 1. For this reason, the draft law will be submitted to Parliament by end-October 2013, and adopted by end-December (modified **structural benchmark**).

- To avoid budget overruns, which are a higher risk at a time when budget resources are tight, we will address gaps in our commitment control systems by introducing pre-invoicing controls. To this effect, we will modify our systems and procedures and publish a circular to announce that government orders are subject to pre-commitment validation by end-March 2014. This will help to minimize the risk of over committing public funds and thus of overspending or accumulating arrears.

- To help monitor fiscal developments in a timely manner so as to identify potential problems early on, starting with September data, the Treasury department will provide monthly reports on key indicators (on revenue, expenditure and borrowing) for the general government level to the MOF Budget Directorate.

- Finally, to allow more regular assessment of the risks stemming from government guarantees, given an already very high level of public debt, we will change the Public Debt Management Law by end-December 2013 to assign responsibility for monitoring the stock of guarantees to the Public Debt Management Office, while ensuring adequate staffing. This will allow closer monitoring of developments related to guarantees on a continuous basis.

20. **We are committed to managing our hydrocarbon resources in a transparent and efficient manner and in line with international best practice.** To this end, we are developing the legal basis for the transparent management of natural resource revenues through the budgetary framework. To ensure that all natural resource revenues and any public spending related to these revenues and the development of the natural gas sector are channeled through the budget provisions to this end will be included in the FRBSL. In due time, we will also develop, in consultation with program partners, the legal framework for a natural resource fund, which will be established in line with international best practice.

21. **We are moving ahead with developing and implementing a legal and institutional framework for public investment, including public-private partnerships (PPPs).** Currently we do not have a clear legal and institutional framework for public investment budgeting and for managing public investment projects. In this regard, we will include in our new FRBSL provisions that ensure that public investment projects are integrated in the budget process. The law will formalize the role of the Minister of Finance and his Services in reviewing and approving public investment projects, including PPPs.

Privatization

22. **We are also making progress with the preparation of a plan and a legal framework for privatization.** We have already prepared an inventory of the assets with the highest commercial value. While the valuation of the assets needs to be refined, a first assessment provides an indication that the target for privatization proceeds by end-2018 (€1.4 billion) is achievable. To prepare for the actual privatization process, we will appoint an external consultant to develop by end-November 2013 a privatization plan and a draft legal framework. The legal and institutional framework will be implemented by end-December 2013.

E. Program Financing and Monitoring

23. **In line with our earlier commitments, we have taken several measures to reduce program financing needs.** We have successfully completed the exchange of €1 billion domestic debt falling due

during the program period into new debt at 6–10 year maturities and keeping the interest rate unchanged. Similarly, we have rolled over the €1.9 billion Laiki recapitalization bond at original terms. We are making progress on the restructuring of the €2.5 billion Russian bond falling due in 2016 and we expect this will take place at the terms envisaged in March. We will plan for an allocation of central bank profits of €0.4 billion (in line with CBC duties under the Treaties and the Statute) to be distributed in 2014. Moreover, an asset swap will be decided by the CBC in accordance with its rules and the Treaty so as to contribute approximately €1 billion to the reduction of our public debt by end-June 2014.

24. **Implementation of policies under our program will continue to be monitored through quarterly reviews.** Our program includes continuous performance criteria, indicative targets, and structural benchmarks, which are defined in the attached Technical Memorandum of Understanding (TMU). As is standard in IMF arrangements, there is a continuous performance criterion on the non-accumulation of external payment arrears. We also include in our program a continuous performance criterion on non-intensification of restrictions of payments and transfers for current international transactions or to introduce multiple practices.

25. **We authorize the IMF to publish the Letter of Intent and its attachments, and the related staff report.**

Table 1. Cyprus: Quantitative Conditionality 1/

(In millions of euros)

	Performance criteria					Indicative targets	
	Jun-13			Sep-13	Dec-13	Mar-14	Jun-14
	Target	Adjusted target	Actual				
Floor on the general government primary balance 2/	-222		67	-402	-549	-47	-367
Ceiling on the general government primary expenditure 2/	3,230		3,156	5,065	7,223	1,581	3,196
Ceiling on the stock of general government debt	17,153	17,083 5/	16,930	18,521	18,744	18,728	18,498
Ceiling on the accumulation of new general government guarantees 3/	145.3		9.9	145.3	145.3	0	0
Ceiling on the accumulation of external arrears 3/ 4/	0		0	0	0	0	0
Ceiling on the accumulation of domestic arrears 3/	0		0	0	0	0	0
Ceiling on the accumulation of VAT refund arrears by the general government 3/	10		-0.9	10	10	10	10

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since the beginning of the corresponding year.
3/ For 2013, cumulative since March. For 2014, cumulative since the beginning of the year.
4/ Continuous performance criterion.
5/ The target was adjusted downward by the size of the revision of the stock of debt at end-2012, in line with the TMU.

Table 2. Cyprus: Structural Conditionality for the First Review

Measures	Timing	Status	Remarks
Prior actions			
Establish the legal framework for an appropriate ownership and governance structure to manage the government's majority stake in the CCI sector	Before Board meeting		
Amend the cooperative and banking laws provisions to establish the CBC as the single supervisor of CCI sector	Before Board meeting		
Performance criterion			
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	Met	
Structural benchmarks			
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	Partially met	The valuation study was completed on July 26
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	Partially met	Capital needs of individual CCIs have been assessed on time but the viability assessment was completed on July 19.
Develop a strategy to recapitalize and restructure the CCI sector with public money as needed	End-July 2013	Met	
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	Completed on July 1	The closing date for the exchange was set on July 1, as the deadline of June 30 fell on a weekend.

Table 3. Cyprus: Existing and New Structural Conditionality

Measures	Timing
Existing Structural benchmarks	
CBC to prepare an assessment of BoC's restructuring, business, funding and capital plans 1/	End-October 2013
Adopt the legal framework for a central credit register (TMU ¶18)	End-September 2013
Revise the anti-money laundering legal framework (TMU ¶16)	End-September 2013
Adopt a law on fiscal responsibility and budget systems (TMU ¶19) 2/	End-December 2013
Implement a new social welfare system to improve the targeting of social assistance, consolidate welfare programs, and streamline administration costs 3/	End-June 2014
New Structural benchmarks	
CBC to instruct Hellenic Bank to launch an offer for private participation in the bank's capital	End-September 2013
Recapitalize Hellenic Bank in line with the capital needs identified by the PIMCO exercise	End-December 2013
Adopt measures to fight tax evasion (TMU ¶20)	End-December 2013
Merge the credit cooperative sector into a maximum of 18 institutions which will be recapitalized to fulfill the capital requirements under the law	End-March 2014

1/ The content of this benchmark has been modified and the deadline moved from end-September to end-October.
2/ The original benchmark referred to submission to Parliament.
3/ The original deadline was end-December 2013.

Attachment 2. Cyprus: Technical Memorandum of Understanding

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 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 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 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 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.

- 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 (requited 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 staff.

6. The floor on the GGPCB of end-December 2013 will be adjusted downwards by the payments to compensate pension funds for the losses related to the resolution of Laiki up to €146 million.

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.

- 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 (requited 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 staff.

8. The ceiling on the GGPE of end-December 2013 will be adjusted upwards by the payments to compensate pension funds for the losses related to the resolution of Laiki Bank up to €146 million.

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.
- Upwards, 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 (requited 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 staff.

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. This excludes €3.8 billion of temporary government guarantees issued on March 25 to facilitate the sale of Laiki's Greek branch and which were cancelled on June 27.

12. The ceiling on the accumulation of new general government guarantees will be adjusted upwards for the issuance of government guaranteed bonds to be used in monetary policy operations to boost BoC's liquidity up to €2.9 billion.

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

13. 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)

14. Domestic expenditure arrears are defined as unpaid invoices that have passed 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.

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

15. 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

16. **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, along the following lines:
    - The company secretary is the holder of beneficial ownership information and is accountable for providing adequate, accurate and current beneficial ownership information to competent authorities
    - The company secretary is i) a regulated professional supervised by a Cypriot authority, or ii) if the company is excluded from the scope of the TCSP Law, a natural person resident in Cyprus;
- 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).

17. AML supervision's implementation: On a quarterly basis, in the context of the program review starting in the fourth quarter of 2013, the supervisory competent authorities will, on a confidential and anonymized basis, share information with Fund staff, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.

18. **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;

- Ensure adequate access by credit institutions and exchange of consumers' data among credit institutions to enhance credit underwriting policies.

19. **Adopt 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.

20. **Adopt measures to fight tax evasion (end-December 2013)**

Specification. The adopted measures will include the following:

- Develop a work program for conducting targeted joint audits through end-December 2014;

- Amend relevant legislation to establish self-assessment for all income taxpayers;

- Pass legislation to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to seize assets, or prohibit the alienation or use of assets, including property and bank accounts, and turning the act and assistance of to tax evasion into a criminal offense.

C. Reporting Requirements

21. 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

Information required	Data Frequency	Institution/Department responsible for providing information	Maximum time lag for submission after the end of the reporting period
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 provided30 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). Details on any financial balance sheet transactions	Monthly	MOF. Public Debt Management Unit.	25 days after the end of the month
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 and VAT refund arrears and their corresponding monthly flows (i.e. inflows, outflows) by type of expenditure.	Monthly	MOF. Customs & Excise Department, VAT Service	15 days after the end of the month
Stock of government guarantees and their monthly flows by institution.	Quarterly	MOF. Treasury Department.	25 days after the end of the month
Stock of external arrears	Monthly	MOF. Treasury Department.	15 days after the end of the month
Assets and liabilities of the central bank	Monthly	Central Bank of Cyprus	30 days after the end of the month
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, including foreign operations), aggregate balance monetary balance sheet of credit institutions by institutional category	Quarterly	Central Bank of Cyprus	45 days after the end of the reporting period

Table 1. Cyprus: Reporting Requirements (Concluded)			
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, 1/	Monthly	Central Bank of Cyprus	30 days after the end of the month
Details for the largest banks and coops 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/	Daily	Central Bank of Cyprus	Next working day
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, capital adequacy ratios	Quarterly	Central Bank of Cyprus	60 days after the end of the month

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

Attachment 3. 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;

- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit by 2016, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and

- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

1. Financial sector reform

Key Objectives

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

Progress since April

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

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

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. As bank liquidity was under pressure after the two largest domestic Cypriot banks have been put under resolution, exceptional measures were necessary with a view to preventing large deposit outflows and preserving the solvency and liquidity of credit institutions. Temporary restrictive measures for cash withdrawals and exports of cash, card payments, credit transfers, the cashing of cheques and account opening were introduced. These measures were designed to minimise disruptions in the payment systems and to ensure the execution of transactions essential for the functioning of the economy. The Government has introduced and implemented the restrictions in line with the rules on the free movement of capital set out in the Treaty on the Functioning of the European Union. The impact of the restrictions has since been monitored on a daily basis by the Cypriot authorities with full information sharing with the European Commission (EC), the European Central Bank (ECB), the European Stability Mechanism (ESM) and the International Monetary Fund (IMF). A Monitoring Board has been established by the EC and the Cypriot authorities, with the ECB, the IMF, ESM and the EBA participating as observers, in order to ensure monitoring, assessment and timely relaxation of the implemented temporary restrictive measures. A number of restrictions have already been relaxed or lifted, following a gradual approach, after consultation with the Monitoring Board. The remaining restrictive measures will remain in place no longer than is strictly necessary to mitigate serious risks for the stability of the domestic financial system.

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

1.3. Furthermore, the CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector. The CBC will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules. In this respect, the

Cypriot authorities stand ready to consider the issuance of additional government guarantees, if needed.

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

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

Regulation and supervision of banks and cooperative credit institutions

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

1.7. Non-performing loans are threatening bank profitability and need to be properly monitored and managed in order to safeguard the banks' capital buffers. A new definition of non-performing loans has entered into force on 1 July 2013. The time series for non-performing loans will be published including historical observations reaching as far back as possible.

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

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

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

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

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

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

1.14. Cooperative credit institutions have played a significant role in the domestic economy and an important objective of the programme is to strengthen the regulation and supervision of the cooperative sector. To complete the alignment of the regulation and supervision of cooperative credit institutions to that of commercial banks, the Cypriot authorities will integrate the supervision of cooperative credit institutions into the CBC, for which legislation will be passed as a **prior action**. Subsequently, the CBC will finalise **by end-September 2013** a detailed action plan to effectively exercise the supervision of the cooperative sector. This action plan should include steps to recruit experienced staff, and to apply the CBC supervisory and regulatory model for the effective monitoring of the entire cooperative credit sector, to be fully operational **by end-March 2014**.

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

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

Monitoring of corporate and household indebtedness

1.17. The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. Data from surveys will be used until the credit register becomes fully operational. The Financial Stability Report, to be published on a yearly basis **as of December 2013**, will include an extended analysis on corporate and household indebtedness. The first quarterly monitoring report has been received in the beginning of July 2013 and its scope and content will be further enhanced.

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

- Several steps have already been taken and the Cypriot authorities need now to finalise the banks' Code of Conduct for dealing with troubled borrowers and framework for the management of arrears **by end-August 2013**. In this regard, in addition to the central credit registry, a framework for seizure and sale of loan collateral will be implemented

- **By end-September 2013** banks will be asked to submit to the CBC a strategy to implement the framework for the management of arrears. Banks will need to include in the strategy a diagnostic of areas that require strengthening and an action plan to ensure full implementation.

- **By end-October 2013**, banks will submit to the CBC their plan to implement the restructuring framework within their organization. They will also be required to report on restructuring progress along specific performance indicators (e.g. number of loans restructured, cash collections, etc.).

- Building on recent work to identify and address impediments for private debt restructuring, **by end-October 2013** the authorities will perform a legal review of the relevant legislation with technical assistance as needed.

On this basis, legislation will be passed to expand the role of the mediation service between banks and their clients to achieve fair debt restructuring **by end-November 2013, while ensuring adequate resources for the service given the expected case load.**

Increasing financial transparency

1.19. The anti-money laundering (AML) framework will be further strengthened in line with best practice. While Cyprus' AML regime received an overall positive evaluation in the 2011 MONEYVAL report, the April 2013 audit undertaken by MONEYVAL and an independent auditor identified specific shortcomings. The Cypriot authorities are committed to further enhancing the AML framework and to ensuring its implementation, under the timetable set out in the agreed AML Action Plan (see Annex 2) and in particular by taking the following measures:

- Strengthen preventive measures of obliged entities with regard to customer due diligence, use of introduced business and reporting of suspicious transactions (Action Plan – sections 1, 2 and 3).

- Ensure transparency and timely access to information on beneficial ownership of trusts (Action Plan – section 4). The programme partners take note of the Cypriot authorities' commitment to establish trust registers with the supervisory authorities (Action Plan – section 4.3.1)

- The supervisory competent authorities will review their off-site and on-site supervisory procedures and further implement a risk-based approach to AML supervision for financial and non-financial (lawyers, accountants and TCSPs) institutions (Action Plan – sections 5 and 6).

- On a quarterly basis, in the context of the programme review starting **Q4 2013**, the supervisory competent authorities will, on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.

Moreover, to address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have committed to revise the legal framework so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts in response to requests related to money laundering and tax matters:

- To this end, the Cypriot authorities will promptly, **by 11 September 2013** and in any event prior to the release of the second tranche of financial assistance, adopt revisions to the Trust and Company Services Provider law.
- In addition, **by 11 September 2013** and in any event prior to the release of the second tranche of financial assistance, the authorities will amend the Anti-Money Laundering Law in order to enable the provision of the widest possible range of cooperation to foreign counterparts (including with regard to the laundering of the proceeds of tax crimes involving fraudulent activity), and by giving precision to the scope of cooperation by the financial intelligence unit.
- In addition, the authorities will ensure that directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) are revised to lay down clear implementing procedures, in line with relevant legislation and international standards **by Q3 2013**.

B. Recapitalisation, resolution and restructuring

Restoring adequate capital buffers

1.20. The CBC will increase the minimum Core Tier 1 capital ratio from the present level of 8% to 9% by end-December 2013.

Restructuring and resolution of Cyprus Popular Bank and Bank of Cyprus

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

Restructuring and recapitalisation of other commercial banks

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

Restructuring and recapitalisation of cooperative credit institutions

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

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

1.25. The restructuring plan for the cooperative sector will be submitted to the EC **by September 2013**. Cooperative credit institutions in need of aid from the State will not be recapitalised before the restructuring plan has been formally approved under state-aid rules. The terms and remuneration of the public support will comply with the EU State-aid rules with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process, which will be scrutinised by an external monitoring trustee. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones.

1.26. The legal framework for a new governance structure to manage the stake of the State in the cooperative credit sector will be established, as a **prior action** for the review. The framework will allocate clear levels of continued accountability and will define the role of the State as the main Central Cooperative Bank shareholder. On this basis, a relationship framework between the State and the Central Cooperative Bank will be established and fully operationalized **by end-October 2013**, to ensure that the Central Cooperative Bank adopts sound policies and restructuring measures to enhance the viability of the cooperative sector, but without interfering in commercial business decisions. Sufficient funds for the recapitalisation of the cooperative credit institutions will be made available from the programme following the fulfillment of the prior action, as mentioned above, and will be deposited in a securities account with the CBC to boost confidence in the system. EUR 1.5 billion of state funds will be injected in the Central Cooperative Bank in exchange for common shares on the basis of capital needs identified in the PIMCO exercise and in line with state aid rules, **by end-October 2013.**

2. Fiscal policy

Key objectives

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

In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation in order to achieve a 3% of GDP primary surplus in 2017, 4% of GDP in 2018 and maintain at least such a level thereafter; (2) to achieve the annual budgetary targets as set out in this Memorandum of Understanding (MoU) through high-quality permanent measures, and additional measures in the outer years, in particular to reduce the growth in expenditure on the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on vulnerable groups; (3) to this end, to fully implement the fiscal consolidation measures for 2013, listed in Annex 1 and below; (4) to correct the excessive general government deficit by 2016; and (5) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see Section 3), including the implementation of a Medium-Term Budgetary Framework designed in accordance with EU specifications.

The Cypriot authorities adopted a number of fiscal measures for 2012–14 as well as initial steps in relation to fiscal-structural reforms. The authorities commit to the full implementation of these measures (see Annex 1) and to monitoring the budgetary effect of the measures taken on a monthly basis. Any deviation from the projected budgetary effect of the measures will be evaluated and addressed accordingly in the quarterly programme reviews, taking into account macroeconomic developments. In the event of underperformance of revenues or higher social spending needs, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the programme period, cash revenues above programme projections, including any windfall gains,[1] will be saved or used to reduce debt. If instead over-performance materialises, to the extent that it is deemed permanent, this can reduce the need for additional measures in the outer years.

Sound fiscal policy and expenditure prioritisation should contribute to preserving the good implementation of Structural and other EU funds, in respect with the programme's budgetary targets. In the light of Cyprus' economic challenges, EU funds will be targeted to those areas that deliver the most important economic and social impact, in accordance with the priorities to be set in the relevant EU regulatory framework. In order to ensure the effective implementation of EU funds, the Government will ensure that the necessary national funds remain available to cover

[1] Windfall gains associated with hydrocarbons shall mean only the blocks' licencing fees or related signature bonuses for exploration thereof. It is noted that any streams of revenues associated with hydrocarbon exploitation are dealt with under section 5.6, second bullet-point, indent 3. The Cypriot authorities have submitted Law N. 205(I)/2012 (enacted on 28 December 2012), transposing the Directive, to the European Commission.

national contributions, including non-eligible expenditure, under the European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD and EFF/EMFF) in the framework of the 2007-2013 and 2014-20 programming periods, while taking into account available EIB funding. The authorities will ensure that the institutional capacity to implement current and future programmes is improved and the appropriate human resources of Managing Authorities and implementing bodies are available.

In accordance with Regulation 472/2013, Cyprus shall provide all the information that the programme partners consider to be necessary for the monitoring of the implementation of the economic adjustment programme. The Cypriot authorities will consult ex-ante with the European Commission, the ECB and the IMF on the adoption of policies that are not included in this Memorandum but that could have a material impact on the achievement of programme objectives.

Fiscal policy in 2013

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

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

2.2. A reform of the tax system for motor vehicles with effect **from budget year 2014**, based on environmentally-friendly principles, with a view to raising additional revenues in the medium-term, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.

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

Fiscal policy in 2014

The Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 678 million (4¼% of GDP) in 2014. To this end, Cyprus should fully implement permanent measures for 2014, amounting to at least EUR 270 million in 2014 (Annex 1). The total amount of fiscal policy measures to underpin the 2014 budgetary targets will be agreed in the context of the 2014 Budget Law consultation.

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

Ensure additional expenditure savings, including by revising the formula for calculating overtime compensation on weekdays and in weekends for state officers and apply the revision pro rata in the case of hourly paid employees.

Fiscal policy in 2015–16

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

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

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

3. Fiscal-structural measures

Key objectives

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

Pension reform

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

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

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

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

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

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

<u>Health care expenditure</u>

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

a) preserve and implement all fiscal measures relating to compulsory health-care contribution for public servants and public servant pensioners to be reviewed by **Q2-2014** with the programme partners and all co-payments for using public health care services;

b) restructure public hospitals according to the action plan as approved by the Council of Ministers at end-June 2013 and aim at full implementation by **Q2-2015**;

c) taking into account the results of the updated actuarial study and after consultation with the programme partners, implement without further delay a National Health System (NHS), to be in place by **end-2015**, ensuring its financial sustainability while providing universal coverage and considering the possibility of implementation in stages by **end-2015**;

d) secure adoption by the Council of Ministers of a binding set of contingency measures (e.g. revision of the basket of publicly reimbursable medical services and products, cuts in tariffs for medical products and providers of medical services, limits to the volume of reimbursable products and services) **by Q4-2014**, in order to ensure that the agreed budget limits of public health expenditure are not exceeded**;**

e) to complete the IT-infrastructure necessary for implementing the NHS, explore all options for improving the IT-infrastructure via the most cost-effective web-based applications as an alternative to the currently-defined IT tender by **Q4-2013**;

f) review income thresholds for free public health care in comparison to the eligibility criteria for social assistance, while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures by **Q4-2013**;

g) continue to publish clinical and prescription guidelines and to audit their implementation; continue to establish the system for health-technology assessment. Periodic reviews of the basket of publicly-reimbursable medical services will be conducted, based on objective, verifiable, criteria, including cost-effectiveness criteria (health technology assessment will contribute when feasible); prepare quarterly reports on the results of the respective workstreams;

h) introduce a coherent regulatory framework for pricing and reimbursement of goods and services based on the actual level of costs incurred in accordance with Article 7 of Directive 2011/24/EU of the European Parliament and of the Council of 9 March 2011. An interim report will be ready **by Q3-2013**;

i) continue to code inpatient cases by the system of diagnosis-related groups (DRGs) with the aim of replacing the current hospital payment system by payments based on DRGs **by Q3-2013**; and,

j) in a first step, establish working time in the Health Service, in conjunction with moving the starting time by half an hour (from 7.30 to 8.00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00). Following a review, in a second step, revise the regular working hours and stand-by shifts of healthcare staff, including rules to increase the mobility of staff; revise current regulations on overtime pay and fully implement existing laws on recording/monitoring overtime payments (see 3.10) **by Q1-2014**.

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

Budgetary framework and public financial management

3.3. The Cypriot authorities will:

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in the high-level Fiscal Responsibility and Budget System Law (FRBSL), which will be adopted **by Q4-2013** (including an implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance);

- Enact a FRBSL applicable to the entire general government sector. The umbrella law will encompass, inter alia, macro-fiscal policy-making, and budget formulation, approval and execution. It will take on-board and deepen existing provisions transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and implementing the Two-Pack EU Regulation 473/2013 and the Fiscal Compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts (on budget documentation and statistics) ensuring that adopted measures are fully effective **by Q4-2013**.

As regards expenditure controls in the state budget, which shall avert the risk of overspending against existing appropriations and/or accumulating arrears, the Cypriot authorities, **by Q4-2013**, will:

- Remove the risk of overspending by making sure all spending commitments are timely and properly recorded and reported in the accounting system.

- Improve the monitoring of government guarantees through a risk assessment analysis. To this end, amend the Public Debt Management Law, **by end-December 2013**, in order to ensure a proper risk assessment of the outstanding stock of government guarantees and ensure appropriate human resources to that end.

Public private partnerships (PPPs)

3.4. The Cypriot authorities will:

- create an inventory of PPPs including information on the objectives of current and planned PPPs and more detailed information on signed contracts, including their nature, the private partner, capital value, future service payments, size and nature of contingent liabilities, amount and terms of financing. In addition, an inventory of contingent liabilities including information on the nature, intended purpose, beneficiaries, expected duration, payments made, reimbursements, recoveries, financial claims established against beneficiaries, waivers of such claims, guarantee fees or other revenues received, indication of amount and form of allowance made in the budget for expected calls, and forecast and explanation of new contingent liabilities entered into in the budget year will be compiled. The inventories will be shared **by Q3-2013** with the programme partners. **As of 2014**, the inventories will be updated annually and included as "Statement of PPPs" and "Statement of Contingent Liabilities" in appendices to the annual budget law and to the annual financial report;

- put in place an adequate legal and institutional framework for public investment projects, including PPPs, to assess fiscal risks and to monitor their execution through: (i) establishing an effective gateway process that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Minister of Finance and his services (i.e. the Ministry, Planning Bureau and Treasury) in reviewing and approving public investment projects and in particular PPPs at critical points in the gateway process; and (iii) developing financial reporting and accounting rules that ensure timely and transparent communication of public investment project and PPP related obligations. The legal basis for managing public investment and specifically PPPs will be included in the FRBSL, which will be drafted **by Q3-2013** and implemented **by Q4-2013**; and

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

State-owned enterprises and privatisation

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

- establish an inventory of assets, owned by central government and local authorities, including real estate and land. The inventory shall include all SOEs, reflecting up-to-date valuations of those with the highest commercial value **by Q3-2013**. The inventory will indicate which SOEs could be subject to divestment or restructuring or liquidation. The inventory of the largest and most valuable real estate and land assets (those of market value exceeding EUR 1 million) will be ready **by Q3-2013**. The full inventory of all assets

(SOEs, real estate and land) will be completed **by Q4-2013**. The inventory will be gradually submitted to the programme partners;

- prepare a plan to strengthen the governance of SOEs in accordance with international best practices and draft a report reviewing the operations and finances of SOEs (see 3.10) **by Q3-2013**. The report will assess these companies' business prospects, the potential exposure of the government to the SOEs and the scope for orderly privatisation. The Cypriot authorities will adopt the necessary legal changes to fulfill this requirement **by Q4-2013**. No additional SOEs will be created throughout the duration of the Programme; and

- submit to the House of Representatives a draft law to regulate the creation and the functioning of SOEs at the central and local levels and enhance the monitoring powers of the central administration, including reporting on SOEs in the context of the annual budgetary procedure **by Q4-2013**.

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

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

- The privatisation plan will be based on the report reviewing and assessing the operations and finances of SOEs (3.5), as well as the inventory of assets. The privatisation plan will be finalised after consultation with programme partners, including asset-specific timelines and intermediate steps **by November-2013**;

- In parallel, the specific legal and institutional framework for the privatisation process will be implemented **by Q4-2013**, after consultation with programme partners; and

- The privatisation plan identified by the Government after consultation with the programme partners will raise at least EUR 1 billion **by the end of the programme period** and an additional EUR 400 million **by 2018 at the latest**.

<u>Revenue administration, tax compliance, and international tax cooperation</u>

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

Enact legislative changes to enhance tax collection and voluntary compliance by

- attributing personal responsibility for payment of company taxes to those, who -in the case of non-listed companies- truly and effectively control a company and to the responsible manager for fraudulent filing of company taxes;

- harmonising the legislation among tax types so that not paying taxes is a criminal offense regardless of the type of tax and ensure tax fraud is prosecuted as a criminal offense; and

- strengthening powers by the tax authorities to ensure payment of outstanding tax obligations, e.g. by having authority to seize corporate assets, prohibiting alienation or use of assets, including property and bank accounts, by the taxpayer.

Improve efficiency and effectiveness of the administration by,

- ensuring staff mobility between different tax administration entities in order to ensure appropriate staffing of entities with high revenue collection capacities;

- optimising the use of IT systems in the tax administration based on: (i) facilitating information exchange between tax administration entities and with other relevant authorities, taking into account legal provisions for data protection; and (ii) enhancing the use of e-filling of tax returns and e-payment (e.g. by allowing payment through bank transfers);

- enacting the necessary legislation to establish self-assessment for all income taxpayers by changing from a pre-assessment verification of income tax returns to post assessment audits selected on the basis of risk;

- deciding on a joint audit programme for large taxpayers, to be conducted **in 2014;**

- developing a joint work programme for conducting targeted audits and enhancing voluntary compliance of known high-risk groups; and

- conduct an independent formal review to recommend changes to legislation to determine the appropriate level of discretion available to the tax administration management and how it is exercised.

The long-term reform will include the following sets of measures:

- A comprehensive compliance strategy that will be put in place **by Q2-2015**. The strategy will be firmly based on analytical work on risk identification and analysis and on an evaluation of different risk treatment strategies. Work for the risk identification and analysis will begin **in Q4-2013**.

- The full integration of the two tax departments will be completed in several phases and will be accompanied by a set of flanking reform measures, such as the development of a common tax procedure code. As a first step, the authorities will,

    1. establish the project management, including a high-level governmental steering committee chaired by the Minister of Finance and an executive technical committee, which manages the development and implementation of the reform plan and which will be chaired by the Permanent Secretary of the Ministry of Finance **by Q3-2013**;

    2. develop a reform plan that reflects the recommendations of the TA received in February 2013. The reform plan will be agreed with program partners and approved by the government **by Q4-2013**; and

    3. reinforce the tax unit in the Ministry of Finance that is responsible for tax policy formulation and for monitoring the implementation of tax policy and the revenue performance (including by measuring the tax gap) **by Q2-2014**.

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

- fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation[2] and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;

- ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States;

- improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer; and

- implement the recommendations put forward in the in-depth review of Cyprus' legal and regulatory framework under the OECD Global Forum on Transparency and Exchange of

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

Information for Tax Purposes and commit to address any shortcomings to be identified in the forthcoming evaluation of implementation issues.

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

Immovable property tax reform

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

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

- implement a property price index that establishes the average market valuation in 2013 by square meter of habitable surface and land plot. This index shall be operational to provide imputed market valuations for each cadastral plot **by Q2-2014**, in time for the immovable property tax collection in 2014. The index shall vary according to location and zoning as well as other tangible building- and plot-related characteristics. Moreover, the authorities will implement a methodology for annual updates of such imputed market valuations;

- implement the recurrent immovable property tax based on such imputed market valuations **by Q3-2014**. The tax rates shall reflect the progressivity and revenue of the preceding property tax. For co-owned land plots, individual owners shall be taxed according to ownership proportions as provided in the cadastre;

- establish the legal basis for a mandatory annual adjustment of the property unit tax base by a competent authority **by Q3-2014**;

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

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

- a study on the scope of consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope of shifting revenues from transaction fees and taxes to recurrent taxation.

Public administration reform

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

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

- as a second step, further reductions of overtime and related costs to the public sector wage bill are foreseen, by making working time more flexible so as to cover - as a minimum - service hours from 7:00 until 17:00 in the entire public sector and service hours from 7:00 to 19:00 for public sector services with extended operating hours (including, but not limited to, healthcare and security), under regular working time. Working hours outside regular working time shall be limited by enforcing strict controls, including requiring pre-approval of any non-emergency work outside regular working time (see 3.2) by **Q1-2014**.

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

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

- the appropriate system of remuneration and working conditions/conditions of employment in the public sector (e.g. annual vacation leave, sick leave, maternity leave, working time), in relation to the private sector and to other EU countries and based on best practices; and

- the introduction of a new performance based appraisal system in the public sector, for development and promotion purposes, linking performance with the remuneration system/ increments.

The results of the horizontal review will be presented **by Q3-2014.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with the programme partners, submit it to the House of Representatives for approval and implement it **by Q4-2014**.

The sectoral element will cover:

- an examination of the role, the competences, the organisational structure and the size/ staffing of relevant ministries, services and independent authorities;

- an examination of the possibility of abolishing or merging/consolidating non-profit organisations/companies and state-owned enterprises; and

- the re-organisation/re-structuring of local government,

and will comprise two batches:

- the first batch will be undertaken by the World Bank and the UK public administration and will cover the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies and Official Receiver. The results of the first batch will be presented by **Q1-2014.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with programme partners, submit it to the House of Representatives for approval and implement it by **Q2-2014**.

- the second batch will cover all remaining Ministries (Labour and Social Insurance, Communications and Works, Energy, Commerce, Industry and Tourism, Interior, Defense, Justice and Public Order, Foreign Affairs), and the Ministry of Finance, including the Treasury and the Planning Bureau being covered under the PFM. It will also include all SOEs (subject to the decisions taken under the provision of 3.5 regarding privatisation, restructuring or liquidation). Finally, it will cover the President's Office and the Council of Ministers, as well as the Constitutional and Independent Services (see Annex 3 for a detailed list). The results of the second batch will be presented by **Q4-2015.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with the programme partners, submit it to the House of Representatives for approval and implement it by **Q1-2016.**

Welfare system

3.11. The existing welfare system in Cyprus encompasses a broad range of individual benefits provided by different Ministries and Departments. To ensure efficient use of public funds within the welfare system, while at the same time ensuring an appropriate balance between welfare benefits and incentives to take up work (as further specified in section 4.3 below), and enhancing the protection of vulnerable households, the Cypriot authorities will implement the reform plan of the welfare system, as of **1 July 2014**.

The Cypriot authorities will ensure that the reform will be achieved through:

- consolidating the existing social benefits by streamlining, and, inter alia by merging some benefits and phasing out others, and integrating them under the Ministry of Labour and Social Insurance.

- improving the targeting of benefits; and

- providing work incentives to avoid welfare dependency.

To this end, the Cypriot authorities will take the following steps:

- first, define the minimum consumption basket in terms of composition and weights **(Q3-2013)**;

- thereafter, refine the costing and the coverage of the new guaranteed minimum income scheme (GMI) which will replace the existing public assistance scheme **(end-October 2013)**;

- refine the means testing mechanism by introducing a common definition of income sources, financial assets and movable and immovable property, so as to ensure the consistency of eligibility criteria, across different benefit schemes **(Q4-2013)**;

- ensure that a comprehensive database and the necessary IT requirements are in place to support the administration of the reformed welfare system (**by May 2014**); and

- transfer all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour and Social Insurance, which should be appropriately equipped in terms of financial and human resources, the latter being reassigned from other departments of the public administration **by April-2014**, except the benefits to be provided by the Ministry of Education and Culture (education benefits) and the Ministry of Interior (benefits to displaced people), (see 3.10).

The reformed welfare system must be consistent with the fiscal targets defined in this MoU. Draft legislation will be submitted for review to the programme partners before submission to the House of Representatives. The law will be adopted by end-May 2014.

4. Labour market

<u>Key objectives</u>

While the Cypriot labour market was characterised by high employment rates and low unemployment in the years leading up to the crisis, the unwinding of unsustainable imbalances and worsening of macroeconomic conditions and prospects have resulted in rapidly rising unemployment and important labour market challenges over the medium-term. Labour market reforms can mitigate the impact of the crisis on employment, limit the occurrence of long-term and youth unemployment, facilitate occupational mobility and contribute to improving the future resilience of the Cypriot economy in the face of adverse economic shocks. In this context, the objectives are: (1) to implement a reform of the system of wage indexation commensurate with ensuring a sustainable improvement in the competitiveness of the economy and allowing wage formation to better reflect productivity developments; (2) to prepare and implement a comprehensive reform of public assistance in order to achieve an appropriate balance between public assistance and incentives to take up work, target income support to the most vulnerable, strengthen activation policies and contain the public finance impact of rising unemployment; and (3) to help attenuate adverse competitiveness and employment effects by linking any change in the minimum wage to economic conditions.

Cost of living adjustment (COLA) of wages and salaries

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

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

As foreseen in section I.2 (Annex 1) of this agreement, the suspension of wage indexation in the wider public sector will remain in place until the end of the programme.

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

Minimum wage

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

Activating the unemployed and combating youth unemployment

4.3. The increase in unemployment underlines the need for an overall assessment of activation policies and available instruments for income support after the expiration of unemployment insurance benefits. The planned reform of public assistance should ensure that social assistance serves as a safety net to ensure a minimum income for those unable to support a basic standard of living, while safeguarding incentives to take up work, ensuring consistency with the reform of the welfare system as described in section 3.11.

4.4 In their assessment of current activation policies, the Cypriot authorities have identified a series of challenges pertaining to the system. These include: the difficulties faced by the Public

Employment Services in serving an increased number of unemployed people; the lack of a coherent and homogeneous framework for the continuous monitoring and evaluation of the different schemes, which impedes the proper evaluation of the activation system as a whole; the need for increased coordination across different ministries and departments of the administration and the need to reduce fragmentation; and the absence of a data warehouse, which impedes an automatic and immediate processing and exchange of information.

Therefore, the Cypriot authorities will prepare detailed policy proposals to address the identified shortcomings and weaknesses, to be submitted to the programme partners **by end-2013** for review and consultation. These will include:

- the development of a coherent methodology for the continuous monitoring and evaluation of activation programmes, to be applied consistently across the different schemes, thereby enabling the assessment of their performance and effectiveness;

- the development of the appropriate IT infrastructure so as to automatize better and more comprehensive collection (see 3.11), processing and exchange of data across the various schemes as well as with the administration of social welfare services;

- ensuring an effective integration of the different schemes by centralising the administration of all activation programmes and by enhancing the coordination across the different departments responsible for the various programmes;

- enhancing staff mobility to support the administrative capacity of the public employment services so as to enable them to better respond to the increased demand for their services; and

- reviewing and enhancing the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed.

4.5 With one of the steepest increases in the youth unemployment rate in the EU and with the rapid rise of young people not in employment, education or training (NEETs), Cyprus needs to take swift action to create opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will present by **Q4-2013** a draft action plan for the implementation of measures envisaged for support under the Youth Employment Initiative, in line with the conclusions of the European Council of June 2013. The design, management and implementation of these measures targeted to youth shall be well integrated within the broader system of activation policies (section 4.3) and be coherent with the reform of the social welfare system (section 3.11) and the agreed budgetary targets.

5. Goods and services markets

<u>Key objectives</u>

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

Services directive: Sector-specific legislation

5.1. The Cypriot authorities will adopt any remaining necessary amendments to the sector-specific legislation (e.g. construction, tourism, car rental services, employment agencies), in order to fully implement the Services Directive, easing the requirements related to provision of services and establishment. Amendments will be adopted by Q3-2013. Rules that refer to the calculation of fees for professional services (including those adopted by professional bodies) need to be assessed before adoption for compliance with internal market and competition principles, except as otherwise agreed with programme partners. To this end, the opinion of the Cypriot Commission for the Protection of the Competition (CPC) and of programme partners is required.

Reform of regulated professions

5.2. The Cypriot authorities will:

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

Competition and sectoral regulatory authorities

5.3. The Cypriot authorities will strengthen the independence and the effectiveness of the Commission for the Protection of Competition (CPC) by:

- guaranteeing sufficient and stable financial means and qualified personnel to ensure its effective and sustained operation **by Q4-2013;**

- enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers and antitrust, including the power to conduct sector enquiries **by Q4-2013**;

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

The Cypriot authorities will increase competition by ensuring that powers and independence of the National Regulatory Authorities (NRAs) remain effective, by enabling them to have the necessary resources in line with their duties and in accordance with the EU Regulatory Framework. Any legislative amendments that may be necessary to reach these objectives will be adopted **by Q4-2013**.

Housing market and immovable property regulation

5.4. Action is required to ensure property market clearing, efficient seizure of collateral, and restoring demand. A particular risk arises from legal disputes, which may be due to incomplete documentation of ownership and property rights and the slow pace of judicial procedures.

The Cypriot authorities will:

- enact legislation for mandatory registration of sales contracts for immovable property **by Q3-2013** and implement guaranteed timeframes for the issuance of building certificates and title deeds **by Q1-2014**; ensure that the title deed issuance backlog drops to less than 2,000 cases of immovable property units with title deed issuance pending for more than one year **by Q4-2014** (backlog refers to (i) applications, (ii) units that are eligible for the "ex officio" issuance of title deeds, required certificates and permits); take action to accelerate the swift clearing of encumbrances on title deeds to be transferred to purchasers of immovable property **by Q4-2014**;

- every three months, publish quarterly progress reviews, including executive commentaries on developments related to the issuance of building and planning permits, certificates, title deeds, title deed transfers and related mortgage operations, starting end-July 2013;

- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the monetary financial institutions and for all government services **by Q4-2014**. Any requirements on the proof of legal interest for access to these data by these bodies shall be abolished **by October 2013**;

- amend the procedure on the forced sale of mortgaged property (see 1.6) to allow for private auctions by amending the relevant legislation and rules in relation to the forced sales of mortgaged property either by adopting similar principles of the rules for immovable property recovery in bankruptcy regulations or by enacting new legislation **by Q4-2013**; and

- improve the pace of court case handling, in order to eliminate court backlogs by **Q1-2016** and provide for specialized judges by **Q4-2013,** with instructions for the expeditious processing of cases under commercial and immovable property laws.

Tourism

5.5 Since tourism is one of Cyprus' largest economic sectors and a potential driver of future growth and employment, a reinvigoration of its competitiveness is necessary. To that end, the Cypriot authorities will:

- provide a concrete action plan leading to the implementation of the quantified targets identified, inter alia in the recently revised Tourism Strategy 2011-2015 **by Q3-2013**;

- present a progress report on the implementation of the action plan twice per year, starting **in Q4-2013,** including an assessment of its implementation based on performance indicators.

- amend the current hotel and other relevant legislation (e.g. the immovable property law and town planning policies), in order to facilitate mixed-use developments, **by Q4-2013**;

- provide a report on the analysis and assessment of concrete needs based on the existing and the future air services agreements **by Q4-2013**. This report will provide the basis for an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, while ensuring sufficient air connectivity. This strategy accompanied with a concrete action plan will be launched **by Q1-2014**. The implementation of the action plan will be reviewed annually by the Cypriot authorities, starting **in Q1-2015**.

Energy

5.6. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package is fully and correctly implemented particularly during and after the transformation of the sector; and provide clarity on the intended use of the available 'isolated market' and 'emergent market' derogations and indicate their intended duration of the latter derogations;

- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy constitutes a living document to be developed under the full authority of the Cypriot Government. It should include at least the following three key elements, which should be presented to the programme partners for consultation according to the timeline specified below:

    1. a *roll-out plan* for the infrastructure required for the exploitation of natural gas, taking into account possible technical and commercial uncertainties and risks. The plan should cover: the required investments, associated costs, financing sources and methods, related ownership structure; related major planning risks and bottlenecks; and a projection of the revenue streams over time; first version **by Q3-2013**;

    2. *a comprehensive outline of the regulatory regime (CERA) and market organisation* for the restructured energy sector and gas exports, with a view to introducing open,

transparent, competitive energy markets, and taking explicitly into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, and the EU targets for energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include the following elements: a description of the envisaged institutional framework (the various government and private actors with their respective functions); the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the sequence and envisaged timing of the major actions and changes; the potential for setting-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; full unbundling of gas suppliers and customers, in particular electricity companies; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues; by **Q4 2013,** with a view to a final outline **by Q2 2014**; and

3. a plan to establish the institutional framework for the management of hydrocarbon resources, including a *resource fund*, which should receive and manage various types of public revenues from offshore gas exploitation and sales (direct revenues, fees, dividends etc). The preparatory phase should include the required legal steps and their adoption. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices. As a first step, clear rules governing inflows and outflows should be established as part of Cyprus' budgetary framework, coupled with clear accounting rules regarding dividend and fees from government entities and stakes in the energy sector. These will be anchored in the FRBSL (see 3.3) which will be adopted **by Q4-2013**.

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

6. Technical assistance

6.1. Given the nature of the structural challenges Cyprus is facing, including a lack of specific skills in some areas and scarcity of resources, the Cypriot authorities will provide a request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-September 2013**. This request will identify and specify the areas of technical assistance or advisory services, which the Cypriot authorities consider essential for the implementation of the MoU and where they intend to seek such technical assistance services, in coordination with the programme partners. All technical assistance provided by the European Commission, other than technical assistance provided directly under the Structural and other EU funds, will be coordinated by the Support Group for Cyprus.

<u>Annex 1</u>

Budgetary measures adopted by Cyprus in or after December 2012

<u>Fiscal measures with effect in 2012</u>

Expenditure measures

I.1 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-1000: 0%; EUR 1001-1500: 6.5%; EUR 1501-2000: 8.5%; EUR 2001-3000: 9.5%; EUR 3001-4000: 11.5%; above EUR 4001: 12.5%.

I.2 Extend the suspension of the practice of COLA for the public and broader public sector until the end of the programme (Q1-2016) (see 4.1).

I.3 Extend the freeze of increments and general wage increases in the public and broader public sector and temporary contribution in the public, broader public and private sectors on gross earnings and pensions by three additional years until 31 December 2016.

I.4 Reduce the number of public sector employees by at least four thousand five hundred over the period of 2012-16 by: i) freezing the hiring of new personnel on first entry posts in the broader public sector for three additional years until 31 December 2016; ii) implementing a policy of recruiting one person for every four retirees (horizontal); iii) introducing measures to increase the mobility of civil servants within and across line ministries (see 3.10); and iv) implementing a four-year plan aimed at the abolition of at least 1880 permanent posts (see I.16).

I.5 Freeze the hiring of new hourly paid employees and enforce immediate application of mobility within and across ministries and other government entities. In the case of health and security posts, recruitment of one person for every five retirees will be possible to meet urgent needs.

Revenue measures

I.6 Appropriate a one-off additional dividend income collected from semi-governmental organisations.

I.7 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.095% to 0.11% with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.

I.8 Introduce a mechanism for a regular review of excise taxes to secure the real value of excise tax revenue. Such a mechanism should be non-recurring and should, by no means lead to an automatic indexation mechanism of excise taxes to price developments.

<u>Fiscal measures with effect in 2013</u>

Expenditure measures

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

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

i. taxing pensionable allowances provided to senior government officials and employees (secretarial services, representation, and hospitality allowances) in the public and broader public sector;

ii. reducing the allowances provided to broader public sector employees and reducing all other allowances of broader public sector employees, government officials and hourly paid employees by 15%; and

iii. reducing the daily overseas subsistence allowance for business trips by 15%. Ensure a further reduction the subsistence allowance of the current allowance when lunch/dinner is offered by 50% (20% - 45% of overseas subsistence allowance instead of 40% - 90% currently paid).

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

i. suspending the right to travel first/business class by state officials, senior government officials and employees with the exception of transatlantic travel. The right to business class travel shall be maintained for the President of the Republic of Cyprus and the President of the House of Representatives;

ii. abolishing the right to duty free vehicles for employed and retired senior public sector officials; and

iii. extending the wage freeze and temporary contribution on gross earnings to cover all state officials and permanent secretaries (129 individuals) for 2013-2016, including members of the House of Representatives. Include pensionable and tax-free allowances of these individuals in the calculation of their taxable income. Introduce a contribution of 6.8% on the pensionable earnings of these individuals.

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

i. freeze public sector pensions;

ii. increase the statutory retirement age by 2 years for the various categories of employees; increase the minimum age for entitlement to an unreduced pension (by

6 months per year) to be in line with the statutory retirement age; while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral;

iii. reduce preferential treatment of specific groups of employees, like members of the army and police force, in the occupational pension plans, in particular concerning the contribution to the lump-sum benefits;

iv. introduce a permanent contribution of 3% on pensionable earnings to Widows and Orphans Fund by state officials who are entitled to a pension and gratuity. Introduce a contribution of 6.8% on pensionable earnings by officials, who are entitled to a pension and gratuity but are not covered by the government's pension scheme or any other similar plan;

v. amend Article 37 of the Pensions Law to abolish the provision according to which, in the case of death of an employee, if the deceased had a wife/husband at the time of his/her retirement and thereafter he/she remarried, his/her last wife/husband is considered a widow/widower. With the abolition of this provision, the second wife/husband will not be considered a widow/widower and thus she/he will not be entitled to pension;

vi. increase the contribution rate on the pensionable earnings of the members of the Tax Tribunal Council and the Tender Review Authority from 3.4% to 6.8%; and

vii. the contributions to the Widows and Orphans Fund will no longer be reimbursable.

viii. introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018;ix. introduce a change of indexation of all benefits from wages to prices; and

x. pension benefits will be calculated on a pro-rata basis taking into account life-time service as of January 2013 (in place since January 2013).

I.13 Implement further reform steps under the General Social Insurance Scheme by:

i. actuarially reducing pension entitlements from the General Social Insurance Scheme by 0.5% per month for retirements earlier than the statutory retirement age at the latest from January 2013, in line with the planned increase in the minimum age for entitlement to an unreduced pension to reach 65 (by 6 months per year), between 2013 and 2016;

ii. freezing pensions under the Social Security Fund for the period 2013-2016;

iii. abolishing the increase of pensions for a working dependent spouse under the General Social Insurance Scheme at the latest from January 2013 onwards.

iv. increase the minimum age for entitlement to an unreduced pension by 6 months per year to be brought in line with the statutory retirement age;

v. introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral;

vi. introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018;

vii gradually (1 year per year) extend the minimum contributory period in the system from the current 10 years to at least 15 years over the period 2013-17 (in place since December 2012); and

viii. ensure that pension entitlements that will accrue after 1 January 2013 are considered as personal income, thus becoming fully taxable also in the case in which they are received as a lump-sum payment. At the same time, employees will be granted the option of converting all or part of the lump-sum into an actuarially neutral annuity (in place since January 2013).

I.14 Reduce transfers by EUR 25 million from central government to state-owned enterprises and semi-public institutions.

I.15 Ensure a targeted reduction of budgetary appropriations for a series of semi-governmental organisations in the 2013 Budget Law, supported by well-defined activity-reducing measures.

I.16 Implement a four-year plan as prepared by the Public Administration and Personnel Department aimed at the abolition of at least 1880 permanent posts over the period 2013-2016.

The additional permanent expenditure measures for 2013, which were adopted by Cyprus **prior to the granting** of the first disbursement of financial assistance:

I.17 Introduce the following measures to control healthcare expenditure:.

a. abolish the category of beneficiaries class "B" and all exemptions for access to free public health care based on all non-income related categories except for persons suffering from certain chronic diseases depending on illness severity. Introduce as a first step towards a system of universal coverage a compulsory health care contribution for public servants and public servant pensioners of 1.5% of gross salaries and pensions. The measure will be reviewed **by Q2-2014** with the programme partners. For families with three or more dependent children, the participation in this health care scheme will be voluntary;

b. increase fees for medical services for non-beneficiaries by 30% to reflect the associated costs of medical services and create a co-payment formula with zero or low admission fees for visiting general practitioners, and increase fees for using higher levels of care for all patients irrespective of age;

c. introduce effective financial disincentives for using emergency care services in non-urgent situations;

d. introduce financial disincentives (co-payment) to minimise the provision of medically unnecessary laboratory test and pharmaceuticals; and

e. adopt a new decision by the Council of Ministers concerning a restructuring plan for public hospitals, improving quality and optimising costs and redesigning the organisational structure of the hospital management, by putting into practice recommendations from the 2009 "Public Hospital Roadmap".

I.18 Reduce the expenditure on various housing schemes by at least EUR 36 million by consolidating and streamlining the schemes for the displaced and the Comprehensive Housing Scheme, discontinuing the special grant for acquiring a first residence and ceasing the provision of loans and loan guarantees related to house construction and acquisition under all government-administered housing schemes.

I.19 Further streamline the Easter allowance to pensioners by limiting the benefit to pensioners with a monthly per household income of at most EUR 500.

I.20 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-2.000: 0.8%; EUR 2.001-3.000: 1%; EUR 3.001-4.000: 1.5%; above EUR 4001: 2.0 %.

Revenue measures

I.21 Increase excise duties on tobacco products, in particular on fine-cut smoking tobacco, from EUR 60/kg to EUR 150/kg. Increase excise duties on cigarettes by EUR 0.20/per packet of 20 cigarettes.

I.22 Increase excise duties on beer by 25% from EUR 4.78 per hl to EUR 6.00 per hl per degree of pure alcohol of final product. Increase excise duties on ethyl alcohol from EUR 598.01 to EUR 956.82 per hl of pure alcohol.

I.23 Increase excise duties on energy, i.e., on oil products, by increasing tax rate on motor fuels (petrol and gasoil) by EUR 0.07.

I.24 Increase the standard VAT rate from 17% to 18%.

I.25 Introduce a tax of 20% on gains distributed to winners of betting by the Greek Organisation of Football Prognostics S.A. (OPAP) and the National Lottery for winnings of EUR 5,000 or more.

I.26 Abolish all exceptions currently in place for paying the annual company levy of EUR 350.

The additional permanent revenue measures for 2013, which were adopted by Cyprus **prior to the granting** of the first disbursement of financial assistance:

I.27 Ensure additional revenues from property taxation of at least EUR 75 million by: (i) updating the 1980 prices through application of the CPI index for the period 1980 to 2012; and/or (ii) amending tax rates and/or (iii) amending value bands.

I.28 Increase the statutory corporate income tax rate to 12.5%.

I.29 Increase the tax rate on interest income to 30%.

I.30 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.11% to 0.15% with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.

I.31 Complete the increase in fees for public services by at least 17% of the current values

Fiscal measures with effect in 2014

Expenditure measures

I.32 Ensure a reduction in total outlays for social transfers by a at least EUR 28.5 million to be achieved through streamlining and better targeting of child benefits and educational grants, and abolition of social cohesion benefits provided by the welfare services.

I.33 Implement a further reduction in emoluments of public and broader public sector employees and pensioners by a flat rate reduction of 3% on all wages.

I.34 Introduce a fee on monthly transportation cards for the use of public transportation services by students and pensioners.

I.35 Introduce as of the budget year 2014 structural reform measures in the educational system, notably, a reduction of the number of teachers seconded to the Ministry of Education and Culture, the removal of 1:1.5 teaching time ratio from evening schools of general and technical and vocational education, the elimination of teaching time concession to teachers for being placed in two or more educational districts, the elimination of mentoring components for pre-service and in-service training for newly appointed teachers and the reduction of the cost of afternoon and evening programmes.

Revenue measures

I.36 Extend the application of the temporary contribution on gross earnings and pensions of public and private sector employees up to 31 December 2016 as follows: EUR 0 – 1,500: 0%; EUR 1,501 – 2,500: 2.5%; EUR 2,501 – 3,500: 3.0%; and > EUR 3,501 - : 3.5%.

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

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

I.39 Increase excise duties on energy, i.e., on oil products, by increasing the tax rate on motor fuels (petrol and gasoil) by EUR 0.05.

I.40 Increase the contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point on pensionable earnings, i.e. 0.5 of a percentage point from employees and 0.5 of a percentage point from employers and 1 percentage point in the case of self-employed persons.

Annex 2

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

	Heading/Deficiency	*Action*	*Timeline*
1	**Customer Due Diligence**		
1.1	**Business profile**		
	Business profiles not always properly established.	1.1.1 CBC to provide guidance to ensure that obliged entities engage in adequate training of all staff involved in establishing customer business relationships and opening accounts, so that business profiles are properly determined and assigned.	Q4 - 2013
1.2	**Customer risk profile**		
	Lack of understanding of cumulative risks in complex ownership structures / introduced business.	1.2.1 CBC to provide sufficient guidance to ensure that obliged entities have sound and effective risk management systems in place to identify and understand ML/TF risks within their customers, products and services, geographical locations/areas, and delivery channels. Risk management systems should include an overall policy for identifying and understanding, measuring, controlling, and monitoring ML/TF risks. The risk management policies, procedures and measures should be submitted to the board for approval on an annual basis, or as required by changes in the business model.	Q4 - 2013 Q1-2014
	New legislative measures.	1.2.2 CBC and other supervisory authorities to issue guidance to obliged entities in order to explain the new provisions on the introduction of tax crimes (including tax evasion) as predicate offences.	Q4 - 2013
	Particular issues relating to PEPs.	1.2.3 CBC to issue additional guidance to obliged entities to adequately identify and establish the source of wealth for PEPs or for customers that become PEPs after the business relationship has been accepted.	Q4 – 2013
1.3	**Ongoing CDD**		
	Higher risk customers/changes in risk not dealt with appropriately on an ongoing basis. Particular issues relating to PEPs.	1.3.1 CBC to issue additional guidance to ensure that financial institutions have sound and effective systems and measures in place to demonstrate enhanced ongoing monitoring for higher risk clients, including PEPs. 1.3.2. CBC to ensure that financial institutions have sound and effective systems and measures including updated CDD measures.	Q4-2013 Q2-2014
2	**Reliance/introduced business**		
	Use of introducers allowed by CY legislation and is widespread.	2.1 CBC to review, strengthen, and amend as needed the regulatory framework and the relevant requirements relating to the use of introducers/third parties to ensure compliance by obliged entities establishing business relationships and/or opening accounts through third parties.	Q4 – 2013

	Training/awareness in institutions.	2.2 CBC to reiterate and clarify the obligation under the CBC directive that obliged entities are required to establish adequate AML/CFT training programs for all staff responsible for establishing business relationships and/or opening customer accounts and updating customer information. CBC to ensure that training programs are implemented and include information on current ML and TF techniques, methods and trends, and clear explanations of all aspects of the AML/CFT laws, regulations. In particular, this should include requirements concerning CDD, suspicious transaction reporting and sanctions for non-compliance.	Ongoing
	Mechanisms for coordination with supervisors of introducers	2.3 CBC to establish co-operation mechanisms with CySEC, the Cyprus Bar Association and ICPAC (for accountants) for exchanging information and ensuring supervisory coordination.	Q3 – 2013
3	**Suspicious Transaction Reporting**		
	Changes in the legal framework.	3.1MOKAS to eiterate and clarify through further training the requirements to report STRs, including the new duty to report issues relating to tax crimes as of December 2012, in coordination with relevant supervisory authorities.	Q1 - 2014
4	**Transparency of beneficial ownership**		
4.1	**Access to information**		
	Ensure that transparency and availability of beneficial ownership information is in line with international standards and best practice.	4.1.1 Revision of Trust and Company Services Providers Law as appropriate and AML Law to ensure that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to the domestic competent authorities and their foreign counterparts; and revise the directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, ICPAC). 4.1.2. In the case of nominees, either a) require nominee directors[1] 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).	Q3 – 2013 Q3-2013

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

4.2	**Company Registry**		
	Efficiency of Companies' Registrar as an important aid to CDD.	4.2.1 Carry out a third party review of the functioning of the Companies' Registrar and communicate results to the programme partners, and ensure the department of the registrar is appropriately resourced.	End 2013
4.3	**Register of Trusts**		
	Enhance the transparency of trusts in line with international standards and best practice.	4.3.1 CY to establish trust registries with the supervisory authorities for all express trusts established under CY law, where the name of the trust and the name and address of the trustee will be contained therein. The trust registers will be accessible by the supervisory authorities in order to facilitate them in their supervisory duties.	Q3 - 2013
5	**Supervision of financial institutions**		
5.1	**Revise the AML/CFT supervisory structure within the CBC, ensuring it is adequately resourced**	5.1.1 Revise and/or establish organisation structure and management within the CBC's Banking Supervision and Regulation Department (BSRD) to address AML/CFT matters,[2] in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Q4 – 2013
		5.1.2 CBC to ensure adequate human resources and technical capacity to undertake effective AML/CFT supervision. The level of resources should be commensurate with the size, complexity, and risk profiles of the financial institutions operating in the system.[3] To meet this objective, if deemed necessary by the CBC, hire AML/CFT experts with the necessary professional skills and experience (e.g. foreign supervisors retired or on leave) – subject to necessary confidentiality restrictions.[4]	Q4 - 2013
5.2	**Develop risk-based supervisory tool(s) for offsite surveillance/monitoring activities prior to implementation**	5.2.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas,[5] and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - institutional risk profiles; - specific AML/CFT supervisory strategies (adapted to institutional risk profiles).	Q4 - 2013

[2] in accordance with BCP 2 and FATF 26-27

[3] FATF Immediate Outcome (IO) 3

[4] See BCP 2.6c

[5] The off-site supervisory tool will include monthly reporting by obliged entities on the breakdown by country of origin of the main depositors and the main beneficiaries of loans (and of their beneficial owners).

5.3	**Develop risk-based supervisory tool(s) for onsite inspections prior to implementation**	5.3.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: -Corporate Governance; -Risk Assessment Systems; -Policies & Procedures; -Compliance Function; -Internal & External Audit Functions; -Training Program.	Q1 – 2014
5.4	**Establish Formal AML/CFT Training Program**	5.4.1 Establish a formal AML/CFT training program for CBC staff to ensure adequate implementation of the offsite and onsite tools. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools; - customer acceptance policies; - customer due diligence (CDD); - monitoring of transactions; - identification and reporting of STR; - funds transfers; - correspondent banking; - recordkeeping; - compliance function; - internal controls; - audit functions; - corporate governance; - risk assessment systems	Q2 – 2014
		5.4.2 Provide CBC supervisory staff with ongoing training to ensure adequate knowledge of risks and supervisory techniques.	Ongoing
5.5	**Implement adequate supervision**	5.5.1 CBC to establish corrective actions and follow-up on the cases revealed by Deloitte. Apply appropriate enforcement actions with regard to any breaches of compliance, and apply sanctions if applicable.	Q3 - 2013
		5.5.2 On a quarterly basis, in the context of the programme review, starting Q4 2013 the CBC will on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Q4- 2013, ongoing
		Subsequent to the successful development of the tools stipulated under 5.2 and 5.3, the CBC will undertake the following: 5.5.3.1 Implement and adjust the new risk-based offsite analytical tool(s) using the results of the pilot reviews, and develop an onsite supervisory program for 2014.	Q2 - 2014

		5.5.3.2 Assign institutional ML/TF risk profiles to financial institutions reviewed under the pilot exercise. 5.5.3.3 Develop customised supervisory strategies for financial institutions reviewed under the pilot exercise. 5.5.3.4 Apply the risk-based off-site analytical tools, assign ML/TF risk profiles, and developed customised supervisory strategies to all financial institutions under its responsibility.	
		5.5.4.1 CBC to start implementing the new examination/verification procedures in line with the inspection program for 2014, and to adjust/fine-tune the procedures using the results of the pilot inspections. 5.5.4.2 CBC to update the institutional risk profile and supervisory strategy based on the results of the pilot inspection.	Q2 - 2014
6.	**<u>Supervision and monitoring of lawyers, accountants and TCSPs</u>**		
6.1	**Align resources with risks** **Establish an effective monitoring structure for AML/CFT matters**	6.1.1 Ensure adequate human resources and technical capacity to undertake effective AML/CFT monitoring. The level of resources should be commensurate with the size, complexity, and risk profiles of each business and professional. To meet this objective, if deemed necessary by the supervisory authorities, hire AML/CFT experts with the necessary professional skills and experience (e.g. professionals having performed monitoring or supervision of these professions abroad) – subject to necessary confidentiality restrictions.	Q4 - 2013
6.2	**Develop risk-based tool(s) for Offsite surveillance/monitoring activities prior to implementation**	6.2.1 Design, develop, adopt, and pilot a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas, and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - risk profiles; - specific AML/CFT monitoring strategies (adapted to institutional risk profiles).	Q1-2014 (CBA and ICPAC) Q3-2014 (CySEC)
		6.2.2.1 Implement the new offsite analytical tool(s) through pilot reviews of a selected group of business and professionals. Adjust/fine-tune the offsite analytical tool(s) using the results of the pilot reviews. 6.2.2.2 Assign ML/TF risk profiles to businesses and professionals reviewed under the pilot exercise. 6.2.2.3 Apply the risk-based off-site analytical tools, assign ML/TF risk profiles, and developed customized supervisory strategies to all business and professions under monitoring.	Q2-2014 (CBA and ICPAC) Q3-2014 (CySEC)
6.3	**Develop risk-based tool(s) for Onsite inspections prior to implementation**	6.3.1 Design and develop a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: - Risk Assessment Systems - Policies & Procedures - Compliance Function	Q2 – 2014 (CBA and ICPAC) Q3-2014 (CySEC)

		- Training Program	
6.4	**Establish Formal AML/CFT Training Program**	6.4.1 Establish formal AML/CFT training program and develop and deliver customised AML/CFT training courses. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools - customer acceptance policies - customer due diligence (CDD) - monitoring of transactions - identification and reporting of STR - recordkeeping - compliance function - risk assessment systems etc.	Q2– 2014 (CBA and ICPAC) Q4-2014 (CySEC)
6.5	**Implement adequate supervision**	6.5.1. On a quarterly basis, in the context of the programme review, starting Q4-2013, the CySEC, CBA and ICPAC will, on a confidential basis, share anonymised information with the programme partners by granting access, to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Q4 – 2013, ongoing
		Subsequent to the successful development of the tools stipulated under 6.2 and 6.3, the Supervisory authorities will undertake the following: 6.5.2 Implement the new offsite analytical tool(s) through pilot reviews of a selected group of lawyers, accountants and TCSPs. Adjust/fine-tune the offsite analytical tool(s) using the results of the pilot reviews, and come-up with a supervisory program for 2014	Q3 – 2014 (CBA and ICPAC) Q4-2014 (CySEC)
		6.5.3 Implement the new examination/verification procedures through pilot onsite inspections of a selected group of lawyers, accountants and TCSPs. Adjust/fine-tune the procedures using the results of the pilot inspections.	Q3 – 2014 (CBA and ICPAC) Q4-2014 (CySEC)

Annex 3

The Public Administration Review: Second Batch of Studies

The second batch of studies to be carried out in accordance to paragraph 3.11 will cover the following areas:

Ministries and the Departments/Services falling under each Ministry

i. Ministry of Labour and Social Insurance
ii. Ministry of Communications and Works
iii. Ministry of Energy, Commerce, Industry and Tourism (excluding the Companies Registrar and Official Receiver, to be covered in the first batch of studies)
iv. Ministry of Interior
v. Ministry of Defense (excluding the National Guard and Cyprus Army)
vi. Ministry of Justice and Public Order
vii. Ministry of Foreign Affairs

Note: Ministry of Finance, including Treasury and Planning Bureau, will be reviewed under the PFM.

Constitutional Powers /Services

i. President's Office and Council of Ministers
ii. Law Office
iii. Audit Office
iv. Public Service Commission

Independent Services/Authorities

i. Educational Service Commission
ii. Internal Audit Service
iii. Office of the Commissioner for Administration (Ombudsman)
iv. Office for the Commissioner of Personal Character Data Protection
v. Tender Review Body
vi. Refugee's Review Body

Independent Services/Authorities to be excluded from the external review and justified in the Notes below

i. Office for the Commissioner of State Aid Control [1]
ii. Authority for the Supervision of Cooperative Societies [2]
iii. Competition Protection Commission[3]

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

[2] The relevant organisation is dealt within the context of the financial sector part of the MoU.

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

CYPRUS

FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA—SUPPLEMENTARY INFORMATION

September 10, 2013

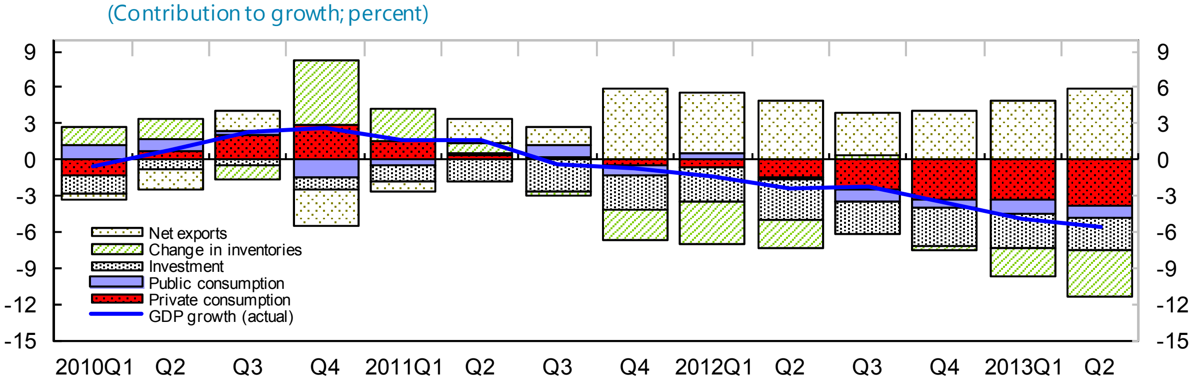
Prepared By | European Department

1. **This supplement provides information that has become available since the issuance of the staff report on September 3, 2013**. This information does not alter the thrust of the staff appraisal.

2. **Growth in the first two quarters was revised downward but remains better than program projections.** Recent data suggest that output declined by 4.9 and 5.7 percent year-on-year in the first and second quarter, respectively. These revisions imply a 5.3 percent year-on-year contraction in the first half of 2013, relative to an 8.7 percent decline assumed for 2013 under the program projection. Domestic demand continued to fall, driven by both consumption and investment. Investment was revised downward sharply and public consumption upward, reflecting a correction of the accounting treatment of gas exploration sign in bonuses. While exports of goods and services declined moderately, the contribution of net exports to growth remained positive, reflecting plummeting imports. Economic confidence in August continued to improve.

Figure 1. Composition of Growth

GDP Growth - Demand side
(Contribution to growth; percent)



Sources: Cystat

3. **Unemployment continued to rise while inflation moderated**. Non-seasonally adjusted unemployment increased to 17.7 percent in July from 16.9 percent (revised 17 percent on a seasonally adjusted basis) in June. HIPC inflation moderated to 0.1 percent in August, mainly due to lower food prices. The year-to-date average inflation of 0.9 percent remains in line with the program projections.

4. **On September 10, the shareholders of Bank of Cyprus held their annual meeting and elected a new 16-member board**. The board will be tasked with the restructuring of Bank of Cyprus. The Laiki creditors were represented by a proxy appointed by the Resolution Authority, now comprised by the Central Bank, Ministry of Finance, and the Securities and Exchange Commission. The new composition of the Resolution Authority was the result of an amendment of the Resolution law that was passed by the House of Representatives on August 27. Staff will discuss this amendment with the authorities during the next review to ensure it conforms to best international practices and continues to protect Cyprus's financial stability.

5. **Prior Actions for the first review have been met**. On September 5, 2013, the House of Representatives adopted new legislation establishing the legal framework for an appropriate ownership and governance structure to manage the government's majority stake in the cooperative credit sector as well as amendments to the cooperative and banking sector laws making the Central Bank of Cyprus the single supervisor for the cooperative sector. On the same day, the House of Representatives also adopted amendments to the current anti-money laundering (AML), companies, and international trusts laws, thus fulfilling the end-September structural benchmark to strengthen the AML legislative framework.

INTERNATIONAL MONETARY FUND
COM
COMMUNICATIONS DEPARTMENT

Press Release No. 13/344
FOR IMMEDIATE RELEASE

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes First Review Under Extended Fund Facility Arrangement for Cyprus and Approves €84.7 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Cyprus's performance under an economic program supported by a three-year, SDR 891 million (about €1 billion, or US$1.3 billion) Extended Fund Facility (EFF) arrangement. The completion of this review enables the disbursement of SDR 74.2 million (about €84.7 million, or US$113.1 million), which would bring total disbursements under the arrangement to SDR 148.5 million (about €169.4 million, or US$226.2 million). The Executive Board also approved the authorities' request for modification of performance criteria on September 2013 fiscal targets.

The EFF arrangement, approved on May 15, 2013 (see Press Release No. 13/175), is part of a combined financing package with the European Stability Mechanism (ESM) amounting to €10 billion. It is intended to stabilize the country's financial system, achieve fiscal sustainability, and support the recovery of economic activity to preserve the welfare of the population.

Following the Executive Board discussion, Ms. Christine Lagarde, IMF Managing Director and Chair, said:

"The Cypriot authorities have made commendable progress in implementing near-term stabilization policies. They remain committed to taking further steps to restore financial stability and the sustainability of public finances to support long-run growth.

"Important policy actions were taken to advance the banking sector strategy, including the recapitalization of the two largest banks without the use of public support, and the exit from resolution of the merged institution. Adequate short-run liquidity support by the Eurosystem remains critical to restoring confidence while a strong business and funding model is being put in place to ensure the bank's long-run viability.

"Steps are being taken to recapitalize and restructure remaining solvent banks and the cooperative credit sector. The authorities will also strengthen the supervision and regulation of these institutions, and ensure the full implementation of the anti-money laundering framework by banks. Improvements to the private debt restructuring framework aim to facilitate corporate and household deleveraging and maximize asset recoveries.

"Payment restrictions that were earlier introduced to safeguard financial stability will be eased gradually to boost confidence and support economic activity. The authorities need to implement carefully the measures included in their recently published roadmap, based on achieving specific milestones in the banking sector strategy, while maintaining sufficient flexibility in the event of unanticipated developments.

"Cyprus is on track to meet its 2013 fiscal targets, thanks to the significant consolidation underway and prudent budget execution. Given still high macroeconomic uncertainty, continued fiscal prudence is called for.

"The authorities are embarking on an ambitious structural reform agenda. Revenue administration reform aims to protect revenues and boost the efficiency of collections, while overhauling the welfare system will help mitigate the impact of the crisis on vulnerable groups.

"Risks to the program remain substantial, leaving no room for implementation slippages. Continued strong ownership, including steadfast policy implementation, is critical for the program's success," Ms. Lagarde said.

Statement by Mr. Menno Snel, Executive Director for Cyprus, and Mr. Ektoras Kanaris, Advisor to the Executive Director
September 16, 2013

Directors will recall the shockwaves felt in Cyprus and beyond following the decisions to bail in the uninsured depositors of the island's two largest banks as part of a joint EU-IMF support programme. At the epicenter, amidst financial turmoil and public outcry, consecutive bank holidays were imposed, followed by the introduction of capital controls and restrictions on cash withdrawals. Cyprus was in a state of paralysis and feelings of hopelessness and disappointment were the common denominator among the people.

Five months have gone by since then, taking away in their passing much of that despair. The social and political tensions appear to be slowly fading away and the Cypriot people have, once again, started to think about the day after. Faced with considerable hardship, the level of social cohesion has been no less than remarkable. In the same spirit, and despite their disappointment, the authorities have been standing firm by their commitments in their efforts to address the country's longstanding imbalances. To achieve this, the support and guidance from Cyprus's international partners has been instrumental, particularly given the island's limited resources.

Programme implementation on track

To date, performance has been resolute with all performance criteria met, structural benchmarks delivered, and all pending prior actions completed. Cyprus is committed to continue in this vein.

Fiscal performance through end June has markedly exceeded expectations. Despite the adverse macroeconomic environment, resilient tax collections on income, wealth and VAT supported the revenue side. In addition, the sizeable consolidation measures coupled with strong execution allowed expenditures to be contained more than those forecast despite higher one-off expenses in pensions and gratuities due to accelerated early retirements. Overall, the total budget balance and primary balance exceeded their targeted values by 2.3% and 1.6% of GDP respectively (in ESA95 terms).

Important steps have also been taken towards restoring the viability and confidence of the **financial sector**. First, the independent valuation of Bank of Cyprus (BoC) and Cyprus Popular Bank (CPB) balance sheets was completed on July 26, on the basis of which the final deposit conversion rate was agreed at 47.5%. As a result, the new BoC was successfully capitalized at a core tier 1 ratio of around 12% and taken out of resolution. On August 1, BoC regained its eligible counterparty status for ECB normal monetary policy operations. Second, the capital needs and viability of cooperative credit institutions (CCIs) have been assessed, thus enabling the development of a comprehensive strategy for their recapitalization and restructuring. The completion of the abovementioned structural benchmarks took slightly longer than foreseen due to the complexity of the exercises. However, the authorities were quick to take organizational steps to meet all subsequent deadlines without delay. A strategy to recapitalize other banks in a timely fashion has been finalized and supervision and regulation policies were strengthened. The new classification of nonperforming loans has been in effect since July 1, a unified data reporting system for both commercial and cooperative banks has been implemented and on July 23 the financial stability indicators under a new framework were available on the website of the Central Bank of Cyprus. Finally, the prior actions approved by parliament last week established the legal framework to facilitate the recapitalization and restructuring of the CCI sector and to strengthen the sector's supervision by establishing the Central Bank as the single supervisor of the CCI sector.

On **Anti-Money Laundering**, an action plan addressing the identified legal framework and implementation shortcomings has been agreed on with the programme partners whereby, inter alia, the Central Bank will review its AML/CFT supervisory structure on the basis of relevant Basel Core Principle and FATF standards. Furthermore, all cases revealed by the auditor that possibly involve misclassification of customer risk and suspicious transactions will be followed up. The end-September structural benchmark to strengthen the AML legislative framework has also been met, following parliamentary approval last week.

In their efforts to strike a more appropriate balance between financial stability and economic activity, the authorities have been pressing forward with a significant relaxation of the **administrative restrictions and capital controls** imposed at end-March. While this led to more deposit outflows, it was necessary to allow the domestic economy to breathe. To enhance the transparency and predictability of policies, a roadmap for completely lifting the restrictions has been agreed and published in August. The aim is to anchor the public's expectations, while retaining some flexibility to adapt to unexpected new developments.

Significant **financing measures** have also taken place, allowing the programme finances to remain well on track with a sizeable buffer still in place. The authorities were successful in rolling over €1 billion of maturing domestic debt and the €1.9 billion CPB recapitalisation bond. Further easing was achieved with the help of Russia, by way of the significant restructuring of Cyprus's bi-lateral loan. More debt reducing measures will follow, including privatizations and a €1 billion debt swap held by the CBC for state-owned assets. The latter transaction, originally due for end 2013, was postponed to mid 2014 to allow more time to complete the valuation of assets which are numerous and fall across many ministries. As a result, the Cypriot authorities are requesting a modification of the end September public debt performance criterion.

Overall, tangible progress has been made towards restoring the health of the Cypriot economy, in pursuit of regaining the lost confidence from Cyprus's citizens and international investors. Central to the underlying performance is the Cypriot authorities' determination to fully own and implement the programme, and to demonstrate achievement of the challenging benchmarks set out therein. At the same time, the authorities recognize the risks and scale of the adjustment task still ahead.

Economic developments

Recession, as expected, hit hard. The Cypriot economy is trying to adapt to major shocks. The implementation of the bail-in has led to a substantial loss of private wealth and, beyond household savings, the corporate sector's working capital was substantially reduced and frozen. The severe credit shortage will further stress the corporate sector's limits.

Further to the above, the fiscal consolidation drag, the ongoing controls on transactions and the persisting lack of confidence, are all taking their toll on growth, mainly through domestic demand and investment. The decline in activity was pronounced in the construction sector, while the disruptions to financial intermediation weighed on the services sector. Net exports, on the other hand, provided a significant positive contribution to GDP growth, led by a significant drag on imports in conjunction with a small increase in exports.

Unfortunately, unemployment has been taking the brunt of the adjustment, increasing from 11.7 percent in June 2012 to 17.3 percent in June 2013, the steepest increase observed in the EU. Much of this increase also takes into account the employees of BoC and CPB who took the first voluntary exit schemes which were introduced in late 2012 and early 2013. A much higher number of BoC and CPB employees have taken the second voluntary exit scheme at end-July 2013 and this will be reflected in the Q3 unemployment figures. The rapid increase in youth and long-term unemployment is particularly worrying, displaying a rate of more than twice that of total unemployment. The authorities are currently looking for ways to promote employment in both of these key areas within their limited policy space.

Faced with the above developments, the Cypriot economy has remarkably managed to exhibit some signs of resilience. The recently revised Q2 GDP figures, point towards a 5.3% decline for the first semester, still faring better than market consensus forecasts and containing the negative outturn by more than that foreseen in the programme. Furthermore, as noted earlier, fiscal performance through end-June was better than programmed by a considerable margin despite adverse macroeconomic developments and the decrease in employment. Finally, confidence indicators, albeit still at low levels, have been rising for the last three months from April's low. However, with only a few months into the program, these developments should not be extrapolated.

Having taken note of these positive developments, the authorities remain vigilant to the lingering and emerging risks and are in strong agreement with those identified in the staff report. Indeed, significant parts of the economy continue to be hit while credit markets have, for a long time now, been shut down due to sparse liquidity in the system. Without a credible solution to the banks' funding pressures, lending will remain frozen. Moving forward, as the bail-in impact unfolds, further household and corporate defaults may propagate through the economy. A further worsening of labour market conditions may lead to a more prolonged loss of business and consumer confidence, and strain public revenues. Also, there are concerns for further deterioration of confidence in the banking system while, more broadly, unease over financial sector stability could have stronger spillovers on related professional business services and financial services' exports.

On the whole, the Cypriot economy has to rely on its small and open nature which should facilitate its ability to adjust. Restoring sustainability requires economic growth and employment creation, but growth drivers have to emerge. Therefore, transition to a more varied growth model will be challenging for the economy in the coming years. The flexible, decentralized wage setting framework in Cyprus and highly educated workforce ought to provide support for a rather rapid adjustment. From a medium-term perspective, hydrocarbon related investments that will occur during the exploration phase (as contractually agreed by the successful bidders) are expected to mitigate the impact.

Going forward

The authorities' main priority continues to be the restoration of confidence and soundness of the banking system. In this regard, efforts must be made to alleviate BoC's high reliance on exceptional support, having been burdened with 9 billion of ELA from the resolution of CPB. While this amount has somewhat decreased after the bank recovered its counterparty status with the ECB, normal ECB operations for all banks remain challenging because of the country's non-investment grade rating. Specifically, assets pledged as collateral by banks suffer from significant haircuts, averaging more than 50% across government/government guaranteed asset classes. With the banks' funding structure being extremely vulnerable as outflows continue, and with no other Eurosystem tools at Cyprus's disposal, an adjustor has been proposed to allow a maximum of €2.9 billion in additional government guarantees to enhance BoC's pool of Eurosystem eligible collateral.

Beyond the efforts needed to address the banks' liquidity position, more steps are being taken to enhance the banking system's viability and BoC in particular. The bank has now been handed to its new owners that have emerged from the bail-in, who have every incentive to restore its profitability. The new shareholders' Annual General Meeting was held on September 10 and a new Board of Directors was appointed. With the new Board in place, BoC has to submit to the Central Bank capital and funding plans as well as a strategic restructuring plan that is now being developed with the expertise of a consultancy firm.

More broadly, having completed the relevant prior actions, the authorities will proceed with the capitalization and restructuring of the CCI sector, while strengthening the sector's supervision and regulation. Progress is also being made in the area of loan origination and by aiding the banks towards more informed loan decisions by merging and expanding the databases of the two existing credit registers. Finally, to address the high level of private indebtedness, the debt restructuring framework is being revamped aiming to enable fair and expeditious restructuring across the banking sector.

The authorities will also embark on a substantial overhaul of their revenue administration with the integration of the Internal Revenue Department and the VAT Service being a key feature. This is expected to significantly increase compliance, improve efficiency and reduce administrative costs. In addition, significant reform in the social welfare system will be undertaken, including by better targeting overlapping benefits, to ensure effective social protection for those most deprived in the difficult times ahead. Finally, an independent external review of the public administration is already underway by the World Bank and the UK government, notably by reviewing the size, employment conditions and functional organisation of public services. Based on the findings, the authorities will undertake all necessary reforms to improve the public administration's functioning and cost-effectiveness.

Conclusion

Cyprus is suffering from severe economic dislocations, the full effects of which remain to be seen as their impact continues to unravel. However, the Cypriot authorities are resolved to restore Cyprus's economic health and ensure its long-term sustainability. In this regard, they view their commitments under the programme as necessary steps to achieve this goal. While a difficult adjustment is still ahead, Cyprus has placed itself in a good position to continue along the agreed path. In support of the continuing efforts by the government and the people of Cyprus, the authorities are requesting the Board's approval of the completion of the first review and associated modifications of performance criteria.

In closing, I wish to extend my authorities' appreciation for the hard and diligent work of the Fund staff, and for their patience and professionalism that has made the difficult road so far a good basis for the success of the program.